

Developing Regional Financial Markets – The Case of East Asia

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"Regional Economic Integration Beyond Europe"
German Development Institute (GDI)
19-20 December 2007, Bonn.

My paper will discuss

- Benefits of regional financial integration
 - Regional risk sharing
 - Sheng(2006) East Asian savings intermediated in Asia
 - BIS (2004, 2005) shows that foreign investment has brought substantial benefits in the form of efficiency and stability to emerging markets.
 - Efficiency
 - Transfer know how- adoption of international best practices
 - Contestability of markets leading to the balanced development of the domestic financial sector
 - Stability ..diversified institutions absorb domestic risks easier
- Global and regional financial integration: progress in Asia?
- How has Asian growth strategy shaped their financial systems?
- What needs/can be done?

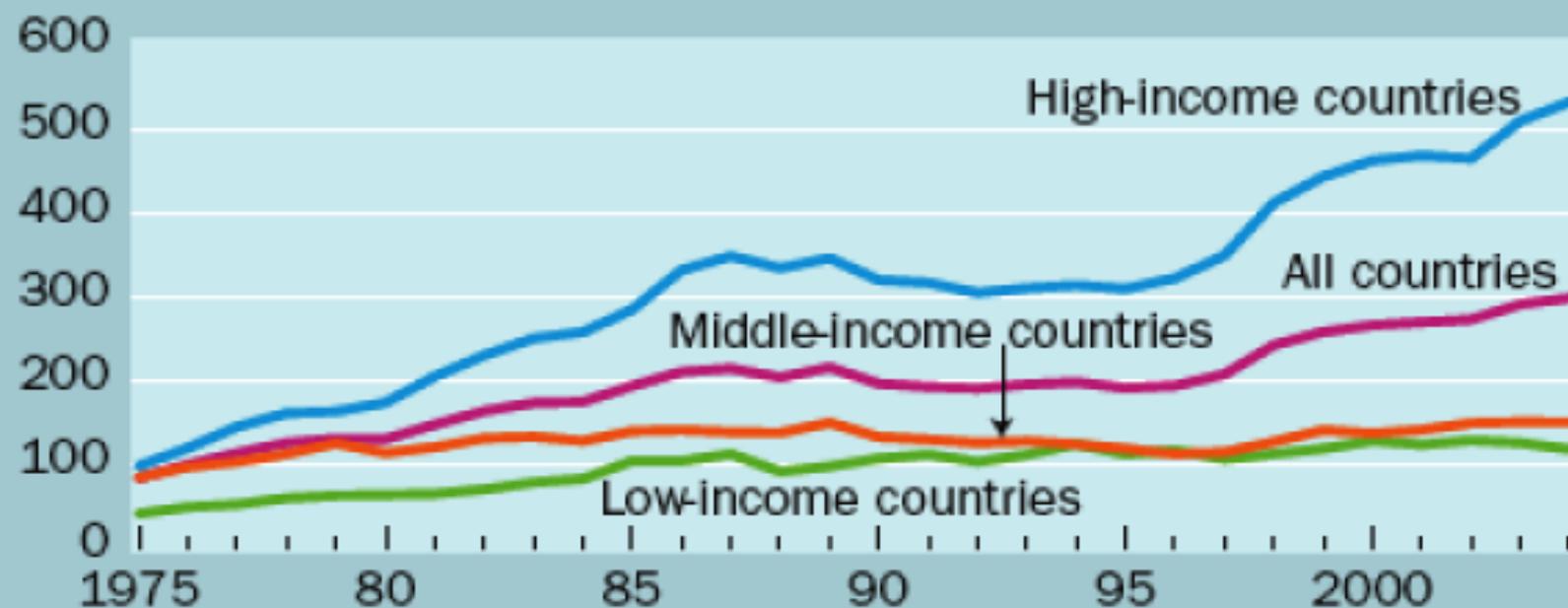
Global and regional financial integration: progress in emerging markets

- Recent papers review measures of financial integration and the progress of global and a regional integration in emerging markets :
 - Research Department of the International Monetary Fund (IMF 2007)
 - García-Herrero and Wooldridge (2007) in the *BIS Quarterly*
- The IMF (2007) finds that financial globalisation has increased dramatically over the past three decades
- García-Herrero and Wooldridge (2007) find that the new members of the European Union achieve high levels of regional integration, as a result of their close ties to major EU financial centres, but relatively little integration with markets outside the region.
- The geographical reach of integration is broader in Latin American countries, but regional financial integration lags behind that of the new EU members.
- The situation in Asia is somewhere in between, with geographical links broader than among the new EU members, but with regional integration more developed than in Latin America.
- **Begs the question- Why is Asia, with surplus savings- lagging?**

Leader of the pack

The worldwide increase in financial globalization has been driven mainly by high-income countries.

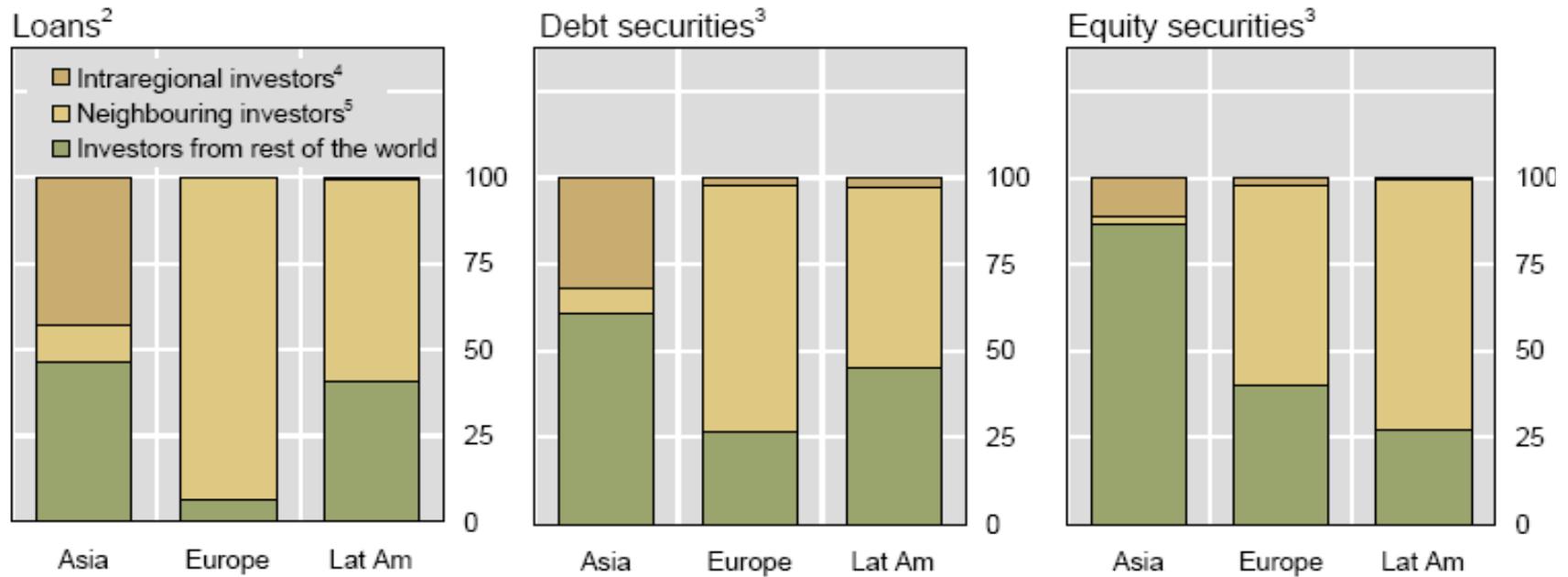
(gross external assets and liabilities, percent of GDP)



Source: IMF, World Economic Outlook.

Sources of foreign investment

As a percentage of the stock of foreign investment in the host region, at end-2005



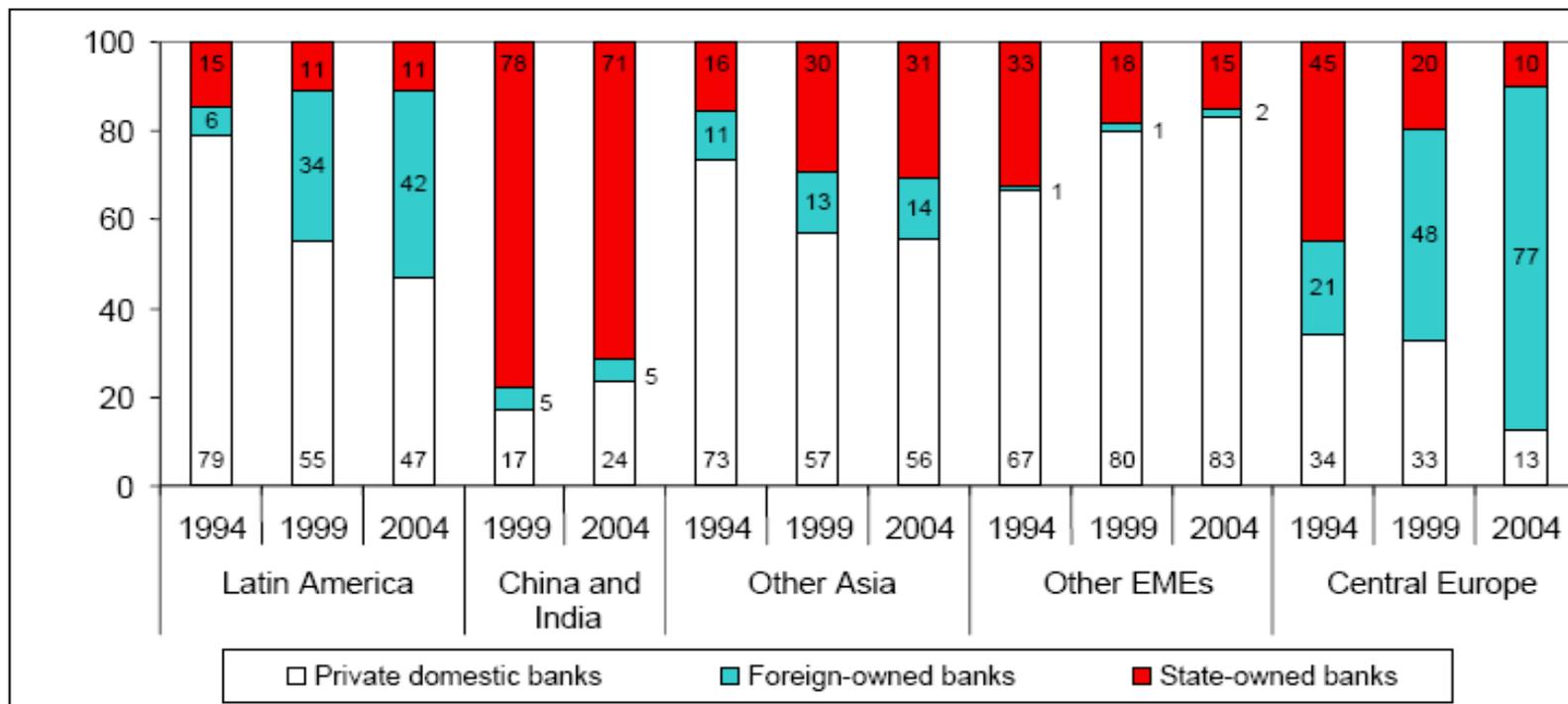
¹ For a list of countries in each region, see Graph 1. ² Cross-border liabilities, in the form of loans and deposits, to BIS reporting banks. ³ Derived from foreign portfolio assets reported by countries participating in the IMF's Coordinated Portfolio Investment Survey. ⁴ Investment by the residents of the region. ⁵ Investment by residents of mature economies neighbouring the region; for Asia, Japan; for Europe, EU 15 countries; for Latin America, Canada, the United States and Caribbean countries.

Source: García-Herrero and Wooldridge (2007)

Foreign participation in local banking systems.. Asia lags : from 11% in 94 to 14% in 2004

Commercial banks by type of ownership

Share in total bank credit, in per cent



Source: National data (BIS questionnaire).

Source: BIS Papers No 28 The banking system in emerging economies: how much progress has been made? August 2006 <http://www.bis.org/publ/bppdf/bispap28.htm>

Role of foreign banks in Asia

	<i>Share of foreign banks in total assets (%)</i>		<i>Number of foreign banks, % total</i>
	2000 or 2001	2005 or 2006	2006
China	2	7	10
Hong Kong	59	93	49
India	20	24	22
Indonesia	36	45	25
Korea	25	26	8
Malaysia	19	20	17
Philippines	35	50	28
Singapore	36	3	30
Taiwan, China	2	6	7
Thailand	22	26	20
Average:			
Africa	52	64	45
Eastern Europe	53	72	45
Latin America	36	38	25

Source: Bankscope data.

Note: Note: Foreign banks: companies with ultimate owners or shareholders (owning together 51%) located in another country (incl. subs. with a country n.a.)

No evident success in creating regional banks

- **DBS Group**

- Annual Report 1999: Responding to this challenge, DBS instituted a regional integration programme in November to accelerate its move towards operating as a regional bank. www.dbs.com/dbsgroup/annual99/review/partnering.html
- The Economist Nov 29th 2007 : Temasek, Reverse charges, : Mr Dhanabalan said that as a result of the impact of rising nationalism on sovereign-wealth investments, Temasek would no longer seek controlling interests in companies outside Singapore, would use local partners and consider the “emotional sentiments” that may be aroused by its acquisitions

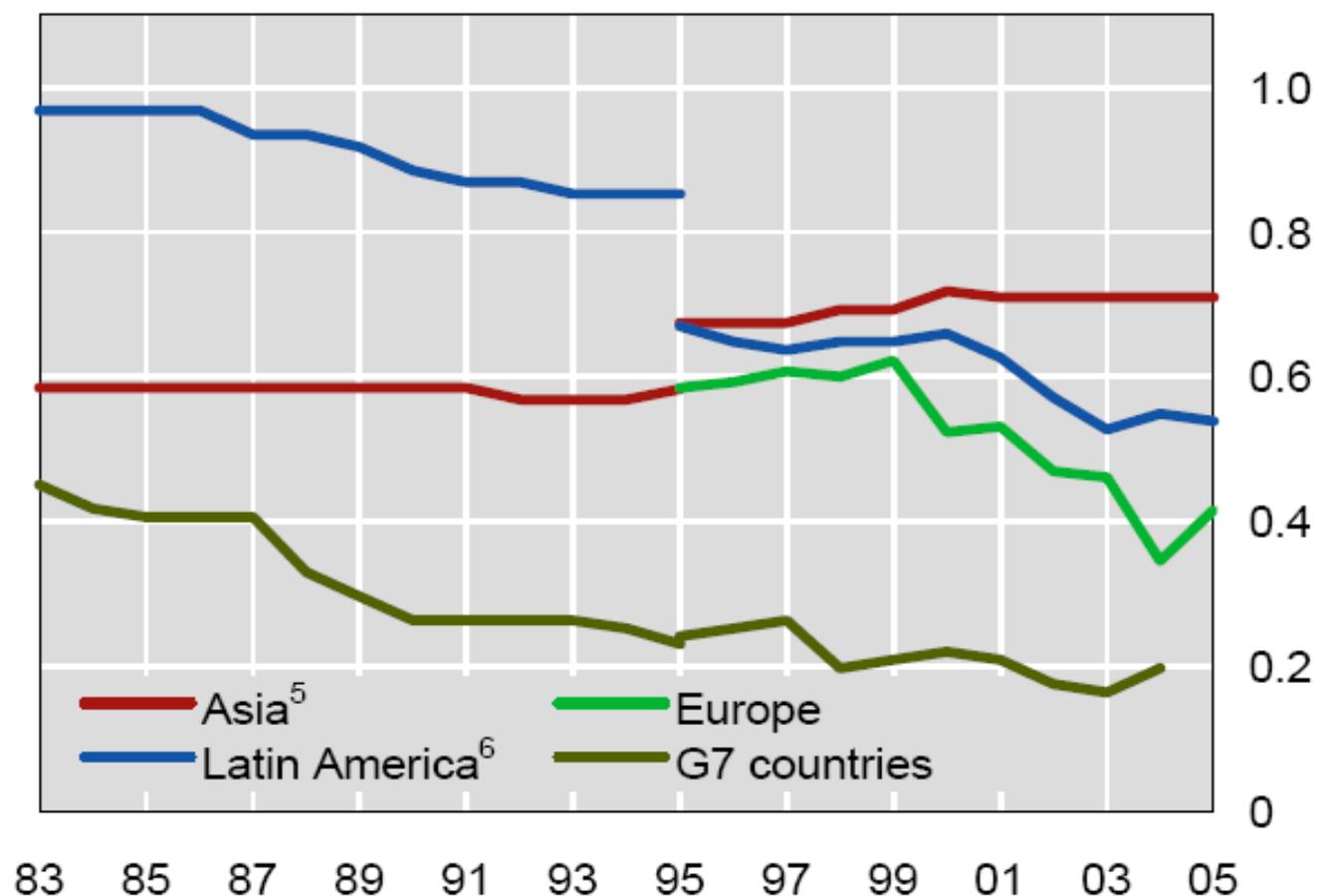
- **Kookmin Bank (Korea)**

- In South Korea, Kookmin Bank has transformed itself ..good credit and risk-management systems
- Limited opportunistic initiatives in the region: Indonesia ..but no coherent regional strategy

Why?... Answer 1

- Sauvè and Steinfatt (2001) are cautionary re the progress of trade and investment in financial services.
 - strong indication that trade agreements are used primarily to consolidate and ‘lock in’ existing liberalisation rather than to promote further market opening.
 - considerable barriers to trade in financial services are embedded in domestic regulatory practices

Why?.. Legal restrictions



Average of 1/0 dummy variable indicating the existence of controls on capital account transactions; data for 1983–95 are from Miniane (2004); data for 1995–2005 are from various editions of the IMF's *Annual report on exchange arrangements and exchange restrictions*.

Source: Global and regional financial integration: progress in emerging markets - BIS Quarterly Review, September 2007 Alicia García-Herrero , Philip Wooldridge

But we need to dig deeper...Answer #2 and the major thesis of this paper

- The Asian growth model – predicated on Wade’s “governing the market “.
- The growth model required directed credit from the bank based financial system
- Asia’s financial systems are bank based .. banks dominated systems are subject to domestic growth considerations; relationship banking and vested interests
- ...and hindered opening up
- Market based systems are more conducive to financial integration
- Therefore market forces need to be allowed to play a greater role
- But...
 - Transparency lags
 - Development and regulation of non bank financial lags...
-slowing regional financial integration

Evidence – Asian economies are bank based systems

Table. Financial system assets 1995, 2000 and 2005
Percent of GDP

	1995			2000			2005		
	Deposit money banks' assets	Equity market capitalisation	Total bonds	Deposit money banks' assets	Equity market capitalisation	Total bonds	Deposit money banks' assets	Equity market capitalisation	Total bonds
Asia, larger economies	65	22	6	102	40	38	107	54	57
Other Asia	94	88	21	89	49	50	73	62	52
Latin America	37	25	33	42	34	50	41	45	60
Central Europe	42	9	22	39	20	34	46	31	52
Russia	18		0	22	15	17	30	72	9
Other	43	95	5	68	75	23	64	143	26
TOTAL	56	36	19	74	41	41	77	62	53
Developed countries				83	141	142	96	124	168

Note: Deposit money banks' assets refer (whenever available) to the claims on the private sector, non-financial public enterprises and central and local governments (lines 22a, 22b, 22c and 22d of the IMF's International Financial Statistics). Total bonds include domestic money market instruments (Table 2a of the CGFS questionnaire), domestic bonds and notes and international bonds, notes and money market instruments from the BIS database.

Sources: Datastream; IMF; Standard & Poor's; World Bank; BIS.

Non Bank Financial Institutions lag...

- Non-bank financial institutions - equity and bond markets, mutual funds, pension funds, insurance companies, and other institutions, such as venture capital and leasing companies—have important roles to play in the Asian economies, but lagging behind
- E.g., - Bond market: low investor participation; low liquidity; low price transparency; low credit rating; high taxation....but this is starting to change
- Diagnosis: Neglect
 - Inadequate coherent policy framework to develop the industries
 - Inadequate regulatory and supervisory apparatus

Role of non bank financial institutions

Country	Region	Other Financial Institutions Assets /Deposit Money Bank Assets
Thailand	East Asia & Pacific	23%
Philippines	East Asia & Pacific	10%
Turkey	Europe & Central Asia	3%
United States	High Income	249%
Netherlands	High Income	85%
Japan	High Income	68%
Canada	High Income	46%
Korea, Rep.	High Income	43%
Singapore	High Income	14%
Mexico	Latin America & Caribbean	33%
Chile	Latin America & Caribbean	23%
Colombia	Latin America & Caribbean	18%
Venezuela, RB	Latin America & Caribbean	3%
Brazil	Latin America & Caribbean	2%
Tunisia	Middle East & North Africa	24%
South Africa	Sub-Saharan Africa	143%

Source: Thorsten Beck, Asli Demirgüç-Kunt and Ross Levine, (2000), "A New Database on Financial Development and Structure," World Bank Economic Review 14, 597-605.

What is needed?.. In order or priority

Skills, Capacity

- Financial sector skills
- Regulatory and supervisory capacity

Adopting the International Highway

- Standards and codes
- Transparency

Coherent Policy framework for the development of NBFIs

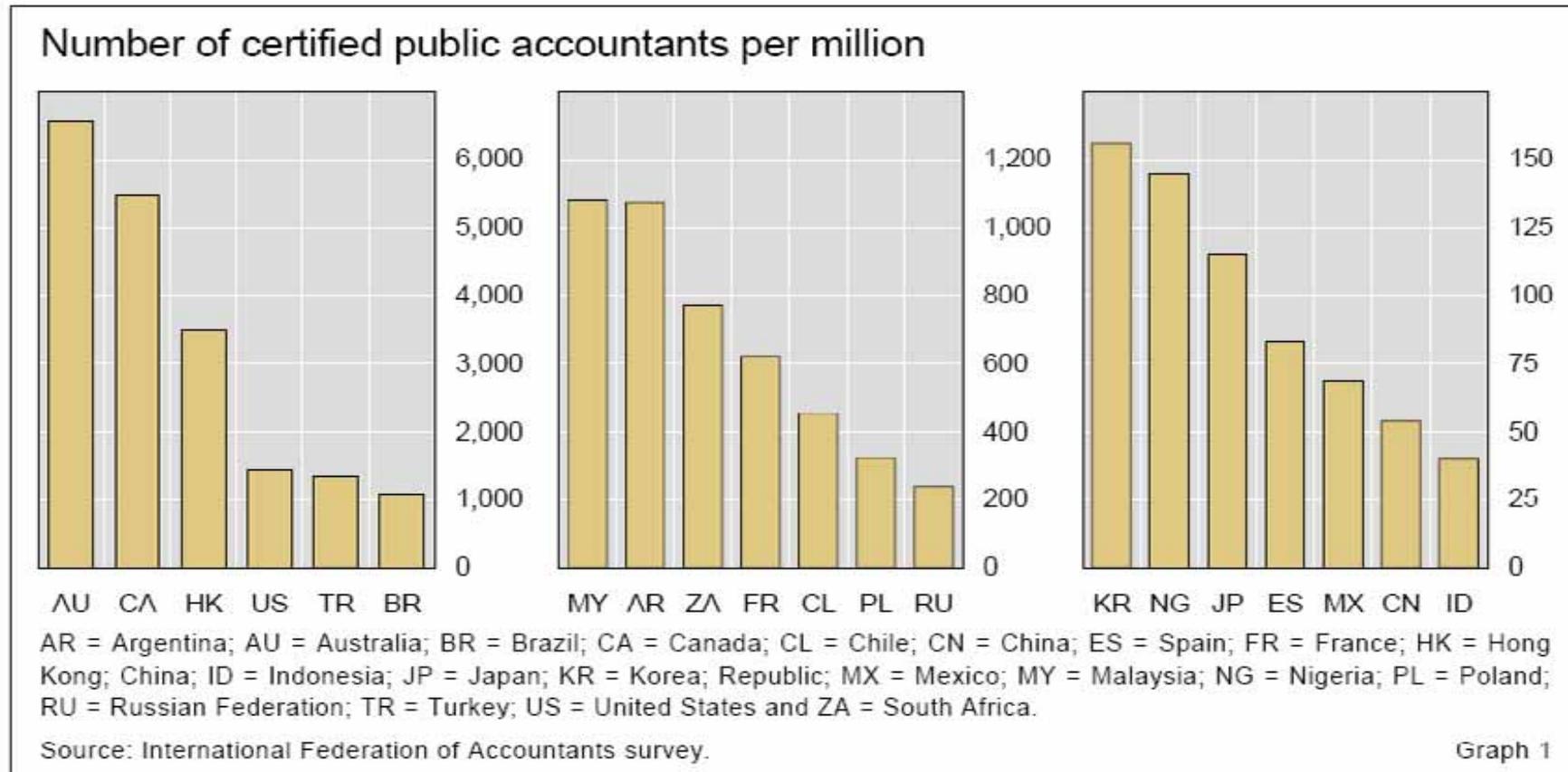
- Sound regulatory and supervisory framework for banks as well as NBFIs

Regional cooperation

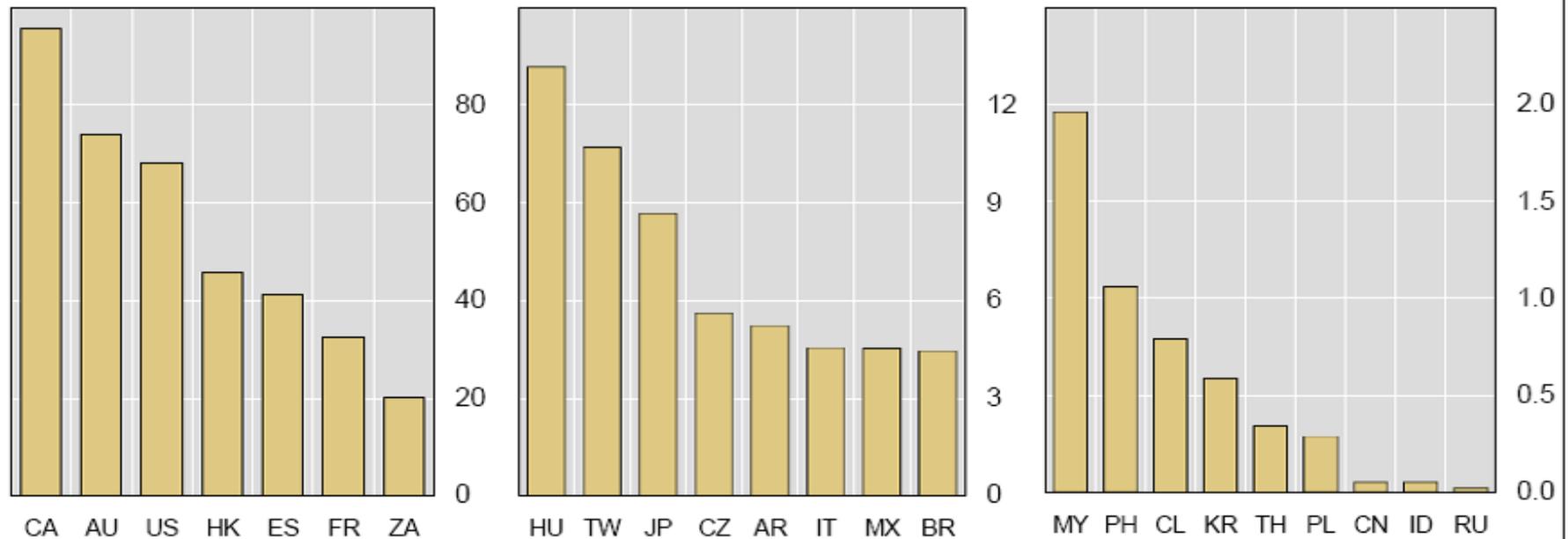
Need to develop the skills...

.....needed for the development of banks,
NBFIs and regulatory agencies

Compelling case for financial integration- abundant financial skills in HK, lack thereof in Indonesia



Number of actuaries per million



AR = Argentina; AU = Australia; BR = Brazil; CA = Canada; CL = Chile; CN = China; CZ = Czech Republic; ES = Spain; FR = France; HK = Hong Kong; HU = Hungary; ID = Indonesia; IT = Italy; JP = Japan; KR = Korea; MX = Mexico; MY = Malaysia; PH = Philippines; PL = Poland; RU = Russian Federation; TH = Thailand; TW = Taiwan; US = United States and ZA = South Africa

Source: International Association of Actuaries.

Graph 2

Standards and Codes

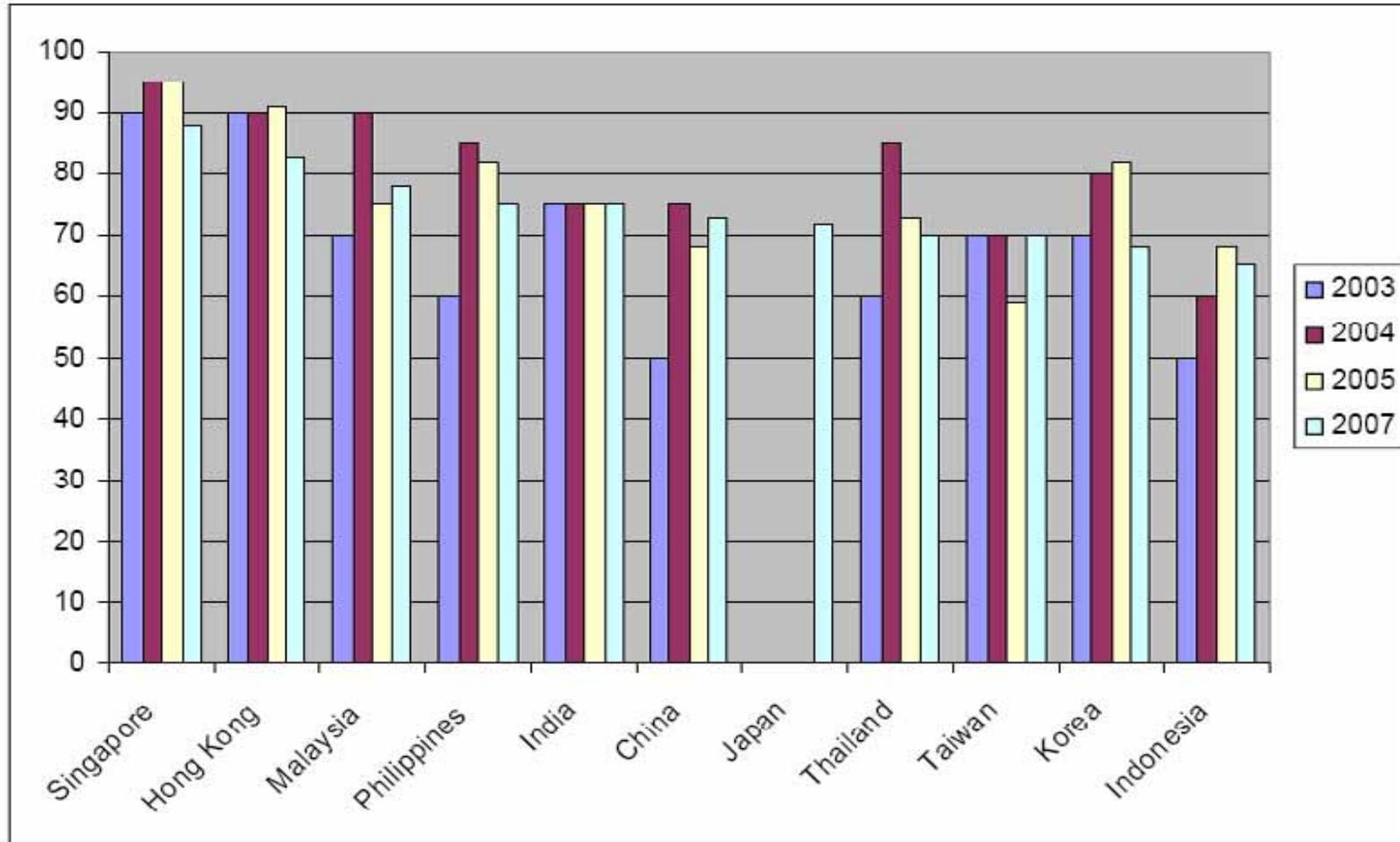
Macroeconomic policy and data transparency	Institutional and market infrastructure	Financial regulation and supervision
<ul style="list-style-type: none">• Data dissemination• Monetary policy transparency• Fiscal policy transparency	<ul style="list-style-type: none">• Insolvency• Accounting• Corporate governance• Auditing• Money laundering• Payment and settlement systems	<ul style="list-style-type: none">• Banking supervision• Securities regulation• Insurance supervision

Financial Sector Assessment Program

Assessed Countries – Where is Asia: China, Indonesia, Malaysia and Thailand?

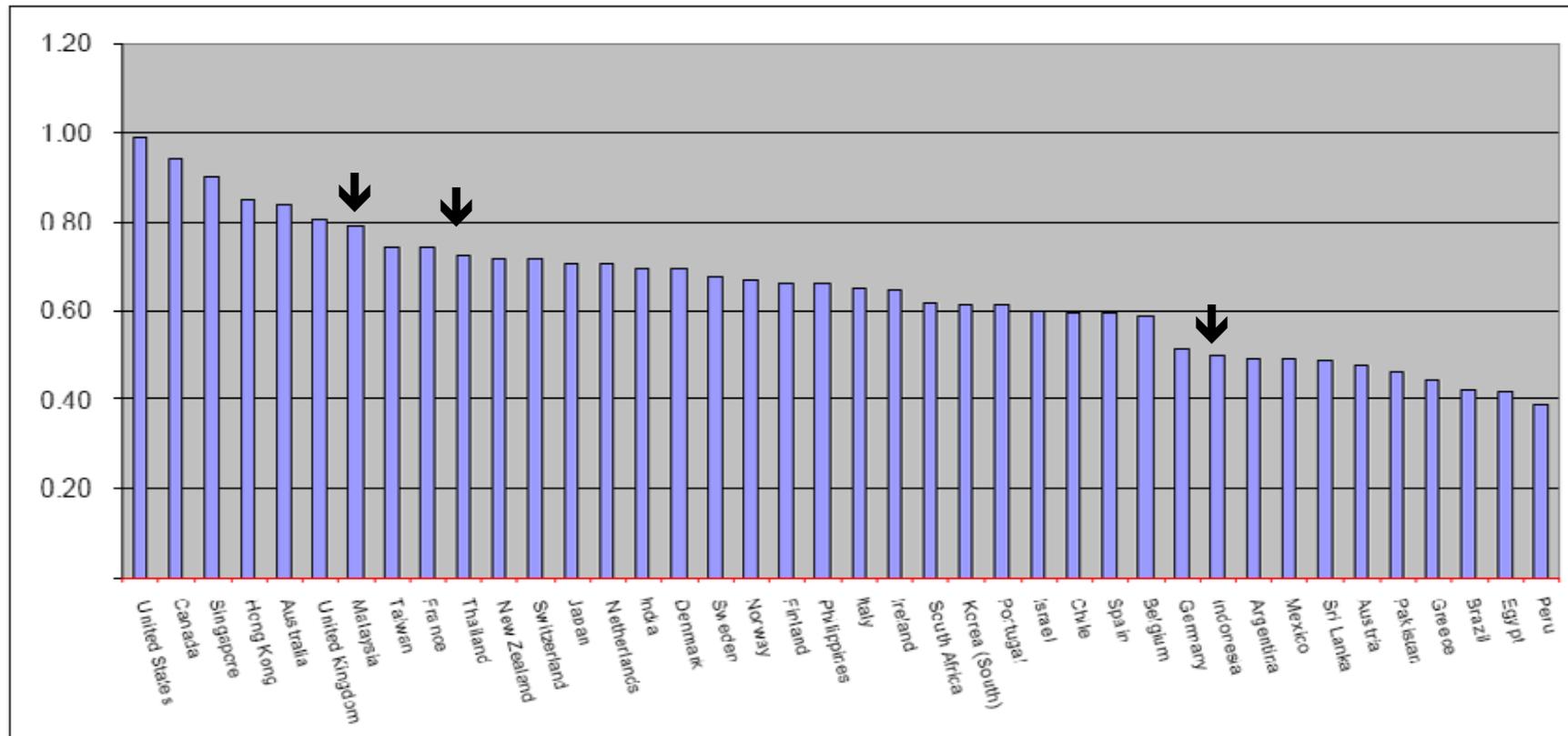
Argentina	Croatia	Israel	Nigeria
Armenia	Czech Republic	Japan	New Zealand
Australia	Egypt	Jersey	Oman
Austria	Estonia	Jordan	Panama
The Bahamas	Finland	Kazakhstan	Pakistan
Bahrain	France	Kenya	Philippines
Bangladesh	Georgia	Korea	Poland
Barbados	Germany	Kuwait	Romania
Belgium	Ghana	Labuan (Malaysia)	Russian
Bermuda	Gibraltar	Latvia	Federation
Brazil	Greece	Liechtenstein	Senegal
British Virgin	Guernsey	Lithuania	Singapore
Islands	Hong Kong	Luxembourg	Slovak Republic
Bulgaria	Hungary	Malta	Slovenia
Canada	Iceland	Mexico	South Africa
Cayman Islands	India	Monaco	Spain
Chile	Ireland	Morocco	Sri Lanka
Colombia	Isle of Man	Netherlands	Sweden

Accounting/Auditing as reflected in IGAAP: standard for international financial reporting...progress has stalled



Source Asian Corporate Governance Association "Corporate Governance Watch 2007"...

Transparency index



Average of the following 3 variables

- DISREQ measures the level of disclosure regulation based on an index of disclosure requirements in securities offerings
- SECREG captures the strength of securities regulation mandating and enforcing disclosures. It is measured as the mean of the disclosure index, the liability standard index and the public enforcement index
- LAW represents the general quality of the legal environment and is measured as the rule of law enforcement index (divided by 10) from La Porta et al. [1997].
- All securities regulation variables from La Porta et al. [2005].

ACGA secretary-general Jamie Allen was scathing in his criticism of the easing of the pressure to reform around the region ...

CG Watch scores

Market	2004 ¹	2005 ²	2007 ³
1. Hong Kong	67	69	67 ↓
2. Singapore	75	70 ↓	65 ↓
3. India	62	61 ↓	56 ↓
4. Taiwan	55	52 ↓	54
5. Japan	-	-	51
=6. Korea	58	50 ↓	49 ↓
=6. Malaysia	60	56 ↓	49 ↓
8. Thailand	53	50 ↓	47 ↓
9. China	48	44 ↓	45
10. Philippines	50	48 ↓	41 ↓
11. Indonesia	40	37 ↓	37

Introduced a detailed survey and scoring methodology in 2004. Made the methodology more rigorous in 2005. Enhanced the methodology further in 2007. (No survey in 2006.)

Source: "CG Watch", a joint report by ACGA and CLSA Asia-Pacific Markets



Illustrative initiative: EMEAP's/BIS Asia Bond Fund 2 initiative to Develop Bond Markets in Asia

Challenges to Asian Bond Markets

- o Low investor participation
- o Low liquidity
- o Low price transparency
- o Low credit rating
- o High taxation

Objectives of ABF2

- o Providing a low-cost and efficient instrument to broaden investor participation in regional & domestic Asian bond markets; and
- o Identifying impediments to bond market development in Asia and acting as a catalyst for regulatory and tax reforms and improvements to market infrastructure.

Market Development Impact

- o Broadening investor base
- o Accelerated tax reforms
- o Enhanced regulatory frameworks for ETFs
- o Further liberalisation of capital accounts
- o Improved market infrastructure through the set-up of a regional custodian network
- o Harmonisation of legal documentation for investment funds in the region
- o Introduction of a set of credible, representative and transparent Asian bond indices

Efforts designed to foster regional financial integration

E.g., of an effective initiative: EMEAP - a cooperative organization of central banks and monetary authorities in the East Asia and Pacific region.

Conclusions

- Some progress ..but the cup is only half full
- I am encouraged by the potential for and rewards of financial integration in East Asia , but it is the potential that I am encouraged about...

THANK YOU