FINANCIAL MARKETS, INSTITUTIONS AND INTEGRATION

IN EAST ASIA

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East Asia has been through a lot in the past decade and it faces many new challenges. In general, the region's financial markets are relatively weak, undeveloped and unsophisticated, although there are exceptions, notably Japan, Singapore, Hong Kong SAR and Australia. In general, the region's financial institutions are weak, again with a number of exceptions. Not only are the banking sectors of some of the crisis-affected economies still heavily burdened by the fallout from the financial crises of 1997 and 1998, but most banks in China and Japan are overwhelmed by non-performing loans. Financial integration in East Asia is still in its infancy.

This has a bearing on the economic outlook of the region. Weak financial markets and institutions impede economic efficiency, economic growth and risk management, making East Asia more vulnerable to adverse economic and financial shocks. Financial weakness and fragmentation mean that the region lacks international influence, and remains reactive rather than proactive to international market and policy developments. The current state of East Asia's financial markets, institutions and integration provides many big opportunities for significant improvement and deepening. Ultimately, responsibility for this lies with policymakers - officials and politicians - and how they design and enforce market and institutional mechanisms. It is also incumbent on financial institutions to deepen their expertise.

This paper explores East Asian finance in two parts.

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The first part of the paper provides an overview of the state of regional financial markets in East Asia. It looks at recent trends in capital flows and cross-border banking, the state of financial market infrastructure, and at developments in financial markets – stocks, foreign exchange, bonds, and derivatives – in East Asia.

The picture is not pretty. East Asian financial markets are tiered: the developed markets of the region (Japan, Singapore, Hong Kong SAR and Australia) perform well by international standards, most of the others (like Korea, Malaysia, Taiwan PoC and Thailand) are average, and a couple (like Indonesia and the Philippines) look dismal. Infrastructure and risk management in the region are, in general, at relatively low levels by international standards. Many countries face serious challenges. Institutions are generally weak. Developing ASEAN has to compete more and more with China for funds. Continued weakness in its financial institutions, market structure, and economy are diminishing the importance of Japan and impeding regional development.

The second part of the paper explores in more detail four of the many issues that arise in looking at finance in East Asia. The first is refocussing on harmonising markets in East Asia, as a complement to institutional development. East Asian financial markets are fractured, and increasingly so relative to the Americas and Europe. The tiered nature of East Asia's financial markets and institutions suggests that the way forward for integration is through the more developed markets and, through cooperation with them, the less well developed markets of the region. There is enormous scope for capacity building. There are special challenges for Japan in this whole process because its regulatory structure has different legal origins and its institutions and markets, while bigger, are structurally weaker and less efficient than the other developed markets in the region. This may mean that Japan is not the natural focus for financial integration in East Asia, especially in South-East Asia, even though it is of course a major player in the process.

The second issue is the development of a market mentality in East Asia. Deep and diverse financial markets and well-structured and healthy financial institutions boost economic efficiency, help create

wealth, and enable risk management. They are essential for economic development and maturity. But the growth of markets depends on having market-friendly systems, infrastructure and mechanisms. Applied to financial markets, the challenge for policymakers is not just to accept, but nurture, speculation since this is the lifeblood of financial markets. Derivatives markets also need to be developed since these are necessary for proper risk management. Encouraging speculation and developing derivatives markets may also create exposure to other risks, including the possibility of destabilising speculation.¹ Effective regulatory systems need to be in place to deal with this. Depending on the economy, this may or may not involve swap limits on offshore speculators and limiting the international use of the domestic currency, since such controls can adversely affect risk management and financial deepening.

The third issue is the rise of regionalist sentiment and policymaking in East Asia. This has both potentially destructive and constructive elements. On the minus side, it can lead to insularity and a weakening of global rules and mechanisms. But these are unlikely eventualities in East Asia. Regionalist action in the finance domain is, on balance, more likely to provide benefits, like better policy dialogue, deeper cooperation, and financial development. It can also boost East Asia's influence globally, although this largely depends on East Asia keeping its regional focus outward-looking.

The final issue explored is the need for more market players in order to develop and deepen financial markets in East Asia. This entails expanding the range of financial institutions in markets, like institutional investors, to balance bank concentration in East Asian financial systems. And it means domestic systems accepting more foreigners and foreign institutions from within and without the region.

¹ See de Brouwer (2001).

1. FINANCIAL MARKETS AFTER THE CRISIS

This part looks at recent developments in capital flows, financial infrastructure, financial markets, financial reform in East Asia.

Capital flows and cross-border banking

The financial crises in 1997 and 1998 led to a tumultuous shift in gross and net capital flows to East Asia which still persists in 2002. Consider net capital flows. Figure 1 shows net private capital flows to the five crisis-affected East Asian economies,² taken from the IMF's March 2002 Global Financial Stability Report. Reflecting their current account surpluses, these countries are net providers of international capital. While FDI and portfolio investment flow into these countries on a net basis, they are still paying back cross-border loans.

As shown in Figure 2, other emerging East Asian economies are also paying back international loans, but in their case the inward portfolio investment is sufficiently large as to dominate these net outflows and make them net importers of international capital (as would seem 'right' for emerging markets).

² Indonesia, Malaysia, Korea, the Philippines and Thailand.

Figure 1: Net Private Capital Flows to the Crisis-5 East Asian Economies

Source: IMF(2002)

Figure 2: Net Private Capital Flows to Other Asian Emerging Markets

Source: IMF(2002)

The net repayment of loans is also seen in the cross-border assets of BIS reporting banks. Table 1 shows exchange-rate adjusted changes in banks' cross-border loans in selected East Asian economies. There are three points to note.

Table 1: Exchange-Rate Adjusted Changes in Cross Border Loans

	1996	1997	1998	1999	2000	2001 (to Sep)	Level, Sep 2001
China	15.8	12.5	-8.5	-23.4	-7.2	-1.6	50.0
Indonesia	9.3	7.9	-12.7	-7.4	-3.5	-4.6	33.1
Malaysia	6.5	3.6	-5.0	-3.8	-0.1	-1.0	14.8
Philippines	5.5	3.0	-1.8	1.1	-1.9	1.0	13.4
Korea	23.0	-2.9	-30.7	-2.0	-5.5	2.0	52.8
Taiwan PoC	1.2	0.2	-0.4	-3.8	-4.1	2.6	14.8
Thailand	9.8	-17.7	-27.6	-17.4	-7.6	-4.2	18.9
Total	71.0	6.5	-86.8	-56.8	-30.0	-5.7	197.8

Source: BIS(2002b), Table 7A.

Figure 3: Bank Consolidated Claims on Emerging Asia, including Hong Kong SAR and Singapore Offshore Financial Centres

Source: BIS(2002b).

First, the fall in cross-border loans has been monumental: about \$220 billion has been pulled out of these economies in the past five years, with \$76 billion from Thailand, \$47 billion from Korea and, accelerated by the ITIC collapses in 1999, \$42 billion from China. The bulk has come in the collapse of loans from Japan, which was the main creditor to emerging East Asia (Figures 3 and 4). Japanese banks cut back most aggressively in all the crisis-affected economies, especially Thailand (Figure 5). This is part of a broader pattern of decline of Japanese banks in international finance

(BIS 2002b). Jeanneau and Micu (2002) trace the shifts in cross-border lending to push and pull, internal and external factors like high domestic real interest rates, bilateral trade, emerging economy economic growth, bilateral exchange rate volatility, external debt (to GDP), and risk aversion - although this last factor looks circular: what explains risk aversion?

Second, the decline in cross-border loans to emerging East Asia looks like it is slowing down. Loans to the Philippines, Korea and Taiwan PoC actually increased in the first three quarters of 2001, and the rate of decline is slowing for the others, with the possible exception of Indonesia which remains subject to substantial political uncertainty.

Third, China and Korea are the main recipients of loans. The decline in Japanese loans to East Asia was smallest in the case of loans to China, and Japanese banks now have more cross-border loans in China than elsewhere in emerging East Asia (Figure 5). They are also increasing, reflecting the growing importance of China as a destination for Japanese and other foreign capital. ASEAN not only faces a serious challenge from China in attracting FDI and portfolio investment, but also in finance.

Figure 4: Bank Cross-Border Consolidated Claims on the East Asian Crisis-5 Economies (Indonesia, Korea, Malaysia, the Philippines and Thailand)

Source: BIS(2002b).

Figure 5: Japanese Banks' Cross-Border Consolidated Lending to Key East Asian Countries

Source: BIS(2002b).

The quality of infrastructure

Developing financial markets rests on providing a well-functioning infrastructure. The quality of infrastructure can be judged by a number of key factors: an effective legal framework, reliable accounting and disclosure standards, and an efficient and reliable clearing and settlement process, and reliable and easily accessible information (Herring and Chatusripitak (2000).

How does East Asia perform? Based on La Porta, Lopez de Silanes, Shleifer and Vishny (1998), Herring and Chatusripitak (2000) set out a collection of tables assessing countries by the quality of their financial infrastructure, creditor rights, judicial systems and information systems. These are replicated in Table 2 but broken down into the four relatively developed markets (Japan, Singapore, Hong Kong SAR and Australia), six relatively less developed markets (Indonesia, Korea, Malaysia, the Philippines, Taiwan PoC and Thailand), and, as reference markets, the United Kingdom and the United States.

Table 2: Indicators of 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
Developed East Asian markets	8.27	9.02	8.45	8.94	8.81	7.6	6.80
Australia	9.06	8.71	8.52	10.00	10.00	8.0	9.12
Hong Kong SAR	7.75	8.82	8.52	8.22	6.90	7.3	6.72
Japan	8.67	9.69	8.52	8.98	9.82	7.1	7.92
Singapore	7.58	8.86	8.22	8.57	8.52	7.9	3.44
Developing East Asian markets	5.84	7.27	4.96	5.60	5.02	6.7	5.47
Indonesia	3.52	6.09	2.15	3.98	2.50	n/a	2.86
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
Taiwan PoC	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	8.96	9.32	8.87	9.29	10.00	8.1	8.25
United Kingdom	8.93	9.63	9.10	8.57	10.00	8.5	7.78
United States	8.99	9.00	8.63	10.00	10.00	7.6	8.72

Source: adapted from Herring and Chatusripitak (2000)

As set out in Herring and Chatusripitak (2000), the quality indicators set out in Table 2 include contract realisation (the converse of the risk of contract modification through repudiation, postponement, or scaling down), lack of corruption (special payments or bribes to officials), rule of law (a tradition of law and order), bureaucratic quality, accounting standards (based on inclusion and omission of key items in a large sample of company reports), and press freedom (repressive actions and laws on the press). Press freedom is included because it gives business people a sense of whether they can get full, reliable and easy access to information. These are qualitative subjective assessments. While the exact ordering may vary, the general placement of markets is robust to the inclusion of other factors or exclusion of included factors.

The differences between markets are striking. The four developed markets of Japan, Singapore, Hong Kong SAR and Australia stand out as the high quality markets, with Australia and Japan on a par with the quality of infrastructure in the UK and US financial markets. Singapore is disadvantaged by its relative lack of freedom of access to information. The developing East Asian markets as a whole are substantially below developed market quality but there are three clear sets: Taiwan PoC stands at the top (and is not so different from Singapore), followed by Korea, Malaysia and Thailand in the middle, and the Philippines and Indonesia at the bottom. This breakdown

should come as no surprise. There is room for improvement in all markets, and this is most compelling for the less well developed economies of the region. There is enormous scope for cooperation between countries in the region to build up capacity.

Developments in financial markets

Stock markets

Given that they are relatively developed (compared to other financial markets in the region) and accessible by foreign investors, there is considerable focus on East Asia's stock markets. Looking at stock market performance, markets seem poised for their second recovery since the crisis, with Korea looking especially strong relative to the other emerging stock markets (Figure 6).

Figure 6: Stock Prices in the Crisis-Affected Economies

Source: ARIC

But behind the very modest recovery that is generally underway, there are serious problems in market microstructure and efficiency that impede solid recovery. De Brouwer and Smiles (2002) examine differences in East Asian stock markets with other markets in the United Kingdom and United States. They look at high-frequency (five-minute) equity returns in 2000 and report three tentative key findings.

First, there are microstructural differences between East Asian equity markets and those elsewhere, especially in terms of size, number of stocks, extent of foreign listings, and trading hours (Table 3). The US, Japanese and UK markets are the largest in terms of capitalisation, number of listed stocks, and market turnover. The Malaysian, Indonesian, Taiwanese and Thai markets tend to be at the lower end of the spectrum. The investor base is narrow in the equity markets of most economies in East Asia. These economies are associated with restricted and highly regulated contractual savings systems, underdeveloped mutual funds, a highly regulated asset management industry, and a limited role for insurance companies in capital markets. US and UK markets have higher proportions of listed foreign stocks, Japan has a substantially lower share of foreign stocks while Singapore has a very high share. Malaysia, Indonesia, Taiwan PoC and Thailand have either no foreign listings or virtually no foreign listings. The markets also have diverse sectoral weightings, although these do not seem to be related to geography or level of development.

But there seem to be few distinguishing features in price formation between East Asian, US and UK markets (and they are discussed below). Rather, there are substantive areas of similarity in the formation of equity prices. For example, intra-day trading patterns exist in all markets, especially the standard intra-day U-shape in absolute or squared returns and lunch-time effects, as shown in Figure 7. Markets around the world share these characteristics, as do those in East Asia. There is also no consistent difference in the variance properties between East Asian and other equity markets.

Second, the patterns of returns and variances and the pattern of intra-day trading substantially differ even between markets in East Asia. East Asian markets are heterogeneous. It is not possible to talk with any accuracy about ‘an East Asian equity market’.

Third, there seem to be two key differences between East Asian and US/UK equity markets. One is that the market opening impact on equity prices is relatively larger in smaller East Asian equity markets, as evident in Figure 7. This could be because they open for fewer trading hours. Or it

may be because so much of the global price action that matters to equity markets occurs in New York and London, and all this information needs to be incorporated into domestic equity prices. If this is so, this difference is likely to persist and it should not be an issue of concern for policymakers.

The other key difference is in the level of relative market efficiency. The weak-form test of market efficiency — testing whether past returns contain information about current and future movements in returns — does not hold in any equity market on high frequency data like five-minute returns.³ But past information matters considerably less for the large US and UK markets than for all equity markets in East Asia, including Japan but apart from Singapore.

³ This is tested by including past 30 minute, hourly and daily returns and variances in GARCH(1,1) specifications of 5-minute changes in regional equity prices.

Insert Table 3 here

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Figure 7: Intra-day Five-Minute Variability in Equity Returns

At one extreme, for example, information beyond one hour is irrelevant for the US Dow, UK FTSE, and Hong Kong HKSE. But at the other extreme, only information beyond five days is irrelevant for Indonesia's JKSE and China's Shanghai A (domestic) stocks. This is a substantial gap, with the other East Asian equity markets lying somewhere in between. For Australia's ASX, Japan's Nikkei 225 and Malaysia's KLSE, two previous days' returns help explain current 5-minute returns. For Taiwan PoC's TIWI and Thailand's SETI, the previous three days matter. There is clearly still room for development in East Asian equity markets, including in longer trading hours and wider foreign listing and participation in stock markets – narrowing the microstructural differences between East Asian and UK/US equity markets. The relative lack of efficiency in East Asian equity prices *is* an issue for policymakers.

Foreign exchange markets

Almost a quarter of the world's foreign exchange market activity takes place in East Asia, but this is highly concentrated in the regional financial centres in Japan, Singapore, Hong Kong SAR and Australia (Table 4).⁴ Most trading in Hong Kong SAR and Singapore is in G-3 currencies, not the local currency. A notable feature of these markets is increased concentration among the firms doing foreign exchange business, although this is also characteristic of other foreign exchange markets like that in the United States, and reflects narrowing margins, increased competition, and the global consolidation of financial institutions. The concentration of activity has increased and the number of players in the markets has generally declined, in some cases very substantially (Table 5).

⁴ The Singapore figures for foreign exchange trading are regarded by some as artificially high. Sheng (2001, 2002) argues that the limited foreign exchange trading in much of East Asia shows the region's lack of financial sophistication and influence.

Table 4: Foreign Exchange Market Turnover in East Asia

	Amount, US\$ billion					Percentage share of total				
	1989	1992	1995	1998	2001	1989	1992	1995	1998	2001
Australia	29	29	40	47	52	4.0	2.7	2.5	2.4	3.2
China				0	0				0.0	0.0
HKSAR	49	60	90	79	67	6.8	5.6	5.7	4.0	4.1
Indonesia				2	4				0.1	0.2
Japan	111	120	161	136	147	15.5	11.2	10.2	6.9	9.1
Korea				4	10				0.2	0.6
Malaysia				1	0.1				1	0.1
NZ		4	7	7	4		0.4	0.4	0.4	0.2
Philippines				1	1				0.1	0.1
Singapore	55	74	105	139	101	7.7	6.9	6.7	7.1	6.2
Taiwan				5	4				0.3	0.2
PoC										
Thailand				3	2				0.2	0.1
East Asia	244	287	403	424	392.1	34.0	26.7	25.6	21.5	24.2
US	115	167	244	351	254	16.0	15.5	15.5	17.9	15.7
Total	718	1,076	1,572	1,969	1,618	100.0	100.0	100.0	100.0	100.0

Source: BIS (2002a)

Table 5: BIS Foreign Exchange Market Survey

	Number of banks covering 75 per cent			Number of participants			
	1995	1998	2001	1992	1995	1998	2001
Australia	10	9	10	72	75	66	56
China					--	426	
HKSAR	22	26	14	375	376	366	272
Indonesia		5			--	25	15
Japan	24	19	17	330	345	356	342
Korea		21	14		--	99	71
Malaysia		5	9		--	5	9
NZ	5	4	4		8	6	5
Philippines		10	10		--	51	42
Singapore	25	23	18	208	218	206	192
Taiwan		24	20		--	49	53
PoC							
Thailand		12	11		--	33	35
Reference - US	20	20	13	180	130	93	79

Source: BIS (1996, 1999, 2002a)

The fact that Japan has the most foreign exchange market activity in East Asia does not mean that much of the trading activity in the region is done directly in the yen. The dollar-yen is the second most common transaction in foreign exchange markets, after the dollar-euro.⁵ But there is very little direct trade of local East Asian currencies with the yen. As shown in Table 6, local East Asian currency trade with the yen is largely done indirectly, through local currency-dollar and dollar-yen trades (and vice versa). A minuscule 0.3 per cent of local-currency foreign-exchange transactions in East Asian countries are done with the yen as the direct counterpart. Direct trade with the euro is

⁵ The dollar-euro currency pair accounted for 30 per cent of global turnover in April 2001, compared to 20 per cent for the dollar-yen and 11 per cent for dollar-sterling (BIS 2002a: 2).

10 times this. For South-East Asia, the value of direct yen foreign currency trade has even fallen over time.

Table 6: Local Currency Foreign Exchange Turnover
US\$ million, daily average turnover

	1995				1998				2001			
	Total	- of which			Total	- of which			Total	- of which		
		dollar	euro	yen		dollar	euro	yen		dollar	euro	yen
Australia	16,327	15,667	167	205	23,600	22,462	196	339	26,839	25,641	265	391
China												
HKSAR	15,305	14,286			18,711	17,484			24,578	24,260		
Indonesia					972	935	1	17	579	568	3	3
Japan	130,810	121,929	6,689	n/a	124,045	113,275	6,478	n/a	109,708	101,634	6,225	n/a
Korea					2,289	2,222	14	34	8,416	8,297	32	57
New Zealand	3,959	3,675	39	41	4,928	4,702	28	25	2,794	2,517	53	44
Philippines					492	488	0	1	459	454	1	2
Singapore	5,881	5,545	32	65	17,644	17,210	22	104	11,600	11,345	75	53
Taiwan PoC					1,720	1,592	22	63	2,647	2,525	17	57
Thailand					2,574	2,485	7	63	1,520	1,477	9	23
Total East Asia	172,282	161,102	6927	311	196,975	182,855	6,768	646	189,140	178,718	6,680	630
United Kingdom	74,167	53,147	15,471	3,240	114,817	88,692	21,270	1,466	122,852	102,152	17,104	1,666
United States	211,072		84,819	49,316	315,872	n/a	103,183	78,541	236,436	n/a	84,395	62,145
Total	693,078	373,220	158,142	57,961	919,930	502,952	163,879	86,426	835,380	518,924	119,724	75,127

Source: BIS (2002a); Notes: in 1995 and 1998, the euro is estimated as the sum of German mark and French franc reported daily average turnover; n/a indicates not applicable.

Bond markets

It is generally accepted that bond markets in East Asia are poorly developed. This reflects a number of factors, namely borrower and lender preference for bank intermediation and generally low government debt associated with a strong policy aversion for fiscal deficits. The decline in directed lending in the 1990s and the severe recessions of the past few years have changed this in many countries. There are now many calls for developing broad and deep bond markets in East Asia.⁶ The argument is straightforward: a broader set of financing provides greater opportunity for risk-pooling and risk-sharing for borrowers and lenders, boosting financial and economic efficiency and reducing individual and collective risk.

But with only a few exceptions, notably Australia, Singapore and Japan, regional bond markets in East Asia, especially corporate bond markets, are weak and poorly developed. The development of government bond markets also depends on the degree to which institutions, like banks, insurance companies and pension funds, are forced to acquire bonds and thereby finance government

⁶ See, for example, Herring and Chatusripitak (2000) and Asian Policy Forum (2001).

spending or obligations. Generally, forced acquisition of government securities retards market development because it hinders the growth of secondary markets.

The development of viable corporate bond markets depends on three factors. First, market development depends on getting the basic infrastructure right for firms and financial markets to operate. The countries with the best corporate and financial infrastructure have the best developed and most efficient bond markets.

The second requirement for developing bond markets is to strengthen the banking system (Asian Policy Forum 2001). Indeed, a necessary prerequisite for developing corporate bond markets is a healthy active and innovative banking system since banks are not the major investors, guarantors and underwriters, but also the major issuers of corporate bonds. The Asian Policy Forum (2001) argues for authorities to enhance the soundness and efficiency of their banking sectors by minimising government direction and enhancing banks' monitoring power, strengthening prudential and regulatory systems (including the possibility of higher standards for developing countries), and examine corporate structures in banking to remove monopoly power and increase institutional efficiencies. They argue for enhancing corporate bond markets by streamlining and improving domestic market-priced primary and secondary government bond markets, providing a range of maturities taken to the market over regular intervals, improving the legal, regulatory and informational infrastructure for bond markets, and improving clearance and settlement processes. This sounds right and, again, there are no short cuts to achieving it.

The third requirement is a trigger for the development of a corporate bond market. The infrastructure may be in place, and banks may be healthy, but the market needs something to make it take off. Countries have different 'triggers'. There is no 'one size fits all' that all countries need to use. In Australia's case, the trigger for market development has been the strong growth in demand for fixed-interest securities driven by the rapid expansion of the funds management industry (due to Australia's compulsory long-term savings scheme) and the contraction of the

Government bond market.⁷ In Singapore's case, the trigger was the easing of MAS Notice 757 to allow non-residents to access the market and the introduction of tax incentives to buy corporate bonds.⁸

The Australian experience raises the question of whether a Government bond market is always necessary for a corporate bond market to prosper. The standard view is that deep liquid Government securities markets are essential for the development of private bond markets. This is most likely true for a market to start but it is not necessarily so for a market to continue. While Government debt has provided a benchmark for risk-free paper in Australia, the AAA-rated corporate paper market may now be deep enough to set its own benchmark. Increased demand for fixed-interest exposures has also led to the expansion of credit risks, pushing the market out beyond AAA-rated corporate paper to even BBB-rated corporate paper, so there is an increasing and ongoing market-based differentiation of risk. It also raises the question of whether tax benefits are necessary forever to grow a domestic corporate debt market. Tax benefits are a subsidy to firms and so should increase the market. They may be a useful way to ignite a market. But they are also a cost and distortion to households. The Australian experience shows that corporate bond markets can develop very well without tax subsidies.

There are two other issues that are raised in discussion of East Asian bond markets.

The first is 'original sin'. Eichengreen and Hausmann (1999) use the term 'original sin' to refer to the inability of a country to borrow from non-residents in its own currency. They relate 'original sin' to a variety of country characteristics, including sovereign risk, a history of inflation and depreciation, and a narrow investor base. The idea is often quoted with approval; it is certainly a

⁷ See Battelino (1999), Reserve Bank of Australia (2001), and de Brouwer (2002).

⁸ See Ngiam (2002).

smart tag. As shown in Figure 1, there are only two countries in East Asia - Australia and Japan - that borrow from non-residents in their own currency in a meaningful way.

Figure 8: Borrowing in One's Own Currency
share of local-currency external debt securities and external bank liabilities, 1998-99

Source: Hausmann, Panizza and Stein (2000)

East Asia should beware of tags developed to explain things elsewhere. The idea of 'original sin' was developed to explain a Latin American phenomenon. What is Latin America's legacy?

Political instability and military dictatorships. Hyper inflation. Regular debt defaults. Cycles of major economic collapse. Unworkable governments. How long has this been going on? The past century and more. Latin America is synonymous with instability. It is hardly surprising that countries in Latin America do not borrow in their own currency from foreigners. They can not. Latin America is not so much afflicted by 'original sin' as much as the sins of its past. They are 'mortal sins', the ones that are so serious that they send the sinner to hell. From the market's point of view, they are apostates: simply put, they are beyond redemption.

East Asia is hardly in the same league as Latin America. It certainly has had its share of political instability, corruption, and economic shocks. But they are not widespread, and tend to be concentrated in a few countries. There are few countries that have a history of problems with inflation or managing government debt in East Asia. There is very little history of government debt

default in the region, and none in the East Asian financial crisis. Most market-based countries in the region are in fact relatively balanced and well managed, the East Asian financial crisis notwithstanding. Based on all these factors, the only countries in East Asia that an investor would be really wary of are Indonesia and the Philippines. The region as a whole has sins. But they are more akin to ‘venial sins’, the ones that do not stop the sinner from getting to heaven.

So why has East Asia not been borrowing in its own currency from foreigners? For two reasons. Its governments have not had to borrow because they have kept their books balanced. And (more importantly) it has not wanted to because it is fearful of creating exposures to foreigners and losing control. East Asia has a tendency of governments wanting control over the market. Borrowing from foreigners means giving up some control. And borrowing in one’s own currency means giving up even more control and potentially exposing one’s currency to the vagaries of foreign demand. The ‘original sin’ hypothesis is a conjecture for Latin America, not for most of East Asia.⁹

The second issue relating to bond markets is the development of an integrated East Asian *regional* bond market. The Asian Policy Forum (2001: 22) succinctly expresses the proposal:

Given the limited size of each individual economy and hence its local bond market, it may not be cost-effective to develop a local bond market in each country. Fixed costs for establishing institutional infrastructures are relatively expensive and economies of scale are limited in such a small individual market. ... In comparison, an international bond market located in Asia (ie an Asian regional bond market) could be more cost-effective because of economies of scale. Further, this regional bond market could help diversify corporate financing, provide an extra investment avenue, and better tap and more effectively mobilise not only abundant regional financial resources but also corporate reputations within Asia.

The idea sounds nice in theory but it has gone nowhere. Countries in the region issue international public sector and sovereign bonds in the European and US, not Asian, markets. The issue by

⁹ See Ngiam (2002).

foreigners of yen-denominated (Samurai) or foreign-currency-denominated (Shogun) bonds in Tokyo is negligible. The Asian markets are not attractive because they do not provide the right infrastructure and do not have the right liquidity.

There are three additional problems in the proposal for a regional bond market that need to be resolved before a regional bond market can develop.

First, there is the issue of currency exposure: issuing in a foreign currency may create unwanted foreign currency exposures, especially in a regional currency for which there is limited scope for managing risk. The only regional currencies that offer sufficient hedging instruments – that is, swaps, forwards and options - are the yen and the Australian dollar, which are respectively the third and seventh most traded currencies in the world. This does not leave a lot of choice. This tends to lead to talk about the need for a regional currency unit or even a regional currency. A regional bond market may be the outcome of such a regime but it should not be regarded as the driver or motivation for common exchange rate arrangements; other criteria will drive this debate.

Second, there is the issue of support for financial innovation in East Asia. A deep and liquid East Asian bond market will only develop if the region is prepared to embrace deregulated and liberalised financial markets. This is deep-rooted and complex. It means that countries may have to accept greater internationalisation of their currencies and that they need to embrace speculation in financial markets. The former is the opposite of the trend in much of the region, and the latter is instinctively repugnant to many in the region. These issues are raised here because they lie at the heart of the viability of a regional bond market. For example, consider this quote from the Asian Policy Forum (2001: 22) on the relative merits of a regional bond market:

... if the bonds are issued in the local currency (hence avoiding a currency mismatch), this may lead to nonresidents having substantial holdings of the local currency (or an internationalization of the local currency), which can, in turn, give rise to currency speculation.

The legacies of the 1997 and 1998 financial crises are the implicit assumptions that internationalisation of the currency and speculation are best avoided. The merit of these arguments is discussed in Part 2 of the paper.

Finally, there is the issue of Japan. Japan is a leader in the East Asian debate on regional development and policy initiatives, including a regional bond market. While this is welcome, there is polite questioning of, and confusion about, Japan's motives in the region.¹⁰ Is Japan arguing for a regional bond market because it thinks this is the best way to promote stable development in emerging East Asia? Or is it a way to promote the status of the yen and Japan, and cement Japan's place at the centre of regional arrangements ahead of the expected rise of China? People say that Japan's rhetoric about an East Asian regional bond market is strong but that it does little in practice: it has a mixed record of supporting competition by foreign financial institutions in Japan and it has not provided the right sort of institutional infrastructure and arrangements to support wide participation, and strong secondary markets, in its own bond market (Asian Policy Forum 2001).

Derivatives markets

Derivatives, including swaps, forwards and options, are an essential part of risk management for firms, financial institutions and governments. Table 7 provides a snapshot of the depth of derivatives markets in East Asia. As for foreign exchange trading, derivatives trading is concentrated in the region's financial centres - Japan, Singapore, Hong Kong SAR and Australia. Over the counter derivatives trading elsewhere in the region is negligible, and reflects the limited ability of firms and households to manage financial risk.

The region largely holds its own in terms of foreign exchange derivatives: East Asia's share of foreign exchange derivatives was about 24 per cent in April 2001, on par with its share of world

¹⁰ This is based on the author's conversations with policymakers and market participants from around the region. See also de Brouwer (2003 forthcoming) for a discussion of related issues.

foreign exchange trading. But East Asia is particularly weak when it comes to interest-rate derivatives, with only 4.7 per cent of the world market. These derivatives are simple – only 6 per cent are options with the rest just swaps (68 per cent) and forwards (26 per cent). They are largely concentrated in US dollar interest rates; yen interest rate derivatives have been declining. There is a striking difference between regional financial centres in this regard, with Australia standing out in relative strength (Figure 9). The general implication from the low interest rate derivatives activity is that East Asia is poorly developed in its financial risk management.

Table 7: OTC Derivatives Market Activity in East Asia
average daily turnover, US\$ billion, net of local inter-dealer double counting

	Total		Foreign exchange		Interest rate	
	April 1998	April 2001	April 1998	April 2001	April 1998	April 2001
Australia	31.6	50.7	28.8	40.9	2.8	9.8
China		0.0		0.0		0.0
HKSAR	51.4	52.0	48.9	49.4	2.4	2.6
Indonesia	1.0	0.5	1.0	0.5	0.0	0.0
Japan	120.6	131.7	89.0	115.9	31.6	15.8
Korea	1.1	4.0	1.0	3.9	0.0	0.1
Malaysia	0.8	0.9	0.8	0.9	0.0	0.0
NZ	5.4	3.4	5.0	3.1	0.4	0.3
Philippines	0.4	0.6	0.4	0.6	0.0	0.0
Singapore	90.7	72.5	85.4	69.3	5.3	3.2
Taiwan	1.6	1.8	1.5	1.7	0.1	0.1
PoC						
Thailand	2.2	1.3	2.2	1.3	0.0	0.0
East Asia	306.8	319.4	264.0	287.5	42.6	31.9
Reference -						
UK	591.2	628.1	468.3	390.3	122.9	237.8
US	293.8	284.7	235.4	169.1	58.4	115.7
Total	1,681.7	1,862.2	1,338.1	1,186.1	343.6	676.1

Source: BIS (2002a)

Figure 9: Derivatives Trade in East Asia (Gross)

Source: BIS (2002a)

Financial reform

Financial systems in East Asia are dominated by banks. They are weak and vulnerable to adverse shocks, making them a constraint on economic growth and efficiency.

In the crisis-affected economies, there has been some improvement in taking bad loans off bank balance sheets into asset management vehicles but non-performing loans (NPLs) generally remain high. The ADB estimates that NPLs have fallen in most crisis-affected economies, with, for example, Malaysia falling from 15 per cent of loans at end-1999 to 10.7 per cent at end-2001, Korea falling from 13.9 per cent at end-2000 to 9.9 per cent at end-2001, and Indonesia falling from 56.3 per cent at end-2000 to 49.8 per cent at end-2001. There are also severe problems in China and Japan. The FSA in Japan reckons that NPLs in its banks rose to about 7½ per cent of bank loans at September 2001. Private sector estimates are higher. Banking systems are strong in Singapore, Hong Kong SAR and Australia.

2. ISSUES

There are many issues that warrant serious discussion with respect to financial integration, markets and institutions in East Asia. Let me discuss just four.

2.1 Harmonising markets

Much of the focus on finance in East Asia since the crises of 1997 and 1998 has been on institutional development, especially in repairing the banking and supervisory systems of many of the affected and other economies. The ongoing depth of the NPL problem and the weak structure of banks in East Asia suggests that this has been right and needs to continue. But East Asia as a whole is also weak in terms of its equity, foreign exchange, debt and derivatives markets. Most of East Asia is becoming a smaller part of the financial world.

The ability of the region to attract international funds and financial expertise is being made more difficult by changes going on elsewhere in the world. The introduction of the euro is having a substantial effect on the development, structure and integration of financial regulations, instruments and institutions in the euro area.¹¹ The consolidation of trading, clearing and settlement in the European Union is expected to reduce clearing and settlement costs by around \$1 billion a year.¹² European financial markets are becoming more harmonised and, as a result, bigger and more efficient. The Americas are dominated by the US dollar and US regulations and market practices. Many institutions in the Americas are dollarised and focus on US standards, even if they are outside the United States. In a world where everyone else is integrating, it is harder for a yet-integrated East Asia to remain relevant in global finance.

East Asian financial markets are segmented and fractured. They are poorly integrated. Markets which are relatively highly controlled and closed are relatively small, inefficient and lack innovation, as shown in Part 1 above. There is substantial scope and need for financial market development, conformance and harmonisation.

¹¹ See Studener (2001) and OECD (2002).

¹² See Sheng (2001).

This is not an easy process. As is discussed in the following subsections, there are practical ways to strengthen financial markets and they go to greater acceptance of a market mentality, balancing regional ambitions with the global orientation of finance, and widening market access. There are also ways to do this that suit the market structure of East Asia. There are four relatively strong centres of finance in East Asia – Japan, Singapore, Hong Kong SAR and Australia. The challenge is to integrate these markets and use and adapt this structure to develop and integrate the other markets in the region. In short, the well-developed Four need to integrate and work together with others in the region to develop and integrate their markets to best-practice levels.

This process is in train in a number of respects. The Four Markets Meeting addresses issues of common interest to policymakers in financial markets in Japan, Singapore, Hong Kong SAR and Australia, and, while its membership is relatively small, it is regarded as an effective forum for policy dialogue. EMEAP¹³ meetings bring regional central bank governors and officials together, and its working groups on foreign exchange markets, payments systems, and bank supervision are constructive and well-regarded. There are also regional meetings of commercial financial and business services firms.

There has also been a shift to initiatives which link developed markets. The Australian and Singaporean stock exchanges have agreed to mechanisms by which investors use their local exchange to access and buy stocks in the other exchange, with their local exchange acting as intermediary and trustee. This enables domestic investors – be it the householder or the institutional investor – to access foreign stocks, boosting both investment opportunities and the potential supply of funds. The Japan-Singapore New Age Economic Agreement provides for both those countries to do the same thing (but, as discussed below, it only half delivers this). It is straightforward to close the triangle by extending it to Australia and Japan and then introduce Hong Kong SAR as the next

¹³ EMEAP stands for Executive Meeting of East Asia Pacific.

partner. This process can then be extended to other countries, within and without the region, in the process bringing the region's less well developed financial markets up to the standards of the more developed ones.

There is a lot to do in terms of integrating regional financial markets, not least by simplifying and harmonising listing and licensing requirements, accounting standards, settlement and clearance, and taxation. If it is not possible to adopt common standards, practices, and regulatory frameworks, it may be possible to work towards mutual recognition, as has been the initial approach in financial integration in Europe. This is more easily done with economies that have respected and trusted regulatory frameworks. This is not just a challenge between the more developed and less developed financial markets in the region. Integration and mutual recognition is in fact more easily done between Australia, Singapore and Hong Kong SAR, than between them and Japan.

Japan is an outlier for several reasons. As a legacy of the occupation after the second world war, Japan's securities law was based on that of the United States. As a legacy of their colonial past, the other three economies' legal systems were based on the British common law. This matters with issues like stock market linkages, for example. Japanese, like US, securities law prohibits foreign securities being offered locally unless they are registered, and registration is an involved process akin to listing on the local exchange. Under the process outlined above, Singaporeans can invest in Japanese stocks but, unless there is reform of the securities law, Japanese cannot invest in Singaporean stocks. There is no such regulatory impediment between Australia and Singapore. Or with Hong Kong SAR for that matter.

While obviously much bigger, Japan's markets are less sophisticated than those in Australia, Hong Kong SAR and Singapore. They are, for example, more likely to be paper-based than electronic. Oddly for such a major technology provider, Japanese law still requires some financial transactions to be documented in paper. The stock exchanges in the three smaller centres have been demutualised for a fairly long time; the TSE only did so at the end of 2001. There is also a sense

among market participants that Japanese financial markets are unusually opaque for a major market, in the sense that the authorities are thought to be more likely to intervene in stock and bond markets through ‘price-keeping operations’, or that market participants, notoriously the Japanese broking houses, may try to manipulate the market for commercial or political gain.

Japan’s markets do not provide a suitable role model for regional development if price formation is unclear and not seen as market-based. Market estimates of non-performing loans at banks and the technical insolvency of the insurance sector are invariably higher than those published by the Japanese authorities. The authorities appear to think that understating the numbers is an indication of official confidence in the system. The opposite is true and, in the eyes of depositors and investors, the credibility of the authorities is damaged even more. While no market or regulatory regime is perfect, the general view is that the Australian, Hong Kong and Singaporean markets and regimes are ‘cleaner’ and healthier than those of Japan. This would matter much less if Japan had a strong and robust financial sector and economy. But it does not. In the past decade, it has suffered four recessions and its banking and financial systems are in a mess.

Japan leads the region in its calls for functional cooperation and integration, especially in finance. But its capacity to lead is hamstrung by the weakness of its financial institutions and markets. The structure and operation of its legal process make it the outlier, at least for South-East Asia. This poses an important challenge for Japan as the region ponders the way forward in financial integration. Does financial Japan become more like the other three developed financial markets in East Asia or do they become like Japan? The small Three developed financial markets will not converge on Japan because, for the reasons stated above, that would damage their wellbeing and economic interests. In turn, Japan also offers a weaker role model than the smaller developed Three for the developing financial markets of East Asia. While Japan will remain at the heart of East Asian financial integration for the next few decades, its importance is likely to diminish under its current policy approach, to become ‘just another (but very big) economy in the region’.

2.2 A market mentality

If the decision is made to grow financial markets to support stable economic growth, then policymakers need to adopt pro-market policies. In particular, they need to overcome a popular and widespread aversion to speculation.

The financial crises in 1997 and 1998 left many policymakers in the region with the view that speculation - and hedge funds - are destabilising. While the crises had many causes, there is now enough evidence and analysis to be able to say with some confidence that there were serious bouts of destabilising speculation during 1997 and 1998 in East Asia and South Africa which substantially raised the economic and social cost of the crises.¹⁴ This is *not* to say that the crises were caused (only) by speculators. There were in fact many causes of the crises and their depth, and there were serious policy mistakes by national and international policymakers in most countries which also compounded the costs.

Destabilising speculation was fed by the presence and activities of large influential players, especially a handful of the large macro hedge funds, and by manipulative behaviour by a range of highly leveraged institutions, including the macro hedge funds and the proprietary trading desks of international investment banks and securities companies.¹⁵ This is consistent with a large theoretical and empirical literature which looks at the nature of overshooting and herding in financial markets: these features are first-order characteristics in financial markets.¹⁶

But it would be a mistake to think that all, or even most, speculation is destabilising. The events of 1997 and 1998 were relatively unusual. It is now well established that Milton Friedman's argument

¹⁴ See FSF Working Group on HLIs (2000) and de Brouwer (2001).

¹⁵ See, for example, Rankin (1999), Yam (1999) and de Brouwer (2001)

¹⁶ See, for example, Cutler, Poterba and Summers (1990), DeLong, Shleifer, Summers and Waldeman (1990), Devenow and Welch (1996), Shleifer (2001) and de Brouwer (2001).

that speculation is necessarily stabilising - because speculators buy low and sell high – is not necessarily true in the presence of herding. But speculation is fundamental to risk management and is the lifeblood of financial markets. Unless a person who wants to hedge an exposure finds another would-be hedger with identical opposite preferences, the only way to hedge risk is to find a speculator who is willing to bear that risk. Basic transactions in financial markets could not take place without speculators. The concern should not be speculation as such – indeed, speculation should be encouraged in order to provide depth and liquidity to markets – but the conditions that give rise to destabilising speculation, like deep information asymmetries, market power, action-, information- and trade-based manipulation, and weak fundamentals. These latter issues remain ones to be dealt with.

If speculation is important in financial markets – and it is – then speculators are also important. The main speculators today are financial institutions, particularly banks (commercial and investment), securities firms, and hedge funds. The idea of encouraging hedge funds sends a shiver down the back of most policymakers in East Asia. The events of 1997 and 1998 are still fresh, and the tactics and aims of some of these institutions still repulses many, as indeed there are good reasons why they should.¹⁷ But the highly leveraged institutions that caused some of the problems in 1997 and 1998 were literally a handful of macro hedge funds and a handful of proprietary trading desks at the some of the US and European investment banks and securities companies (mostly in their Singapore and New York branches). There are literally many thousands of hedge funds and, as a class, they are important providers of innovation, liquidity and efficiency in markets. If East Asian financial markets are ever to develop and deepen, policymakers have no choice but to promote speculation and speculators, including hedge funds. This also means encouraging innovation, initiative, and entrepreneurial skills.

¹⁷ See de Brouwer (2001). The following discussion follows the arguments in that book.

There are ways to deal with the rogue elements that were apparent in 1997 and 1998.¹⁸ One strategy that has become popular in some of the emerging East Asian markets is to limit the ability of non-resident speculators to access funding in the swaps market in order to limit selling pressures in foreign exchange markets. There are two conditions for this to work. First, the authorities have to be in a position to enforce the regulations. As in South Africa in 1998, if the authorities do not enforce the restriction, then it will not be applied.

The second condition is that restricting access to swap financing for non-residents in the domestic market only works so long as there is not a substantial offshore market in the currency – that is, if the currency is not ‘internationalised’. The clearest examples are Malaysia and Taiwan PoC. In Malaysia, the authorities restricted swap access to fund short ringgit positions in the domestic market in August 1997 but this did not curtail speculative positioning because a large liquid offshore ringgit market existed in Singapore; offshore speculation only stopped when the authorities closed off the access of this market to the domestic Malaysian banking system in September 1998. In Taiwan PoC, the authorities imposed swap limits on non-residents in September 1997 and this was effective because there was no offshore market in the new Taiwan dollar.

While any government can impose limits on borrowing in the swaps market, not every government has the will or institutional capacity to enforce them. Looking at East Asia, it is hard to argue that many countries are in a position to do this. Korea, Malaysia and Singapore certainly can, Thailand probably can, but it is hard to imagine that porous economies with weak regulatory structures and enforcement processes, like Indonesia, the Philippines, and southern coastal China, could.

While limiting the access of non-residents to the domestic swaps market can be an effective tool in limiting offshore speculation, it does not protect against many forms of domestic speculation – and

¹⁸ These include binding codes of conduct in foreign exchange markets to limit manipulation, proper margining requirements for hedge funds, disclosure of aggregate positions, and regulating electronic broking (de Brouwer 2001).

it is worth remembering that this is the more usual type of speculation. And, it potentially imposes other serious costs on the economy because it makes it harder to manage risk which makes the economy more vulnerable to shocks. When there is an offshore market in a currency, residents – essentially farmers, firms and banks - can hedge their exposures and offshore parties bear the risk. This is the case for Australia and New Zealand, both of which have internationalised currencies (especially Australia) but were able to deal with big negative external shocks and exchange rate movements in the East Asian financial crises without adverse balance-sheet effects in their corporate or financial sectors. While internationalising the currency may create new risks, it also makes the economy more adept at dealing with risk. Considering the poor development of derivatives markets in East Asia generally, there is a fundamental weakness in the region's ability to manage risk.

2.3 Regional versus global markets

There is a growing swell of regionalist sentiment in East Asia. This has been motivated by a range of economic, strategic, and chauvinistic or emotional factors, centred on disillusion with international processes and the inaction and actions of the United States in the financial crisis. There is also an emerging consensus that East Asia must cooperate and integrate more if it is to protect and advance its economic and strategic interests in a globalised but also increasingly regionalised world economic environment.¹⁹

From an economic perspective, there are both constructive and destructive elements to this. On the minus side, there are two main concerns. One is that East Asian regionalism will be inward-looking, insular, and chauvinistic. There are elements of all these descriptors in the calls for, and debate about, bilateral and regional free trade and finance arrangements in East Asia. It is also evident in the way that some parts of the region deal with identity, both nationally and regionally,

¹⁹ See de Brouwer (2003 forthcoming).

including the degree to which the region (or parts of it) perceives countries like Australia, New Zealand and Philippines, for example, as natural participants in East Asian regional dialogue and cooperation.²⁰ There is no homogeneous ‘East Asian identity’, just as there is none for Europe or the Americas, but there are shared geographic, economic and strategic interests.

But concerns about insularity are likely to be exaggerated because the region’s primary economic and strategic interests are global; regional integration will tend to be kept within the perspective of countries’ broader interests. This is especially the case for the bigger economies of the region, such as Japan, Australia, China, Korea and Singapore. Moreover, the rhetoric of regionalism – ‘Asian solutions for Asian problems’ - will tend to be stronger than the substance of regionalism because it is a political device to garner support for change and action. It is important to look beyond the rhetoric used by the proponents of regionalism to the actual policy agenda they propose.

The other potential minus in the debate about regionalism is that it may result in rules and mechanisms which weaken, and may be weaker than, global rules and mechanisms. Financial services tend to be homogeneous, making it difficult to differentiate financial products and services at the local level. The efficiencies from financial integration and common rules and processes are probably greatest at the global level. This suggests that the ‘natural’ place to discuss and negotiate the financial infrastructure is in international forums.

But even if this is so, it does not mean that regional financial arrangements have no purpose. To the contrary, regional financial arrangements can play a crucial part in this. Here we move into the ‘constructive territory’ of regional arrangements. Regional cooperation and integration can promote financial development, of which East Asia is sorely in need. As outlined above, the two-tiered development of East Asian financial markets indicates that there is a strong case for harmonising

²⁰ One participant at the Asia Cooperative Dialogue, initiated by Prime Minister Thaksin of Thailand in 2002, is said to have explained exclusion of Australia on the basis that ‘we don’t have blond heads in Asia’.

the Four Developed Markets and using cooperation as a basis for improving the less well developed financial markets of the region.

Regional financial cooperation and integration should also provide East Asia with a stronger voice in global forums and greater influence in global policymaking.²¹ As Sheng (2001: 6) argues, '[u]nless we are large enough, we can't even have a say in the evolution of such standards, So it is very important to unify for strength.'

Sheng argues for greater institutional development to discuss and progress cooperation. He reckons that the BIS and EU Commission are good examples of institutional forums. This is a valuable suggestion and one that should be pursued. The BIS, EU Commission and OECD may have some weaknesses, but they are strong in the sense that they have expert secretariats which provide background analysis and a forum for policymakers in member nations to meet, discuss and decide policy on particular issues. Unlike institutions like the IMF and World Bank, they embody the principle of subsidiarity: the member states are the decision-makers, not the institution itself.

Grenville (2000, 2001, 2002) argues that greater regional policy dialogue and cooperation are important because they provide the region with influence over global rules setting. These matters cannot just be left to America or Europe. East Asia needs a voice but the only way that it will have influence is if it has strong markets. Rules-setting is not over - and never is - because financial markets are dynamic and fluid. The region has been slow in the past to respond to this challenge but the rise of networks governed by technology means that the markets and regulations that structure them remain contestable.

This provides a strong motivation for enhanced policy cooperation and financial market development in East Asia. There is a strong case to be made for strengthening the region's policy

²¹ See Sheng (2001, 2002).

infrastructure, which would entail including all the region's financial centres. Currently, Australia and Hong Kong SAR are part of the regional debate that occurs within the Four Markets Meeting and EMEAP meetings but not within the ASEAN+3 framework. And to have maximum influence on global rule-setting and cooperation, the region's policy infrastructure also needs to remain outward-looking. Given the current membership structure of regional organisations, the APEC Finance Ministers' process is the most appropriate forum to pursue issues of regional financial integration.

2.4 More market players

Markets will remain narrow if there are too few participants in them. This suggests that more domestic and foreign participants need to be brought in; indeed, the less efficient equity markets in the region are the ones with the most limited trading and tightest limits on access by non-residents or foreigners.

Financial systems in most of East Asia are bank-based. There is substantial scope for expanding the range of domestic institutions, including local institutional investors.²² Table 8 shows the relative size of local mutual funds, or open-ended investment companies, in East Asia. It shows that this class of institutional investor, typical of many developed markets, is relatively small in much of East Asia, especially in comparison to the size of bank deposits. East Asia is over-banked and under-uses institutional investors, at a cost to the development, liquidity, and efficiency of its financial markets and the governance and risk management of its business sectors. The role and development of institutional investors would itself be a useful part of the work program of an East Asian financial institute or of APEC Finance Ministers.

²² This argument is also raised by Sheng (2001, 2002).

Table 8: Worldwide Assets of Non-US Open-Ended Investment Companies, US\$ billion

	1995	1996	1997	1998	1999	2000	Sep 2001	Sep 2001 bank deposits
Australia	36.5	47.8	42.9	44.1	n/a	328.1	304.1	225.6
HKSAR	33.7	41.0	58.5	98.8	182.3	223.0	183.0	n/a
Japan	470.0	420.1	311.3	376.5	502.8	491.9	466.0	5,018.3
Korea	92.4	n/a	n/a	n/a	167.2	124.9	137.1	332.1
New Zealand	6.9	7.7	7.5	7.3	8.5	7.3	6.8	40.5
Philippines	n/a	n/a	n/a	n/a	0.1	0.1	0.2	36.0
Taiwan PoC	4.4	8.4	12.4	20.3	31.2	38.9	43.6	n/a
United States	2,811	3,526	4,468	5,525	6,846	7,269	6,415	2,903.1
World	5,386	6,343	7,238	8,668	11,416	12,153	10,939	n/a

Source: Investment Company Institute, www.ici.org/facts. Notes: bank deposits equals demand deposits plus time and saving deposits, and, in the case of Japan, certificates of deposit.

There is also scope to make wider use of foreign financial and human capital in developing regional markets. Foreign firms are an important conduit for the transfer of financial skill and technology. It does not mean that they should be allowed unfettered access to a market. Solid supervision and market-consistent regulation are essential.

CONCLUSION

There is considerable room for improvement in East Asia's financial markets and institutions. In general, financial markets in the region are undeveloped and inefficient, and financial institutions are weak. Finance in East Asia does not underpin economic growth and development to the degree it should, leaving economies vulnerable to adverse economic and financial shocks.

This suggests an action agenda for regional cooperation. The economies with the more relatively developed financial markets need to work harder to upgrade and integrate their markets and systems. This is a particular challenge for Japan which is beset by institutional weakness. These economies also need to cooperate more closely with the rest of the region to build up official and private financial capacity in East Asia. The issues that affect the existence, depth, efficiency and stability of financial markets and institutions are a policy priority for East Asia. Financial integration should be put well and truly on the regional policy agenda, and it may indeed prove to be a more fruitful program than trade integration.

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