

Rising to the Challenge in Asia: A Study of Financial Markets

Volume 3
Sound Practices

Asian Development Bank
P.O. Box 789
0980 Manila, Philippines

The views and opinions expressed in this publication are those of the individual authors
and do not necessarily represent the views of the Asian Development Bank.

Published by the Asian Development Bank

All rights reserved

Publication Stock No. 061299
ISBN 971-561-242-3

Foreword

The Asian currency and financial crisis has had far-reaching effects on the regional economies and their trading partners. These effects have threatened to wash away the region's significant social and economic advancement achieved during the preceding years of rapid growth. The crisis has also unveiled many intricate problems and challenges in macroeconomic management, banking and capital markets management, institutional capacity, and governance of the financial systems in the region.

Recognizing the urgency of addressing these problems and challenges, the Economics and Development Resource Center of the Asian Development Bank undertook a regional study of financial markets in nine developing member countries: People's Republic of China, India, Indonesia, Republic of Korea, Malaysia, Pakistan, Philippines, Thailand, and Viet Nam. The objectives of the study were to analyze and deepen the understanding of the sources of the crisis in currency and financial markets, to provide a useful basis for designing and implementing preventive measures and refocused country strategies, and to help the Bank and its member countries build robust and sustainable financial systems in the region.

The study was designed, supervised, and coordinated by S. Ghon Rhee, Resident Scholar, 1997–1999. A large number of Bank staff and renowned scholars and experts contributed to this study.

Regional policy issues and recommendations based on the findings of the study were discussed at the High-Level Workshop on the Asian Financial Crisis in Tokyo, on 25–26 March 1999. This workshop was hosted by the Bank, the ADB Institute, and the Institute of Fiscal and Monetary Policy of the Ministry of Finance of Japan.

The present series of publications seeks to bring the research findings to a much wider audience and hopes to contribute to a better understanding of the Asian financial crisis and how its recurrence can be prevented in the future.

Jungsoo Lee
Chief Economist

Preface

Rising to the Challenge in Asia: A Study of Financial Markets presents the findings of a study carried out under *Regional Technical Assistance 5770: Study of Financial Markets in Selected Member Countries*. Many Asian Development Bank staff members and outside experts contributed to the study's successful completion.

The core members for the study were Ramesh Adhikari, David Edwards, Tobias Hoschka, Sudipto Mundle, Soo-Nam Oh, Pradumna Rana, Yutaka Shimomoto, Reza Siregar, Peggy Speck, Ramesh Subramaniam, and Vo Van Cuong. The outside experts were Stephen Cheung (Hong Kong, China), Yoon Je Cho (Republic of Korea), Jang-Bong Choi (Republic of Korea), Catherine Chou (Hong Kong, China), G.H. Deolalkar (India), Maria Socorro Gochoco-Bautista (Philippines), Akiyoshi Horiuchi (Japan), Masahiro Kawai (Japan), Mohammad Zubair Khan (Pakistan), Joseph Y. Lim (Philippines), Sang-Koo Nam (Republic of Korea), Anwar Nasution (Indonesia), Edward Ng (Singapore), Jaeha Park (Republic of Korea), Mohd. Hafiah Piei (Malaysia), Ken-ichi Takayasu (Japan), Khee Giap Tan (Singapore), S. K. Tsang (Hong Kong, China), Stephen Wells (United Kingdom), Richard Werner (Germany), Min-Teh Yu (Taipei, China), and Barents Group LLC (KPMG).

Thirty-seven reports are contained in a series of 12 volumes:

Volume 1: Regional Overview

- Macroeconomic Policy Issues
- Banking Policy Issues
- Capital Market Policy Issues

Volume 2: Special Issues

- Asset Management Entities
- Deposit Protection Schemes

Volume 3: Sound Practices

- Corporate Governance (Hong Kong, China)
- Currency Board (Hong Kong, China)
- Central Provident Fund (Singapore)
- Dichotomized Financial System (Singapore)
- Banking Sector (Taipei, China)

Volumes 4–12: Country Studies

- Macroeconomic Policy Issues
- Banking Policy Issues
- Capital Market Policy Issues

The volumes benefited extensively from constructive comments from the Bank interdepartmental working group, and the ministries of finance, central banks, and securities and exchange commissions of the nine member countries that participated in the regional technical assistance study program and in the High-Level Workshop on the Asian Financial Crisis in Tokyo, on 25–26 March 1999. Mitsuo Sato, former President of the Asian Development Bank; Bong-Suh Lee, former Vice-President (Region West); and Peter Sullivan, Vice-President (Region East) provided strong support and guidance throughout this project.

Soo-Nam Oh coordinated the research and publication activities. Wilhelmina Paz, Lagrimas Cuevas, Anthony Ygrubay, Ruben Mercado, Virginia Pineda, and Rosalie Postadan provided administrative and technical support. The volumes were edited by Gloria Argosino, Mary Ann Asico, Graham Dwyer, and Muriel Ordoñez. Typesetting, computer graphics, and conceptualization of the cover design were done by Segundo de la Cruz, Jr.

S. Ghon Rhee

K. J. Luke Chair of International Finance and Banking
University of Hawaii
Resident Scholar of the Asian Development Bank
(June 1997–June 1999)

Contents

<i>Foreword</i>	iii
<i>Preface</i>	v
<i>Acronyms and Abbreviations</i>	x
Corporate Governance in Hong Kong, China: Rising to the Challenge of Globalization	1
<i>Stephen Y. L. Cheung</i>	
INTRODUCTION	2
STATE OF CORPORATE GOVERNANCE	2
Characteristics of Firms	2
Regulatory Framework	3
PROBLEMS ENCOUNTERED AND MEASURES UNDERTAKEN	6
Ensuring Independence of Management	6
Disclosure and Transparency	7
Financial Disclosure of People's Republic of China Companies Listed on the Stock Exchange of Hong Kong, China	8
MAJOR CASES OF POOR CORPORATE GOVERNANCE	9
The Peregrine Case	9
The CA Pacific Securities Case	10
POLICY RECOMMENDATIONS	11
PROSPECTS FOR THE ENHANCEMENT OF CORPORATE GOVERNANCE	12
APPENDIX	15
NOTES	17
REFERENCES	17
The Currency Board Arrangement in Hong Kong, China: Viability and Optimality Through the Crisis	21
<i>Shi-ki Tsang</i>	
SUMMARY	22
Overview	22
The Currency Board Arrangement in Hong Kong, China	22
Technical Assessment	23
Economic Optimality	24
Relevance of Hong Kong, China's Experience for Asia	24

TECHNICAL FEASIBILITY AND OPTIMALITY: AN OVERVIEW	25
Currency Board Arrangements: Three Anchors for Fixing the Exchange Rate	25
Economic Optimality of Fixing the Exchange Rate Through a Currency Board Arrangement	27
THE CURRENCY BOARD ARRANGEMENT IN HONG KONG, CHINA	27
How the System Began	27
Initial Operations of the Link	28
Toward the Establishment of a Central Bank	30
The Strengthening of the Market Exchange Rate in the 1990s	31
The Real-Time Gross Settlement System	32
The Monetary Base and the Currency Board Arrangement	33
Autopilot(?) Developments after the October 1997 Attack	35
TECHNICAL ASSESSMENT	37
Vulnerability, Strength, and Uniqueness of the Currency Board Arrangement	37
Cash Arbitrage as a Nonstarter	37
The Argentina, Estonia, Lithuania Model of a Convertible Monetary Base	38
Reservations about the Argentina, Estonia, Lithuania Model	40
Overall Comments on Technical Feasibility	42
ECONOMIC OPTIMALITY	42
Williamson's "Four Virtues and Seven Vices" of Currency Board Arrangement	42
The Economics of Small Open Economies: Fixed versus Floating Exchange Rate	44
Growth and Inflation in Hong Kong, China	45
Inflation and Asset Price Bubbles	46
Overall Comments on Optimality	48
RELEVANCE OF HONG KONG, CHINA'S EXPERIENCE FOR ASIA	49
Hong Kong, China's System as an Idiosyncratic Currency Board Arrangement	49
Can Hong Kong, China's System or the Argentina, Estonia, Lithuania Model Be Imitated?	49
Indonesia as an Example	50
NOTES	52
REFERENCES	52
Central Provident Fund in Singapore: A Capital Market Boost or a Drag?	55
<i>Edward Ng</i>	
A BRIEF HISTORY	56
Central Provident Fund as a Financing Tool	56
CHANGES IN THE CENTRAL PROVIDENT FUND SCHEME	57
THE CENTRAL PROVIDENT FUND SCHEME AND THE DEVELOPMENT OF THE GOVERNMENT BOND MARKET	59
ISSUANCE OF GOVERNMENT SECURITIES	60
The Secondary Market and Trading System	62
Holdings of Singapore Government Securities	62
Turnover of Singapore Government Securities	62

THE CENTRAL PROVIDENT FUND SCHEME AND THE DEVELOPMENT OF THE EQUITY MARKET	64
Government Philosophy on Risky Investments with Central Provident Fund Savings	65
Central Provident Fund-Approved Investment Schemes	66
Impact of Central Provident Fund-Approved Investments on Trading Volume and Prices	68
MACROECONOMIC POLICY IMPLICATIONS OF THE CENTRAL PROVIDENT FUND'S ROLE	68
CONCLUSION	69
APPENDIXES	72
NOTES	80
REFERENCES	80

Singapore's Dichotomized Financial System	81
<i>Tan Khee Giap and Chen Kang</i>	

SUMMARY	82
THE MACROECONOMIC CONTEXT AND ITS EFFECT ON FINANCIAL SECTOR POLICIES	84
THE DICHOTOMIZED FINANCIAL SYSTEM AND ITS EVOLUTION SINCE THE 1960s	85
Contribution of Financial and Business Services to Economic Growth	87
The Dichotomized Financial Structure: Conceptual Framework and Rationale	90
The Dichotomized Financial Sector: A Performance Review	91
A Two-Tier Financial Entity: The Domestic Banking Unit vs. the Asian Currency Unit	92
Regulatory Rules	95
Prudential Safeguards	98
The Dichotomized Financial System: Issues and Policy Implications	104
Management and Transmission Mechanism of the Singapore Dollar	104
Trade Competitiveness and Current- and Capital-Account Liberalization	107
Domestic Banking Unit vs. Asian Currency Unit: A Flow-of-Funds Analysis	112
Noninternationalization of the Singapore Dollar and Its Implications	120
Some Popular or Persuasive Arguments for Internationalization	123
Rules of the Game and the Role of Financial Institutions	125
CONCLUDING REMARKS: SOME OBSERVATIONS AND LESSONS	127
APPENDIXES	130
REFERENCES	139

Banking Environment and Reform Measures of Taipei, China During the Asian Financial Crisis	141
<i>Min Teh Yu</i>	

INTRODUCTION	142
FINANCIAL INSTITUTIONS	143
Banking Institutions	144
Nonbanking Financial Institutions	150

CURRENCY RISK OF BANKS	151
Foreign-Exchange Market Development and Recent Changes	151
SUPERVISION AND EXAMINATION	153
Deposit Insurance System	153
BANKING BUSINESS ENVIRONMENT	156
Asset and Liability Management Standard for Most Banks	156
RECOMMENDATIONS	162
Close Insolvent Institutions Immediately	162
Convert Community Financial Institutions Into Commercial Banks	163
Institute a More Accountable Regulatory Framework and Transparency of Information	163
Privatize Government-Owned Institutions	163
Deal with the Problem of Lack of Confidence	163
Check Government Guarantees	163
Develop Regional and International Economic Coordination	164
REFERENCES	165

Acronyms and Abbreviations

ACU	Asian currency unit
ADM	Asian dollar market
AEL	Argentina, Estonia, Lithuania model
AES	Approved Education Scheme
ALCO	asset-liability management committee
ALM	asset-liability management
ANRPS	Approved Nonresidential Properties Scheme
ARPS	Approved Residential Properties Scheme
ASEAN	Association of Southeast Asian Nations
BCCS	Board of Currency Commissioners, Singapore
BIS	Bank for International Settlements
BIS	Basic Investment Scheme
BOT	build-operate-transfer
CAMEL	capital adequacy, asset quality, management, earnings, and liquidity
CBA	Currency Board Arrangement
CBC	Central Bank of China
CDC	China Development Corporation
CDIC	Central Deposit Insurance Corporation
CDP	central depository
CEO	chief executive officer
CI	certificate of indebtedness
CMU	Central Moneymarket Unit
CPF	Central Provident Fund
CPFAIS	Central Provident Fund-Approved Investment Scheme
CPFIS	Central Provident Fund Investment Scheme
CPI	consumer price index
CRPRS	Call Report Percentile Ranking System
CSFC	Committee on Singapore's Financial Competitiveness
CSRC	China Securities Regulatory Commission
DBU	domestic banking unit
DCB	domestic commercial banks
DSPI	domestic supply price index
DITIC	Dalian International Trust and Investment Company
DvP	delivery versus payment
EC	effective cost
EDI	electronic data interchange
EDRS	Examination Data Rating System
EIS	Enhanced Investment Scheme
EMU	European Economic and Monetary Union
FCGF	Farmers Credit Guarantee Fund
FSRG	Financial Sector Review Group
GDP	gross domestic product

GIC	Government Investment Corporation
GITIC	Guangdong International Trust and Investment Corporation
GLC	government-linked companies
HDB	Housing and Development Board
HIBOR	Hong Kong interbank offered rate
HKAB	Hong Kong Association of Banks
HKMA	Hong Kong Monetary Authority
HKSA	Hong Kong Society of Accountants
HPIS	Home Protection Insurance Scheme
HSBC	Hongkong-Shanghai Banking Corporation
HUDC	Housing and Urban Development Company
IAS	International Accounting Standards
ICBC	International Commercial Bank of China
IFIEWS	Insured Financial Institutions' Early Warning System
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commission
IPO	initial public offering
ISA	International Standards on Auditing
ITIC	international trust and investment company
JTC	Jurong Town Corporation
LAF	liquidity adjustment facility
LIBOR	London interbank offered rate
LOLR	lender of last resort
M&A	merger and acquisition
MAS	Monetary Authority of Singapore
MCB	minimum cash balance
MINDEF	Ministry of Defense
MNC	multinational corporation
MOF	Ministry of Finance
MSS	Minimum Sum Scheme
MTI	Ministry of Trade and Industry
NBFI	nonbanking financial institution
NC	nominal cost
NCD	negotiable certificate of deposit
NDF	nondeliverable forward
NEER	nominal effective exchange rate
NER	nominal exchange rate
NFIEWS	National Financial Institutions' Early Warning System
NIB	note-issuing bank
NIE	newly industrialized economy
NIWM	note-issuance and withdrawal mechanism
NPL	nonperforming loan
NRPS	Nonresidential Properties Scheme
NT	New Taiwan
OBSA	off-balance-sheet activities

OBU	offshore banking unit
OECD	Organization for Economic Cooperation and Development
OECDF	Overseas Economic Cooperation Development Fund
OHQ	operating headquarters
OTC	over the counter
P/E	price/earnings
PECC	Pacific Economic Cooperation Council
PHS	Provident Housing Scheme
PRC	People's Republic of China
PSS	postal savings system
PvP	payment versus payment
RC	reserve cost
RECI	relative export competitiveness index
REER	real effective exchange rate
RER	real exchange rate
ROA	return on assets
ROE	return on equity
RTGS	real-time gross settlement
RULC	relative unit labor cost
SAR	Special Administrative Region
SBS	Singapore Bus Service Ltd.
SDIO	Securities Disclosure of Interest Ordinance
SE	Singapore Exchange
SEHK	Stock Exchange of Hong Kong
SES	Stock Exchange of Singapore
SESDAQ	Stock Exchange of Singapore Dealing and Automated Quotation
SFC	Securities and Futures Commission
SGSM	Singapore government securities market
SGS	Singapore government securities
SIMEX	Singapore International Monetary Exchange
SMBCGF	Small and Medium Business Credit Guarantee Fund
SOTUS	Share Ownership Top-Up Scheme
SSAP	Statements of Standard Accounting Practice
ST	Singapore Telecommunications
ULC	unit labor cost
UVI	unit value index
VAR	value at risk

Korea refers to the Republic of Korea.