Emerging
Markets
Forum

Building National and Regional Financial Markets: The East Asian Experience

Andrew Sheng

Discussion Draft

Part of the EMF Series of papers on International Capital Flows, Domestic Capital Markets and Growth and Development in Emerging Markets Countries

2006 Global Meeting

Emerging Markets Forum

2006 Global Meeting
Jakarta, Indonesia

Building National and Regional Financial Markets: The East Asian Experience

Andrew Sheng[1]

21 September 2006

Abstract:
This paper reviews key trends in the development of financial markets in East Asia. Despite the lessons of the Asian crisis and efforts to develop bond and equity markets, the Asian financial system remains bank-dominated, with still fledgling bond markets, speculative stock markets and relatively small insurance and pension and social security systems. Even though economic fundamentals and the resilience of Asian financial systems have improved, the vulnerabilities to global imbalances have also increased. It is also recognized that financial integration is proceeding slower than trade integration, and there remains considerable regulatory and other barriers to greater integration. The paper suggests that a deeper problem in building markets is the mindset of policy-makers who have been overly influenced by the neo-classical paradigm that has emphasized the elegance of theory at the expense of institutions and institutional management. Social and economic development is not about theory, but about performance. Hence, building markets would require the management of complex social, economic and historical factors, including the pressures from globalization, technology and vested interests. It points out that building effective markets require effective public bureaucracies where providing the property rights infrastructure, enforcing regulation and basic social services effectively for private business to thrive is a core function of social development. Finally, it examines what possible steps can be taken by both the private and public sectors, including the role of International Financial Institutions (IFIs), in accelerating financial market deepening and integration in the region.

[1] Andrew Sheng is the holder of the Tun Ismail Ali Chair in Monetary and Financial Economics, Faculty of Economies and Administration, University of Malaya and Adjunct Professor, Graduate School of Economic Management, Tsinghua University. The author is grateful to Dr Pieter Bottelier, Ms GL Tan and others for very helpful comments and Ms Sharmila Sharma for research in the preparation of this paper, but bears total responsibility for any opinions, errors and omissions.

Building National and Regional Financial Markets: The Asian Experience

Introduction

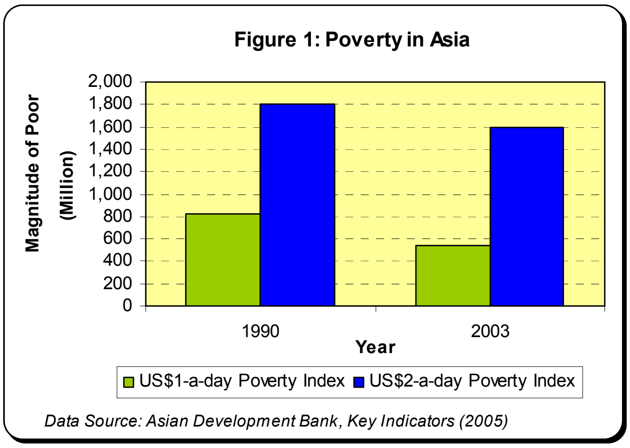
September 2006 is a good time to look back and to look forward at the Asian financial system. In nine months time, we shall mark the tenth anniversary of the Asian financial crisis. Where are we now? Where do we go from here? Or rather, why can't we move faster in heading where we want to go?

Nicholas Kristof (2001), writing in *Thunder from the East*: "It (*the Asian crisis*) entailed a terrible human cost, but it is also helping to destroy much of the cronyism, protectionism and government regulation that had burdened Asian business. The crisis helped launch a political, social and economic revolution that is still incomplete but that ultimately will reshape Asia as greatly as the fall of the Berlin wall reshaped Europe."

This paper argues that despite its obvious successes, Asian bad habits and parochial thinking have not completely gone away, but the problems lay deeper than we all commonly realize. To move forward, we need to know where the roadblocks exist and how to move ahead.[2]

Where are we now?

The first good news is that the Asian economies have definitely recovered from the crisis and have regained not only their growth, but also shown greater resilience in many ways. Recent International Financial Institution (IFI) reports would suggest that by and large, there is improved corporate governance, stronger supervision, healthier fiscal and balance of payments positions and higher reserves. In 2005, the Asian economies remain amongst the fastest growing region in the world, with the highest savings, in spite of higher energy prices. Overall poverty has come down, although there still remains a large number of poor (Figure 1).



2 Asia in this paper is defined as the 10 members of the Association of Southeast Asian Nations (henceforth ASEAN), the People's Republic of China (henceforth China), Hong Kong SAR (henceforth Hong Kong), Japan, the Republic of Korea (henceforth Korea), Taiwan Province of China (henceforth Taiwan) plus India. The 10 ASEAN members are Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand and Viet Nam.

The second good news is that Asia has emerged almost naturally as the third area of trade integration, next to the European Union (EU) and the North American Free Trade Agreement (NAFTA) region in terms of size and importance. The process of regional integration is driven by trade integration (Table 1).

Table 1: Asian Intraregional Trade (as % of total world trade)[1]

	1980	**1985**	**1990**	**1995**	**2000**	**2005**
Brunei Darussalam	80.1	77.3	81.7	79.5	74.2	75.0
Cambodia	n.a.	67.4	68.6	81.5	35.8	46.8
Indonesia	58.3	53.3	51.7	49.5	50.6	54.6
Lao PDR	n.a.	82.6	85.7	65.3	72.8	74.0
Malaysia	46.7	54.1	49.6	48.2	49.4	54.7
Myanmar	50.6	42.9	58.7	72.5	62.2	74.9
Philippines	33.8	36.0	32.8	37.5	39.7	52.7
Singapore	36.8	40.6	39.5	47.2	46.5	45.4
Thailand	38.1	42.7	42.6	43.7	44.9	49.5
Viet Nam	n.a.	10.5	27.8	57.6	56.4	52.7
China	29.4	36.2	21.3	33.7	33.1	30.0
Korea	29.2	26.7	29.1	35.4	36.6	43.6
Japan	20.7	20.3	21.2	29.9	30.9	36.8
ASEAN+3	30.2	30.2	29.3	37.3	37.0	38.2
Memo Items:						
ASEAN	17.9	20.3	18.8	23.9	24.5	24.0
ASEAN+3+Hong Kong+Taiwan	**34.6**	**37.1**	**43.0**	**51.7**	**51.9**	**54.5**
SOUTH ASIA	4.6	3.2	2.9	4.0	4.2	5.5
European Union (EU-25)	**61.3**	**59.8**	**67.0**	**67.4**	**66.8**	**66.2**
NAFTA	**33.8**	**38.7**	**37.9**	**43.1**	**48.8**	**45.0**

[1]For regional groupings, intraregional trade share is calculated using export data and the formula: Xii /{(Xiw + Xwi)/2}, where Xii is export of region i to region i; Xiw is export of region i to the world, and Xwi is export of world to region i.

Source: Rana (2006) based on data from International Monetary Fund, Direction of Trade Statistics C.D. Rom (2006) and CEIC.

n.a. denotes not available

Over the last quarter century, 1980-2005, intra-Asian trade has risen steadily from 34.6% to 54.5% of the region's total world trade. This is still lower than EU (66.2%) but higher than that of NAFTA (45%). Asia has emerged as the manufacturing global supply chain; initially centred around Japan, but increasingly China has begun to play a significant role. In the software and information technology (IT) services area, India is emerging as the hub of the global services supply chain (Sheng 2006d). In terms of Gross Domestic Product (GDP), Asia had the smallest GDP level in 2004 of US$8.9 trillion, whereas the NAFTA led with GDP of US$13.4 trillion and the EU following next with GDP of US$12.7 trillion. Asia had the most population of 3.1 billion, whereas NAFTA had 430 million and EU 460 million respectively.

The third feature of Asian markets is the fact that its financial sector lags its manufacturing prowess and remains bank-dominated (Table 2). The larger banking sectors in Asia account for 80–177% of GDP in terms of deposits, despite the fact that the Japanese banking system has withdrawn significantly from regional lending since the Asian crisis. The Bank for International Settlement (BIS) cross border lending showed that the Japanese banking system pulled back around US$250 billion from a peak of US$375 billion in 1994 to US$125 billion by 2001 (Jeanneau and Micu 2002). Part of the Japanese withdrawal has been compensated by US and European investment in banks and bank branches in Asia, but the impact in Asia has not been significant in size and impact except in Korea.

Table 2: Financial Structure in Selected Countries, 1990 and 2004 (% of GDP)

	Bank deposits[a]		Equity Market[b]		Bond Market[c]		Insurance Premiums[d]	
	1990	**2004**	**1990**	**2004**	**1990**	**2004**	**1990**	**2004**
ASEAN								
Brunei	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Cambodia	4.0[3]	14.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Indonesia	29.8	38.9	4.4	24.9	0.4	24.1	0.9	1.3
Lao PDR	4.0	17.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Malaysia	52.1	88.7	100.7	152.6	69.8	89.3	3.0	5.5
Myanmar	7.9	8.9[5]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Philippines	24.1	48.4	20.6	30.6	22.1	28.7	2.0	1.5
Singapore	74.3	104.4	95.8	149.0	27.8	58.6	3.0	9.1
Thailand	56.8	79.7	29.2	72.3	9.7	38.9	1.7	3.5
Vietnam	10.9[4]	48.1	n.a.	n.a.	n.a.	n.a.	0.5[4]	2.0
ASIA – Others								
China	75.6	177.8	2.4[1]	40.3	8.5	29.4	0.8	3.2
Hong Kong SAR	205.6	299.3	107.2	486.3	1.5	28.3	3.0[1]	9.4
India	31.4	51.1	10.4	48.4	19.9	31.7	1.5	3.1
Japan	100.0	120.5	121.7	73.2	85.9	181.6	8.5	10.7
Korea, Rep. of	32.6	68.8	48.2	56.1	34.1	74.9	11.0	10.1
Taiwan	n.a.	n.a.	107.6	135.3	17.0	58.3	n.a.	14.2
LATIN AMERICA								
Argentina	5.5	21.3	2.7	28.2	9.8	15.4	2.4	2.7
Brazil	15.3[1]	21.8	6.7	46.9	2.2[1]	55.8	1.4	3.0
Chile	28.2	32.2	38.3	108.6	29.0	44.3	2.7	4.3
Mexico	14.1	23.0	10.6	21.9	21.1	24.2	1.1	1.8
OTHERS								
Russian Federation	12.9[2]	24.6	0.1[1]	43.1	0.4[2]	2.7	n.a.	2.8
South Africa	48.3	60.0	120.8	170.5	100.2	43.2	9.6	14.4
SELECTED OECD ECONOMIES								
Australia	49.0	73.0	40.6	108.4	35.6	52.9	7.3	7.8
Canada	43.5	62.9	46.9	106.4	72.3	75.5	5.4	7.1
Germany	53.8[1]	96.7	21.7	42.2	51.6	80.3	5.7	7.0
Switzerland	102.5	133.8	70.6	217.6	57.8	67.6	7.8	11.7
United Kingdom	87.8	115.0	85.2	123.0	36.8	43.9	9.6	13.8
United States	59.6	58.8	57.5	131.6	122.0	157.2	8.3	9.4

Sources: CEIC data; World Bank, Financial Structure Dataset, February 2006

a. Bank Deposits/GDP b. Stock Market Capitalization/GDP c. Public and Private Bond Market Capitalization/GDP d. Life and Non-Life Insurance Premium Volume/GDP

1. 1992 data; 2. 1994 data; 3. 1995 data; 4. 1996 data; 5. 2003 data.

n.a. denotes not available

Since the Asian crisis, Asian authorities have been extremely active in restructuring the banking system and trying to build capital markets. There are two distinct camps. The more sophisticated markets, such as Hong Kong, Singapore, Malaysia and Korea have been much more successful in reforming and deepening domestic bond markets, and to some extent strengthening their equity markets, but the others are still struggling in their efforts. A common feature in the struggle to build domestic markets is the willingness to allow foreign financial intermediaries to help build these markets.

Using balance sheet data recently available from Lane and Milesi-Ferritti (2006), it seems reasonably clear that Asia's success in its export-orientation had created a high level of net foreign asset position. Instead of the traditional view that emerging markets should run current account deficits and rely on foreign investment from developed markets, we have a situation where Asia is both an exporter of manufactures and services, but also an important exporter of capital.

At the end of 2004, Asia had a net asset position of US$2.7 trillion or 30% of GDP, whereas Europe had a net liability position of US$1.2 trillion or 9.3% of GDP. The NAFTA had the much larger net liability position of US$3.1 trillion or 22.9% of GDP. In other words, roughly two-thirds of the net liability position of NAFTA and EU are held by Asia. Looking at the gross asset position, however, the Asian position is much lower at US$8.6 trillion, whereas the EU and NAFTA positions are much larger at US$31.2 trillion and US$11.0 trillion respectively.

Fourth, despite stated policy initiatives of deepening regional bond markets, capital and debt markets are still relatively shallow and lack integration. There is no doubt that there is considerable political will in Asia to push for regional financial integration, such as the 2000 Chiang Mai Initiative (CMI) on regional swaps, the 2003 Asian Bond Market Initiative, the Asian Bond Fund Initiative (ABF1 and ABF2 created in 2003 and 2004 respectively) and recently in 2005, the FTSE/ASEAN Index Series to help standardize market indices. In addition, efforts to revive the Asian Monetary Fund appear to surface in different forms.

Fifth, the sharp rise in Asian balance of payments surplus and foreign exchange reserves have served as a flash point of cross-Pacific debate. It is seen as the counterparty to the growing global imbalance, a codeword for the US balance of payments deficit. The view from Washington is that excessive savings in Asia is causing the US to run a larger than necessary trade deficit (Bernanke, 2005). The solution is for Asia to adopt more flexible exchange rates (codeword for upward revaluation). Asians, on the other hand, feel more comfortable with the status quo. A more benign view is that the relationship between Asia and the US is a Total Equity Return Swap (Dooley, Folkerts-Landau and Garber, 2003). Since Asian financial systems are not strong and deep enough to absorb its high level of savings, it is natural that surplus savings are placed in the deep and robust markets such as the US and Europe. The savings are recycled back into Asia in the form of foreign portfolio investment (FPI) and foreign direct investment (FDI), with US and European financial intermediaries leveraging such investments to earn higher yields than the deposit and bond yields paid to Asian investors.

So why is Asian financial development so patchy?

Problems of Analysis

Having had the benefit of Claudio Loser's analysis of the Latin American experience in developing financial markets, one begins to appreciate that there are significant differences and similarities in comparing and contrasting the Asian and Latin American experience. The differences are commonly known – Asia has been much more trade-oriented and have therefore enjoyed faster growth with higher savings, whereas Latin America, under the inward-looking bias of the "Raul Prebisch" approach in the 1950s, made the mistake of adopting an import-substituting industrialization strategy based on high debt and has therefore suffered a whole series of financial crisis since the early 1980s.

Loser identifies the following weaknesses in Latin American financial systems, which echo some of the problems in certain Asian economies:

- Low savings rates hindered the deepening of domestic financial markets in Latin America in the 1990s;
- An unstable macroeconomic environment has been holding back financial system development, with chronic inflation, periodic external crises, and intermittent deposit freezes imposed heavy losses on holders of financial assets;
- A range of structural factors, mostly microeconomic and institutional in nature that deterred bank lending and creation of a strong credit culture;
- Highly volatile capital inflows, which was one of the key problems faced during the Asian crisis.

Seen from a global perspective, however, in the financial intermediation sphere, Latin America seems to have more similarities with Asia than the superficial differences of different growth rates. In terms of capital markets and financial intermediation, both regions are witnessing loss of domestic and global market share to New York and London. Latin American blue chips are more heavily traded as American Depository Receipts in New York than in their home markets. Both regions were heavily dollar-based, with several Latin American economies experimenting with dollarization. With the floating of the Chinese renminbi (RMB) and the Malaysian ringgit, Asia is now experimenting with more flexible exchange rate regimes, but the dollar remains the key trading and financial transaction currency in the region.

In terms of policies and broad trends, I would say that the differences in views across the Pacific and with Europe are less stark or clear than the regular press portrays. There is general acceptance that globalization is inevitable, that flexible exchange rate regimes are here to stay and that capital account convertibility is a matter of time. The major difference of opinion is the speed of implementation of these policies, with the common proviso that domestic institutional and structural conditions do not permit the immediate liberalization, without clear understanding of the risks associated with financial liberalization. In other words, Asia, like Latin America, faces the same cyclical and structural problems that are very much microeconomic and institutional in nature.

Hence, given the fact that the global community have had nearly sixty years of experience with economic development and crisis since Bretton Woods, why is it that we are still surprised by how slow and frustrating it is to change policies and the capacity of national economies to build robust and efficient financial markets that help economic growth with stability?

We are left with the classic Sherlock Holmes maxim of detection that "*when you have excluded the impossible, whatever remains, however improbable, must be the truth.*"

During the Asian crisis, it was fashionable to blame the Washington Consensus. As someone who has worked in Washington and accept mea culpa in the policies and practices of the Washington Consensus, I have come to the realization that we must look deeper into what stands in the way of change.

Allow me to conjecture that the problems of analysis of real world problems, especially in the area of building financial markets lay not in the practice of development economics, but in the whole neo-classical paradigm of assuming away the most important pieces of the political economy conundrum. Keynes' dictum that "practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist" (Keynes, 1936) is still valid today in the analysis of market development and institutional building.

The first basic problem of the neo-classical paradigm was the emphasis on flow analysis. It took more than 50 years after the United Nations had published the first System of National Accounts before we have finally begun to publish and use national balance sheets for serious analytical purposes (see Lane and Milesi-Ferritti, 2006). The emphasis on the two-gap analysis of fiscal and balance of payments deficits meant that balance sheet weaknesses were not the primary focus of analysis.

By assuming away the institutional framework as given, policies could be formulated without getting into the messy area of political economy, vested interests, bureaucratic inertia, corruption and other long-haul issues that had no easy short-term solutions. It was so much easier to focus on elegant policies supported by universally acclaimed theories that were logically impeccable but practically flawed.

The second basic problem was the emphasis on theoretical search for the right policies, rather than devoting greater resources on looking at the institutional context of policies. This emphasis on policy, using empirical models of behaviour, made bold and simplistic assumptions that the institutional framework of accounting, law and efficient judiciary and bureaucracy were in place for policies to be effected. As we all know, in many emerging markets, the quality of the property rights infrastructure were in many ways defective and policies that worked in market economies were in many instances ineffective when applied in emerging markets.

Indeed, the neo-classical emphasis on policies seemed to consider that when policies fail, it was the countries and the institutional framework that were wrong, rather than the theory or the naive use of theory that was wrong. Because the neo-classical theory is so logically complete, there is a tendency for policy makers to assume that if only the market was complete, policies will work better. Just as real world practitioners realize that perfection is the enemy of the good, trying to impose completeness is enemy of the whole. Policy conditionality in recent years have been so demanding by number that in reality the capacity of emerging markets to meet such conditionality is stretched to the limit.

To be fair, there has been a gradual but significant recognition of the importance of institutions and political realities in the formulation of policies. The September 2005 issue of the IMF World Economic Outlook (WEO) devoted a full chapter on “Building Institutions”. The preliminary findings are music to the ears of those involved in institutional reforms:-

- Openness is robustly associated with greater institutional quality;
- Greater accountability of the political executive is associated with higher institutional quality;
- A higher initial per capita income is associated with stronger institutions;
- The quality of institutions in the neighbouring countries and education levels are associated with better institutions, but there is
- Some evidence that greater natural resource dependence is associated with weaker institutions.

The WEO report concluded that “institutional change has to be designed and driven by countries themselves”, but “external factors can play an important supporting role.”

Furthermore, in a recent publication, the IMF Working Paper on “*Financial Globalization: A Reappraisal”*, there is an important insight that “the main benefits from successful financial globalization are probably catalytic and indirect, rather than consisting simply of enhanced access to financing for domestic investment (Kose, Prasad, Rogoff and Wei, 2006). “There is now a rapidly growing literature showing that financial openness can – in many but not all circumstances – promote development of the domestic financial sector, impose discipline on macroeconomic policies, generate efficiency gains among domestic firms by exposing them to competition from financial entrants, and unleash forces that result in better government and corporate governance."

This new orientation towards greater appreciation of the institutional aspects of development still ignores the how. It was one thing for brilliant macro-economists to give policy advice; it was another to get experienced market and institutional practitioners to teach emerging markets how to build or reform institutions. To say that there is "no one size fits all" solution and that reforms do not succeed because of the "lack of political will" is a cop out. Anyone with a basic understanding of institutions would appreciate that every political structure, however autocratic, does not have one view, but a whole spectrum of views and that every reform or change involves trade-offs between interests.

A key lesson, not well taken in during the post-crisis analysis of the Asian crisis, was the capacity and ability of the Asian bureaucracy to understand globalization and market forces. Having been groomed since independence to participate in mercantilist export growth, with fairly strong "window guidance" toward integration with global markets, Asian policy makers became complacent and did not fully appreciate how global competition, financial innovation and changes in global standards, include standards of transparency, market practice and conduct, had profoundly changed the rules of the game. This lack of depth of understanding also impacted on the lack of capacity to manage the transition to fuller integration with the global economy.

Fortunately, there is already enough experience with institutional and market reforms in developed markets to know that there are common elements and principles of change management that could be more methodically applied to many emerging markets with greater chances of success. Change management is already a well-understood discipline in the (corporate) managerial science, but has not been applied widely in the area of public institutional development. IFI support in this area has generally been under-resourced relative to the importance of building long-term public management capacity.

A major reason why institutional change is so much tougher than realized is because there is usually too many vested interests and conflicting views on the outcomes of change. Change managers understand that a first priority of institutional change is ownership or the creation of the common understanding of issues, common language of reform and at least sufficient acceptance of the tradeoffs of change. This involves game theory, a greater grasp of local conditions and values and is so much more inter-related and complex than providing macro-economic policy advice.

I shall illustrate this conundrum with the ongoing saga of developing bond markets in Asia. Here is an example where there is universal agreement within Asia that bond markets are both necessary and good, but progress is much tougher than realized at both the national and regional level.

The recent book on "*Developing Bond Markets in APEC*" (Parreñas, Waller and Sinsiri, 2005) amply demonstrates the frustration of many policy officials and the private sector with progress to date. The Asian crisis led to one key consensus conclusion. The crisis was due to a fundamental liquidity and currency mismatch in the Asian financial system. Because Asian savings were predominantly in the banking system, there were two mismatches. The first is the banking system maturity mismatch – the deposit base was short-term, whilst a large part of the banking loans were used to finance projects with fairly long payback periods, such as real estate and infrastructure. The second mismatch was a currency mismatch, where borrowing became increasingly in foreign currency whilst assets were in domestic currency. The two mismatches made Asia vulnerable to sharp capital withdrawals and flight. With high domestic savings, the obvious solution was the creation of deep and liquid bond markets. As Asian populations began to age, the demand for deeper bond markets to provide the investment channels for growing pension and retirement funds became also a demographic imperative.

However, despite this impeccable rationale and consensus, why are bond market developments so patchy in Asia? In China, India, Indonesia, Hong Kong and Philippines, the bond market still account for only around 30% of GDP, whereas the developed market average was around 60-80%, with Japan and US having levels exceeding 100% of GDP due to their recent fiscal deficits (Table 2 above). One interesting point is that the four markets - Singapore, Hong Kong, Malaysia and Taiwan - showed better improvements than others, but they were collectively not large enough to have a serious impact on the creation of regional markets. These markets also happened to be most global in terms of trade as a share of GDP.

The APEC survey revealed a host of legal, fiscal, regulatory and systemic impediments. A key observation was that foreign bondholders still play a very small role in Asia's local currency market, with only 4% in Japan and around 1% in Hong Kong, Indonesia, Malaysia, Korea and Thailand. Intra-regional investments in Asian bonds were also insignificant. According to the IMF data survey, out of US$9.1 trillion worth of cross-border investments in long-term debt securities at the end of 2003, Japan accounted for 15%, Hong Kong 1.7% and Singapore 0.6%. The rest of East Asia accounted for another 0.3%. These bond investments within Asia were also paltry. Japan invested only 0.8% of its overseas investments in Asia, Hong Kong 14.4% and Singapore 17.2%.

These data confirmed that Asia preferred to put its overseas investments in the markets outside Asia, rather than within Asia. It demonstrated the superiority of US and European financial intermediation skills, and also the weaknesses of Asian financial markets.

The APEC study divided the major legal and fiscal impediments into three broad categories of restrictions, omissions and disparities. The restrictions include:-

- Restrictions on foreign firm participation in local markets;
- Exchange controls;
- Withholding taxes, stamp duties and levels of foreign ownership
- Inadequacies in bankruptcy laws and property laws that affect securitization
- Problems on asset transfers, especially to foreign asset holders,
- Problems in enforcement of court rights, including against state-owned enterprises and sovereign governments.

The omissions include:-

- Inadequacies of creditor rights;
- Lack of clarity in settlement, custody, netting and transfer arrangements;
- Lack of recognition of trusts, and onshore and offshore special purpose vehicles;
- Lack of clarity of master trading and repurchase agreements;
- Lack of clarity on taxation and other legal processes;

The disparities include:-

- Differences in treatment of taxation, duties, refunds and administrative decrees;
- Arbitrary differences in creditor status and treatment in bankruptcy arrangements;

- Rules relating to usury or religious principles which may obviate repayment or recovery;
- Imprecise and conflicting laws.

In addition, the APEC study quoted another 28 different regulatory and systemic impediments to cross-border investment in Asian capital markets, ranging from technical matters, discriminatory treatment of foreigners, difficulties of market access, quality of infrastructure, illiquidity of markets, lack of supporting institutions, laws, regulations, supervision, oversight, standardization etc.

For example, there is common agreement that a minimum condition for development of a domestic bond market is a benchmark yield curve. But this is not yet a reality in many markets in Asia, where trading in domestic government bonds markets is still discontinuous and illiquid. Even in Malaysia, which has developed the domestic private bond market to 89.3% of GDP, the government bond market does not have the same liquidity as say, any European treasury market. Part of the reason is the dominance of one single holder of government bonds, the Employees Provident Fund relative to other investors.

Developing markets domestically face many vested interest issues, both from the private sector and the public sector. Although the private sector may prefer a good bond market as an alternative to the present bank dominated system, they also like the personal relationship that arises from long-term banking relationships. After all, it is not unknown in Asia for large borrowers to end up with haircuts in their debt repayment or eventually being able to buy back their defaulted loans at a discount. Large borrowers understood the principle that in a crisis, it was the banks that got into trouble for excessive exposure, not necessarily the borrowers.

Bond market development also cut through many jurisdictions, requiring huge coordination efforts between the central bank, the ministry of finance, the securities regulator and the companies' registry. There needs to be major changes in the bankruptcy law. In addition, the banking system would have to develop skills in market making, whilst the master agreements, trading and settlement rules and processes need to be put in place. Very often, domestic banks do not have the risk management systems to control their market risks well, while at the same time, they fear the entry of foreign banks that have all the skills and technology available to dominate the domestic bond and banking markets.

One of the key questions that domestic policy makers face is the degree of foreign bank and financial participation. Foreign banks can bring new technology, skills and access to foreign markets and resources. At the same time, domestic policy makers are wary because they also fear that the market share of foreign banks would increase considerably at the expense of domestic banks. Strong nationalist sentiment would constrain the speed of opening up.

As the World Trade Organization (WTO) begins to focus on a level playing field and greater liberalization to foreign entry, Asian financial markets will inevitably have to open up to greater regional and foreign participation. Nevertheless, there remains considerable home bias to banking. Despite having a common market in banking services, EU domestic banks have not totally lost their home markets in the core banking areas, although their ownership has become more European and international. At the same time, several leading US and one or two European investment banks have taken the lead to dominate the investment banking and securities business in Europe. This trend is also becoming evident in Asia, as leading investment banks in Asia are invariably non-Asian.

From the above, it seems abundantly clear that even though the technology and expertise to make bond markets happen are readily available, making the markets successful and liquid is much more difficult than policy-makers initially estimated. Why were policy makers not able to overcome these institutional impediments? Since the Asian crisis, numerous Ministerial task forces, conferences and seminars have been held at the national and regional (ASEAN, ASEAN+3 and APEC) levels to push for bond market development.

Recent available data showed that the quality of the financial infrastructure mattered in the development of bond markets. It was the bureaucratic capacity to implement policies and introduce institutional reform that was key. Table 3 shows indicators (not the cause) of such capacity.

Table 3: Indicators on Quality of Financial Infrastructure; 0 to 10 scale, higher is better

	Total score	Contract realisation	Lack of corruption	Rule of law	Bureaucratic quality	Accounting standards	Press freedom
Australia	9.06	8.71	8.52	10.00	10.00	8.0	9.12
Hong Kong	7.75	8.82	8.52	8.22	6.90	7.3	6.72
Indonesia	3.52	6.09	2.15	3.98	2.50	n.a.	2.86
Japan	8.67	9.69	8.52	8.98	9.82	7.1	7.92
Korea	6.73	8.59	5.30	5.35	6.97	6.8	7.36
Malaysia	6.55	7.43	7.38	6.78	5.90	7.9	3.90
Philippines	4.14	4.80	2.92	2.73	2.43	6.4	5.54
Singapore	7.58	8.86	8.22	8.57	8.52	7.9	3.44
Taiwan	7.50	9.16	6.85	8.52	n.a.	5.8	7.16
Thailand	6.50	7.57	5.18	6.25	7.32	6.6	6.02
Reference markets							
U.K.	8.93	9.63	9.10	8.57	10.00	8.5	7.78
U.S.A.	8.99	9.00	8.63	10.00	10.00	7.6	8.72

Source: de Brouwer, Kawai and Rosengard (2003)
n.a. denotes not available

One personal experience is sufficient to illustrate how even the widely touted Asian Bond Fund Initiatives have not attained the desired policy objective. The Asian Bond Funds were the culmination of the heroic efforts of the ministries of finance and central banks in ASEAN+3. However, the securities regulators were not brought into the planning process. The result was that the Bond funds were launched in an environment where the Funds could trade actively in the two regional markets of Hong Kong and Singapore, but local rules and regulations in other markets regarding mutual funds did not allow for active trading within each country. The Hong Kong Securities and Futures Commission (SFC) therefore took the initiative to sign Letters of Intent with other regional securities regulators to try and achieve equivalence in regulatory standards to make the market in Asian Bond Funds less segmented and regionally tradable.

One anomaly of the development of mutual funds and bond markets in Asia is that Asian regulatory authorities have unconsciously built up considerable barriers to cross-regional trading of financial products. In equity markets, the number of foreign listing in Japan has actually declined in the last 15 years. In the bond markets area, it is easier to get approval for a bond listed in the Irish Exchange to trade in Asia than it is to get approval for an Asian issued bond. Similarly, a mutual fund registered in Luxembourg is more likely to be marketed throughout Asia, whereas a mutual fund issued in Hong Kong cannot be traded in Singapore and vice versa without greater regulatory equivalence.

Asian financial integration is proceeding much slower than the EU experience because there are still too many national currencies, national rules and regulations and different market standards. If Asian markets have any chance of becoming more regional, it will require the willingness of Asian regulators and policy makers to become much less protective of their domestic markets from competition and be willing to remove impediments, barriers and disparities in their markets. The devil is clearly in the details.

In the words of Professor John Kay (Kay, 2004), the market is embedded in an elaborate social, political and cultural context and cannot function outside this context. Markets are adaptive and the behaviour of market participants is influenced by incentives and enforcement of rules and laws. The level of vested interests and ability of policy makers to make institutional change depended therefore very much on the ability and capacity of policy makers to build consensus and make the necessary changes. This is clearly an under-researched and low area of attention in the literature of development economics and IFI advice.

There is of course more recent awareness of the inadequacies of the neo-classical paradigm. Nobel Laureate Robert Merton recognized in his seminal paper on financial innovation and institutional change (Merton, 1995) that the neo-classical paradigm was flawed because "it is essentially an "institutional-free" perspective in which only functions (of prices and quantities) matter." The institutional school propounded by Nobel Laureate Douglass North and others tended to focus on the institutional structure and how it influenced behaviour. However, even though today the neo-classical and institutional schools recognize that both policies and institutions matter, they do not give you much insight on how to build or change these institutions.

This missing element of the role of management in the institutional and policy framework is clearly the dog that did not bark in Asia.

I come now to the discipline of management, which is much better developed in the corporate field than in the area of public governance. I contend that the lack of progress in institutional change in Asia, indeed in many emerging markets, is the lack of attention and understanding in academia, business, government and IFIs of the importance of managing change in public bureaucracies, particularly towards a government-market relationship that leads to sustainable development. In other words, we tend to emphasize too much on the easy areas of policy formulation and debate, at the expense of establishing and strengthening the institution framework and managing institutional change in order to create transparent, liquid and effective markets.

I would go further to say that even though there is now recognition at the IFI level that institutional effectiveness is important for growth, focusing on corruption is looking at the symptoms rather than the roots of the institutional barriers to growth. The above bond market example illustrate that even if there is no shortage of political will, the management know-how of how to effectively make the institutional changes necessary for effective market trading is still lacking. It is in practice a massive coordination job, one of balancing huge vested interests, building coalitions, changing laws, standards and ultimately market and bureaucratic behaviour. Neo-classical theory assumed that implementation of policies is costless and that there is no principal-agent problem between the policy-maker and the bureaucracy. We know from the lessons of the Asian crisis and the post-crisis implementation of structural change that this assumption is naive, but also flawed and costly if not damaging to the reformers.

As the late management guru, Peter Drucker recognized, "it became clear fairly early in the post-World War II period that management is the crucial factor in economic and social development. It was obvious that the economists' traditional view of development as a function of savings and capital investment was not adequate. Indeed, savings and investment do not produce management and economic development. On the contrary, management produces economic and social development, and with it savings and capital investment (Drucker, 1985, pg 13)." It is a pity that many development economists did not pay too much attention to this advice.

The fall of the Berlin Wall brought the triumphalism of free markets, but it was a triumphalism of policies, not institutions. It took the Asian crisis to recognize that institutions and corporate governance matter and only recently was there recognition that public governance to complement markets is crucial to the function of markets. Indeed, as Francis Fukuyama so insightfully pointed out, building the appropriate bureaucracy that complements markets is part of the larger issue of "state-building", which "is one of the most important issues of for the world community because weak or failed states are the sources of many of the world's serious problems, from poverty to AIDS to drugs to terrorism (Fukuyama, 2004)".

Hence, I come back to the major theme of this essay. The difficulties faced in the creation of financial markets in Asia, indeed in Latin America and elsewhere, are not the shortage of right policy advice, the shortage of money, technology and the like. It is the lack of understanding that theory is always theory, and institutional change is not just about theory and policies, but also about managing social change effectively. We need to be able to walk the talk. We need to focus on how to help emerging markets walk the talk[3].

Because markets and institutions are embedded in the social, cultural and political environment that they grow in, we cannot organically transplant markets and new institutions without tissue rejection. We need to create the DNA of market change through the education and establishment of right class of entrepreneurs, managers and technical experts who can make that market come alive. Deep and liquid markets in Europe and the US were not created overnight and we cannot realistically expect such markets to become instantly deep and liquid in Asia. Indeed, with globalization and standardization, we would expect the European and US markets to achieve network effects of "winner-take-all" dominance, even as Asia begins to build its own liquidity in absolute terms.

Hence, I come back to a realization that we need to go back to basic principles of political economy to admit that we need to start with building effective bureaucracies in Asia that understand how to balance the government's role in a market economy. To illustrate, the attempt so far in building markets was top-down in approach, whereby the policy and institutional design often involved only the public sector and did not fully consult the private sector. The foreign sector, which has the expertise and the motivation to expand the market were often excluded in the decision process. The domestic players are often unwilling to build competitive markets that erode their own franchises and market share. The result is that domestic private sector participants or state owned enterprises often play along the "liberalization" game, whereas in practice, they have little or no incentive to innovate or change unless forced by crisis.

Moreover, the Asian crisis brought home the need for global standards of accounting, governance, transparency and even social conduct. Once global standards of accounting and transparency are imposed, domestic players are exposed in terms of hidden losses, inefficiencies and competitive weaknesses. There is therefore every incentive for the vested

3 It is interesting that the new management language follows exactly the Chinese maxim "Listen not what a man talks, but watch how he walks (the word for "walk" is the Chinese word for "act"). 听其言，观其行.

interests to resist opening up and/or to buy time for internal change to prepare for global competition. For the market to work effectively, we need effective public bureaucracies that can simultaneously educate, regulate, lead and motivate change. To do this will need also leadership from academia, the business community and the media to work together to facilitate change.

As Fukuyama correctly points out, "it is true that government in the developing world is often too large and bloated in the scope of functions they seek to carry out. But what is most urgent for the majority of developing countries is to increase the basic strengths of their state institutions to supply those core functions that only governments can provide." Asian bureaucracies need to recognize that complementing and facilitating effective markets is a core function in today's global economy.

Once that is recognized, the next step is to strengthen and motivate the bureaucracy to effectively exercise that core function. Policy thinkers need to accept that in the real world, bureaucracies have monopolistic positions and functions that markets cannot change easily. We need to accept the fact that unless the bureaucracies fulfil that function effectively, the markets cannot function effectively.

To be fair, there is sufficient awareness that Asia, like many other emerging markets, have to move to global standards, processes and practices because of global competitive forces. The elite have also become aware that markets are the way to go, but are uncomfortable that free markets create winner take all situations and therefore lead to social instability. Hence the state or rather the bureaucracy, complemented by civil society such as non-governmental organizations (NGOs), may be the only way forward to deal with market failures, such as environmental degradation, social inequality, terrorism and natural disasters.

Herein are the horns of the institutional dilemma. It is a fact that in emerging markets, many public bureaucracies are underpaid, under motivated and under-managed. Why should they help facilitate change when all it does is to appear to benefit the private sector? If the existing bureaucracies, for various reasons, are unwilling or unable through under-resourcing, inertia, ignorance, corruption or lack of incentives to move effectively to make the necessary social, institutional and policy changes, then these market failures will not be tackled. And if the bureaucracies cannot change, the market cannot change and perform effectively.

This essay is not about the blame game, but about the need to become aware what are the very real problems facing emerging markets in building an effective market economy, both domestically and regionally. We have moved beyond the policy game, into the real world of institutional and social change. If we accept that development is about social change, then we have to accept that institutions are the instruments of change. However, if Asian bureaucracies, as institutional instruments become the end, not the means of social development, then Asia will neither create sustainable growth with equity, nor rise to play its rightful role in the global economy.

I end this essay with a note about the role of the key players, including the IFIs. The Bretton Woods Institutions have played a crucial role in the development process. They are the intellectual custodians of the development ideals, guarding the flame of global change with stability. They have helped the process of globalization and acted as effective teachers, stewards and referees of the growth of emerging markets. But they have also been the channels through which the neo-classical paradigm has imposed both its benefits and its costs.

We have reached a stage in the global economy where the neo-classical paradigm has been turned on its head. The emerging markets are now the providers of liquidity for the developed markets. The developed markets and the IFIs are no longer the most important sources of finance for development. Neither are they willing to be the lender of last resort for emerging markets.

Hence, to change the global imbalance requires not only changes in the consumption pattern of emerging markets, but also the way in which the institutions of emerging markets have to evolve to create a balanced and mutually sustainable global market. To push the old medicine of appropriate macro-economic policies is necessary but not sufficient. The IFIs must review their own roles in the development process and draw lessons as to how to help emerging markets make that important institutional change. Their own institutional capacity to help that change should be reviewed.

At the national and regional level, the elite must accept that the transition to global markets is inevitable. The question is time and pace of change. The burden of change is to accept sunken costs now, reform the institutional framework as soon as possible or to delay that change and pay the price of crisis.

The private sector has a crucial role to play in this evolutionary change. The business leadership has to rise above parochial interests and work with the policymakers to make the necessary transition to globalization. Opening up should not be the "can-opening" mantra of foreign businesses backed by foreign governments. It should be the joint efforts of both domestic and foreign businesses to demonstrate to the community that they share common goals in economic development and that they have corporate social responsibilities.

The developed part of Asia, being richer and more advanced in institutional capacity, has to play a much larger role to help the developing part of Asia in its institution building. Regional cooperation and global cooperation shares the same objective: how to ensure that member weaknesses do not become a systemic problem. We need to cooperate and share resources, financial, human and knowledge, in order to strengthen ourselves against the inevitable stresses and strains that come from globalization.

To sum up, structure follows strategy. If the strategy is to accept that globalization and markets will bring both benefits and costs/risks to emerging markets, then the priority is to change structure/institutions that fit this strategy. But changing structures itself requires vision, mission, resources and the determination to make that change. This is about leadership. Who in Asia has the vision, mission and will to make that change is a question that is beyond the scope of this essay.

Kuala Lumpur and Beijing,
6 September 2006.

References:

Asian Development Bank (2005), *Key Indicators 2005: Labor Markets in Asia: Promoting Full, Productive and Decent Employment,* Manila: Asian Development Bank.

________, World Bank and Japan Bank for International Cooperation (2005b), *Connecting East Asia: A New Framework for Infrastructure,* Manila, Washington D.C. and Tokyo: Asian Development Bank, World Bank and Japan Bank for International Cooperation.

Bernanke, Ben (2005), *The Global Saving Glut and the U.S. Current Account Deficit*, New York: Board of Governors of the Federal Reserve Bank System.

de Brouwer, Gordon (2003), Financial Markets, Institutions and Integration in East Asia, *Asian Economic Papers*, 2(1), 53-80.

_________, Masahiro Kawai and Jay Rosengard (2003), National Markets and Institutions to Support Financial Development in East Asia, *Conference on Institutional Development in East Asia, 31 October – 1 November 2003, Bangkok*.

Drucker, Peter F. (1985), *Management: Tasks, Responsibilities, Practices*, New York, NY: Harper & Row.

Dooley, Michael P., David Folkerts-Landau, and Peter Garber (2003), An Essay on the Revived Bretton Wood System, *NBER Working Paper*, No. 9971, Cambridge, MA: National Bureau of Economic Research.

Fukuyama, Francis (2004), *State Building: Governance and World Order in the Twenty First Century,* Harper Collins.

Goto, Junichi and Kawai, Masahiro (2001), Macroeconomic Interdependence in East Asia, *International Conference on Economic Interdependence: Shaping Asia-Pacific in the 21st Century, 22–23 March 2001, Tokyo*, International Monetary Fund and World Bank.

Jeanneau, Serge and Marian Micu (2002), Determinants of International Bank Lending to Emerging Market Countries, *BIS Working Papers*, No. 112, Basel: Bank for International Settlements.

Karacadag, Cem, V. Sundrarajan, and Jennifer Elliot (2003), Managing Risks in Financial Market Development: The Role of Sequencing, in Litan, Robert E., Michael Pomerleano, and V. Sundrarajan (eds.), *The Future of Domestic Capital Markets in Developing Countries*, Washington: Brookings Institution.

Kay, John (2004), *The Truth About Markets: Why Some Nations Are Rich But Most Remain Poor*, London [etc.]: Penguin Books.

Keynes, John Maynard [1936] (1942), "The General Theory of Employment, Interest and Money", London: Macmillan.

Kose, M. Ayhan, Eswar Prasad, Kenneth Rogoff and Wei Shang-Jin (2006), Financial Globalization: A Reappraisal, *IMF Working Paper*, WP/06/189, Washington D.C.: International Monetary Fund.

Kristof, Nicholas and Sheryl WuDunn (2001), *Thunder from the East: Portrait of a Rising Asia*, First Vintage Book Edition, New York, NY: Vintage Books.

Lane, Philip R. and Gian Maria Milesi-Ferritti (2006), The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970-2004, *IMF Working Paper*, WP/06/69, Washington D.C: International Monetary Fund.

Loser, Claudio (2006), *Financial Markets in Latin America*, Centennial Group Latin America.

Merton, Robert C. (1995), Financial Innovation and the Management and Regulation of Financial Institutions, *NBER Working* Paper, No. 5096, Cambridge, MA: National Bureau of Economic Research.

Nijathaworn, Bandid (2006), *East Asian Financial Markets: Some thoughts on the Way Forward*, Bangkok: Bank of Thailand.

Parreñas, Julius Caesar, Kenneth Waller and Newin Sinsiri (2005), *Developing Bond Markets in APEC: Towards Greater Public-Private Sector Regional Partnership*, Singapore: Institute of Southeast Asian Studies.

Rana, Pradumna B. (2006), Economic Integration in East Asia: Trends, Prospects and a Possible Roadmap, *Working Paper Series on Regional Economic Integration*, No. 2, Office of Regional Economic Integration, Asian Development Bank.

Sa, Sopanha and Guérin, Julia (2006), Recent Developments in Monetary and Financial Integration in Asia, *Financial Stability Review (Banque de France),* 8, 111 – 129.

Severino, Rodolfo C., Jr. (1999), Regionalism: The Stakes for Southeast Asia, *ASEAN Faces the Future: A Collection of Speeches by Rodolfo C. Severino, Jr., Secretary-General of the Association of Southeast Asian Nations,* Jakarta: ASEAN Secretariat, 31 – 40.

Shanmugaratnam, Tharman (2001), *An Asian Wall Street*, Singapore: Monetary Authority of Singapore.

Sheng, Andrew (2006a), The Art of Reform: Applying Lessons from Suntze to Asia's Financial Markets, *Finance and Development*, 43 (2), 20 – 23.

_____ (2006b), *Financial and Monetary Integration in East Asia*, mimeo, University of Malaya.

_____ (2006c), *Infrastructure Reform as a Precondition to a Stable Regulatory Framework in Asia*, paper presented at the APEC Policy Dialogue Workshop on Financial Sector Reform, 3- 4 July 2006, Shanghai, Asia-Pacific Economic Cooperation.

_____ (2006d), *The Asian Network Economy,* Washington D.C: World Bank.

_____ (2006e), *ASEAN Integration to Meet Global Challenges*, Malaysia: Ministry of Finance, Malaysia.

Ziegler, Dominic (2003), The Weakest Link: A Survey of Asian Finance, *Economist* (February).

Emerging Markets Forum

The Emerging Markets Forum is a not-for-profit initiative that brings together high level government and corporate leaders from around the world for dialogue on the key economic, financial and social issues facing emerging market countries – *a dialogue that concludes with consensus and commitment to actionable outcomes.*

The Forum is focused on some 50 emerging markets economies in Asia, Europe, Latin America, Middle East and Africa that share prospects of superior economic performance, already have or seek to create a conducive business environment and are of near term interest to private investors, both domestic and international.

The dialogue at the EMF Global and Regional Meetings is based on a Series of papers written by world-renowned authorities exclusively for these meetings.

For more information about the Emerging Markets Forum, please visit our website,

http://www.emergingmarketsforum.org

or email us,
info@emergingmarketsforum.org

The Watergate Office Building, 2600 Virginia Avenue, N.W., Suite 201
Washington, DC 20037, USA Tel: (1) 202 393 6663 Fax: (1) 202 393 6556

2006 Global Meeting