DIRECTIONS IN DEVELOPMENT

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Foreword

Despite recent economic "miracles," East Asia is not immune to short-term setbacks. A slowdown in exports in 1996 has generated turbulence in many of the region's financial markets. Real estate and stock market reversals have occurred in most countries. Exchange rates have been adjusted in Indonesia, the Philippines and Thailand. Corporate failures have been linked to loans-for-kickbacks schemes in the Republic of Korea. And broader concerns about weak financial systems resonate from Japan to Vietnam. As a result some observers are questioning East Asia's prospects for continued rapid growth. Should the region's economic health be reassessed? Is pessimism about East Asia's financial sector well founded?

Stijn Claessens' and Thomas Glaessner's analysis shows that East Asia's financial sector is more robust than the doomsayers would have us believe. In macroeconomic management, savings and investment, and depth of international economic integration the region enjoys advantages that are lacking in other countries that have experienced deep economic or financial crises. In this sense East Asia remains a world apart.

At the same time, East Asia's success is no miracle. Rather, it is the result of determined efforts to build solid foundations for sustainable growth. Nowhere are such efforts more apparent than in the financial sector, which is of strategic importance for ensuring macroeconomic stability, supporting corporate growth, mobilizing savings, and tackling the new challenges of private infrastructure finance, expanded housing needs, and pensions and insurance development. East Asia's "tigers" have gotten the fundamentals right by keeping real deposit rates positive, liberalizing their financial systems, and developing supportive institutional frameworks.

Yet much remains to be done. Many countries have poor-quality assets, often as a result of excessive lending for real estate development or consumer credit. There are perverse connections between lenders and borrowers. Short-term borrowings—especially from offshore sources—are often overextended. And bank supervision must be improved. In the past, rapid economic growth and high domestic sav-

ings spared East Asian economies from the adverse effects of these shortcomings. But in an increasingly integrated global economy, the penalties of a fragile, underdeveloped financial system are severe. Thailand's current financial crisis is a case in point—foreign investors have sharply limited their exposures as underlying weaknesses have been revealed. Similar, albeit less severe, weaknesses in other countries are leading foreign and domestic investors to withhold new funds.

East Asia is working to develop more efficient and competitive financial systems. Heavy state control over financial systems is being phased out in many countries. Countries also recognize the need to liberalize dimensions of and remedy structural weaknesses in their financial systems. A Korean commission, for example, has recommended fundamental changes in the country's financial system. Japan is undergoing "big bang" liberalization.

Financial reform is, however, a complex area that requires years of careful work. Success will come only if countries adopt a consistent set of reinforcing actions. A strong institutional and incentive framework for the banking system, including sound supervision and regulation and effective mechanisms to avoid failures, is essential. Efficient capital markets—those that foster institutional investment by reforming pensions and expanding insurance—must be developed. And the region must respond to the international liberalization of financial services. In sum, reaping the substantial benefits of a robust, well-functioning financial system requires a credible, consistent financial sector development strategy, especially in the current environment.

There is every reason to believe that, with prudent macroeconomic management and comprehensive plans to deal with financial sector weaknesses, East Asia will be able to ride out the inevitable bumps on the road to a new and promising century.

Jean-Michel Severino
Vice President
East Asia and the Pacific Region

Summary

Even though East Asia has been the region of "miracles," recent events have raised concerns about the quality of its financial systems. In the wake of a slowdown in exports in 1996, the region is experiencing turbulence in its financial markets, with significant exchange rate adjustments in Indonesia, Thailand, and the Philippines and pressures on other currencies, a large-scale financial crisis in Thailand and property and stock market reversals in several countries, corporate failures linked to loans-for-kickbacks in the Republic of Korea, and broader worries about weak financial systems from Japan to Vietnam. Although in many ways the region's financial systems are more robust than the doomsayers would have us believe, a number of structural weaknesses should be addressed quickly, especially given the increasingly integrated global economy.

Countries in the region recognize that efficient financial systems are essential for a market economy and that financial sector development and economic growth are inextricably linked. In economies throughout East Asia, building more robust banking systems will require liberalizing financial systems—that is, allowing greater competition—and creating incentives for prudent, safe, and sound banking. Crafting such incentives will require bolstering supervision and oversight of the financial system, with particular attention to enforcement; strengthening regulations (on accounting, capital, valuation guidelines, and the like) to foster market discipline; and improving the quality and timeliness of information disclosed to the public, which can also help discipline market participants.

Although East Asia's equity markets have developed rapidly in recent years, bond and other securities markets have lagged. All the region's economies need to develop these markets to mobilize long-term funds for infrastructure financing and other long-term investments, including housing. Furthermore, rapid structural changes in the real economy are requiring improvements in corporate governance, for which securities markets will be important.

The internationalization of financial services is of regional importance because many countries maintain significant entry barriers to for-

eign providers of financial services or have restricted cross-border consumption of such services. Some have capital controls in place as well. Freer trade in financial services would boost the efficiency of the region's financial systems and contribute to macroeconomic stability.

In sum, to achieve efficient and resilient financial systems—essential to a market economy—countries in the region must adopt a consistent set of reinforcing actions. Financial reform will take time, but today, more than ever, there is a large premium on a credible financial sector development strategy.

1
Are Financial Sector Weaknesses Undermining the East Asian Miracle?

To ensure that the East Asian miracle of rapid economic growth continues into the twenty-first century, policymakers will have to build more robust banking systems, further develop securities markets, and intensify efforts to internationalize financial services.[1] Financial sector development is essential because it will vastly improve the allocation of the substantial domestic savings being mobilized by many East Asian economies. Although the level and sophistication of the region's economies differ—ranging from transition economies (Cambodia, China, and Vietnam) to much more developed countries (Japan, the Republic of Korea, and Malaysia)—all should pursue financial reform.

Recent developments have raised concerns about the quality of East Asia's banking systems. Prolonged financial distress in Japan, banking problems in Korea, the financial crisis in Thailand, and pressures on exchange rates throughout the region have led many observers to question whether the East Asian model of banking and banking reform needs revision. In many countries, such as Indonesia, nonperforming loans are not declining, and estimates of nonperforming loans across the region (including in Japan) reach as high as $660 billion (*Business Week*, 24 February 1997). Many banks also have liquidity problems, and state-directed lending, political pressures, and poor lending practices, particularly by state-owned banks, remain pervasive. Moreover, in quite a few countries basic accounting, auditing, and disclosure procedures are not up to international standards. These shortcomings point to structural problems and the need for rapid reform—especially given the increasingly integrated global economy.

Building more robust banking systems will require liberalizing financial systems—that is, allowing greater competition—and creating incentives for prudent, safe, and sound banking. Crafting such incentives will require bolstering supervision and oversight of the financial system, with particular attention to enforcement; strengthening regulations (on accounting, capital, valuation guidelines, and the like) to foster market discipline; and improving the quality and timeliness of information disclosed to the public, which can also help discipline market participants.

2
Overcoming Problems in Banking Systems

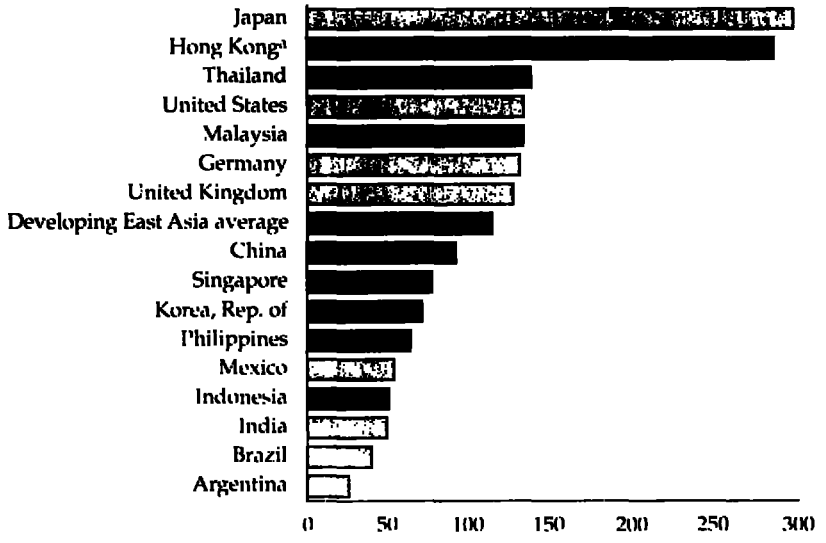
Most East Asian banking systems are large and dominate financial intermediation (figure 1). On a stock basis the region has some of the largest equity market capitalization in the world, but banking systems still control most new financial flows—as in many financial sectors around the world. Stock markets, by contrast, do not raise much financing for firms, and in many markets the extent of float (or true number of shares actively traded) is limited, since many of the companies whose shares trade are closely held.[2]

Thus financial sector reform in East Asia should focus, at least initially, on banking systems. Although many banking system reform and development issues will have to be tailored to each economy or group of economies (transition, lower-income, or middle-income), some issues are relevant for all of East Asia. These issues center around building more robust banking systems and restructuring, modernizing, and privatizing state-owned banks and banking systems.

Global and Regional Efforts to Build Better Banking Systems

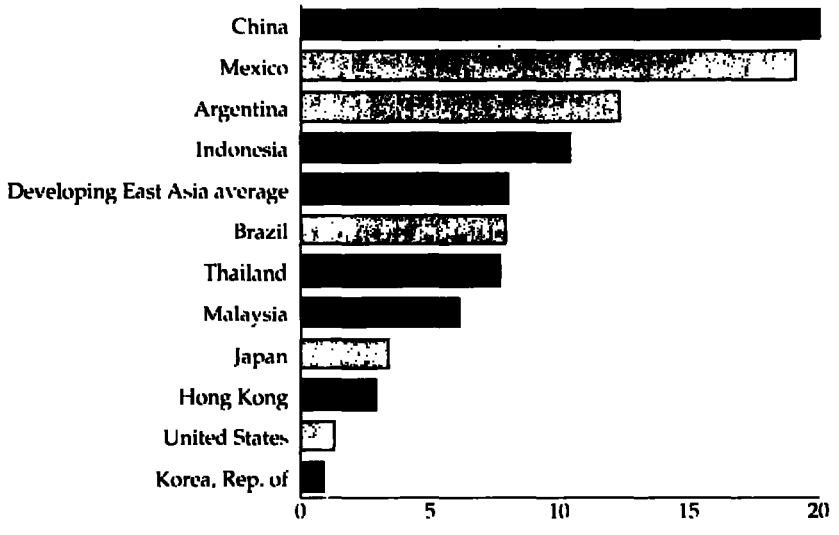
Throughout the world, it has proven difficult to build robust financial systems. Many countries (developing and industrial) have experienced a banking crisis in recent decades—Thailand being the latest example—with significant economic costs (figures 2 and 3; Caprio and Klingebiel 1997). The increased frequency of crises partly reflects global structural changes. Domestic deregulation and liberalization of financial services have increased competition. Advances in communications and information systems have further enhanced competition—increasing the capacity to exploit the opportunities offered by a liberalized environment—both within countries and across borders.[3] These developments have contributed to structural problems in banking systems because in many countries banks that were used to operating in sheltered environments have seen their profitability and asset quality plummet.

Figure 1 Credit Provided by the Banking Sector, 1995
Percentage of GDP



a. On July 2, 1997, Hong Kong reverted to China.
Source: World Bank data.

Figure 2 Nonperforming Loans, 1995
Percentage of total loans



Source: BIS 1997; official estimates for China.

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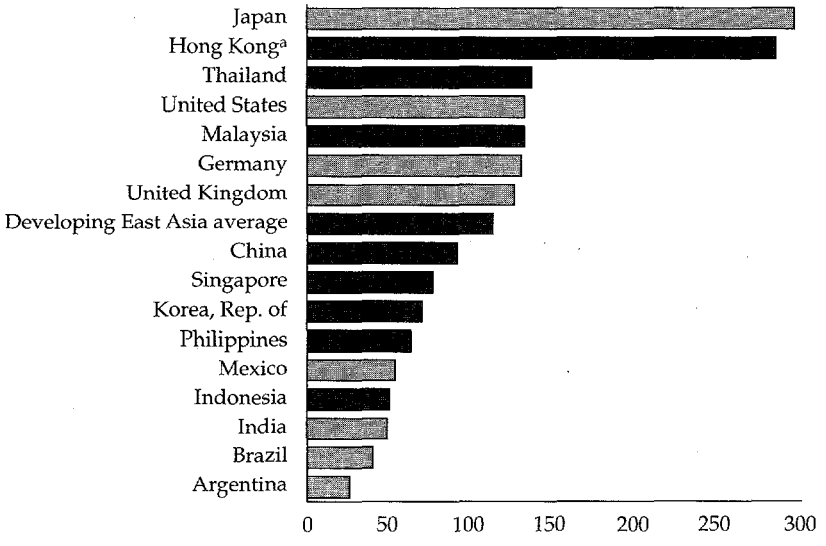

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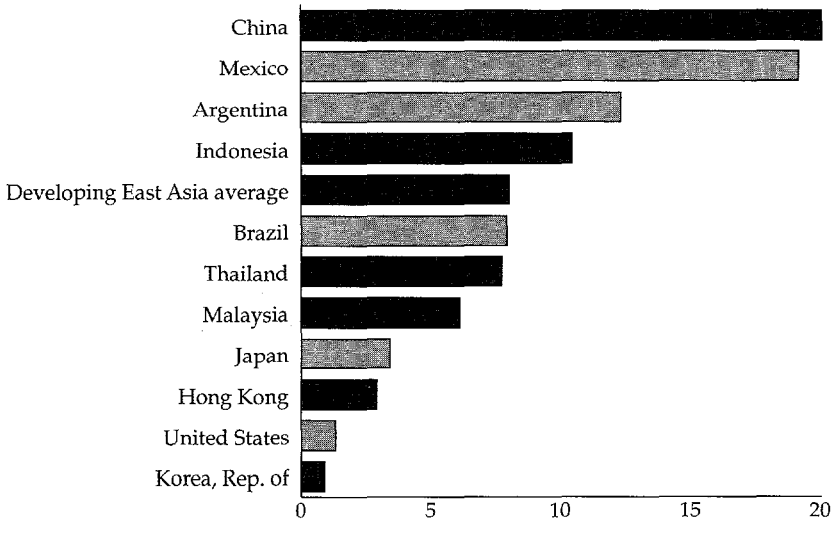
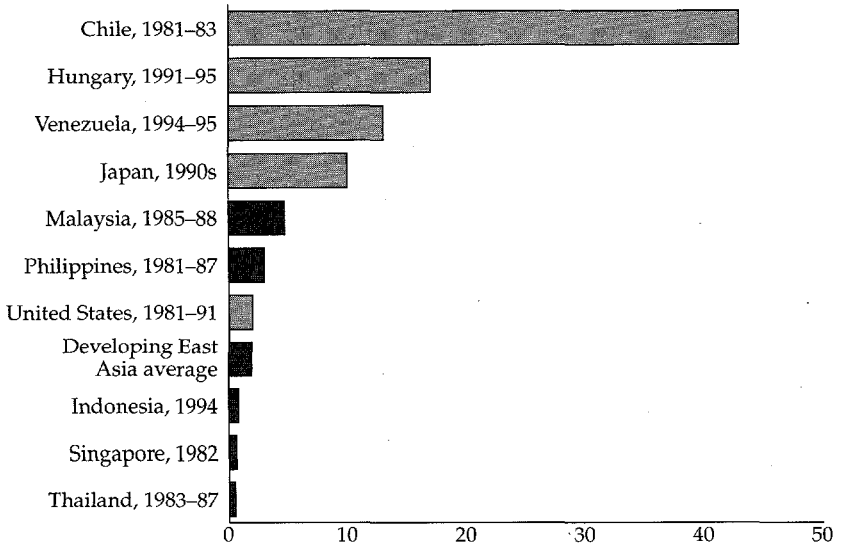


Source: BIS 1997; official estimates for China.

Figure 3 Costs of Banking Crises
Percentage of GDP



Source: Caprio and Klingebiel 1997.

Financial reform has also been blamed. Casual observers are quick to note that a wave of financial crises followed financial reforms in the 1970s and 1980s. The same arguments have recently appeared in response to the financial turbulence in East Asia. Has reform indeed led to crises? Two points should be considered. First, initial conditions matter. Countries rarely start to reform when the financial system is performing well. Rather, they often start after a long period during which the government was intervening in financial markets by allocating and pricing credit, often to unprofitable ventures (box 1). Recent financial reform efforts in Japan and Korea, for example, came after a long period of government intervention. Alternatively, many countries pursue change only after a financial crisis intensifies, making it difficult to assign causality.

When postreform crises occur, they may merely reveal preexisting weaknesses. The large nonperforming loans in transition economies, for example, reflect the poor allocation of resources under central planning. And in the Philippines financial reform in the late 1980s and early 1990s brought to light the quasi-fiscal costs that had been building because the Central Bank was the distributor of funds. As a result the Central Bank had to be recapitalized.

Second, reform has often been poorly timed because it coincided with shocks that weakened banks. Countries that move faster with

Box 1 What Does Financial Reform Mean, and Why Has It Been So Difficult?

Financial reforms differ depending on a country's stage of development. Most reforms, however, aim to reduce or eliminate government intervention in determining interest rates and decrease its role in credit decisions. Reforms also may increase competition in markets, allow foreign entry, rehabilitate or restructure banks, revise the supervisory and regulatory framework, and deepen financial markets.

Countries that have liberalized interest rates, credit controls, and international capital flows often have failed to upgrade accounting and reporting standards, strengthen the legal system, create better incentives for bankers, and address other institutional issues. Moreover, few countries have made significant attempts to develop human capital in the financial sector. These trends have been exacerbated by the failure of many governments to properly screen prospective new owners or to ensure that banks were adequately capitalized at the time they were privatized (as in Mexico).

These shortcomings should come as no surprise. Liberalization is inexpensive, fast, and easy to implement; building institutional capacity is expensive, slow, and complex. Thus many countries have done the quick and easy reforms first. However justified this sequence may be on political grounds, and even though it increases demand for a better infrastructure for finance, it undermines the stability of the financial system.

Countries that have experienced bank insolvencies often have tried to correct them by providing blanket coverage for liabilities, offering open bank assistance, and imposing regulatory forbearance. Although such actions can postpone or stem immediate problems (such as bank runs), they are less effective in correcting the underlying conditions that led to the problems. In fact, these corrective efforts have often generated moral hazard and created perverse incentives. When combined with macroeconomic shocks, the result has often been a costly and extended banking crisis.

reforms during good times and slower during bad times can cope more easily with the inevitable adjustment costs. Malaysia did so in the mid-1980s when it restructured its banking system during a period of rapid economic growth. At other times it has eased the pace of financial liberalization.

Of course, banking problems have other causes, including poor supervision, limited disclosure, insider lending, weak corporate governance, bad macroeconomic policies, high credit growth rates, and inadequate payment systems or other infrastructure characteristics that can increase systemic risks (see Goldstein and Turner 1996; Caprio and

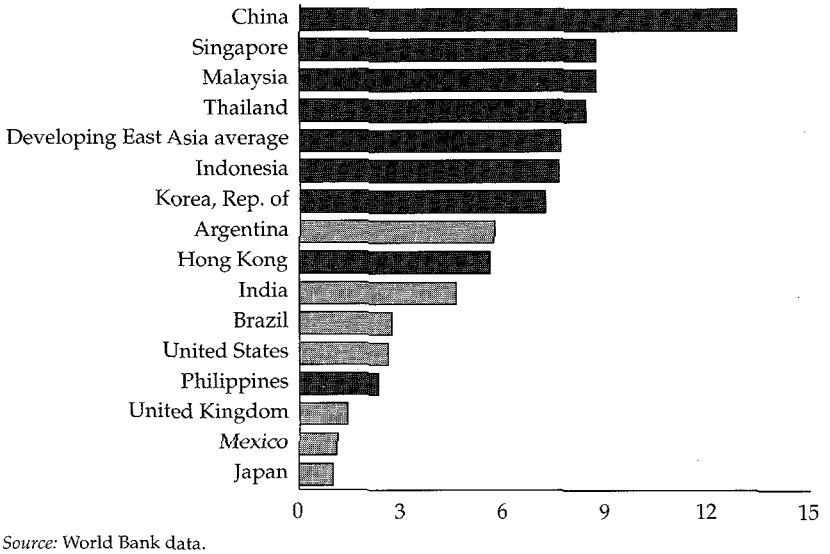
Klingebiel 1997; Honohan 1997). In some countries these weaknesses have developed because financial reforms created a dangerous gap: liberalization with poorly designed regulatory and supervisory systems. Thailand's current crisis is a case in point: a liberal capital account, a fixed exchange rate, and a current account deficit of 8 percent of GDP are rarely a good mix. But in a weak, poorly regulated financial system, they are never a good mix.

East Asia Avoided Major Banking Crises . . .

East Asia's rapid economic growth (figure 4) and high domestic savings (figure 5)—mostly intermediated through banking systems—prevented *structural problems from leading to major banking crises or failures.* Although some East Asian countries (Malaysia, the Philippines, Singapore) experienced banking crises in the past decade, they were able to overcome them relatively quickly. Moreover, the crises were not as damaging as those in other countries (see figure 3). And strong fiscal positions (figure 6) made investors confident that governments could back up their banking systems and bail out depositors should crises occur.

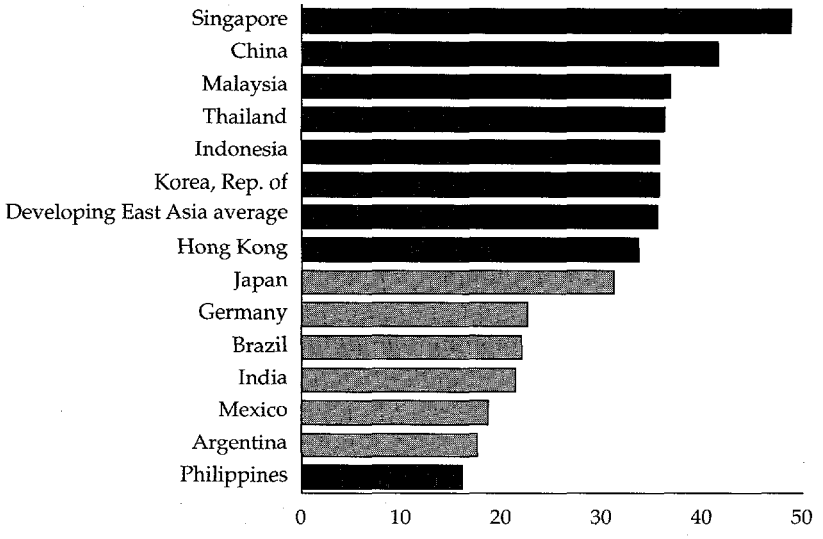
Figure 4 Annual GDP Growth, 1990–95

Percent



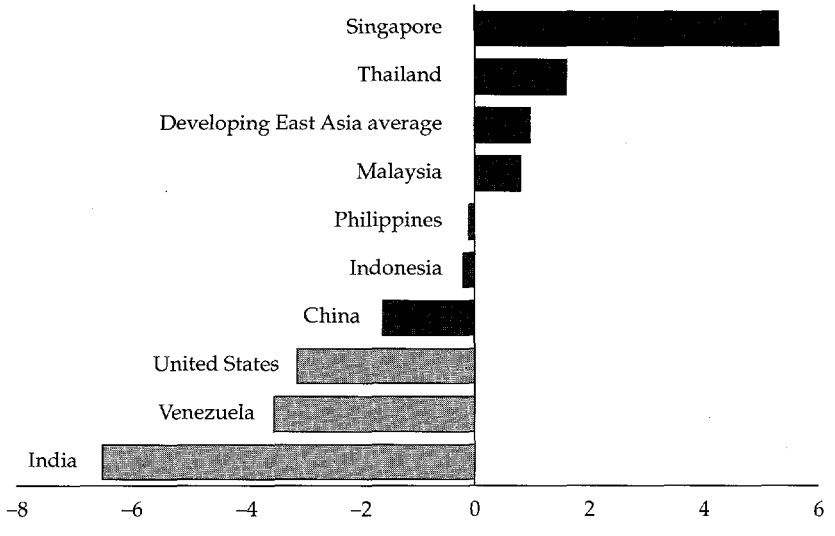
Source: World Bank data.

Figure 5 Gross Domestic Savings, 1993–95
Percentage of GDP



Source: World Bank data.

Figure 6 Fiscal Surplus, 1993–95
Percentage of GDP



Source: World Bank data.

. . . But Banking Systems Are in Urgent Need of Reform

Structural problems have recently surfaced in East Asia's financial systems. Japan has suffered prolonged financial distress. Korea's banking problems have recently taken on more urgency. Thailand is facing a severe liquidity crisis, triggered by widespread insolvencies of finance companies as well as some banks as a result of excessive commercial real estate and consumer credit lending. The Philippines has had problems with industrial lending. Indonesia's nonperforming loans are not declining, and several private banks have liquidity problems. Because of state-directed lending, political pressures, and poor lending practices, nonperforming loans across the region (including in Japan) could total as much as $660 billion. In Thailand's case nonperforming loans, as reported by Standard & Poor's, could account for more than 20 percent of total loans.

Although nonperforming loans have weakened banks, implicit state support has often maintained their creditworthiness (box 2). In several East Asian countries, banks' credit ratings now depend to a large extent

Box 2 East Asia's Banking Models—Not All Cut from the Same Cloth

There is no single East Asian banking model. There is a Japanese model of relationship banking (the "main" bank system), and a Chinese and Indonesian model of state bank lending to state enterprises (followed by relatively liberal entry in Indonesia). Korea has in many ways followed the Japanese model. Although Malaysia has quite a few privately owned banks, the state's role in lending decisions remains large. In Thailand and the Philippines bank ownership is concentrated but is largely in private hands. However, the government continues to play a role—albeit a much smaller one than in the past—in guiding commercial lending.

Still, the region's banking systems share many similarities. For the most part financial repression has been modest, with deposit rates, although kept low, slightly positive in real terms in most countries. Moreover, the state historically has played—and in some countries continues to play—a large role in setting interest rates for loans and determining the allocation of resources, whether directly (through state and development banks) or by guiding the decisions of commercial banks. In addition, family relationship lending has been important in many countries.

Source: Stiglitz and Uy 1996.

on the quality of expected support from the state rather than on the quality of the banks' balance sheets and profitability. In Indonesia, for example, Standard & Poor's and Moody's high ratings of state-owned banks reflect the banks' state support.

Weak banks have also affected macroeconomic policies. Several East Asian countries have been forced to alter the mix of macroeconomic policies—interest rate adjustments, exchange rate management, and so on—because of problems facing the financial system. In Thailand, for example, the large current account deficit required raising domestic interest rates or devaluing the currency to lower domestic demand and increase export competitiveness. But a large stock of nonperforming loans and the declining profitability of firms and financial services firms limited the degree to which interest rates could be raised without further weakening the financial system. And devaluing the currency risked adverse effects on banks and firms that had accumulated sizable foreign exchange exposures. In the end the Thai authorities were forced to devalue the currency because the government's foreign exchange reserves were rapidly being depleted. Only by strengthening the financial system, without creating moral hazard, could the authorities have gained the freedom they needed. Indonesian and Philippine authorities also had to let their currencies float after foreign exchange losses, triggered by concerns among investors.

New Challenges Have Emerged

Banking reforms need to be accelerated throughout East Asia. Moreover, financial systems in many countries are poorly equipped to deal with the demands being placed on them by rapid changes in corporate governance, global integration, economic and industrial structure, and the formalization of business. Different countries face different challenges, including modernizing banking systems, dealing better with external and internal shocks, channeling more resources to small and medium-size firms, assisting in the restructuring and opening up of enterprises, and increasing the share of the services sector in overall output.

Pressures to remedy these shortcomings are coming from many sources. Most important, foreign investors are seeking assurances that authorities are committed to a consistent financial sector development strategy. In addition, nonfinancial corporations in East Asia have started to complain about the poor financial services and high costs of domestic banking systems. Korea's *chaebols,* for example, are leading proponents of financial reform, and firms in Malaysia, the Philippines,

and Thailand are complaining about high real interest rates. Consumers also receive poor services and are seeking alternatives to investing their savings in bank deposits. High dollarization triggered by a lack of confidence in the formal banking system is keeping Cambodia's (and, to a lesser extent, Vietnam's) financial system shallow. Disintermediation may become an issue for China as financial liberalization and global integration proceed.

Disintermediation is already happening throughout the region as borrowers go abroad to obtain funding at more attractive terms and avail themselves of better financial services. As a result the market is becoming segmented, with good borrowers going abroad or to foreign banks and bad borrowers staying in the country or with local banks. Such segmentation has major implications for the financial system's solvency and efficiency. The creation of special offshore centers—which offer regulatory and tax advantages—is helping to retain firms in the domestic financial sector, but the reform may be a mixed blessing (box 3). Extensive offshore borrowing also has contributed to the recent exchange rate adjustments, as borrowers bought foreign currencies to cover their open positions.

How Should Reforms Proceed?

Recent events have confronted East Asian countries with the challenges facing their banking systems. In a world that is increasingly integrated financially, East Asia can no longer postpone difficult choices—the penalty of maintaining a fragile, underdeveloped banking system are too severe. The issue is not whether to reform, but how and at what pace while maintaining financial stability. Countries increasingly recognize this. In Korea, for example, a blue-ribbon commission recently issued a report proposing financial sector reform.

Modernizing banking systems requires years of careful work and involves a broad range of topics, from developing the infrastructure for banking to acquiring the necessary human skills. Efforts to further develop banking infrastructure should focus on the design and implementation of regulatory and supervisory systems. East Asian countries could benefit from adopting aspects of the approaches used in Chile, New Zealand, and the United States, particular those that encourage market forces to discipline banks and other financial intermediaries. Other recent global efforts to strengthen the regulation and supervision of financial systems—for example, the banking supervision principles, capital adequacy requirements, and risk measurement techniques developed under G–10, G–30, Bank for

Box 3 Should East Asian Economies Create Offshore Financial Centers?

Several East Asian economies have (or are creating) offshore financial centers. Malaysia is promoting Labuan as a financial center, the Philippines recently developed an offshore euro-peso market, Thailand has developed the Bangkok International Banking Facility, and Singapore and Hong Kong (China) plan to further develop their roles as regional financial centers. These markets often have regulatory and tax advantages over domestic markets. Offshore markets can provide additional external financing because investors may be more attracted to them. The net financing gain will, however, depend on the degree of substitutability: if foreign or domestic investment simply moves from the domestic market to the offshore market, there will be no net financing gain and only a loss of tax and regulatory coverage. These markets can also put pressure on domestic markets to deregulate because domestic firms will avoid the domestic markets in favor of the offshore market.

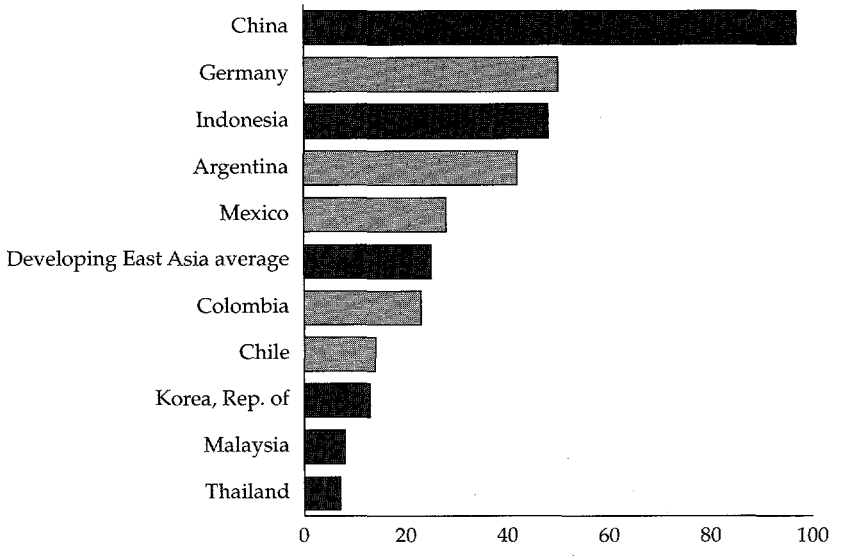
At the same time, offshore markets can create adverse dynamics. Because these markets are likely to be accessible by only certain types of domestic firms—usually those with good credit standing—preferential regulatory treatment can lead to (further) market segmentation. This segmentation can create economic and political pressures not to reform the domestic market because firms with access to the offshore market would lose some of their advantages. Moreover, it is unlikely that more than one or two of these offshore centers will become a regional financial center, negating many of the reasons to grant preferences. Thus domestic deregulation may be the best and preferred approach—as has been used in Hong Kong (China).

International Settlements, and other auspices—should be fully and rapidly implemented. In particular, many countries in the region should strengthen the supervisory and regulatory framework for financial groups or conglomerates and improve financial intermediaries' internal risk management. Requiring better disclosure and reducing the role of the state will also be necessary to create more robust and agile financial systems.

Restructuring, Modernizing, and Privatizing State-Owned Banks and Banking Systems

Almost all East Asian countries—not just Thailand—face challenges with intervening in troubled banks and finance companies, restructur-

Figure 7 State-Owned Bank Assets, 1994
Percentage of total bank assets



Source: BIS 1997.

ing or merging private or specialized government-owned banks, and privatizing state-owned banks. In the transition economies (Cambodia, China, and Vietnam) reforming large state-owned banking systems and placing them on sound footing will be a central financial sector issue as state-owned enterprises are restructured and privatized. State banks also have a substantial market share in other countries, such as Indonesia (figure 7), and are only beginning to adapt to a more market-oriented financial system. Experiences with systemic bank restructuring in other parts of the world (for example, Eastern Europe) and lessons learned from bank privatizations (for example, Mexico) of relevance to many countries in the region are only slowly being absorbed.

Striking the Right Balance with Entry, Exit, and Competition Policies

The management of rapid entry and slow exit of banks and nonbanking entities (such as insurance companies) has arisen in a number of countries (Indonesia, the Philippines, and Thailand). Entry policies determine the franchise value of banks, the degree of contestability, and the merits of restructuring state banks (relative to relying on growth through new

private entry). In many countries entry policies fail to take these considerations into account; worse, international standards for evaluating the owners and managers of new financial institutions are not being rigorously applied.

Exit policies also influence the incentives facing market participants and the overall efficiency of the financial system, particularly in the presence of explicit or implicit liability or deposit coverage. Yet in many East Asian countries the exit of insolvent and poorly managed firms has been limited. In Thailand many weak finance companies were allowed to continue operating and received liquidity support from the Bank of Thailand amounting to about 10 percent of GDP. A period of relatively liberal licensing has left Indonesia with a large number of private banks, many of which are probably too small to compete—especially if entry barriers to foreign financial services firms are further lowered. But few of these banks have been merged with other banks or closed. Experiences from other countries, such as Argentina and Estonia, show that intervention in and resolution of problem banks quickly generate sizable improvements in incentives and substantial efficiency gains, and can prevent a large-scale financial crisis.

Creating Incentives for Self-Regulation

Prudential regulatory and legislative frameworks in many East Asian countries are in need of modernization. For example, Cambodia and Vietnam are only now developing basic accounting standards, asset classification standards, and prudential standards. Indonesia, the Philippines, and Thailand have extensive gaps in their regulatory, supervisory, accounting, auditing, and disclosure frameworks. For example, although the General Banking Act of the Philippines does not require commercial banks to maintain risk-adjusted capital adequacy ratios, the central bank calculates these ratios for its universal banks on a shadow basis. In Thailand the rules for classifying assets allow loans to be in nonaccrual for twelve months before being classified as nonperforming. As a result nonperforming loans were underreported by a factor of two. In many countries information about commercial banks' exposure in such key areas as residential and commercial real estate is often unreliable or outdated, exacerbating the volatility of asset prices because economic participants can overreact to news or events. The lack of transparent and adequate information in Thailand meant that there was little early warning for investors about the extent of the problems.

A broad range of East Asian countries are making efforts to modify these legal and regulatory frameworks in ways that create stronger

incentives for market participants to monitor the behavior of banks and other providers of financial services. Both research and experience suggest that good design and strong enforcement of key prudential regulations in such areas as capital requirements, valuation guidelines, regulatory accounting principles, and disclosures can create incentives for self-monitoring by market participants. Efforts should also be made to permit the further development of institutions (such as rating agencies) that will demand higher-quality financial information, improve the quality of financial information by raising the standards of key professions (auditing, accounting, financial analysis), and raise standards for self-regulating organizations such as clearing houses, exchanges, and secondary mortgage institutions. Korea, for example, recently liberalized entry of foreign rating agencies in an effort to improve market discipline.

3
Developing Securities Markets

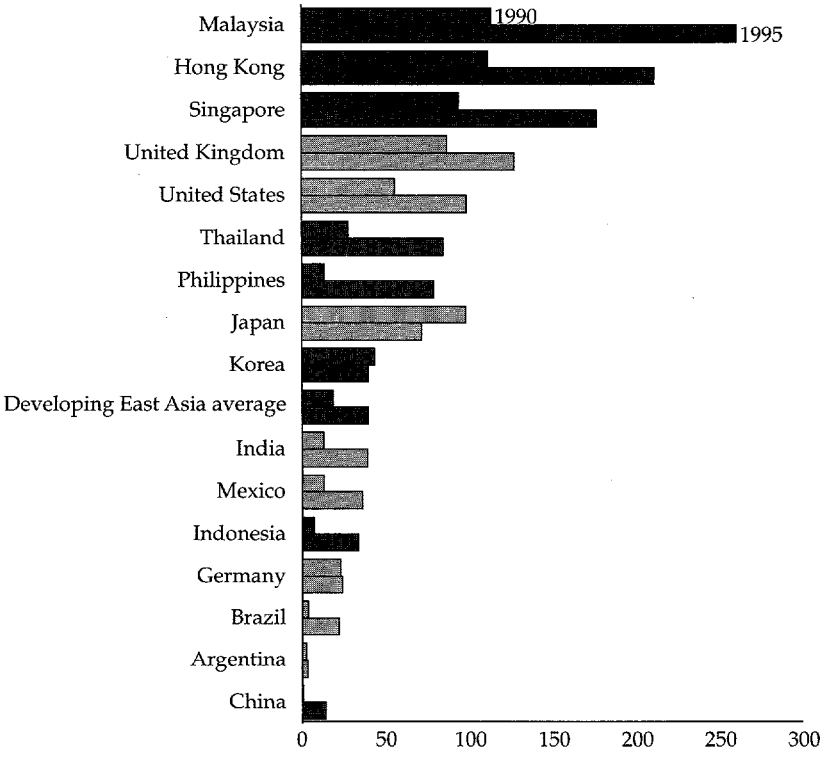
One of the most complex challenges facing East Asian economies is further developing their securities markets. Most advanced East Asian economies have well-developed equity (stock) markets, both relative to industrial countries and to other developing countries (figure 8). Much of the growth in these markets has been driven by foreign portfolio investors, which are active traders in many countries (figure 9). Moreover, market liquidity in securities markets has increased in recent years and is relatively high (figure 10).

Few economies, however, have well-developed bond and other securities markets (figure 11). Even high-income countries like Korea are only beginning to develop such fixed-income markets. Most bond and other securities markets are also relatively illiquid (figure 12). Equity markets in East Asia still lack transparency and play a limited role in corporate governance, where family control over firms often dominates. Better securities markets are needed because they can be a competitive force for improving banking systems and because banks and securities markets are complementary sources of finance. Improved securities markets will lead to more balanced, and more robust, financial systems. Global experience suggests that further growth of securities markets will depend on the interaction between developing a solid institutional investor base and a sustainable demand for funds, and developing a supporting institutional framework.

Fostering a Base of Institutional Investors

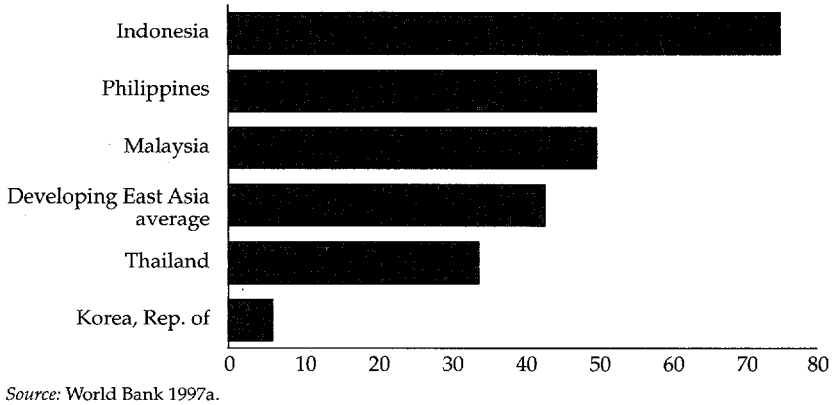
A sustainable securities market requires a solid investor base, usually consisting largely of institutional investors seeking long-term financial instruments. Countries with successful securities markets, such as the Netherlands, Switzerland, and the United Kingdom, often have total assets in contractual savings institutions close to or exceeding 100 percent of GDP. Except for some notable exceptions in East Asia (Malaysia and Singapore), few developing countries have contractual savings institutions with assets close to or exceeding 50 percent of GDP.[4]

Figure 8 Stock Market Capitalization, 1990 and 1995
Percentage of GDP



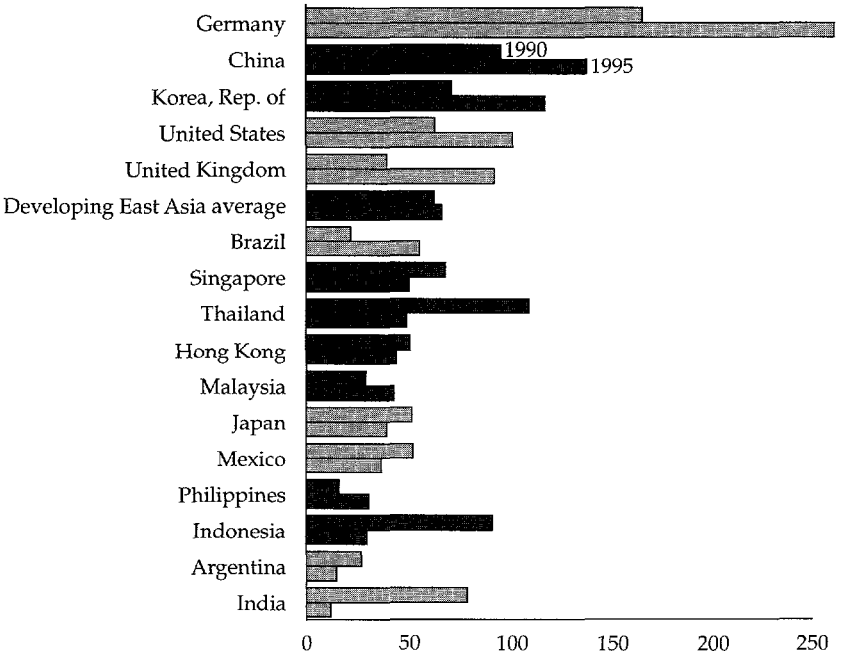
Source: IFC Emerging Markets Database and World Bank 1997b.

Figure 9 Foreign Activity in Stock Market Trading
Percentage of trading activity



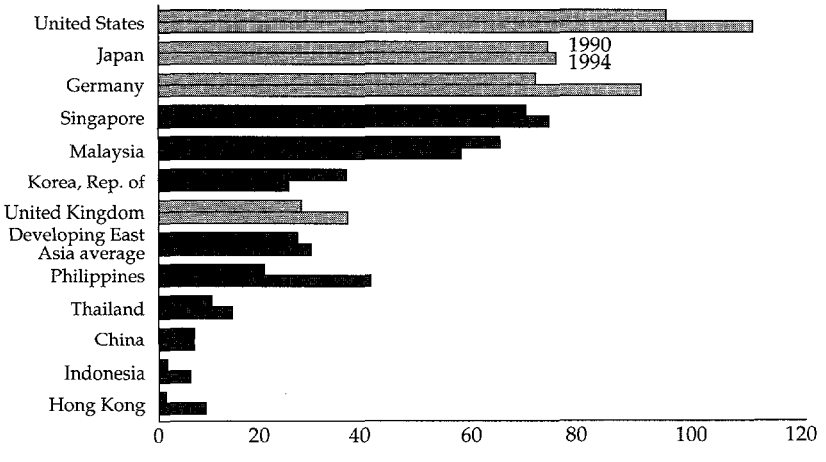
Source: World Bank 1997a.

Figure 10 Trading Volume, 1990 and 1995
Percentage of market capitalization



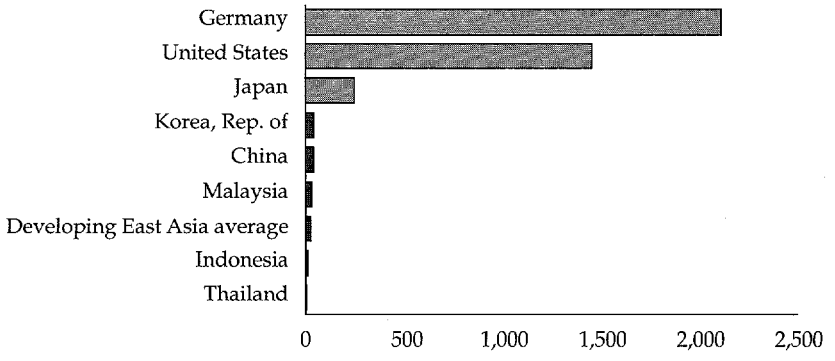
Source: IFC and World Bank data.

Figure 11 Bond Market Capitalization, 1990 and 1994
Percentage of GDP



Source: World Bank 1995.

Figure 12 Bond Trading Volume, 1994
Percentage of market capitalization

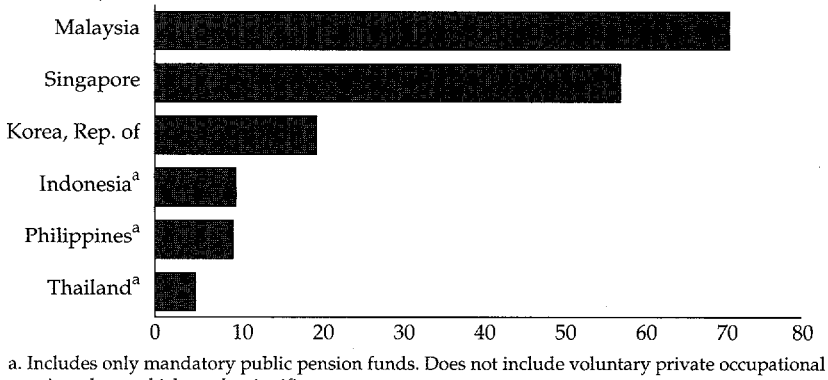


Source: World Bank 1995.

Although a complete picture of the size, structure, and development of East Asia's contractual savings and institutional investor base is unavailable, a partial picture is provided in figure 13. Developing the region's securities markets will likely require expanding the domestic institutional investor base.

Detailing all the impediments to developing this class of investors is beyond the scope of this study, but several East Asian countries are making efforts to address them. Reforms of pension and insurance systems, coupled with actions to develop mutual funds, should expand the institutional investor base and improve the liquidity of securities

Figure 13 Pension Fund Assets in Selected East Asian Countries
Percentage of GDP



a. Includes only mandatory public pension funds. Does not include voluntary private occupational pension plans, which can be significant.
Source: World Bank data.

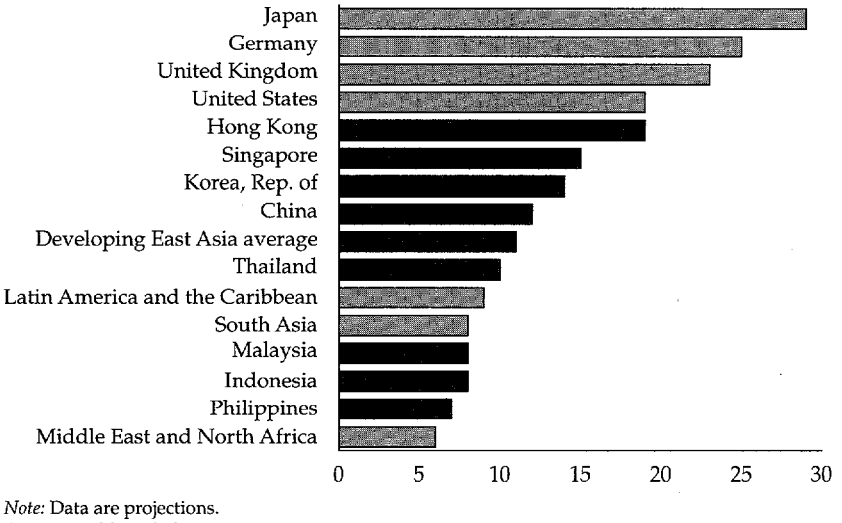
markets. The growth of the mutual funds industry in Indonesia, for example, has spurred the development of its domestic bond market. Insurance companies, mutual funds, and specialized onshore and offshore pooled investment vehicles (such as infrastructure debt and equity funds) are being introduced. And many East Asian countries are starting to allow foreign entry in the provision of these services and other investment management services.

Pension Reform—Difficult but Essential

Developing securities markets in many East Asian economies will require pension reform. Several countries in the region with well-developed pension funds—the provident funds in Malaysia and Singapore, for example—are introducing new pension management schemes, allowing domestic and international fund managers to play larger roles in managing the funds, and giving individual contributors more choice in designing their investment strategies. China, Indonesia, Korea, Malaysia, the Philippines, Thailand, and Vietnam are undertaking or have recently conducted analytical work and receiving technical assistance on pension reform and pension fund management. Although the current population is still relatively young in most East Asian

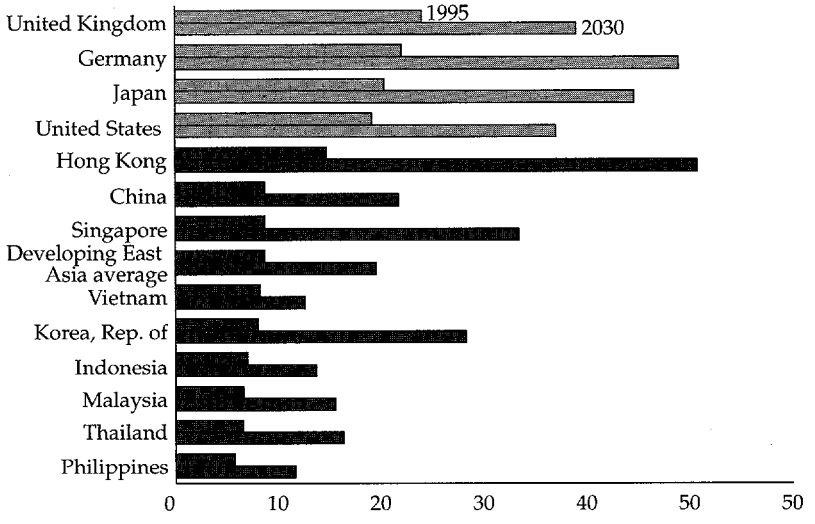
Figure 14 People above the Age of 60, 2010

Percentage of population



Note: Data are projections.
Source: World Bank data.

Figure 15 Old Age Dependence Ratio, 1995 and 2030



Note: Dependence ratio compares population over 65 to population between 15 and 64. Data for 1995 are estimates; data for 2030 are projections.
Source: World Bank data.

economies (figure 14), rapid aging will create pressures to accelerate pension reforms in the region (figure 15).

Pension reform raises complex macroeconomic and microeconomic issues. Many of these issues are dependent on a country's economic development, its population size and demographic structure, and the maturity (or immaturity) of its social insurance systems. Characteristics of the region's social insurance systems are shown in table 1. These systems vary in terms of the form of benefits provided (that is, defined benefit or defined contribution), the extent of funding in defined benefit plans, and the degree of private participation in offering voluntary occupational pension plans and in managing the investments of mandatory government and public or private voluntary occupational pension plans.

Different Economies Face Different Challenges

In terms of social insurance, East Asia contains at least three types of countries. For countries with relatively new social insurance systems that do not cover much of the population (China, Thailand, and Vietnam), a central challenge will be designing fiscally sustainable

Table 1 Social Insurance Programs in East Asia

Economy	*Mandatory pension plans*	*Voluntary pension plans (public and private)*
Australia	Means- and asset-tested universal public plan Mandatory funded occupational pension plans recently introduced	Both defined benefit and defined contract plans offered by public and private companies
Cambodia	No explicit system	Some private plans offered by large companies
China	Enterprise-based defined benefit pay-as-you-go pension plans, pooled at the municipal level Partly funded multipillar system being introduced	Voluntary pillar not that highly developed
Hong Kong, China	Means- and asset-tested universal public plan Mandatory funded defined contribution occupational plans about to be established	Many voluntary employer-sponsored plans
Indonesia	Defined contribution provident fund covering 30 percent of formal sector workers	Voluntary employer-sponsored plans covering 10 percent of formal sector workers
Japan	Mandatory partly funded defined benefit system Employers able to opt out of earnings-related portion under certain (stringent) conditions	Some additional employer-sponsored plans
Korea, Rep. of	Partly funded defined benefit system being revised to make it more sustainable	Some voluntary plans, most of which offer defined benefits
Lao PDR	Defined benefit pension fund for public sector employees	Voluntary company plans insignificant for public or private employees
Malaysia	Provident fund covers most formal sector workers	

(Table 1 continues on the next page)

Table 1 (continued)

Economy	*Mandatory pension plans*	*Voluntary pension plans (public and private)*
Philippines	Partly funded defined benefit schemes Some provident funds 60 percent of workforce covered	Substantial voluntary employer-sponsored defined benefit plans offered by private companies and public agencies
Singapore	Defined contribution provident fund covers almost entire labor force	
Thailand	Defined contribution provident funds cover 1 percent of labor force Special government provident fund now operational New partly funded defined benefit plan to be put in place	Voluntary employer-sponsored defined contribution plans that almost all take the form of provident funds
Vietnam	Pension plan for public sector employees	Voluntary company plans not well developed

Source: World Bank data.

social insurance systems that are not beset by the political risks that have often hindered efforts in OECD countries and in Latin America. Moreover, these countries will have to make important macroeconomic decisions in deciding on the extent of desired coverage and the form and size of benefits, and in moving from partly or unfunded pension systems to more fully funded ones. At a more microeconomic level, the public agencies providing partly funded defined benefits in new systems that are or will be experiencing a rapid buildup of reserves are examining how the governance of these funds (coupled with actuarial or other public disclosures) can reduce the political risk of funds being allocated to low-return investments.

A second class of issues affects countries like Malaysia and Singapore, which are starting to manage large investment portfolios and must decide whether to diversify investment portfolios beyond national boundaries and give individual investors more control over investment choices.

The third group of countries (Indonesia and the Philippines) lies in between these two cases. Both countries already have multipillar pension schemes, limited population coverage under these schemes, and demographic structures that will change dramatically over the next

thirty years. Hence the fiscal costs of these schemes—including rapidly rising implicit pension debt—could increase quickly if actions are not taken in the next several years to reform parts of these systems. In addition, proper reform could contribute to capital market development and improve the corporate governance of nonfinancial corporations.

All three groups of countries would benefit from increasing the role of private insurance companies in providing social insurance in such areas as annuities, disability, and survivorship benefits. In this regard many East Asian economies are lagging behind developments not only in OECD countries but also in some Latin American countries.

Generating Sustainable Demand for Funds

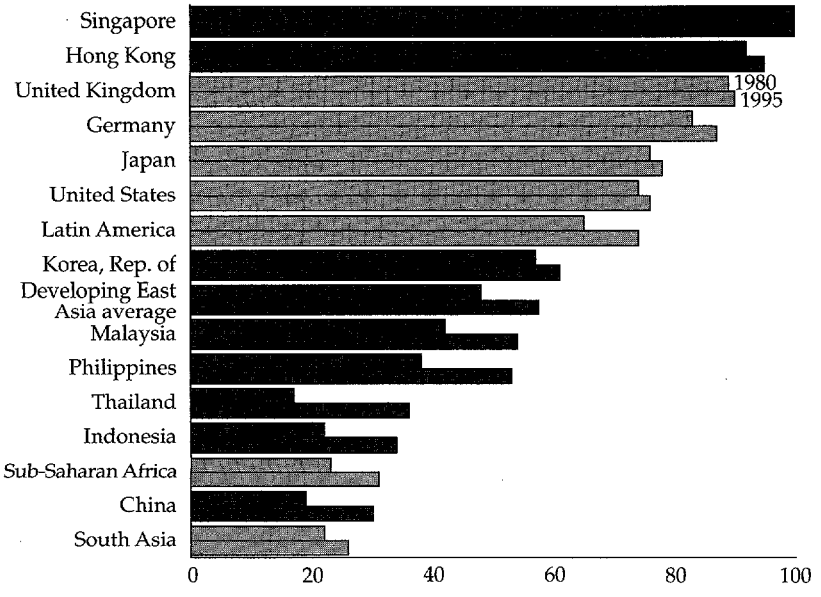
Two areas where demand may particularly stimulate the development of securities markets are housing and infrastructure. The role of securities markets in corporate governance will also be increasingly important in East Asia.

Making Markets for Housing Finance

Fueled by high economic and population growth, East Asia is experiencing rapid urbanization (figure 16). As a result demand for housing is on the rise. Yet most East Asian economies have poorly developed housing finance systems, with households often having to rely almost entirely on personal savings or informal borrowings, and no significant mortgage markets. Accordingly, housing quality is often low, and cities expand in haphazard ways. Good housing finance could lead to better-quality houses and more livable cities.

The link between housing finance reforms and securities market development is being studied in China, Indonesia, Malaysia, the Philippines, and Thailand. Malaysia has one of the region's longest histories of a secondary market for mortgages, a trend that is growing worldwide and in East Asia in particular (table 2). Some high-income East Asian economies are also exploring the possibility of introducing mortgage-backed securities; Hong Kong (China), for example, recently established a secondary mortgage corporation. These economies are developing and improving the overall framework for secondary mortgage markets (including the roles of the public and private sectors), low-income housing (including how to deliver subsidies to poor households), and supervisory, legal, and regulatory issues (including how to preserve incentives for proper credit evaluation for primary loan orig-

Figure 16 Urbanization, 1980 and 1995
Percentage of population



Source: World Bank data.

ination and how to avoid increases in systemic risks resulting from the securitization of high-quality bank assets).

Meeting Infrastructure Needs

Publicly provided infrastructure contributed greatly to East Asia's past success. Today, however, the region's power, transport, water, and telecommunications needs are vast—an estimated $1.2–1.5 trillion over the next decade (figure 17). These needs far exceed the public sector's financial and managerial capacity and can be met only if the private sector's role is increased significantly and infrastructure provision is commercialized. Private capital accounts for no more than 10 percent of infrastructure investment in East Asia; over the medium term, however, private investment could increase to some 30 percent.

In some countries outside the region, such as Chile, most new infrastructure projects are already privately financed, often with external funds. Many East Asian economies' infrastructure requirements are too large to be financed externally, as doing so would create a major currency

Table 2 Secondary Mortgage Institution Development, Various Economies

Economy	*Status*	*Ownership structure*[a]
East Asia		
Hong Kong, China	Approval granted by government	Government-owned
Indonesia	Developing a secondary mortgage facility model	Privately owned
Malaysia	Operational December 1986	Government-controlled, but private sector has shareholdings
Philippines	Feasibility to be studied	Mixed public-private model being discussed
Thailand	Being discussed in light of the new Securitization Act	Not yet determined
Other		
Bolivia	Studying feasibility	Government-owned
Brazil	Being considered	Privately owned
Central America	Studying feasibility	Regional secondary mortgage institution
Colombia	Studying feasibility	Privately owned
Ecuador	Studying feasibility	Quasi privately owned
India	Studying feasibility	Government-owned
Jordan	Approval granted by government	Public-private ownership
Mexico	Studying feasibility	Government-owned
South Africa	Creation beingdiscussed	Quasi privately owned
West Bank and Gaza	Being established	Government-owned

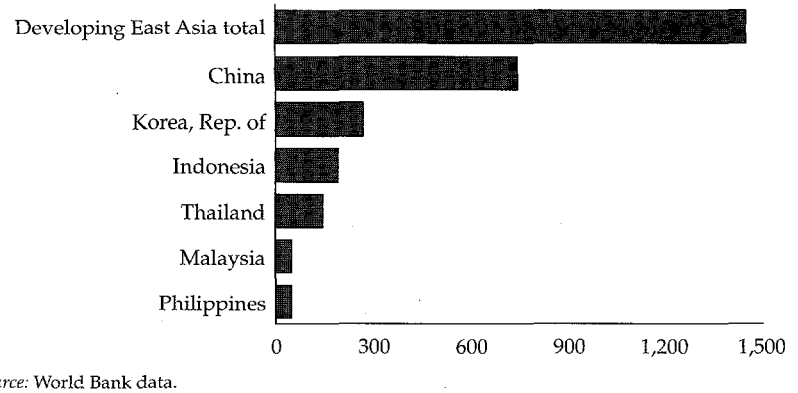
a. For most countries, as proposed or currently discussed.
Source: World Bank and IFC data.

mismatch. Thus in the medium term most of these needs will have to be funded locally. An important constraint on increased private provision of infrastructure, then, is effective domestic financing mechanisms.

The financial sector challenge for East Asia is to create an environment that allows long-term, local currency debt and (quasi-) equity markets. In addition, insurance markets need to be reformed to allow for greater mitigation of the risks associated with project finance. The links between infrastructure financing and securities market development are still in their infancy. Good examples from industrial countries of securities markets supporting private provision of infrastructure are few, and developing countries are often spearheading this concept. Most infrastructure finance in East Asia has been project-based, with financial sector development—either by developing the institutional infrastructure or incurring an "innovation premium"—as an externality. Until recently the necessary regulatory and legal framework for infrastructure finance has been less of a concern.[5]

Work in these areas is accelerating in a variety of countries, however, including China, Indonesia, Malaysia, the Philippines, Thailand, and Vietnam. Private provision and financing of infrastructure raises a number of legal, regulatory, and judicial issues in terms of both policy and institutional frameworks and specific sectoral issues. It can also require the use of government and international financial institutions' guarantees to enhance credit and mitigate risk during the early phases. Thus a broad approach phased over a long period is needed. Examples include ongoing work on the development of asset-backed securities (for example, in the Philippines and Thailand) and on municipal finance in countries where fiscal decentralization is progressing (for example, in Indonesia and the Philippines). These efforts

Figure 17 Estimated Infrastructure Needs, 1995–2005
Billions of U.S. dollars



Source: World Bank data.

will help mobilize domestic savings in support of infrastructure finance.

Fostering Effective Corporate Governance

In addition to providing resources, securities markets can create incentives for corporate governance that ensures an efficient allocation of capital and good firm management. To date this area has received scant attention in East Asia, partly because rapid economic growth and high savings have placed a lower premium on ensuring good corporate governance and efficient allocation of savings. Put another way, alternative corporate control mechanisms—including family-related control—have worked relatively well. But as East Asian economies become more formalized and move away from other control mechanisms, corporate governance becomes more crucial and should be given more attention.

Countries that fail to improve corporate governance are in danger of building up excessive risks in banks and losing the efficiency gains that come from better firm management. Moreover, nonfinancial firms will be less competitive. Bank-based corporate governance systems are generally quite effective for economies with many growth opportunities. But as economies mature, growth opportunities in existing firms decline, and excess positive cash flow may develop. Bank-based systems typically have a hard time disciplining managers in such an environment and controlling excessive and inefficient investments. As firms and economies mature, more diverse forms of corporate governance—through securities markets, for example—become necessary. To a large extent the bad loan problems in Indonesia, Korea, and Thailand arose from the weak governance of firms.

As East Asian economies reform their legal and regulatory frameworks for securities markets, they should pay more attention to corporate governance considerations (complementary to the discipline imposed on companies through bank lending). Securities market, corporate, and bankruptcy laws determine the rights of equity owners, debt holders, and other creditors and thus influence the role securities markets can play in corporate governance. Weak minority and legal protections in many countries, for example, may imply that domestic investors prefer to have large equity investments because such investments give them control and access to information.[6] This does not necessarily imply that stock markets will be small, but they may not be as liquid as is desirable.[7] Less liquid stock markets may inhibit market efficiency (and economic growth) because the information content of equity prices may be compromised. Moreover,

they may stifle other securities markets. Bond investors, which already suffer from poor legal protection even if they try to design careful legal convenants in bond indentures, will not lend to insider-owned or -dominated firms unless yields are high. Thus better protection of minority shareholders may be needed not only to promote equity markets but also to promote bond markets. East Asian economies must confront the issue of governance more broadly. Governance issues feature, for example, in the design of investment policies relating to social security and pension funds, both public and private. Moreover, isolating investments from political risk can be crucial in individual projects.

Developing the Institutional Framework for Securities Markets

The infrastructure needed to support modern securities markets includes payment systems, supervisory systems, securities registration, information infrastructure (rating agencies, auditing and accounting firms, and so on), and custody, clearing, and settlement systems for securities trading. Strengthening such infrastructure will increase domestic market liquidity and help attract foreign portfolio and direct investment.

East Asian economies are at different stages in developing this infrastructure, from quite sophisticated to entirely absent. Countries like Cambodia and Vietnam lack real securities markets or even well-developed money markets and should put in place basic legal, regulatory, and institutional frameworks while—or, preferably, before—they develop securities markets. Once the basic factors, including macroeconomic stability, are in place, further development of securities markets infrastructure will to a large extent be driven by demand. Thus institutional reform is generally best undertaken and supported in line with the demand for and supply of funds. This approach helps increase the liquidity of these markets to the level of more developed market economies.

Most East Asian economies have been able to avail themselves of technical assistance in building needed legal, regulatory, and institutional frameworks and systems for securities markets. As a result many countries have scored large improvements. A review of the institutional infrastructure of capital markets, for example, found that between 1992 and 1996 Malaysia's efficiency doubled. Indonesia's improvement was almost as good. (The measure of efficiency was based on the number and operational costs of failed and

delayed transactions, administrative costs, complexity of the market, and compliance with G–30 recommendations; see World Bank 1997a.) East Asian economies have now caught up with or surpassed Latin American countries, which started with a much better infrastructure.

There have also been regional initiatives to build the institutional framework for securities markets. For example, foreign firms in joint ventures with local firms have established regional credit rating agencies. And work is under way (under the aegis of Asia-Pacific Economic Cooperation) on how disclosure requirements can be more effectively harmonized across East Asia, with the aim of expanding possibilities for the cross-listing of securities.

On some issues, however, East Asian economies could still benefit from global experience. In particular, the overall design of securities markets—the micro-market structure and the role of various market participants—could be improved. East Asian governments tend to play a sizable role in market regulation. This approach risks excessive regulation, with high costs in terms of slowed market development and reduced foreign inflows. In line with global developments, self-regulating agencies should play a larger role—provided regulation and supervision of such entities are well designed and enforcement capacity is adequate.

In addition, because of rapid expansion, the relationships between market structures and supporting systems (settlement, trading, and clearing) have some gaps and inconsistencies (World Bank 1997a). Countries could gain from advances, global and regional, in the micro aspects of trading, clearing, custody, and settlement systems as well as in cross-border risk safeguards through cooperation between self-regulating associations. Making the tax treatment of different financial services more consistent (for example, in the Philippines interest earned on deposits and loans is taxed differently depending on the currency denomination) will further contribute to the development of securities markets.

4
Responding to the Internationalization of Financial Services

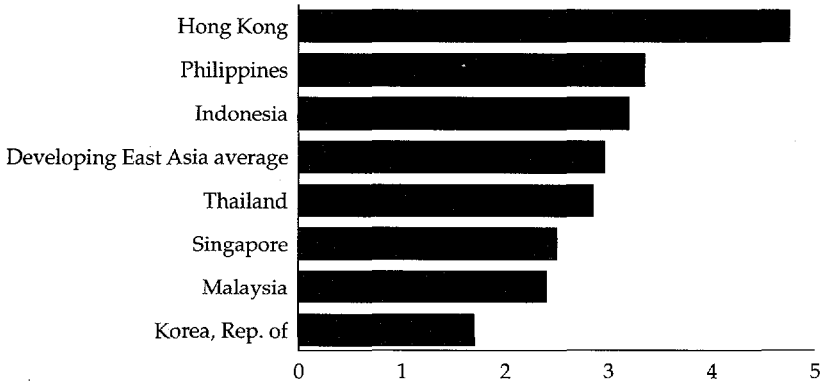
Many economies in the region must respond to the issues raised by freer global trade in financial services (see Claessens and Hindley 1997 and Claessens and Glaessner 1997). Countries in other regions, hoping to reap efficiency gains from better-allocated resources and improved financial services, are opening up capital accounts and allowing freer trade in financial services. These trends are of considerable importance to East Asia because many economies in the region maintain significant entry barriers to foreign providers of financial services (figure 18). Some have capital controls in place as well.[8]

East Asian economies have been under pressure—particularly from the United States but also from the European Union—to further open up their markets. This pressure will likely increase with the current round of negotiations on introducing financial services into the General Agreement on Trade in Services (GATS), which started in April 1997 and is scheduled to be concluded by the end of 1997. Besides the fact that, except for Hong Kong (China), most East Asian economies are relatively closed, a regional focus on the internationalization of financial services is warranted because global pressures and intraregional deliberations may provoke a coordinated regional response.

Freer trade in financial services could generate considerable benefits, including improved access to foreign capital, deeper financial integration with the rest of the world, new and better domestic financial services, and stronger financial infrastructure (including regulation and supervision; see Levine 1996). These benefits could be significant since, relative to their level of economic development, almost all East Asian economies have underdeveloped financial systems. The large financing needs for infrastructure and housing make improving domestic financial services even more necessary. Lowering and removing barriers to trade in financial services is a sensitive topic in the region, however, because it has important macroeconomic and financial sector implications, possibly including lower profits for existing financial intermediaries.

Many countries are quite concerned about these effects and hence about the timing of further action to liberalize trade in financial ser-

Figure 18 Financial Sector Openness
Ranked from 1 to 5, with 1 most closed and 5 most open



Source: Claessens and Glaessner 1997.

vices.[9] Countries are also concerned about the effects on monetary policy and exchange rate management, out of fear of larger and more volatile capital flows.[10] At the same time, private market participants in these countries—particularly business users of financial services—acknowledge that outside pressures have led to much-needed deregulation of domestic financial systems. For example, in Korea the financial services liberalization triggered by accession to the Organization for Economic Cooperation and Development (OECD) is expected to raise the quality and lower the cost of financial services.

The internationalization of financial services is best seen as part of a general, broader process of financial deregulation. Over the past several decades many East Asian economies have significantly deregulated their markets for financial services. Research on the relationships between financial market liberalization and economic development indicates that liberalization of financial systems is a major factor in economic development—but one that requires careful sequencing and management (see Caprio, Atiyas, and Hanson 1994 for developing countries and OECD 1996 for industrial countries).

East Asia lags behind comparator countries in financial deregulation and generally has less developed financial systems. The internationalization of financial services can bring sizable benefits because it can speed up institutional development. And even though it also creates risks and raises concerns, many of these concerns are of a political rather than economic or financial nature. If these political economy issues can be overcome, further internationalization of financial services should occur and generate significant net benefits.

5
Conclusion

Throughout East Asia, improving the functioning and furthering the development of the financial sector is of major interest. Nonperforming loans have been building up. Some countries are facing financial crises and currency adjustments. Governments must decide whether to support illiquid and insolvent banks. And countries increasingly recognize that efficient banking systems are essential to a market economy. To achieve better banking systems, countries must overcome structural weaknesses and reconsider the state's role in the financial sector. Specifically, the role of the state should evolve from controller to supporter.

Although the region's equity markets have developed rapidly in recent years, bond and other securities markets have lagged. All East Asian economies need to develop these markets to mobilize long-term funds for financing infrastructure and other long-term investments, including housing. Furthermore, rapid structural changes in the real economy are requiring stronger corporate governance, for which securities markets will be important.

The internationalization of financial services is of regional importance because many countries maintain significant entry barriers to foreign providers of financial services. Some have capital controls in place as well. Recent experiences in Latin America and elsewhere have shown that deregulation of emerging economies can be usefully accompanied by internationalization of the banking industry. Internationalization of trade in financial services, coupled with parallel efforts to liberalize domestic financial systems, should significantly improve the region's financial systems. As a result East Asian economies will become more competitive, as macroeconomic stability is enhanced and economic growth is increased through a more efficient allocation of domestic and foreign savings.

Notes

1. Besides these three key areas, almost all East Asian countries have large poor populations that have trouble gaining access to credit and financial services. Although beyond the scope of this book, these issues should constitute part of the financial sector development agenda in East Asian countries.

2. The role of stock markets is multifaceted. Recent work summarized by Levine (1997) indicates that the most important role of these markets is to permit economic agents to augment liquidity and diversify risks.

3. New systems have allowed the creation and use of highly complex new financial products. Technological developments have eroded barriers within financial systems. Technological advances and the progressive elimination of official barriers to capital flows have also spurred an enormous increase in cross-border financial transactions and activities and rapid growth in international financial markets. As a result linkages among financial markets have been greatly strengthened, and financial conditions in individual countries have become more sensitive to developments in external markets (for a review of issues for developing countries, see World Bank 1997a).

4. The most prominent are Chile, Cyprus, Fiji, Malaysia, Singapore, South Africa, and Zimbabwe. Although several Arab countries (Egypt, Jordan, Morocco, Tunisia) have contractual savings sectors ranging from 20 to 30 percent of GDP, most developing countries in Africa, Central and East Asia, Eastern Europe, and Latin America have underdeveloped contractual savings sectors.

5. Experiences in Latin America and other regions suggest that creating a supportive policy and institutional framework is key to private provision of infrastructure. Thus creating a pool of bankable projects requires political will and aggressive policy and institutional reforms that develop competitive market structures, sound regulatory regimes, price reforms, risk mitigation measures, and competitive and transparent contracting procedures. Some countries, however, are reluctant to move to a more transparent system.

6. This would in principle put foreign institutional investors at a disadvantage. They may still be interested in buying equities even without control, however, because the diversification and return tradeoff is better for foreign investors then for domestic investors.

7. In part, this will be a measurement problem: because market capitalization owned by outsiders—which is tradable—is far less than total market capitalization, measures like the ratio of turnover to market capitalization will be biased downward. La Porta and others (1997) make a correction to total market capitalization by subtracting the value of equity held by insiders. For most East Asian countries this correction amounts to half of market capitalization, and for

the Philippines it amounts to much more. Thus the turnover ratios would be underestimated by half or more.

8. The degree of entry by foreign financial services firms varies among East Asian countries. Some have been relatively open (for example, Indonesia's joint ventures in banking), while others have been quite closed until recently (Korea). Still, countries in the region are more closed than other developing countries and are often singled out by industrial countries as being closed to foreign providers of financial services (see, for example, Securities Industry Association 1997).

9. Some East Asian countries feel that the pressures from other countries to open up do not fully take into account the special economic issues facing developing countries.

10. Although this is not entirely a financial services liberalization issue but rather a capital account liberalization issue, financial services liberalization (including cross-border provision of services and liberalization of the currency denomination of financial products offered) will require a further dismantling of the significant capital controls in some countries.

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