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**The Future of Capital Markets in East Asia:
Implications for China's Equity Markets**

by

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**China's Market Reforms
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**"The Future of Capital Markets in East Asia: Implications for
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Introduction

This paper examines the experience of East Asia: how its economies have used their financial systems to finance the most phenomenal development and growth the world has witnessed. The lessons here are important, particularly for Mainland China in its development towards market-based capital markets.

This paper focuses on three issues: -

First, what factors have shaped Asian capital markets?

Second, Are Asia's capital markets fulfilling their functions well? And

Third, if not, what needs to change?

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Asian capital markets were developed pragmatically rather than on a clear theoretical path, as part of the mercantilist approach to opening up. Although the financial sector policies were initially spectacularly successful, the Asian financial sector model did not change fast enough with the times, did not pay enough attention to the demographic implications of its financial markets and is currently paying the price of these mistakes.

What Factors Shaped Asia's Capital Markets?

It is important to realise that finance is a derivative of the real sector. Financial systems and services are shaped by the nature of economic activities, and as the Asian crisis has shown, they can also amplify real sector weaknesses.

In the pre-war colonial era, several colonial banking systems comprised largely foreign banks that were geared more to international trade than to domestic financing needs. The banks were part of the colonial trading system that recycled liquidity from colonies which supplied commodities to the "mother country", which in turn re-exported manufactures to the colonies. Any colonial balance of payments surplus was re-invested in the London capital market, and re-cycled back to the colonies in the form of colonial investments (FDI), Sterling loans, and British investments in plantations, mines and trading companies. Foreign exchange reserves were invested largely in silver, gold, or deposits of mainly European banks.

In the post-war period, nationalist financial systems emerged to serve the national strategy of export-led growth and catching-up development. The Japanese mercantilist model became the lead model for post-colonial Asia. This model operated on "mild financial repression", which used the domestic banking system to provide subsidized financing to domestic industries and services engaged in competitive manufacturing export sectors². The banks

² See World Bank, "The East Asian Miracle – Economic Growth and Public Policy", Washington DC, Oxford University Press, 1993

paid positive real deposit rates and since exports turned out to be profitable business in a world of rising trade, Asian banks benefited from the foreign exchange business.

This successful financing model led to a bank-dominated financial system, as ruling elites and governments realized the importance of finance in promoting development. Critics during the Asian crisis drew attention to how ruling elites also sought to control banks in order to direct bank lending to themselves, family and friends. In recent years, regulators have sought to prohibit such lending abuses.

With the end of the war, some newly independent countries nationalised their banks, giving the state control over financial resources to implement the national policy of “planned catching-up development”. The banks initially focused on providing foreign exchange and trade finance, but rapidly became important housing and infrastructure finance institutions. This policy-based lending retarded development in the equity and bond markets as “planners” were more inclined to exercising control over bank lending than developing markets as the engine of growth. Indeed, bond financing was not a priority, since emerging Asia had a young population, rising household savings and enjoyed overall fiscal surpluses. Retirement funds were mainly state-sponsored, and given the young population the retirement funds were normally used to finance fiscal needs. The insurance sector comprised mainly state and foreign firms. The securities markets tended to be speculative, which reinforced ownership and control by the ruling elites.

Today, Asia is still dependent on bank financing (Chart 1). Is such financial system suited for Asia’s future development? My view is that Asia’s economic success was built on an imbalanced growth strategy. This imbalanced growth approach is increasingly unsustainable in a globalised environment, so that it calls for a re-thinking of the “finance for development or growth” strategy.

Chart 1

Asia still Dependent on Bank Financing (% of GDP)

	Bank Assets		Equity Market		Bond Market	
	1998	2001	1998	2001	1998	2001
China	139	160	25	45	12	28
Hong Kong	214	215	206	313	32	28
India	69	133	24	26	21	28
Japan	145	139	64	55	101	153
Korea	233	233	35	46	53	67
Singapore	220	243	112	135	20	41
Taiwan	226	262	97	104	41	20
Thailand	176	134	30	32	23	39
Germany	273	155	51	58	97	90
US	65	63	158	136	141	148

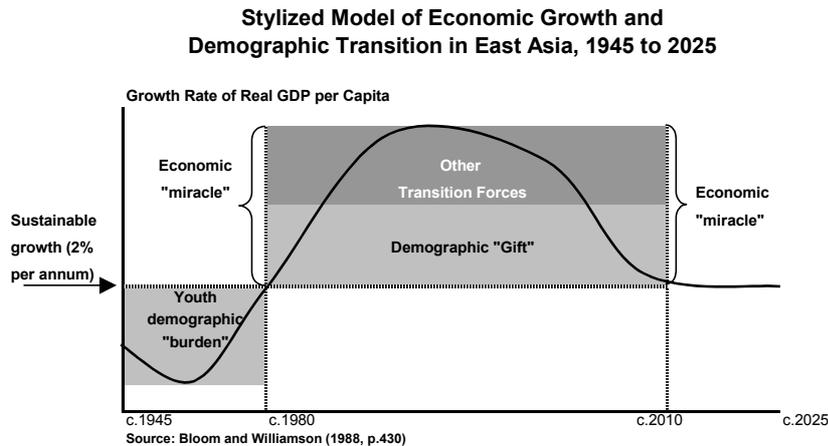
Remark: *1999 figure
Sources: FIBV, CEIC, Bloomberg, various central banks and government websites

East Asian economies started with many advantages: low wage and surplus labour, stable political environment with an educated elite, high savings rate and prudent fiscal management, demographic endowment of a young labour force (Chart 2), and declining trade barriers that opened up export opportunities.

For example, China's high growth period can be attributed to its demographic endowment of a young and well-educated labour force, since China has the same demographic profile as Japan in 1975, when Japan was going through its high growth period.

Chart 2

Demographic Endowment to East Asia



Source: Jeffrey G. Williamson, *Demographic Shocks and Global Factor Flows*

These structural competitive advantages enabled the lead Asian growth economy, Japan, to pursue a “flying geese” dualist mercantilist model that is characterised by a highly efficient export sector open to international competition that is financed partly by the protection of domestic natural resources, services and financial sectors. The system is strongly influenced by a mercantilist “fish-trap” mentality that welcomes the inflow of capital (FDI and FPI) but restricts or delays the outflow of capital by imposing capital controls or liberalizing very slowly capital account transactions by its residents.

This model of development served Japan and Asian economies well in their early stages of development. However, such “finance for development” mindset accorded little importance to the protection of property rights as the foundation both for the development of financial markets and their efficient functioning. This is a weakness of the model that has extracted a high cost on these economies that may have to be borne in later generations.

The bank-dominated financial systems of Asia which have been subject to varying degrees of government direction and influence in pursuit of growth, and its relatively under-developed capital markets are not equipped to deal with the demands of (a) need for risk capital, and (b) aging demographics and (c) serving as

stewards of corporate governance to assist in the structural changes that are necessary for improving their overall competitiveness.

Banks in Asia are currently flush with liquidity, but they are generally wary of financing high-risk ventures after the bad-debt lessons of the Asian crisis. Asian governments have not been successful in developing private equity capital and venture capital funds in their markets. The Asian financial system will not be serving Asia well if over the long term, savings are being accumulated in those banks with high NPLs, low-yielding bonds and over-priced equities with low dividend yield.

Asian economies have generally neglected to prepare for the needs of an aging population for efficient retirement schemes. North Asia is aging with slowing growth, thus requiring real returns and cash flows from their retirement funds.

- For example, McKinsey studies estimate that Japan's retirees are expected to equal the number of working adults by 2051, compared to four working adults supporting one retiree in 2001 and a ratio of 2:1 by 2021. This reflects the expected decline in population from 125 million in 2000 to less than 115 million by 2020.
- Consequently, Japan's pension and health insurance systems are expected to record a combined annual deficit of about \$300 billion, more than twice the total annual government deficit in 2002³.
- Employee pension funds in Japan cover on average only 62% of the payments they need to pay their pensioners, compared with 103% in US and 98% in UK⁴.

It is also unfortunate that some Asian economies have used retirement funds as an option to fund the rescue of failed corporations and in meeting fiscal deficits. Given currently highly

³ TAB Bowers, Gregg Gibb, Jeffrey Wong and McKinsey members, "Banking in Asia: Acquiring a Profit Mindset", 2nd edition, Wiley Finance, Exhibit 1.4 and page 38.

⁴ Greenwich Associates, quoted in Financial Times, "Funding Gap in Japanese Pensions", 9 September, 2003.

priced bonds and equity (i.e. low yields), the future retiring generation may have to bear the cost for the current generation's policy mistakes.

The younger Asian economies therefore should re-examine the above policies. Given the demographics of younger population, there is some time for economies such as Mainland China to develop deep and well-diversified retirement institutional funds. The whole idea is to develop a strong base for the development of an institutional savings market, rather than a pool of funds subject to government influence and direction. This is an important missing link that would help improve the liquidity of bond and equity markets. At the same time, institutional investors can play a key role in strengthening risk management and corporate governance of companies that raise capital from the markets.

Rethinking Asia's Growth Strategy

Globalisation, technology and WTO have exposed weaknesses in the Asia "imbalanced growth strategy". First, abundant labour from China and India has made the old cheap labour export model less viable. Second, the WTO process and the IMF push for a sequenced financial liberalisation have increased the pressures for market opening, and hence competition in both trade and financial services. Moreover, the pent-up domestic liquidity from "fish-trap" policies created domestic credit and stock market bubbles that resulted in large NPLs, exposing domestic inefficiencies in the protected and non-tradable sectors. Last but not least, it has highlighted the plight of an aging population whose savings are highly exposed to market and credit risk that is increasingly getting the attention of policy makers on the need to protect the real value of retirement savings.

It is clear that there is a need to rethink the benefits and costs of "finance for development". The Asian financial crisis and losses are the inevitable costs of the "imbalanced growth strategy". Extracting resources from savers to subsidize growth and infrastructure may be appropriate during the "catching-up" growth phase of emerging markets. But globalisation has exposed the

protected and inefficient sectors and marked them to the global competitive market and to global standards. NPLs and quasi-fiscal deficits are actually manifestations of the inefficiencies of the Asian economies, as they are marked to market, using increasingly international accounting and disclosure standards.

We can attribute NPLs and financial crisis to four factors. First, there is the lack of clarity of property rights in some markets. As state owned systems move towards the market, it is vital that the property registration, transaction and enforcement infrastructure be built in tandem. This includes the accounting, legal, judicial and enforcement professions and institutions, together with the standards, codes and rules and regulations that define and protect property rights. Lack of clarity in such rights would increase market transaction costs, allow corruption and stealing of state assets to occur, erode the creation of a credit culture, and prevent banks from effectively recovering their debts quickly and efficiently.

Second, there is a failure or inertia to restructure the financial system during the high growth period by using resources from the growth to write off inherent losses/inefficiencies. In other words, Asia should have used the gains from its successful growth story to re-write the national balance sheet and clean up the financial system of NPLs and restructure the property rights infrastructure based on a more balanced growth strategy.

Third, because of the imbalanced growth strategy, the Asian economies are prone to periodic speculative bubbles in asset prices, which the bank-dominated financial system somewhat fuels in a pro-cyclical manner.

Fourth, the failure to simultaneously restructure the corporate or enterprise sector that absorbs the bulk of financing for growth. National economic efficiency depends on the efficiency of the enterprise sector, complemented by the efficiency of public sector infrastructure and health, security, regulatory and competitive policies. In those economies which are transiting from a state-owned system to a market system, the transition itself requires

careful sequencing of reforms in the corporate governance of both private and state-owned enterprises, the creation of strong property rights (protecting) infrastructure, and also reforms in the tax and financial structure.

Addressing the NPL problem at all four levels is needed in order to break the cycle of NPLs. This is not easy, because the fiscal cost of restructuring the banking or financial system is not small, as it costs some Asian crisis economies as much as 50% of GDP to resolve. There is a clear policy need to split the commercial functions of the banking system from its social welfare functions, which is rightly the burden of the fiscal budget. Without attention being paid to creating a strong credit culture that assesses credit applications based on sound market principles, backed by a legal and accounting infrastructure, that exercises credit discipline, the banking system cannot perform its role in the efficient allocation of capital to enable the economy to sustain growth and prosperity.

Wither Financial Development?

In hindsight, not much has changed in the global financial order. Asia continues to run persistent balance of payments surplus in its trade with American and European markets. Surpluses are held in US and EU securities, and the funds flow back to Asia in the form of FDI and FPI. In other words, New York and London serve as essential financial centres for surplus Asian savings. This has certain risk management benefits, because Asian financial centres have not been able to recycle these surplus savings effectively within the region.

There are fundamental differences between these Anglo-Saxon financial centres and the Asian financial centres, which are characterized by the depth of the institutional market. In commenting on the lack of depth of debt and derivative markets in Asia, fund managers have lamented on the lack of institutional depth. In other words, there are not more than a handful of large fund managers (many government related) in each of the Asian financial centres, whereas in both London and New York, these number in thousands. Tokyo has large institutional funds, but

these tend to behave more in line with either corporate or government interests.

Institutions and Functions of Capital Markets

Hence, for Asia to deepen its capital markets, with the full range of money, equity, debt and derivative markets, a whole range of institutional and financial services has to be built up. Indeed, other than perhaps Hong Kong and Singapore, which are still relatively small compared with London and New York, the other Asian financial centres function largely as domestic financial centres.

Well-functioning capital markets are supported by strong institutions, backed up by high quality service firms, such as accounting, law and information services. The essential elements of the institutional framework can be represented by six “I’s” and an “E”. They are accurate, timely and accessible *information*, properly aligned *incentives*, educated *investors*, efficient *intermediaries*, strong *issuers*, efficient and robust *infrastructure*, and strong prudential framework with *enforcement*. None of these can be built overnight, but the Mainland has the size of market to achieve critical mass for these institutional funds and intermediaries to be developed. In addition, it has all the skills and infrastructure in Hong Kong to support its financial sector development in that direction.

It has to be recognized that the service sector is essentially a sector to transact, delineate and protect property rights of the real sector. For example, Mainland China has only 28% employment in the service sector, compared with 70% in the US, France, UK, Singapore and Hong Kong. The corollary to this is that a financial system is actually a system to transact and protect property rights of all participants over the whole demographic cycle!

How have the financial markets in Asia fared in discharging these roles?

We can answer this question by assessing this against the four functions of capital markets:

- Resource Allocation - allocating resources efficiently to maximize welfare
- Price Discovery - generating transparent price signals consistent with efficient use of resources
- Risk Management - encouraging good risk management that diversifies losses and profits
- Corporate Governance - promoting sound corporate governance that provides proper incentives for enterprises as well as financial intermediaries.

Resource allocation

The Asian “finance for growth” policy means that resource allocation is “policy or state-directed”, whereby the protected banking system channels resources to “priority sectors” such as exports, industrialization and infrastructure. Even IPO policy can be used to help “priority sectors”, protect SOEs, and allocate “rents”. For example, in a study by Chun Chang⁵, family-controlled chaebols, used as vehicles of Korean export industrialisation policy, enjoyed negative real interest rates or below curb market rates of 40% in the 1960s and 1970s. The highly diversified structure of chaebols included unrelated industries. Profitable affiliates extended loans to loss-making affiliates to keep the entire group afloat.

It has not been uncommon in Asia for funds to be poured into selected industries to achieve “market share growth”, irrespective of profitability. The result of “finance for growth” policy is a distortion in the allocation of resources across sectors, giving preference to the interest of enterprises over that of savers.

Persistent current account surplus as a policy objective can result in an excessive build-up of domestic liquidity. Delayed capital account opening can trap excessive liquidity in domestic

⁵ Chun Chang, The Informational Requirements of Financial Systems at Different Stages of Economic Development: The Case of South Korea

financial markets. A lack of credit culture and heavy reliance on collateral-based lending, coupled with such excess liquidity have fuelled periodic bubbles in Asian property and stock markets.

Too much focus on short-term growth with little regard for profitability of investment over the whole demographic cycle has created distortion in resource allocation across generations. Too much savings are concentrated in Asian banking systems: 80 - 140% of GDP, compared with 60% in US. Asian financial systems' bias in favour of state and enterprises has been at the expense of savers and investors. For example, NPL resolution cost up to 50% of GDP in Asian crisis economies, representing a huge waste of savings as the resolution, ultimately, is funded by savers through either the growing public sector debt burden and/or lower interest rates. In other words, the high-savers and taxpayers ultimately pay for the policy mistakes and excessive debt of the corporate sector.

The point here is that given the different demographic structures across countries and as funding needs change over the demographic cycle, there is a need for cross-country and cross-generation investment of retirement funds to minimize the risks of investments.

Price discovery

Asia generally maintains an openness to trade, thus enjoying stable prices for traded goods at competitive global prices. Hence, there has been generally little consumer price inflation in Asia. But capital controls and supply distortions associated with lending and listing rules distorted key financial prices. The cost of such mispricing of risks is that large amounts of Asian savings can be poured into inefficient investments. Asian economies are still ploughing huge amounts into fixed investments and real estate that yield low returns.

For example, lending rates are low relative to risks as indicated by the banks herding to provide cheap loans that have fuelled property bubbles. Moreover, bank credit risk has not been properly priced: from Japan to Indonesia, bank spreads of 1.5-2 %

(average lending rate less deposit rate less administration costs, before provisions) when NPLs are running at levels of between 10-50% of total assets mean that many banks are inherently not pricing risks adequately. Moreover, bond spreads have also recovered close to or below pre-Asian crisis levels, mainly because there are too many buyers (i.e. savings) relative to low supply of high quality Asian bonds.

In the equity market, price distortion is reflected in the tendency for high PE ratios (Chart 3) relative to global norms. A structural feature of many Asian markets is the small free float that inherently fuelled stock prices. In Japan, PE ratios of many stocks remained around 80, even as the Nikkei 225 plunged from 38,000 to 10,000. Japanese accounting standards are only recently converging to IAS. Mainland China's PE ratio peaked around 60 in 2001 and is now down to 30+, but two-thirds of the stock market capitalization remains in the hands of non-tradable state or legal shares, which account for the high PE ratios.

High PE ratios reflect that the cost of funds to Asian corporations is low, while the high price tends to deter hostile takeovers. The illiquidity of listed stocks in Asia, due to the low float, is also deterring major players in the global fund management market from participating in Asian markets, since total Asian market capitalization ex-MSCI weighting is only 13% (4% excluding Japan), compared with 55% for the US and 17% for Europe.

Risk management

The Asian crisis demonstrated that there was a lack of risk diversification as Asian savings were concentrated in the banking system and residents were not encouraged to hold foreign assets. This was compounded by the high moral hazard risk created through the provision of explicit or implicit deposit insurance that allowed NPLs to grow while banks maintained relatively low capital. In general, late capital account liberalization means that retail and institutional investors lack the ability and experience to invest abroad to diversify domestic risks. Volatile exchange rates

have also deterred retail investors from managing their concentration risks through overseas portfolio diversification.

Chart 3

Capitalization and Turnover of Major Markets

(end Aug 2003, US\$ bn)

	<u>Market</u> <u>Cap</u>	<u>change over</u> <u>Aug 02</u>	<u>Market</u> <u>Turnover</u>	<u>change over</u> <u>Aug 02</u>	<u>P/E</u> <u>ratio</u>
Australia	473	25.5%	328	16.4%	26
China	487	-13.3%	348*	-5.1%	36
Hong Kong	592	24.4%	208	-1.1%	17
India	178	36.7%	138*	19.5%	14
Indonesia	42	34.7%	11	-10.4%	7
Japan	2,560	10.2%	1,622	0.6%	21
Korea	268	30.5%	445	-23.5%	11
Malaysia	153	12.2%	34	-4.1%	16
Philippines	21	2.1%	2	-33.4%	22
Singapore	129	14.8%	65	-8.8%	21
Taiwan	331	23.1%	560	-13.1%	44
Thailand	73	57.0%	48	14.8%	9
Germany	840	6.7%	1,147	-9.9%	n.a.
UK	2,008	7.7%	3,455	-16.3%	17
US	12,517*	11.3%	15,925*	-14.3%	21

Remarks: Turnover - for the 12 months ending Aug 2003, P/E ratio - end Aug 2003 * end Jul 2003
P/E ratio for China is the weighted average of A and B shares markets
Data for India includes only those from National Stock Exchange of India Limited

Sources: FIBV and websites of various exchanges

By definition, imbalanced growth meant weak risk management. By concentrating on “priority sectors”, for example high-tech industries, policy makers never developed a national risk management strategy to assess risk concentrations, diversify sources of financing and growth, and build domestic capacity for absorbing internal and external shocks. From a simple Modigliani-Miller concept of risk diversification, the correct strategy for all surplus economies is not to put all resources in one basket – the domestic economy. There is a need to ensure that national debt management (including private debt, as excessive Korean private external debt demonstrated) must be coordinated with national external reserves management policy, as well as exchange rate policy, to minimize national risks.

Corporate governance

Last but not least, the foregoing weaknesses in Asian financial markets reflect also the failure of financial markets to check against poor corporate governance. In the more developed markets, banks,

investment banks, insurance companies and fund managers play an important role in strengthening corporate governance of companies they lend or invest in. However, in many parts of Asia, the protection of domestic interests such as the legal and accounting professions, as well as restricted entry of foreign financial institutions, delayed corporate governance reforms. One consequence is that the accounting, auditing and disclosure standards and practices were inadequate to act as checks and balances in preventing poor corporate governance.

We need to appreciate that the health of the financial sector depends first and foremost on healthy corporate and household sectors. So far, consumer lending has not been a major problem because of the relative low indebtedness of the Asian household sector⁶. But as bank restructuring experience in East Europe demonstrated, former state-owned banks had at least three cycles of non-performing loans. The first cycle was the writing off of the legacy of state-planning loans to state-owned enterprises (SOEs). The second cycle was new loans to newly commercialised SOEs, and the third cycle was new loans to the emerging private enterprises. This was all part of the lack of development of a credit culture at the bank level, and the lack of the clarity of property rights in the transitional economy, which allowed rents to be earned from tax evasion, appropriation of state assets and other extra-legal activities.

There is a possible fourth stage that some more advanced East Asian banking systems are going through. In the naive assumption that high interest credit card loans to consumers are highly profitable, recent experience in Korea and Hong Kong indicate that even highly competitive private and foreign banks can fall victim to high loan losses in these sectors.

There is also a need for banks to be able to take the necessary action to protect their rights against defaulting borrowers through

⁶ Some Asian banks are already finding losses in lending through credit cards.

effective bankruptcy or insolvency laws, as ultimately losses would be borne by depositors or taxpayers.

The advantage of letting in foreign institutional investors is that they are likely to be more stringent on imposing corporate governance standards and credit discipline on domestic borrowers. In many parts of Asia, regulators and state-owned banks alike have difficulties in enforcing discipline on state-owned enterprises or on politically connected enterprises. Hence, introducing foreign institutional players has an advantage in imposing stronger discipline on domestic players.

The other advantage of allowing foreign institutional players is the importation of global skills in financial product and risk management, as well as the training provided for locals to learn such skills. It is an old adage that “management that are part of the problem cannot be part of the solution”. In developing the domestic financial system to global standards, you have to use personnel that are familiar with global market practice and standards.

Large markets like Mainland China, which have over one million employees in the banking sector alone, would have difficulty developing in-depth management skills in banking, securities and asset management fast enough using domestic institutions alone. China’s opening up under the WTO would hasten the absorption of market discipline into commercial operations that, in turn, would lend greater support to the institutional infrastructure development that is needed for the protection of property rights. The change in mindsets to a truly market economy is critical for China to maintain its growth story.

Balanced Growth Strategy

In the long term, for Asia to sustain its growth and prosperity, there is a need to rethink its old model of development. In my mind, Asian economies have reached the stage of “middle growth”, when it must pursue a balanced growth strategy. What this means is that that we must treat national resource allocation using global

markets as a national risk diversification policy. In this context, the pursuit of comparative advantage means the mutual exchange of opportunities, the mirror image of which is the mutual exchange of risks.

Balanced growth calls for a level playing field that is supported by a balanced incentive structure, and most importantly a change in mindset.

Essentially, this means:

- Developing a mindset of level playing fields, across sectors, across boundaries and across generations;
- Opening up needs time, but not opening up builds up more risks;
- Getting the markets to price risks properly;
- Using markets to strengthen corporate governance, so that domestic firms can compete on a global basis; and
- Understanding that the financial market is a system to protect the property rights of all participants across the entire demographic cycle – not just during growth phase!

There are four areas that Asia needs to address with greater urgency if it wishes to remain in the game and enjoy sustainable growth and prosperity: strengthen corporate governance, lower transaction costs, protect property rights and adopt global standards.

Strengthen corporate governance

Essentially governance is about the contestability of markets and vested interests. But markets cannot be contested if:

- The state controls or directs banks and corporations in their lending and investment decisions, thereby absolving management of their accountability to market discipline;
- Foreign competition is restricted so as to protect weak domestic banks and companies;

- Vested interests are able to influence policies and block reforms; and
- Controlling shareholders can expropriate property rights of minority shareholders with impunity

Is Asia ready to allow entry of foreign intermediaries and professionals? Retention of entry barriers will not create the critical mass of competitive market participants that is essential for promoting a culture of good information, sound investment decisions, and quality markets.

Lower transaction costs

Transaction costs are the key barrier to financial development given that financial transactions are the exchange of property rights under conditions of uncertainty. The cost of making complete contracts is prohibitive, especially for innovative financial products. Hence, under such conditions of uncertainty, market participants rely on trust for the fulfilment of contracts. Such trust is critical for the development of financial products and markets, and reputable financial service providers that are willing to absorb residual risk of such contracts will attract more customers who are willing to pay a premium for certainty. In other words, such intermediaries can enjoy network effects.

Where property rights are unclear and there is a lack of effective institutions to protect such rights, the cost of financial transactions will be expensive, retarding financial development.

A key component of transaction cost is the effectiveness of the legal system. Whilst Asian economies are still struggling with modernizing corporate, securities and bankruptcy law, there is sufficient evidence to show that global fund managers are looking at markets where they feel that their legal and property rights are protected in a fair and expeditious manner. Capital flight, corruption, tax evasion, and extralegal usage of state assets are all symptoms of lack of clarity of property rights. They add to transaction costs of doing business. In a world where capital account mobility is increasing by the day, capital moves to where

there is high return, low transaction costs and greater certainty of protection of capital values.

Protect property rights

As mentioned earlier, I am convinced that NPLs are a manifestation of the lack of clarity in property rights, which cause bad corporate behaviour that lead to bad bank loans. Preliminary experience with the fraud and market misconduct of minying (private Mainland) enterprises listed in Hong Kong suggests that the strengthening of the property rights infrastructure – accounting, legal and information services, is a matter of priority.

A strong real sector creates wealth. But if the financial sector is weak it results in wealth destruction. The irony in Asia is that we have super Asian household savers who cannot afford to spend, as the value of their savings have eroded so that they have to save even more for their retirement.

Adopt global markets and standards

Global financial markets are a network of local markets, and are as strong as the weakest link. The EU and US today set standards for global markets. If one wants to be part of the global market, one has to play by global rules and standards.

For successful integration, Asia needs to adopt equivalent standards so as to ensure stable, orderly and fair markets. Inward looking strategies have retarded the competitiveness of emerging markets in trade and financial services. Asia can be free riders on these standards, and eventually contribute to their evolution.⁷

Conclusion

⁷ Andrew Sheng (2002), *The Future of Capital Market Development in East and South East Asia*, presented at the 10th SEC Thailand Anniversary Seminar: “How Can NBFIs Play a Greater Role in a Bank-based Economy”, Bangkok, Thailand

Asia has been a success story, flawed by an imbalanced growth model that has outlived its usefulness. Once we understand the importance of the financial sector as a system to protect property rights of all participants transparently and fairly over the entire demographic cycle, the need for continuous reform of the financial system and the real sector becomes obvious.

Irrespective of fast growth or slow growth, the issue really is that of preserving and enhancing value for the population. This simply means ensuring that the capital market fulfils effectively its crucial functions of resource allocation, price discovery, risk management and corporate governance. The Mainland Chinese market is fortunate that as a relative latecomer to financial sector development, it has all the lessons of the rest of Asia to draw upon.

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