1. Introduction: A new financial market structure for East Asia

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A general consensus is that East Asia's rapidly growing economies ran into crisis because of the vulnerability of their financial sectors. A frequently cited cause of the crisis was East Asia's heavy reliance on short-term capital borrowing for long-term domestic investment together with unhedged borrowing in foreign currency set off a double mismatch (maturity mismatch and currency mismatch). This double mismatch problem was in essence born out of the financial sector vulnerability. The East Asian financial structure in general lacks proper infrastructure, which leads to the inefficient allocation of high savings and the excessive short-term debt market.

Accordingly, discussion on building an efficient financial system in East Asia is taking two main directions. The first direction suggests enhancing appropriate prudential supervision and regulation of the banking sector. The second direction advocates creating stable sources for the long-term capital market. To that end, a plan to invigorate the domestic bond market has been suggested. Development of a domestic bond market will resolve the double mismatch problem by reducing the excessive dependency of East Asian economies on the advanced financial market centers.

Despite high savings, East Asia's dependency on other financial centers outside the region is relatively high. Both capital exporters, such as Japan, and capital importers coexist in East Asia: however, at the regional level, the financial centers have not properly played their intermediary role. Furthermore, there is no strong region-wide network to connect various financial centers in East Asia such as Tokyo, Hong Kong, Singapore and many others. The East Asian financial centers are basically linked to the financial hubs such as London and New York. There is no clear mechanism to recycle East Asian savings through the hub and spoke network in East Asia. Construction of a region-wide network interconnecting financial hubs and spokes in East Asia will create more stable capital flows for countries in the region and largely contribute to upgrading the financial system across the region.

Against this background, this edited volume seeks to set out means of effective and stable capital recycling in East Asia. Further, the financial intermediary function of the regional financial centers – Hong Kong, Singapore and Tokyo – was evaluated. Discussions are provided on the issues of building an organic network between the financial markets of major economies in the region and enhancing the future role and function of those regional financial centers. Finally, this volume explores policy implications and suggestions for the development of regional financial markets – based on regional financial networks – that can act as intermediaries between the high savings and productive sectors in East Asia.

The volume is the product of a group of experts conducting research on the East Asian financial market that has met twice in 2002 and 2003 under the auspices of the Korea Institute for International Economic Policy (KIEP), with the sponsorship of the Ford Foundation. The book is divided into three parts, corresponding to the three issues identified currently as central to building a new financial market structure in East Asia. First, the state of financial liberalization and integration in East Asia will be reviewed and examined. Second, competition and cooperation among financial centers in East Asia will be discussed country by country. Third, ways to mobilize regional saving into regional investment is considered.

FINANCIAL LIBERALIZATION AND INTEGRATION IN EAST ASIA

Capital account liberalization since the early 1990s turned out to be premature for many developing economies with an underdeveloped and inadequate financial infrastructure, in particular, a weak regulatory system and the poor risk management at financial institutions. For more advanced economies, the ordering of capital account liberalization was inappropriate in the sense that short-term financial markets were opened before long-term markets such as foreign direct investment.

The studies in Part I attempt to analyse structural changes in the East Asian financial sector. A special attempt will be made to identify the causal nexus between financial development and growth. Another point of interest is to examine what kind of, and how much of, financial market opening has contributed to regional financial integration.

In Chapter 2, Yung Chul Park, Wonho Song and Yunjong Wang analyse the three issues on finance and economic development that remain largely unresolved in the context of East Asia. In terms of the indicators of size, activity and efficiency of the financial system, Demirgüç-Kunt and Levine (2001) showed that with the exception of Indonesia and Japan, six East Asian

countries had developed a market-based system even before the 1997 crisis. However, using the same data and methodology, Park, Song, and Wang show that the countries Demirgüç-Kunt and Levine examine could be characterized as bank-based before the 1997 crisis. The results of Demirgüç-Kunt and Levine's estimation are sensitive to the ways of measuring the three indices.

The second issue they examine is the relationship between finance and growth in East Asia. They show that exogenous changes in private credit as a proxy for the financial development indicator have strong and positive effects on growth in seven East Asian countries whereas a negative relationship between the two variables is found for a sample of 12 Latin American countries. The causal nexus between finance and growth is extensively examined in terms of the data sets of different countries over different periods by many authors. While the East Asian experience provides a piece of evidence supporting the positive effect of financial development on growth, the casual nexus between finance and growth requires a further investigation.

Finally, a review of developments leading to and following the 1997 crisis, the authors argue, does not provide any evidence that a market-based financial system works better than a bank-based one or that the East Asian financial frailties were inherent in the intermediary-based system. The financial weaknesses were rather the consequences of the general lack of transparency and repressive financial policies.

Chapter 3 by Barry Eichengreen and Yung Chul Park assesses empirically whether financial market deregulation and liberalization have contributed to regional financial integration in East Asia. From the point of view of portfolio diversification, countries with asynchronous macroeconomic shocks would have stronger incentives to integrate their financial markets with one another than with other countries whose macroeconomic shocks are similar. For the past several decades intra-regional trade expansion in East Asia appears to have synchronized business cycles in the region. This growing similarity of business cycles may have encouraged diversification of their portfolio into the assets of European countries and the United States, thereby inducing financial market integration between East Asia on the one hand and Europe and the United States on the other. However, this global portfolio diversification will tend to lower business cycle correlations over time between the East Asian countries and major financial centers as it increases the scope of intertemporal specialization in production.

In order to examine this possibility, Eichengreen and Park decompose the forecast error variances of the two financial variables – the interest rate and stock return – into a world-common, a region-common, and a country-specific component. The authors find that, as far as the equity market index returns are concerned, the relative share of the global factor proxied by the shocks originating in the U.S. market has risen since the crisis. Unlike in the

stock markets, the effects of foreign market shocks on bond markets are very low in all East Asian sample countries. This result is not surprising in view of the fact that bond markets of East Asia are relatively undeveloped and in many countries in the region these markets are closed to foreign investors and borrowers.

In the European Union, one would expect the monetary unification to have led to regional integration of capital markets. Eichengreen and Park's analyses provide evidence of a higher degree of regional financial integration in Europe than in East Asia. This suggests that the dominance of the global factor in East Asia, compared to Europe cannot be explained by differences in the scope for risk sharing between the respective regions. In turn this result supports the prediction that Europe has gone further in integrating its financial markets regionally through development of its market-supporting infrastructure.

Chapter 4 by Barry Eichengreen and Yung Chul Park views Asian financial integration in a European mirror. Their starting point is the observation that cross-border bank claims in East Asia are smaller by an order of magnitude: they are 33.9 percent of regional GDP in Europe but only 3.5 percent in East Asia. But such bank claims are strongly increasing in per capita income. This fact suggests that the very different levels of economic development in East Asia and Europe, along with other differences in regional circumstance that are largely predetermined from the point of view of policy (the distance between countries, whether they share a common language, and whether they share a land border), explain a good deal of the difference in financial integration between the two regions.

The rest of the gap is explained by policy variables. Evidence that finance follows trade suggests that East Asia is less financially integrated than Europe in part because it has done less to promote the growth of intra-regional trade. Intra-regional exports as a share of GDP are still only a third what they are in Europe. The results also suggest that controls on capital account transactions can have a lingering effect on the volume of cross-border claims, and that their shadow is longest where those controls were maintained for the greatest number of years. The under-development of financial markets and institutions in some potential lending countries also appears to be an impediment to financial integration in the region; this too can be addressed by policy, in particular by initiatives designed to promote the growth of Asian financial markets.

In Chapter 5, Beate Reszat reviews the European monetary integration process and examines how it has contributed to regional financial market integration. She argues that European monetary integration is simply one element in the process of financial integration in Europe, and one that in and outside the region is easily overrated.

The integration effects of monetary union so far have differed across markets and institutions. The euro has been most successful in integrating the inter-bank market for very short-term unsecured deposits and the markets for bonds and derivatives. It had a big impact on volumes in fixed-income markets through the shift from government to non-government securities, both short-term and long-term, as a consequence of the rules of the Maastricht Treaty and the Stability and Growth Pact on public finance. Another remarkable effect was the contribution of the common currency to the explosion of trading in instruments such as interest rate swaps and credit derivatives, and the need it created for developing new strategies and techniques for hedging and trading in the euro area.

In many respects, despite its undeniable advantage of eliminating currency risks and reducing transaction costs for both financial and non-financial firms, the influence of the euro on financial integration in Europe should not be over-emphasized. Markets, regulations, and systems are still highly fragmented and without the further removal of institutional barriers, and a greater commitment to financial reform at the level where individual measures are adopted, Europe's citizens are denied its full benefits.

Soyoung Kim, Sunghyun H. Kim and Yunjong Wang, in Chapter 6, examine the international capital flows and business cycles in the Asia Pacific region. They identify the capital flow shocks and then examine their effects on cyclical movements of key macroeconomic variables in each country. Using the data of twelve Asia Pacific countries, the chapter finds that business cycles in the five Asian crisis countries are highly synchronized and follow business cycles in Japan, while they differ from cycles in Australia and New Zealand. On the other hand, greater China, including Hong Kong and Taiwan, show similar cyclical movements.

Kim, Kim and Wang also provide empirical evidence that positive capital flow shocks (capital inflows) affect output, consumption, and investment positively in most countries, which is consistent with the story of boom-bust cycles. In addition, capital flow shocks are highly correlated across the crisis countries. These two results imply that business cycle synchronization among Asian crisis countries in the 1990s can be at least partially explained by synchronization of capital flows and the ensuing boom-bust cycles after the financial market liberalization.

FINANCIAL CENTERS IN EAST ASIA

The financial markets of East Asian countries had recorded a remarkable growth before the Asian currency crisis of 1997–98. In many East Asian countries, banks expanded their balance sheets rapidly. They were willing

to lend to booming manufacturing sectors, commercial sectors, and real estate sectors. Stock markets in the region also enjoyed rising prices and widening participation of domestic and foreign investors. The Asian region attracted increasing capital flows – bank lending, stock investment, and direct investment – from advanced countries. From the 1980s to the mid-1990s, East Asia was the booming region of the world. The newly industrialized economies (NIEs) – Korea, Taiwan, Hong Kong, and Singapore – were the first to experience high economic growth that was reminiscent of Japan's experience in the 1950s and 1960s. The economic growth rate typically reached 10 percent per annum. Some of the ASEAN countries followed the lead of NIEs and embarked on high economic growth. In particular, Thailand, Indonesia, and Malaysia experienced 7 to 10 percent economic growth rates from the mid-1980s to mid-1990s. High economic growth was financed mostly by bank lending and equity issuance.

Liberalization in financial markets was also in progress. The interest rate ceiling, market entry restrictions, strict licensing and other restrictions were lifted or relaxed. Non-bank financial institutions, securities firms, and insurance companies were also expanding their businesses. Lending booms were observed from Bangkok to Jakarta, to Seoul. It was not clear at those times whether lending was excessive or justifiable from high economic growth. Several countries have also opened up their financial markets to capital flows across border. Both Thailand and Malaysia created offshore financial centers. Restrictions on foreign ownership were gradually relaxed.

The Asian currency crisis of 1997–98 set back the progress of the financial and capital markets. A rapid expansion of the financial markets came to a sudden halt in the summer of 1997. After the Thai baht flotation and depreciation, investors pulled capital out of Asia. Contagion of the financial crisis spread from Thailand to Indonesia, to Korea, and the rest. Domestic financial markets experienced a severe credit crunch, and many banks became insolvent due to non-performing loans to domestic firms, or losses from foreign-currency denominated liabilities.

Massive capital inflows made it possible to have both current account deficits and rising foreign reserves under the de facto fixed exchange rate. Just before the crisis, Thailand experienced current account deficits of 8 percent of GDP, and capital inflows amounting to 10 percent of GDP. The increase in the level of foreign reserves gave a false sense of security.

Foreign banks were willing to lend in US dollars to Asian banks and corporations, as risks in the region were considered to be minimal. Asian banks were willing to borrow in US dollars, because the exchange rate was de facto fixed, and the currency risk was considered to be small. Capital inflows to the banking sector caused local banks to develop currency

mismatch (borrow in US dollars and lend in the local currency) and maturity mismatch (borrow short and lend long).

There are many lessons from the Asian currency crisis. Among others, the following points have been recognized as important and urgent by many policy-makers and academics: (1) strengthening the banking system with good supervision, (2) developing a market for local-currency denominated bonds, and (3) integrating financial markets in the region.

There are some obstacles for developing financial markets. For developing a bond market, credit rating of corporations is important, but there is no region-wide credit rating agency. Also, there is no region-wide settlement system. Securities firms that can be making deals in the region are typically under-developed in Asia.

Eiji Ogawa surveys the Japanese market in Chapter 7. The Tokyo market has a deep, well-functioning money market, bond market, offshore market, and capital markets. Participation by foreign institutions has been increasing in recent years. With the Japanese big bang, rapid liberalization that took place from 1996 to 1998, most of the remaining restrictions on pricing, product development and offering, and participation were lifted. Japanese banks traditionally played an important role in providing long-term industrial financing as well as providing short-term financing.

The Japanese bond market had been repressed for a long time. The government did not issue bonds until 1965 and the outstanding balance remained reasonably low until 1990. Bank loans were preferred to corporate bonds. Issuance of government bonds started to increase sharply in 1998 as a result of large fiscal stimulus packages combating a business downturn.

In Chapter 8, Yiping Huang addresses the question of whether Hong Kong can survive as an international financial center. For the past few decades, it has been an important financial hub servicing the global markets, particularly the rapidly growing East Asian economies. That role was further strengthened when China began its open-door policy. According to recent data, Hong Kong is the seventh largest foreign exchange market and tenth largest stock market in the world. It is also one of the world's major banking centers.

However, doubts grew strongly in recent years about Hong Kong's ability to survive as a major international financial center. Difficulties of structural adjustments in the economy had constantly depressed confidence. Sustainability of the currency peg was frequently in question. Some political changes gave rise to concerns over continuation of political and economic freedom in Hong Kong. The rapid rise of Shanghai in the financial world also led many to believe that Hong Kong is playing a losing game.

Huang takes a glance at Hong Kong's financial markets and its future role on the international scene. Despite overblown concerns, he points to

Hong Kong's need to fight an uphill battle in maintaining its role as an international financial center. He emphasizes that challenges come mainly from within rather than from outside. The Hong Kong authorities need to maintain the tax incentives for the financial industry while attacking the fiscal deficit problem. The exchange rate policy is another important area in maintaining stable expectation and confidence. In addition, political and economic freedom, including free flow of information, form an important part of the foundation for efficient financial activities.

Will Hong Kong eventually lose out to Shanghai? Huang sees that it is possible in the very long run, but certainly does not see it as likely in the coming decade or so. While Shanghai is rapidly taking over businesses from Hong Kong, most of these are domestic-oriented businesses. Shanghai still lacks the necessary institutions to serve as an international financial center. For instance, the capital account control, which is unlikely to go away in the next 5–10 years, seriously constrains Shanghai's ability in financial services. The poor legal system, frequent government corruption and backward regulatory framework also work against Shanghai's role in the financial world. The only advantages Shanghai enjoys over Hong Kong at the moment are its location right at the center of the dynamic Yangtze River delta economy and its relatively low costs.

In Chapter 9, Kee Jin Ngiam provides a chapter on the role of Singapore as a financial center. Singapore has developed a financial hub in Southeast Asia. Singapore offers the most efficient offshore market in the region. Although the Singaporean domestic economy is small compared to other advanced countries, the per capita income is comparable to any developed countries.

The volume of foreign exchange transactions recorded in Singapore ranks fourth in the world, after London, New York, and Tokyo. The strength of the Singaporean market is its wide participation by foreign issuers, institutions and investors. Singapore takes advantage of benefits of operating an offshore market. Loan books and financial products that are traded in Singapore are mostly foreign (non-Singaporean) currency denominated and originated in foreign countries. Restricted license and offshore banks in Singapore can maintain a foreign currency denominated transactions book. This is called the Asian Currency Unit (ACU). The size of the ACU assets grew to a peak of US\$557 billion at end-1997, followed by a decline due to the financial crisis, to US\$471 billion at end-2001.

The Singapore Exchange (SGX), the result of the merger between the Stock Exchange of Singapore (SES) and the Singapore International Monetary Exchange (SIMEX), is a well functioning stock market. It is a fully electronic and floorless securities exchange. Out of about 500 companies listed on the SGX, about 100, with capitalization of one-third,

are foreign. The SGX has cooperation arrangement with exchanges in Australia, Tokyo, and Chicago, and the American Stock Exchange.

The Singapore government, although it is not necessary from the budgetary point of view, has increased issuance of government bonds to set the benchmark yield curve. Singapore also has a strong asset management industry. Funds managed in Singapore are predominantly invested in the region. The government helped the industry to develop by outsourcing some of the fund management, previously done by the government sector. The Monetary Authority of Singapore and the Government of Singapore Investment Corporation (GIC) have placed S\$35 billion with managers in the private sector. This encouraged the growth of the fund management industries. Moreover, liberalization of the rules regarding investment of the Central Provident Fund (CPF) has also aided the industry.

In Chapter 10, Jang-Yung Lee examines Korea's promise as a regional financial center by assessing the country's strengths and weaknesses in terms of the size of the domestic economy, legal and regulatory system, talent pool, infrastructure, taxation and the cost of doing business. He asserts that despite many things that need to improve, Korea has also some potential for an attractive financial sector. He provides a preliminary list of policy recommendations on what Korea's goals and strategic thrusts should be, and what specific actions it could take to achieve the goal.

Among others, Korea should globalize its regulatory framework; further liberalize its foreign exchange system; and open its legal service market to foreign competition. Also he notes that a favorable living environment for expatriates, available talent pool, a strong base of English-speaking, open-minded population all provide a basis for a financial center. To become a financial center, he argues that Korea's strategy should be oriented towards building networks with other financial centers across the region. In other words, Korea should identify mutually complementary niches. He proposes three strategic niches that Korea should develop in the next 10 years. They are the bond, asset management, and equity markets.

In Chapter 11, Zainal Abidin Mahani and Chung Tin Fah provides a review of the Malaysian financial market. Malaysia has a high saving rate, partly due to the Employees Provident Fund (EPF). This holds RM 191.6 billion (or US\$50 billion). The Social Security Organization (SOCSO) has also accumulated RM 6.7 billion. The insurance industry and the fund management industries are also expanding quickly.

The capitalization of the stock market relative to GDP is traditionally very high in Malaysia. At the height of the stock market boom before the crisis, the capitalization was above 300 percent of GDP. In 2001, the capitalization and bank loans were still larger than GDP. The total number of

listed companies grew from 285 in 1990 to 859 in 2002. Relatively speaking, the government bond market is behind.

Before the crisis, the offshore ringgit market and offshore equity market were active. Some of the trading, such as Malaysian equities in Singapore, and non-deliverable forward were curtailed after the financial crisis of 1997–98. The Labuan International Offshore Financial Centre was created in 1990 and has been active in trading various offshore financial products.

One unique feature of the Malaysian financial market is its strength in Islamic banking and financial products. An Islamic banking system is based on a principle that prohibits the payment of interest. The first successful Islamic bank was established in Dubai in 1975, while Malaysia established an Islamic bank in 1983. Now, Islamic financial products of Malaysia are promoted to other countries, in particular the Middle East.

In Chapter 12, Bhanupong Nidhiprabha provides a survey of the Thai financial sector. The financial and capital markets of Thailand had made progress in the 1990s and then suffered a severe setback in the 1997–98 crisis. The recovery has been slow, but stability had been achieved by 2002.

Total loans from banks increased sharply, about 1 trillion baht (50 percent of GDP) in 1990 to 4.7 trillion baht (100 percent of GDP) in 1997. However, it declined sharply in the wake of the financial crisis in 1997–98, to 3.3 trillion baht (62 percent) by 2002. The Thai banking system had been quite strong with several large banks dominating the market. However, banking became liberalized as the offshore market (BIBF) was created and foreign bank loans could be introduced through this market. The overheating in bank lending was partly due to this phenomenon.

The bond market was less developed than the banking or stock market. However, it was progressing rapidly in the first half of the 1990s. The Thai Rating and Information Agency (TRIS) has been a sole rating agency. Several companies successfully issued corporate bonds in 2001–02. The Thai Bond Dealing Center (TBDC) was established in 1998 to facilitate secondary market trading.

In Chapter 13, Titik Anas, Raymond Atje and Mari Pangestu give the overview on the Indonesian financial markets, which suffered a severe blow during the financial crisis of 1997–98. Many banks were closed, merged, and taken over by the state bank. When an agency for bank restructuring (Indonesian Bank Restructuring Agency, IBRA) was formed, the first task was to reform the banking system that was hard hit by the currency crisis. During the crisis, banks were categorized into three groups, category A with capital adequacy ratio (CAR) above 4 percent, category B with CAR between 4 percent and minus 25 percent, and category C with CAR below minus 25 percent. Category C banks were either recapitalized by the owner or taken over by the government. Category B banks were eligible for the

government recapitalization program. The fact that even insolvent banks were recapitalized by fiscal money tells the severity of the currency and economic crisis of Indonesia. However, the banking sector is now stabilized and the market is poised to start growth again.

Even with so many banks being closed and merged during and in the wake of the financial crisis, the number of banks in Indonesia is considered to be too many. There are 141 banks, of which 5 are state owned, 76 private domestic banks, and 34 foreign and joint venture banks. Most of them are small in size. The performances of government owned banks are mixed.

The loan to deposit ratios remains low among state owned and private banks. The corporate sector is not fully recovered from the crisis, and many banks are still low in the CAR. The Indonesian financial sectors are of a relatively small size. Even in the small market, there are many weak banks. The situation needs a lot of reform. Furthermore, the government does not seem to have a strategy to strengthen the Jakarta markets as a regional financial center. The settlement procedures for trading in the stock and bond markets are not yet fully compatible with international standards.

In Chapter 14, Hongzhong Liu and Changjiang Yang have written an overview of Chinese financial markets. The financial markets in China have rapidly grown in the 1990s. The capitalization ratio of stock markets to GDP rose from below 10 percent in 1995 to more than 50 percent in 2000. Since then, the ratio has declined, and stood at 27 percent in 2002.

China's banking sector is much more important than the stock market. The outstanding loans to GDP exceeded 100 percent in 1997, and the ratio rose to above 120 percent in 2002. The big four banks have dominated the banking market. The Shanghai Stock Exchange (SSE) was established in 1990. The number of stocks listed on it was 759 in 2002. It has a centralized bidding system with computer matching. Bonds are also traded on it. The value of total outstanding government bonds is 20 percent of GDP.

In Chapter 15, Gordon de Brouwer reviews the Australian financial market. The financial sector is an important part of the economy, accounting for 7.5 percent of GDP, employing 4 percent of the workforce in 2002. Australia plays a regional role in East Asian finance. First, it has strong domestic financial sectors so that foreign financial institutions use Australia as a base for their East Asian businesses as well as Australian businesses. Second, Australian financial institutions are sophisticated enough to offer financial products including infrastructure finance, privatization, pooled investments, securitization, and asset management. Third, many Australian professionals are working in financial centers, such as Hong Kong and Singapore, in the region.

Australia has a full set of financial markets – money markets (32 percent of GDP), equity markets, bond markets, foreign exchange markets and

derivative markets. The total size of money market is A\$233 billion, or 32 percent of GDP. The equity market totals A\$1110 billion (160 percent of GDP), of which A\$733 billion (106 percent of GDP) are domestic equities, and the rest being overseas-based. The foreign exchange market in Sydney has a comparative advantage in its time zone. It starts just after the New York market closes and continues until the London market opens. Although it mostly overlaps with the Tokyo market, the Sydney market opens a few hours before the Tokyo market. About 40 percent of Australian dollar trades are conducted onshore, while the rest are traded mostly in London and New York. The Continuous Linked Settlement (CLS) in the foreign exchange market is formed as gross real time settlement (RTGS) of foreign exchange transactions between seven major central banks (including the Reserve Bank of Australia).

The Australian financial markets have strong ties with East Asia. The currency and stock price correlations with East Asian counterparts are observed, although the degrees of correlation vary over time. The assets and liabilities of Australian banks are mostly domestic, with some overseas assets in the United States and Europe, but not East Asia. The reasons are twofold. First, most East Asian markets have different degrees of capital controls. Second, a number of Australian banks have experienced problems – both market risk and regulatory opaqueness – in East Asia. However, Australia is active in regional finance through derivative and investment banking services, inviting globally active foreign institutions to Australia, and providing professionals to the rest of the region. In conclusion, the government is keen on developing financial centers in Australia by building up infrastructure and by seeking international businesses. Australia is poised to increase its role in the regional financial markets.

In summary, the financial and capital markets in the region are still quite fragmented by borders and international or regional financial centers in the region, namely, Tokyo, Hong Kong, and Singapore, are not well coordinated. Each center has a strength in a particular line of products, but businesses among the three centers are not well coordinated.

MOBILIZING ASIAN SAVINGS WITHIN THE REGION

Many Asian domestic markets are too small to be really efficient, or allow many banks to flourish. Further reform and consolidation is clearly needed in Indonesia and Thailand. In many countries, banks were traditionally the strongest financial institution category. Commercial banking has been providing both short-term and long-term loans, providing necessary funds

to industries. The saving rate is relatively high in Malaysia and Singapore due to their respective pension programs. Those savings were mobilized to be invested domestically and externally. The fund management industry was encouraged to grow with the governments placing a part of funds with the private sector.

Table 1.1 shows the cross-country comparison of financial markets in the region by several indicators (normalized by the size of GDP).

Traditionally, Tokyo, Hong Kong, and Singapore played regional financial centers. The Tokyo market has expanded its market values, reflecting large domestic markets. The boom – in fact, a bubble – in the Japanese stock market in the late 1980s brought the market capitalization of the Tokyo market to being the largest in the world. Japanese banks were also among the largest in the world. In the early 1990s, between seven and nine of the top ten banks in terms of asset size were Japanese. The bond market was also expanding rapidly. Turnovers of the foreign exchanges in Tokyo increased and became the third largest, after London and New York. Offshore facilities in Tokyo, in the form of book entry, were similar to New York. Futures and derivatives markets were also developed.

The weakness of Tokyo was threefold. First, the market had been shrinking due to the bursting of the bubble. Second, the foreign exchange market was mostly specialized in the yen/dollar pairing. No regional currencies markets are developing in Tokyo. Third, costs of conducting businesses were quite high. The strength of Tokyo is obviously its large domestic

Table 1.1 Ratios of various financial indicators to GDP, 2002

	Bank loans/ GDP	Stock market capitalization/GDP	Government bond/ GDP
Japan ^(a)	0.80	0.46	1.05
Korea	0.78	0.43	0.01
Singapore	0.88	3.47	0.38
Malaysia	1.30	1.38	0.55
Thailand	0.62	0.38	
China	1.25	0.27	0.20
Indonesia ^(b)	0.24	0.18	0.006
Australia	1.26 ^(c)	1.06 ^(d)	0.15

Notes:

(a) 2003

(b) 2001

(c) Total liability of banks / GDP

(d) Includes domestic equities only

market. However, in the future, unless Tokyo moves aggressively to capture more international businesses, a stagnant macroeconomy will be quite an obstacle for it to overcome to be a stronger regional financial center.

The weakness of Hong Kong is its legal status. Although independent status is guaranteed for more than 40 years to come, decision-making in civil life is gradually shifting. More influence by Beijing is detected. There is a political risk and competition from Shanghai in the long run. Whether Hong Kong survives as a regional financial center in the long run will be determined partly by Beijing.

Singapore has benefited from pursuing efficient offshore center activity from very early on. A large market share in currency trading was captured, with fund management, and offshore financial products trading in a strategically important location among the ASEAN countries. Although the domestic economy is small in size, the financial markets are strong and growing.

Among the potential regional financial centers of the future, Sydney seems to be most robust and ready. The domestic market is relatively mature. Shanghai has a long way to go to become a regional financial center, but the high economic and financial growth of China may eventually make it a reality.

In conclusion, the financial markets in East Asia are still rapidly evolving, and the current financial centers may not survive as regional financial centers in the next ten to twenty years. Some middle-income ASEAN countries still need to make domestic financial markets and infrastructure strong enough to avoid another financial crisis. A challenge is to convince governments in the region of the benefits of coordination and cooperation in financial regulation and supervision. Also there is the challenge of promoting the capital markets rather than the banking sector. That will diversify a country's risk and encourage risk capital to be mobilized with investor's responsibility. Financial and capital markets of the East Asian region will flourish if and when the governments cooperate with each other so that financial institutions can raise and place funds in the region freely, taking advantage of economies of scale.

Gordon de Brouwer and Jenny Corbett, in Chapter 16, explore East Asian finance in two parts. The first part of the chapter provides an overview of the state of regional financial markets in East Asia. They observe that they are tiered. The developed markets of the region (Japan, Singapore, Hong Kong and Australia) perform well by international standards, most of the others (like Malaysia, South Korea, Taiwan and Thailand) are average, and a couple (like China, Indonesia and the Philippines) are poor performers.

Based on their assessment of the current state of regional financial markets in East Asia, de Brouwer and Corbett explore four issues. The first

is the need to integrate regional financial markets. The second is a discussion of the methods to pursue integration, including harmonization, mutual recognition, and private insurance. The third issue is the respective roles of Japan and China in regional financial integration. Finally, they look ahead at other issues to include in the policy and research agenda, such as an independent stocktaking of capacity building and cooperation in finance and a consideration of ways to involve the private sector more deeply in this program.

A recent trend of capital movement is likely to undermine capital market development in the region and have a negative impact on the East Asian economy. The characteristic of such movement raises the possibility of a currency crisis in East Asia. Investment of advanced economies in East Asia is concentrated on risky assets, which can respond sensitively to even a slight increase of risk.

Therefore, East Asia needs to adjust the current problems from unsustainable capital flows and to change vulnerable financial structures. The development of the bond market is important for dealing with the current problems in East Asia. It would turn the investment of advanced economies in risky assets to investment in safe assets, as well as contributing to the development of the East Asian capital market. In Chapter 17, Gyutaeg Oh, Dae Keun Park, Jaeha Park, and Doo Yong Yang assert that East Asian bond markets with quality and liquidity would surely promote more regional investment as well as investment from advanced countries.

Securitization is a scheme that is capable of narrowing the credit gap and the maturity gap between investors and issuers in the region. In this way, it is helpful in many ways to the development of the East Asian bond market and the increase of capital flows in the region. First of all, securitization allows the creditworthiness of the asset-backed securities (ABS) independent of the creditworthiness of the company that originally owned the underlying assets. The credit assessment of asset-backed securities is made solely on the basis of the cash flows created by underlying assets.

If credit rating for Asian bonds has increased by a securitization, the liquidity for Asian bonds would improve. Securitization can provide a way to resolve the problem of liquidity gap; that is to issue asset-backed commercial papers (ABCP) with short maturities. In addition, securitization can be also useful in raising funds for emerging market firms located in countries with very high levels of political risk. To promote securitization in East Asia, strategic agents are indispensable, but under the present circumstances, it is difficult to expect strategic agents to emerge from the private sector. In that respect, the East Asian governments should play the role of strategic agents to stimulate securitization in the region at this stage.

In the final chapter, Chapter 18, Choong Yong Ahn, Woosik Moon and Deok Ryong Yoon examine the role of regional development banks as a vehicle for financing development projects in East Asia. Their observations are as follows.

When a certain region intends to pursue cooperation at the regional level, a strong argument for regional DBs emerges as institutions that provide financing for development and solidarity, in the way that the European Union does through the Structural and Solidarity Funds and European Investment Bank. In this context, regional development banks are indispensable for regional economic integration because they help nourish regional identity and solidarity by supporting the economic growth of poorer countries in the region.

As the only multilateral DB in Asia, ADB has contributed much to economic and social development in this region. However, Asia is too big both geographically and in terms of population for one DB to be able to cover all the financial needs. Despite urgent needs for poverty alleviation in the region, many countries are overlooked.

Northeast Asia includes Japan, Korea and China, all of which hold current account surpluses and high foreign exchange reserves. Establishing a sub-regional development bank like a Northeast Asian Development Bank would be therefore a good instrument to develop Northeast Asia and to speed up the regional economic integration process. Such a sub-regional development bank could play a role as a regional financial institution to improve the underdeveloped capital markets because of the institution's potential to attract a good credit rating and its multiplier effect. More active efforts should be made to design a better functioning sub-regional bank.