There is an upsurge in interest among countries in the region to develop corporate bond markets. However, they should be mindful of the challenges and the issues they need to address for development of the bond market, such as the length of time it would take to develop a sound corporate bond market, the need to sequence other financial reforms, develop relevant infrastructures including credit rating system, establish legal and supervisory frameworks and set up market-based pricing systems.

Institutional investors play important roles in transforming the financial structure from bank-based to market-based system. Individual investors who are not holding assets in the form of deposits would likely be placing their savings with institutional investors, namely pension funds, insurance companies and other collective investment agencies. To develop institutional investors, countries in the region should develop funded pension schemes, strong legal and institutional frameworks and robust regulatory structures, and encourage the establishment of foreign institutions.

The role of credit rating agencies is critical in bond market development as well. They provide additional information to their clients and give appropriate ratings to companies, banks, and financial institutions that wish to raise borrowings through bonds and at the same time lower their cost of borrowings.

The capital market, in particular the government securities market, plays an important role in the implementation of monetary policy as it serves as a timely predictor of economic prospects. Central banks use government securities as a direct instrument in the open market operations to influence liquidity and interest rates. The changes in interest rates will influence savings and decisions on investments.
Development of government securities market would require countries to have issuers, investors, intermediaries, trading and settlement infrastructure, legal and regulatory infrastructure, and financial instruments. To promote development of the securities market, governments must ensure sound fiscal policy and allow for the legal empowerment in domestic borrowing and efficient debt management practices.

The banking system will continue its dominance in corporate financing in the region. Since the banking system and the bond markets will be complementary to each other in the future, a new financial market structure needs to be designed with the adoption of a two-prong policy that allows for strengthening of the banking industry and at the same time developing corporate bond markets. This will help ensure balanced and sustainable financial markets in emerging economies.

Introduction

1. This capacity-building seminar entitled Development of Capital Markets was jointly conducted by the ADB Institute and the South East Asian Central Banks (SEACEN) Research and Training Center from 16 to 20 July 2001 in Kuala Lumpur, Malaysia. Altogether 32 officials from 25 government agencies from 19 countries in the region such as ministries of finance, securities commissions, central banks and other financial supervisory authorities attended the seminar. The main objectives of the Seminar are to enhance participants’ conceptual understanding and practical skills in capital market development and at the same time to provide a forum for knowledge dissemination, exchange of views and country experiences. It was designed largely to cover key areas such as dealing with analytical framework and challenges for developing infrastructure for capital markets, and formulating policy recommendations for developing capital market in the region.

2. The seminar provided an in-depth knowledge and learning experience for participants to discuss the various conceptual and practical policy issues concerning capital market development, particularly the bond market. Comprehensive presentations on both general and country specific policy issues by eminent resource speakers from the academia, government agencies, multilateral institutions and the private sector provided the knowledge base for the seminar. Participants also presented their country reports and exchanged views through interactive discussions.

3. The main topics discussed in the seminar are as follows:
   - Problems and prospects for capital market development
   - Operational aspects of capital market development in Asia
   - Strategies and policy recommendations for the development of capital markets
   - Group work on country specific issues on financial structure and capital market development

4. In his welcoming remarks, Dr. Subarjo Joyosumarto, Executive Director of the SEACEN Center extended a very warm welcome to resource speakers and seminar participants. He explained to participants that the purpose of the seminar was to enhance conceptual understanding and practical skills of upper-middle to senior-level government officials in capital market development. Continuing, he explained that the seminar aims to provide a forum for an interchange of experiences among the participants so as to share best practices and information that would be beneficial to develop and manage the capital market in their respective countries. He reminded the participants of the critical lesson that they should learn from the Asian financial crisis of 1997/1998 and that the Asian region needed to broaden and deepen their capital markets. He added that following the economic recovery process in 1999-2000, the region was again subject to sharp deterioration in economic performance in the beginning of 2001 following the slowdown in the global economies. He said that there is a need to analyze the evolvement of the Asian markets and to understand the context in which the emerging Asian markets must operate. He believed that the future for emerging capital markets would be shaped by increasing global opportunities and international market risks. In such a context, he highlighted the need for authorities to develop sound financial systems to overcome economic stress, promote corporate governance, enhance the quality of financial management, improve the quality of supervision of financial institutions and assure the integrity of information to participants in the capital markets. He expressed the hope that given the high quality of the resource speakers and the considerable effort put into organizing the seminar, the seminar participants should seize the opportunity to network and share experiences among themselves. Finally, he wished the participants the most productive and enjoyable stay in Kuala Lumpur.

5. Dr. Masaru Yoshitomi, Dean of the ADB Institute, joined Subarjo in welcoming the participants and resource speakers to the seminar. He explained that the objective of the seminar was to build capacity for countries in the region to develop their capital markets, and that the seminar would discuss evolving policy issues and approaches relating to capital market development, including an analysis of the Asian financial markets, the analytical framework for capital market development, the appropriate institutional and legal settings, the infrastructure issues and finally the strategies and policy recommendations. He said that the seminar would provide the participants with a forum to exchange views on their own country specific issues as well.

6. Yoshitomi highlighted that the 1997/1998 Asian financial crisis was characterized by a capital account crisis, which was caused by massive short-term capital inflows attracted by good macroeconomic performance preceding the crisis and by their sudden reversal. The massive reversal of the international short-term capital flows has caused severe impact on the balance sheets of financial institutions and firms due to the serious combination of the maturity and currency mismatch problem. Continuing, he emphasized the need for countries in the region to concentrate more in developing their domestic capital markets as a way to avoid the recurrence of another financial crisis. He believed that with the deepening of the capital markets in the region, it could mitigate the ma-
turity mismatch problem and reduce the heavy dependence on the banking sector for corporate finance.

7. On the issue on whether the region could face another financial crisis, Yoshitomi stressed that the double mismatch problem that directly caused the 1997/98 Asian crisis would remain. Firstly, countries in the region would have to continue to borrow in foreign currencies for financing projects that generate revenues in local currency, creating a situation that would lead to a currency mismatch problem. Secondly, the problems of poor corporate governance, inappropriate financial regulations and inadequate monitoring of the financial sector in the region would all contribute to the worsening of the maturity mismatch problem.

8. Yoshitomi noted that after the crisis, a strong and prevalent view has emerged on the need to encourage countries in the region to reduce their heavy dependence on the banking sector and to rely more on development of their domestic capital markets to prevent another financial crisis since it is believed that the deepening of capital markets could mitigate the double mismatch problem and contribute to the maintenance of financial soundness and sustainable economic growth in the region. Yoshitomi attributed the problems to the underdeveloped state of the domestic capital markets in the region and the time that it would take to develop sound capital markets. The immediate task is to formulate appropriate policies that would address the mal-functioning of the banks and at the same time develop the capital markets. To develop capital markets in the region, several policy options can be adopted. During the long transition period that it would take to develop capital markets, there is a need to put in place a plan of action to shift from the present bank-dominated to the future capital market-based financial system. Finally, he identified three critical challenges that countries would have to be confronted with in the process of developing the capital markets in the region: (i) the financial system in the region has long been characterized as bank dominated and would be the same at least in the medium-term; (ii) there is only a limited number of large, reputable firms that could provide the required funds for the capital market; and (iii) there is only a limited number of wealthy individuals and institutions in developing countries of the region, a reflection of the low level of income and asset accumulation. The banking sector and capital markets would have to play complementary roles to support sound economic development in the region.

9. Yoshitomi reminded seminar participants that the soundness of their financial systems would soon be put to the test again by the current worsening of the world economic situation not only in the developed countries but also in the emerging developing economies as well. He believed that the IMF might be reluctant to conduct bail-out operations this time around because of the moral hazard problem. The new world economic situation would test the resilience of the Asian financial system and therefore, countries in the region need to speed up in the building of their financial system on a sound basis as soon as possible.

10. Finally, Yoshitomi highlighted the major work that was conducted at the ADB Institute. The Institute is a policy-oriented research institute. During the Second Anniversary of the Institute in December 1999, it started a new policy oriented forum, called the Asian Policy Forum (APF) for the purpose of addressing major policy issues confronting the region in the new decade. They were working closely with about fifteen policy-oriented leading research institutions in the region on important issues that confront the region and its first task was to produce policy recommendations on how to prevent another capital account crisis. The work on this was completed last year and the report was published. The APF had also completed the second selected topic on the development of corporate bond markets in Asia (www.adbi.org/PDF/APF/APFdsgn_Eng.pdf). The ADB Institute had produced the draft recommendations on how to develop corporate bond market in bank-dominated Asian economies. The draft recommendations were presented in a Seminar held in conjunction with the 34th Annual Meeting of the ADB in Hawaii in April 2001 and also presented in the Third Asia Development Forum in Bangkok, Thailand in June 2001. He also mentioned that they were now thinking of the third theme for the APF, namely, on the sequencing of domestic and external financial liberalization, which will be particularly relevant to PRC and India as these two countries would have to liberalize their capital accounts sometime in the future.

Part I—Problems and Prospects for Capital Market Development in Asia

11. The first paper on the Nature of the East Asian Crisis and Appropriate Policy Responses was presented by Yoshitomi and followed by the next topic on an Analytical Framework for the Development of Corporate Bond Market in Bank-Dominated Asian Countries by Dr. Sayuri Shirai, Visiting Scholar, ADB Institute. Yoshitomi’s presentation was on policy options on how to avoid another capital account crisis in the region. He explained that there were two major components of the crisis. The first component was the massive volume of capital inflows surpassing underlying current account deficit such as was the cases of Thailand, Indonesia and Korea. He used the absorption theorem to explain the widening of current account deficit in Thailand, Indonesia and Korea resulting from capital account surplus attributed to the large capital inflows. Domestic bank credits expanded in these countries and were used to fund real estate development in Thailand and manufacturing in Korea. There were excessive investments in these sectors that resulted subsequently in asset prices reaching their peaks during this period. This was a cyclical economic phenomena and the upturn was financed by massive short-term capital inflows in the 1990s. The second major component of the crisis is related with the composition of capital inflows, which has a large component of short-term capital inflows with maturity of less than a year in the 1990s. He emphasized that the composition of capital flows is very important for understanding the so-called currency and maturity mismatch problem.

12. Yoshitomi explained that very poor management of risks by the banks aggravated the currency mismatch problem. The banks monitor their borrowers in three stages. First they evaluate borrowers’ credit before lending. After extending the loans, they are engaged in the problem of moral hazard. Finally, once the borrowers were in financial distress, the banks attempted to differentiate between viable and non-
viable borrowers so that they could resolve their financial liquidity problems. The currency mismatch occurred whenever emerging economies have to borrow from abroad in foreign currency to invest in local ventures that generate revenues in local currency. When their exchange rates depreciated, the liability side of their balance sheets would deteriorate very rapidly. When the massive capital inflows and double mismatch problem were combined together, the twin crises are triggered with the subsequent collapse of the macroeconomic equilibrium, resulting in the withdrawal of bank loans in the affected economies. The net effect is that the affected countries suffered deficits in their current account, declines in their capital accounts, drops in their external reserves, eventually resulting in suffering an international liquidity crisis and a domestic liquidity crisis that affects their banking system. When the twin crises occurred, domestic demand collapsed in the crisis-hit economies. He reiterated that once the twin crises had been overcome, the economic recovery would start but its sustainability remained uncertain because the bank and corporate restructuring have yet to be completed in the crisis-hit economies. After the crisis, the crisis-hit economies experienced an export boom, like in the case of Korea where the ratio of exports to GDP was 30 per cent before the crisis but rose sharply to 45 per cent after the crisis.

13. After explaining the nature of the Asian financial crisis, Yoshibumi proposed the following policy recommendations to prevent the occurrence of another capital account crisis. The recommendations are divided into two parts, the first was on crisis prevention; and the second on crisis management. To prevent another crisis, he proposed that the exchange rate regime should be modified into a mid-way between a freely floating and the currency board system as the fixed exchange rate regime could not be sustained for a long period while the freely floating system will generate too much volatility. There were essentially two reasons for the recommendations, one of which is to protect the development of a sound capital market and to avoid misallocation of between tradable and non-tradable resources as a result of volatility of the exchange rate movements; and the second is to adopt the Chilean type of capital controls for regulating short-term capital flows that would mitigate the problem of maturity mismatch, and preventing massive and sudden reversal of capital movements. Such controls should be adopted until the domestic financial institutions become robust and resilient.

14. With regard to the second part of his recommendations on how to manage sudden reversal of capital flows, Yoshibumi recommended the adoption of restrictions on non-resident holdings of domestic currencies of emerging economies such as was implemented by Malaysia in September 1998. He further recommended the design of a scheme to bail-in rather than bail-out the international investors, a subject which is continually being discussed in international organizations. His next policy recommendation is to establish a regional financial arrangement for assisting those economies that face an international liquidity crisis and for the conditionalities, that would be attached to the provision of international liquidity. The focus would be more on examining the state of domestic financial institutions and the regulatory framework in those Asian economies. Yoshibumi highlighted that countries such as India and the PRC should learn the lessons from the Asian financial crisis so that they could prevent a similar crisis from happening in their own countries once they liberalize their capital accounts.

15. One of the participants asked if any of the recommended policies has been adopted and implemented by the Asian countries after the crisis, then how one can explain the current symptoms of the resurgence a weakening economic trend, slow economic growth and the slow financial reforms in the Asian countries. He also enquired on the possibility of a second round of the Asian crisis in the near future. In response, Yoshibumi explained that the restructuring of the banking and corporate sector in the crisis-hit economies are still in progress. The non-performing loans are still substantial. Most of the insolvent banks have been nationalized and the corporate sector remained fragile to any shock. The exposure of crisis-hit economies to the new economy in the US after the crisis has increased substantially. At the same time, the world economic situation is worsening, for example, the US economy has slowed down, the Japanese economy is still in recession and the European economy is also slowing down. Both the Japanese and the US economies have implemented expansionary monetary and fiscal policies in an effort to expand domestic demand. Despite the measures implemented by Japan in the 1990s, the Japanese economy has turned into a recession. Yoshibumi advocated that Japan should have undertaken vigorous banking and corporate sector reforms before implementing fiscal and monetary expansion to boost domestic demand. In response to the question of midway exchange rate system, between freely floating and Currency Board, he explained that there have been differences of opinion among policymakers.

16. In response to the question by another participant about the sequencing of financial reforms in Indonesia, Yoshibumi emphasized the priority of restoring political stability before implementing any financial reforms. Also in response to the question on whether managed exchange rate regime is better than fixed and freely floating regime in preventing financial crisis, Yoshibumi proposed a mid-way exchange rate regime following the Chilean type of capital control to mitigate massive capital inflows because a flexible exchange rate regime rather than fixed would facilitate trade and would not undermine the development of financial and capital markets in emerging economies.

17. Shirai proceeded with the presentation on Analytical Framework for the Development of Bond Market in Bank-Dominated Asian Countries. She mentioned that there was an increasingly prevalent view that the Asian countries were overly dependent on the banking sector and this was the main cause of the crisis. She quoted Thailand, Malaysia, Singapore and the PRC as examples of countries where the share of outstanding bank loans to GDP exceeded 80 per cent in the 1990s as compared with the US showing a smaller share. Moreover, the banking system did not perform well in Asia and this aggravated the double mismatch problem. Therefore, there should be less emphasis on banks and more on developing the domestic capital markets, particularly domestic bond markets.

18. Based on these stylized facts, there are two categories of fundamental questions to ask. The first category is on the bank-
19. In order to answer these fundamental questions, one needs to look at the fundamental differences between bank loans and corporate bonds. She explained that the firms’ choice of bank loans and bond finance depends on the following three factors: (i) measures to mitigate the extent of severity of information asymmetry between ultimate creditors and ultimate borrowers, are different between banking system and corporate bond market; (ii) stages of economic development affect the number of large reputable firms, diversified institutional and individual investors, which can be potential buyers of corporate bonds; and (iii) development of information, legal and judiciary infrastructures are different between the banking system and corporate bond markets.

20. Shirai explained the important players involved in each of the financial systems. In the banking system, the ultimate creditors are the depositors, and the risk bearers and the intermediaries are the commercial banks. On the other hand, in the corporate bond market, the ultimate creditors are public investors who are many, diverse and disperse while the risk bearers are public investors, the intermediaries, and the investment banks. She also explained the different methods in reducing agency problems. First, with respect to the banking system, it is crucial to reduce this information asymmetry between banks and borrowers and not between banks and depositors. In the corporate bond market, however, they try to reduce the agency problem between issuers and public investors. Based on these differences, they tried to reduce information asymmetry by doing repetitive transactions and trying to get inside information to know their customers income stream and creditworthiness. This type of information is highly idiosyncratic. On the other hand, in corporate bond market, the information about the issuers is standardized by maturity, the coupon rate and risk premium. Based on the standardized and publicly available information, the public investors try to monitor the issuers. In addition, the investment banks as underwriter play important roles in promoting the standardization of information and also the credit rating agencies would be very important to supplement this information asymmetry.

21. Next, Shirai explained the second factor, the stage of economic development. The characteristics of investors and borrowers in developing and developed countries are different. The developing countries have the following characteristics: (i) low income and limited asset accumulation; (ii) individual investors have high demand for highly liquid assets; (iii) insurance and pension industries are underdeveloped; and (iv) they usually have limited number of issuers since there are large numbers of small- and medium-size enterprises (SMEs), and their information are highly idiosyncratic. Therefore, she viewed that the practical solution for developing countries is preferably to adopt a bank-based financial structure. On the other hand, the developed countries usually have high income and asset accumulation. Given this situation, individual investors have high demand for diversified asset portfolios, the countries have well developed insurance and pension industries so these in turn could become potential institutional investors. Also, at this stage, there are numerous, large reputable firms that are able to issue bonds at a reasonably low cost. Therefore, she concluded that for the developed countries, the practical solution is to have a full-fledged capital market financial structure when the issuers have accessed not only to bank loans but also to various other facilities.

22. Shirai highlighted the third factor that is the information, legal and judiciary infrastructures. The objective of the regulatory regime is completely different depending on the structure of the financial sector. Under the banking system, the main objective of bank regulation is focused on how to limit excessive risk taking by banks and prevent the systemic banking crisis. On the other hand, in the corporate bond market, the main objective of the regulation is centered on how to ensure public confidence in the market and to protect public investors. Given these differences, the instruments used for each regulatory regime are different. Under the banking system, the enforcement of banking laws and prudential regulations are very important so as to limit the risk taking behavior. Therefore, prudential regulations such as capital adequacy requirements, limit on credit concentration, foreign currency exposure, accounting, auditing, disclosure rules are very important. Under the banking system, there are possible incidence of systemic banking crisis. Therefore, the supervisory authorities should monitor the banks to comply with prudential regulations. The deposit insurance scheme and the lender of last resort facility are some of the instruments to stem systemic banking crisis. On the other hand, under the corporate bond market, the enforcement of security laws are very important to promote standardization and enhancing full disclosure requirements. The issue of systemic risk is less important in the security market. Instead, the emphasis of regulatory regime should be placed on how to protect the public investors and therefore a comprehensive judiciary system and also credit rating and other information generating agencies to promote transparency would be the most important issues.

23. Shirai stressed that based on the fundamental differences between bank loans and corporate bonds, there were also inherent differences in their features. For example, bank loans are characterized by long-term relationships compared with bond finance where the relationships are at arms length contracts. In addition, bank loans are largely implicit contracts and therefore they are able to provide flexible, discretionary, and repetitive loans, but in the security market, the contracts are explicit and therefore their contracts are inflexible, standardized and usually non-negotiable. Furthermore, the bank loans are based on trust between borrowers and banks whereas under the security market, the borrowers are judged by credit rates and returns. Finally, bank loans are accessible to small and medium enterprises, but bond financing is limited to large
and reputable issuers. Given these inherent features, Shirai explained how stage financing works under the banking system when a company is small and relatively new. Initially, the bank provides small loans and probably with low interest rates. As the company grows and becomes more successful, the bank provides bigger loans and with higher interest rates. In the case of corporate bonds, if a country is able to develop a viable corporate bond market, it can reduce currency and maturity mismatches.

24. Shirai identified the following three main factors that led to the failures of Asian banks before the financial crisis: (i) government interventions in all stages of bank operations such as in project selection and credit operation; (ii) bailing out banks by the government regardless of their viability; and (iii) many Asian banks are owned by family business. She stressed that given these three factors, banks have no interest in processing inside information and monitoring their clients. The government’s major interests in banking matters led to banks’ over-reliance on collateral for their lending activities without close monitoring of their clients. As a result, the relationship base between banks and their clients has shifted to “cronyism”.

Shirai identified four factors affecting the underdevelopment of the corporate bond markets: (i) underdeveloped government bond market and lack of benchmark bond used for pricing; (ii) illiquid secondary markets due to government policy on interest rate, transaction tax and liquidity requirement; (iii) limited supply and demand for bonds; and (iv) inadequate informational, legal, and judiciary infrastructures.

25. Shirai suggested that the Asian countries should adopt the following strategy to overcome the problems outlined previously. First, they should place the first priority on strengthening the soundness of the banking sector since banks are likely to remain dominant. For this purpose, they have to take two steps: (i) remove government interventions that distorted banks’ incentives to collect information, monitor borrowers and enhance internal risk management; and (ii) adopt prudential regulations such as capital adequacy requirement. Second, they should improve the necessary information, legal and judiciary infrastructures for a sound corporate bond market.

Third, they should strengthen the role of the banking sector in developing corporate bond markets since banks will be the major underwriter, issuer and guarantor of corporate bonds given its dominance in the financial sector. Finally, she suggested the following general policies to develop the corporate bond markets: (i) develop government bond markets through regular issuance with various maturities; (ii) remove regulations that discourage the development of secondary markets, (iii) impose strict regulations and judiciary systems against market manipulations and for enhancing transparency; (iv) improve settlement systems to limit systemic risks of the whole financial system; and (v) encourage the establishment of other intermediaries such as pension funds, mutual funds through deregulation.

26. During the open discussion, participants raised following issues: (i) the rationale for dividing the countries into two groups such as bank-based developing countries and bond-based developed countries. In reality, Germany does not have a well developed capital market and placed more emphasis on bank-based financial market and Japan also does not have a well developed capital market compared to Korea; (ii) the possibility of opening domestic bond market in the developing countries to foreign investors; (iii) the contradictory views between both presenters such as Yoshitomi recommended to limit short-term capital flows but Shirai encouraged foreigners to invest in the domestic bond market; (iv) the size of corporate bond for each Asian country in terms of GDP; and (v) the role of securitization in stimulating the development of corporate bond market.

27. In response, Shirai explained that the corporate bond market in Germany was not well developed due to regulatory reasons and the Japanese corporate bond market also was not well developed due to the way the Japanese government managed their financial system. On the question on allowing foreigners to invest in domestic bond market, she emphasized the role of the foreign investors because the investor-base in the developing countries is small. But since foreigners prefer to purchase bonds denominated in foreign currency, the issue of the double mismatch problem may arise. On the third question, Adams responded that there are potential trade-offs between the Chilean capital control and restricting internalization of their own currencies offshore. As countries in the Asian region are not homogeneous and are at different stages of development, different countries might select a different policy. Shirai responded to the next question by saying that there is no specific proposal on the optimal size of corporate bond issue for each country since each country has a different set of problems. Yoshitomi responded on the issue of securitization by referring to the US and Japan cases. Securitization of commercial bank loans is easier with the existence of a very well developed corporate bond market and also very important because it assists in reducing the credit risk on the balance sheet of the banks.

28. Dr. Rhee commented on the Korean experience in developing the bond market. In order to develop bond market in the initial stage, developing countries need some form of credit support from governments. On the possibility of moral hazard, Adams clarified that credit enhancement would cover a broad range of instruments and he would not equate the whole issue of the role of the public sector because the private sector has many means to enhance credit quality. In response to a question on the sequencing of capital market in emerging economies, Yoshitomi explained that the development of corporate bond market should be done in three stages. In the initial stage, the banks should strengthen themselves in order to play an important role in developing the bond market. In the second stage, banks become active in the corporate bond market. However, there arises the danger that banks dominate the corporate bond market and become too strong as in the case of universal banking in Germany and the long-term credit banks in Japan. Therefore, the smooth transformation to the third stage where there are more developed equity and bond markets would be the greatest challenge.

29. Dr. Charles Adams, Senior Economic Advisor, ADB, gave a presentation on “Challenges and Opportunities for Developing Capital Markets”. Adams started his presentation by alerting the seminar participants that one should clearly understand that Asia is not a homogeneous set of countries as was perceived by many people. Asia includes many hetero-
The initial emphasis should be on strengthening the risk management in banks and enhancing supporting regulatory and supervisory structure. A strong and efficient banking system is important in its own right and to lay the basis for sound bond market development. Strengthening risk management is an important key factor in developing market discipline in the corporate bond market regardless of the nature of the financial system. The problem in the past was that the government played a large role in the credit allocation process and did not allow market discipline to work. The key factor to provide incentives for improvements in risk management is to allow greater market discipline, which will set the foundation to build the nature of the financial system and the roles of banks, bond and equity markets.

30. Adams explained that there was an upsurge in interest in developing deep and liquid corporate bond markets in the Asian region. He has identified ten interrelated issues to develop corporate bond market in this region: (i) reduce the double mismatch (currency and maturity) problem by creating a source of long-term fixed-interest domestic currency funding; (ii) move the financial problems outside the banking sector and lower systemic risk (easier for governments to stand aside during a financial crisis); (iii) improve the efficiency and transparency of credit allocation; (iv) provide (together with the equity market) a “Spare-Tire” in the financial system to avert any risks rather than overly depending on the banking sector only; (v) provide a source of financing for “new” dynamic firms (together with NASDAQ type market); (vi) encourage the development of derivatives markets; (vii) strengthen corporate governance and transparency; (viii) lessen government interference in the bond markets; (ix) facilitate the securitization and disposal of non-performing bank loans; and (x) reduce dependence on foreign bond markets.

31. Adams cautioned the participants that some of the benefits of the bond market do not automatically follow due to the following reasons. First, during the double mismatch problem, the introduction of domestic currency local bond market would not necessarily lead to long-term and domestic currency denominated borrowing. Second, the argument is on the creation of bond market, which may lead to neglecting the importance of the banking system. The second argument may not necessarily be true because banks play very important roles in the Asian countries as suppliers of loans and also are important players in the financial system they may be major issuers in the bond market and suppliers of backup credit to the corporate sector.

32. Third, the credit allocation process would be more efficient and transparent only if: (i) purchasers of bonds exercise appropriate management; and (ii) rating agencies correctly assess the risks of bond issuers. Transparency can be enhanced if there are significant secondary trading in the bond market. In addition, the argument to reduce government intervention is valid if there exists bond-based system rather than bank-based system. For example, the Korean government was concerned over the roll over problem and intervened by providing guarantees to bond issuers. Adams also explained that some of the potential benefits of bond market depend fundamentally on a strong, sound underlying risk management practices both in the financial and corporate sector. The initial emphasis should be on strengthening the risk management in banks and enhancing supporting regulatory and supervisory structure. A strong and efficient banking system is important in its own right and to lay the basis for sound bond market development. Strengthening risk management is an important key factor in developing market discipline in the corporate bond market regardless of the nature of the financial system. The problem in the past was that the government played a large role in the credit allocation process and did not allow market discipline to work. The key factor to provide incentives for improvements in risk management is to allow greater market discipline, which will set the foundation to build the nature of the financial system and the roles of banks, bond and equity markets.

33. In response to a question on the sequencing issue, Adams explained that there is no clear answer to it as yet. He indicated three critical steps or stages in terms of bond market development and he cautioned that this should not be treated as sequential steps but merely as ingredients. The first stage is to recognize that banks will still play a predominant role and the role of the capital market can be increased at the margin. As such, a well-structured financial system implies complementary roles played by the banks and the bond market. Banks are still needed to provide liquidity, source of back-up credit line for companies and better pricing of risks. Other reasons why banks are important are because they are major elements in the transmission of monetary policy, supplier of hedging facilities and source of credit to medium- and small-scale enterprises. Even if there was no active and deep corporate bond market at the initial stage, the Asian economies should strengthen their banking system especially in developing the risk management, improving capital adequacy, and establishing and strengthening the supervisory and regulatory regimes.

34. The second stage is to develop specialized officials for primary and secondary trading in the bond market. It is important because it would create a set of dealers, a benchmark for private bonds, instruments to hedge interest rate risk and expertise in bond trading. The third stage is to develop an appropriate supporting infrastructure for corporate bond markets. However, there is a need to be realistic about the time span to develop bond market. Only a small number of countries have deep and liquid private bond markets with secondary trading on a significant scale (United States, United Kingdom, Japan, Australia). Even sophisticated financial centers such as Singapore and Hong Kong, China and Korea are making slow progress. He suggested that they should begin with private placement followed by primary and secondary trading. Adams highlighted that there is a fundamental issue that needs to be resolved whether to develop domestic bond market or allow access to other countries’ bond markets or go to international capital markets. He also posed the issue as to whether access to foreign bond markets would speed up domestic bond market development. There are many issues to be considered before developing the local bond market.

35. Adams listed the following basic infrastructure requirements to develop the private bond markets: (i) clearing and settlement systems; (ii) benchmark yields; (iii) exchange trade versus OTC market; (iv) bond futures and derivatives markets for hedging; and (v) markets to unbundled trading risks.
He also listed the underlying requirements to develop the corporate bond market: (i) establishment of credit rating agencies, institutional investors, credit enhancement agencies, and regulatory and supervisory structure; (ii) linkages with markets in other countries; (iii) encouraging foreign investors to participate in adding liquidity and breadth; (iv) hedge funds to facilitate efficient pricing; and (v) foreign issuance house to play active roles.

36. In conclusion, Adams summarized some of the important areas in developing the Asian bond markets. For the bond markets to be able to provide benefits, certain key underlying conditions should be satisfied. Among others, it is a key requirement to improve risk management and evaluating risks. Bond markets and banks are fundamentally complementary and only compete at the margin. Bond market development needs to be carefully sequenced. There is a need to be realistic about the time span it will take for a deep and broad private bond market to be developed. Ultimately, a critical mass of factors is needed to come together to develop a deep and liquid bond market.

37. In the open discussion, a participant agreed that it would require a long time to develop the local bond market and to establish the infrastructure requirements. However, even though the US and UK did not have all infrastructures as highlighted in Adam’s presentation, but their bond markets have flourished. He asked what were the factors that contributed to the success of their bond markets without those prerequisites of infrastructure. In response, Adams emphasized the distinction between necessary and sufficient conditions and between functions and institutions. Functions have remained unchanged while institutional set up today is different from hundred years ago. For example, one may not have rating agencies but one surely had it in earlier times, people to give comments about the quality of the papers. Ms. Cecile B. Saavedra, Managing Director, Asia Pacific Ratings, Standard & Poor Rating Services added that the issues of transparency and disclosure were ready and the rating agencies at that time were already making comments on the quality of the papers and already trying to address the issue of information asymmetry.

38. In response to the question on the Korean experience, Prof. Rhee of the Seoul National University stated that 70 per cent of government bonds are held by commercial banks, and most of the corporate bonds are held by institutional investors. In addition, Adams highlighted the development of corporate bond market in Korea during the pre- and post-crisis period. During the pre-crisis period, the bulk of the bond issues was guaranteed but after the crisis the guarantees were withdrawn and there was a new set of players including the Investment Trust Company. However, the commercial banks in the Asian economies would continue to be the major players in the short-term bond market and with regard to market makers, it would be the major buyers and issuers and in some cases, they provided back-up credit for the corporate customers.

39. In response to the question about the choice of financing for small- and medium-scale industries and accessibility to capital market, Adams suggested that these industries have several choices but by and large, bank financing would continue to be the major source of financing except for a few companies that might try venture capital. Rhee added that Korea has a guarantee system for corporate bonds, but it is extended only to fragile companies. Adams pointed out that Korea’s scheme to provide credit enhancement to small- and medium-sized enterprises was introduced this year to deal with the problems of some Korean companies that have been exposed to systemic risks and having trouble in rolling over their debt. In essence, the Korean scheme provides some credit enhancement for small- and medium-sized enterprises. Park explained that there were three issues related to the development of the corporate bond market in the developing countries: (i) on the demand side, it involves individuals and institutional investors; (ii) on the supply side, it involves companies that has reasonable reputation to issue bonds; and (iii) on the infrastructure side, it involves establishing legal, supervisory and credit rating agencies. Given the existing gaps in each of the issues, his concern was over the time duration that the Asian developing economies would take to develop a reasonable size corporate bond market.

40. In response to the final question on the potential of developing a regional bond market, Adams was skeptical about the position of some of the smaller countries to develop their own liquid and deep private bond market. He recalled the suggestion that if they could not develop their own individual bond market, then they should develop a regional bond market. Another important issue the developing countries should be concerned with is the lack of domestic currency funding instrument and therefore they were not able to borrow internationally in their own currencies. On the other hand, if there is a domestic currency bond market, the issue of exchange rate risk would arise as who should bear the risk and if the exchange rate is priced correctly, they might get the foreigners to absorb some of the risks.

41. Mr. Chris Ryan, Deputy Chief Manager, Domestic Market Development, Reserve Bank of Australia, gave a presentation on “Role of Capital Market in the Implementation of Monetary Policy”. His presentations covered four main areas: (i) an overview of recent thinking on monetary policy framework and implementation; (ii) the transmission mechanism of monetary policy. (iii) role of the capital markets in the implementation of monetary policy; (iv) the Australian experience. Ryan explained in general that the ultimate goal of monetary policy is price stability and low inflation in the medium term. The short-term effect of monetary policy can be used to help manage the business cycle. Loose monetary policy may stimulate activity in the short run but it will result in high inflation that will be detrimental to long-term growth.

42. Ryan explained that the government usually chooses a country’s monetary policy framework. The framework can comprise the central bank’s policy focus—for example, a stable exchange rate, a monetary target, an inflation target or at a discretionary target—and its characteristics such as independence, accountability and transparency. He explained briefly the mechanics of each policy framework. For example if a country chose a fixed exchange rate regime, the nominal anchor becomes the country’s inflation rate. The main advantage of a fixed exchange rate regime is its credibility and has tended to be the most successful way of bringing down infla-
tion. The disadvantages are its inflexibility and the inability to help facilitate necessary adjustment of the real exchange rate. Fixed nominal exchange rates are ill-suited to countries whose terms of trade fluctuate significantly and whose cost structures have downward inflexibilities. For monetary targets, the success depends on the ability to control a monetary aggregate that directly or indirectly has stable effect on inflation and real growth. In the long run, monetary targeting may fail because of the inability to control targeted aggregate. He noted that most of the IMF programs have not set rigorous monetary target and instead set ceilings and floors for net domestic and foreign assets to achieve certain outcomes for international reserves as for inflation.

43. He explained further that advanced economies including Australia had abandoned monetary targeting in the aftermath of financial liberalization when aggregates become difficult to control and the relationship between aggregates and ultimate variable deteriorated. He also discussed that a number of central banks including developing countries have applied formal inflation targeting. He argued that until recently, inflation targeting was beyond the scope of most developing countries for the following two reasons: (i) lack of political freedom to focus on inflation at the expense of other variables; and (ii) lack of technical expertise to forecast inflation and its relationship to instruments of monetary policy. Ryan continued to discuss on the choice of instruments for implementing monetary policy. He explained that the monetary framework does not pre-determine policy implementation. For example, measures to attain monetary target have been implemented via direct and indirect instruments. Measures to attain inflation targeting have mostly, if not exclusively been implemented via targeting for a very short-term interest rate but this needs not be the case. In the case of direct versus indirect instruments, there are numerous ways in which monetary policy can be implemented. The direct instruments include interest rate controls, bank-by-bank credit ceilings and statutory liquidity ratios. Conversely, the indirect instruments are open market operations in domestic securities and in foreign exchange, lending facilities and deposit facilities. He explained that all these instruments have their advantages and disadvantages.

44. Ryan explained on the transmission mechanism of monetary policy involving complex processes by which changes in policy instruments—short-term interest rates are transmitted to (feed through) the economy and affect ultimate objectives. One of the ways is the so-called exchange rate channel, for example, raising interest rate causes an appreciation, which exerts direct and indirect downward pressure on prices via the exchange rate’s contraction effect on net exports and hence aggregate activity. If the exchange rate is fixed, one can consider the exchange rate channel as having been cut off. Most of the analyses on the transmission mechanism begin with a target for a very short-term interest rate, for example, the interest rate on overnight inter-bank loans, which is determined each day by the interaction of the demand and supply of bank’s reserves at the central bank. Only the central bank can increase the aggregate supply of these reserves—the inter-bank transactions merely recycle a given amount. The general rise in interest rates, fall in asset prices and appreciation of the currency will reduce aggregate demand via a number of channels, such as inter-temporal substitution, cash flow, wealth and asset effects, credit rationing, and the exchange rate.

45. Ryan briefly discussed the role of the capital markets, which serve as a timely predictor of economic prospects and a way by which to affect those prospects. For example, the comparison of yields on the corporate bond and less risky assets makes it a good indicator of the health of the corporate sector. However, he cautioned that one has to be careful in talking about the role of asset prices in the formulation of monetary policy. He argued that there are two broad ways in which securities could be used in the implementation of monetary policy. One is the use of a direct instrument such as minimum holdings of securities and the other is the use of certain securities as collateral for open market operations. He briefly discussed the various possible collaterals for open market operations, such as government securities, central bank’s own securities, non-government domestic securities, foreign exchange swaps and common collaterals or cash pools. As central banks are very conservative in choosing the securities used as collateral, they are inclined to take securities with very high credit rating such as government securities. Turning to asset-backed securities, there are a number of choices which appeal to central banks such as mortgage-backed securities and pure corporate papers.

46. Ryan also cited the common recommendation on the existence of a market in government securities so as to provide a benchmark for pricing, and perhaps to help hedge positions. The issuance of government securities should have the following characteristics, sold at tender, open to purchase by foreigners and institutional investors, well regulated, settled via delivery versus payment, real time gross settlement and be in the form of several deep lines rather than many illiquid lines. He said that as much information as possible should be provided on the state of the market. On the issuance of corporate bonds, Ryan recommended that the right measures must be in place to encourage foreign and institutional interests. In addition to proper regulation, this will require active assessment by the established rating agencies. In the initial stage of development, these measures may be more appropriate than the acceptance as collateral for market operations.

47. Finally, he highlighted the choice of monetary policy framework, including institutional characteristics. Regardless of the chosen framework, however, almost every central bank that has government securities at its disposal makes use of them—in one way or another in its market operations. Increasingly, central banks are using open market operations and repos in particular to target a short-term interest rate with a view to achieving inflation target. A number of central banks also make use of privately issued paper in their market operations. He explained whether the central bank usage of securities has been a major determinant of securities market development, is difficult to say. In some instances, the really big steps in market development are needed to take place before the relevant security could be used in market operations. This may be the case in the future as well. Corporate bond markets contribute to the well functioning of the economy by providing corporations with an alternative source of funding. These markets also provide useful inputs to the formulation of monetary policy—especially if macro-economic data is somewhat limited. But their role in
the formulation of monetary policy may need to be kept in check. Lastly, the central bank errs on the side of targeting asset price inflation rather than consumer price inflation.

Part II—Operational Aspect of Capital Market Development in Asia

48. Dr. Sayuri Shirai, gave a second presentation on “Roles and Rationale of Banking Sectors in Capital Market at the Initial Stage of Economic Development and Policy Implications in Asia”. Shirai explained that Asia has entered in stage two of their financial market development. In the initial stage, the financial market was dominated by the banking sector and their business was concentrated in mobilizing deposits and extending credit. However, subsequent to the aftermath of the financial crisis in the East Asian region, many commercial banks entered stage two of their financial market development. The banking sector has to operate in a new environment of deregulation of the financial sector, development of diversified financial instruments (bonds, derivatives, stocks) and globalization. As a consequence of these developments: (i) the banks’ lending activities and profitability have declined; (ii) the banks faced increased difficulty in collecting implicit rents; (iii) they experienced difficulty in maintaining long-term relationships; (iv) they have to refocus their lending activities by increasing their lending to small, relatively new borrowers; and (v) their default ratio starts getting higher.

49. Shirai argued that given the new environment, banks have to diversify into new securities businesses, such as securities underwriting, securities dealing and brokerage and trust businesses. In addition, banks might engage in other financial activities such as insurance, real estate and investment advice. It is likely that banks provide traditional banking services and at the same time become underwriters, issuers, investors, guarantors and managers of trust accounts. She expected that the financial market structure is likely to become intermediate when bank loans are substituted for premature corporate bonds. Based on some observations, she noted that the banking sector in Thailand, Indonesia, the Philippines and the PRC played a crucial role as issuers in the corporate bond market. She envisaged that in the medium term, the financial structure in Asia, particularly, the banks, would play an important role in developing the bond market. She highlighted the success of the long-term credit bank in Japan in providing long-term lending and expressed concern on whether the credit bank could survive without government assistance in the future.

50. Shirai discussed the advantages and disadvantages that may arise when banks undertake securities businesses. She highlighted the following advantages when banks are engaged in securities businesses: (i) promote efficiency through diversification benefits, using “inside information” about borrowers and saving fixed costs of establishing branches and networks; (ii) foster competition by opening up various areas of finance for entry by banks; and (iii) promote long-term bank-firm relationship. She pointed out that there is empirical evidence to show that underwriting costs and defaults are lower and prices higher when banks enter the securities businesses. She also listed the disadvantages when banks undertook securities businesses as follows: (i) increase in connected lending which hampers the soundness of banking businesses; (ii) greater concentration of economic resources and political power in the banking sector and therefore investors need to be protected with codes of conduct, market discipline, and disclosure; (iii) high switching costs because banks will charge higher premiums to firms that switch from universal banks to investment banks; and (iv) aggravate conflicts of interest for example underwrite securities of troubled borrowing firms where the proceeds of the issues are used to pay off the banks’ own loans to the firms.

51. Shirai continued to explain that there are three organizational forms of banking institutions that serve as the intermediate financial structure. First is the subsidiaries of the bank as practiced in UK. Second is the universal banking as practiced in Germany and Switzerland. In the universal banking model, the major advantages in engaging securities businesses are as follows: (i) full exploitation of “inside information” and monitoring functions of banks; (ii) cheaper due to savings of the fixed costs; and (iii) banks will have more control over profits from securities businesses due to economies of scale and scope. Third is the bank holding company model that has the following advantages if they engage in securities businesses: (i) banks are shielded against risks that securities activities may entail with “firewall provisions”; (ii) promote a level playing field between banking and non banking competitors; (iii) mitigate conflicts of interest; (iv) easier to supervise; (v) promote capital markets; and (vi) improve efficiency by removing unprofitable activities with high costs and low quality services.

52. Shirai concluded that banks in Asia play a dominant role in the corporate bond market, which has the following features: (i) banks are major buyers and investors in the bond market with buy and hold strategy; (ii) banks’ interim monitoring function plays an important role; (iii) credit rating agencies are underdeveloped; (iv) maturity of corporate bonds is relatively short; and (v) difference of bank loans compared to bonds comes from period of the maturity, therefore long-term bond could mitigate a maturity mismatch.

53. Dr. John K. Thompson, Financial Counselor, OECD, Paris spoke on “Developing Institutional Investors for Development of Capital Market”. Thompson focused his presentation on the role of institutional investors in transforming the financial structure from bank-based to market-based system. He noted that people are not holding asset in the form of deposits but increasingly they are placing their assets in institutional investors, consequently the assets of institutional investors have increased as a share of national income and financial assets. There are three categories of institutional investors, namely pension funds, insurance companies and collective investment schemes. He noted that the financial assets of these three institutional investors are growing fast at an average annual growth of 12 per cent between 1990–1998, with investment companies recording the highest growth with an average of 20 per cent followed by pension funds at 15 per cent and insurance companies at 7 per cent. The underlying factors in the growth of institutional savings are due to the
54. Thompson discussed on the share of financial assets of institutional investors as a percentage of GDP in 1998 among the OECD members. The share differs among countries such as US showing the largest share of 218.8 per cent followed by UK 214.2 per cent and Germany and Italy with the lowest share of 70.2 per cent and 80.3 per cent, respectively. The common characteristics of these institutional investors are assets placed in long-term saving instruments, which are managed professionally and supervised by special regulatory regime. They have fiduciary duty to investors supported by proper laws and regulation, and market competition. Other issues related to liability of institutional investors are contractual payment of benefits to pension plan and tax status because some products enjoy tax benefits.

55. Thompson discussed the approaches of the legal and regulatory structure. All the institutional investors are regulated in accordance with the types of businesses they are engaged in. For example, in US, the mutual funds are governed by the Investment Company Act (1940) and the institutional investors are regulated by the Securities Exchange Commission (SEC). The pension funds are governed by ERISA and regulated by the Labor Department and the companies are governed by state laws and regulation. He explained there are two ways to regulate the institutional investors, one is by the directive approach by guiding portfolio allocation, discouraging product innovation and limiting risk taking, and the second is through the non-directive approach by ensuring prudent management, disclosure-based and allowing risk-taking. Investors that are subject to flexible regulation tend to maximize value more aggressively. He referred to a specific example of the institutional investor, which is tailored to a purpose of life insurance companies. Insurance has the following inherent features: (i) most heavily regulated; (ii) slowest pace of growth; (iii) limited to equity investment except for UK; (iv) often used for retirement; (v) biggest growth in tax-advantaged annuities; and (vi) the closest substitutes for collective investment products. He cited France and UK where the share of financial assets of insurance companies to GDP was the highest among the industrial countries accounting for 102 per cent and 66 per cent respectively in 1998. In terms of investment portfolio of insurance companies as a percentage of total financial assets, UK showed a large proportion of the portfolio invested in shares at 58 per cent while US constituted only 26 per cent while bills and bonds formed 56 per cent.

56. Thompson explained that the institutional investors are governed by Collective Investment Schemes (CIS) and each country has its own CIS such as Mutual Fund (US), Unit Trusts (UK, Australia, New Zealand, Singapore, Hong Kong, China and the PRC), Investment Trust (Japan and Korea), European Contractual Funds and European Corporate Funds. He discussed a couple of characteristics of CIS as follows. First, small investors have access to many opportunities in capital markets by pooling savings, since small investors cannot afford diversified portfolios and trade efficiently. Second, they operate within defined legal and governance structure with special laws, regulatory structures, internal systems to resolve conflicts of interest and abide by disclosure rules. Last, it is operated by professional managers with transparent investment policy and low cost. He noted that the share of CIS assets in GDP has been growing in the industrial countries. For example, Luxembourg is one of the industrial countries with the highest share accounting for 3,401.8 per cent in 1998. In terms of distribution of assets in CIS, US has the highest share in 1992 of almost 90 per cent compared with Japan and Korea which accounted for only a smaller share in 1992.

57. In conclusion, Thompson made the following recommendations for Asian countries to develop institutional investors and capital market: (i) build funded pension schemes; (ii) build a strong legal and institutional framework for CIS; (iii) develop robust regulatory structures for institutional investors; and (iv) encourage the establishment of foreign institutions.

58. Ms. Cecile B. Saavedra, Managing Director, Asia-Pacific, Standard & Poor's Credit Market Services, Singapore gave a presentation on “Role of Credit Rating Agencies for Development of Bond Market”. Saavedra welcomed the work of the seminar to help contribute to the development of the Asian bond market in the bank dominated financial system. The Asian economies are currently undertaking financial reforms and the banking sector could not be reformed appropriately unless they improve their corporate governance. As financial intermediaries, the banks provide liquidity and undertake credit assessments. However, there exists information asymmetry between lenders and borrowers in the financial system. Saavedra discussed the role of credit rating agency in providing additional information to their clients. The investors provide the liquidity and the borrowers assume the credit risk. The credit rating agency will provide information on the level of credit risk to the financial intermediaries.

59. She discussed briefly the following benefits to be obtained from using the services of credit ratings agency by issuers and counter-parties: (i) enhances access to new sources of funds in the domestic and international markets; (ii) enhances the terms and conditions of borrowings through interest rate spread, maturities, collateral and covenants; and (iii) provides independent measure of creditworthiness relative to peers and competitors. She explained that there are several reasons why individuals or institutions approach credit rating agencies for assistance. The main purpose is to obtain ratings on companies, banks and financial institutions that intend to raise borrowings in the form of bonds overseas so that the issued bonds could receive favorable response and at the same time help lower their cost of borrowing.

60. Saavedra continued to explain the benefits of credit ratings to investors. Investors like to use the services of credit rating agencies because they provide simple measure of credit risks, enhance transparency and disclosure, provide indicator of risk premium assessment and assist in portfolio monitoring. She also explained the benefits of credit ratings to regul-
lators. The regulators would like to establish or develop healthy and efficient capital markets by enhancing transparency and disclosure and provide rational basis for pricing credit risk. The regulators hope that this could lead to greater capital flows.

61. Next, Saavedra briefly discussed the rating process adopted by Standard & Poors from the preparatory to the final stage, that involves surveillance as well. In the preparatory stage, the rating agency would rely on information provided by the issuer. Each issue is assessed a lead/primary analyst to obtain historical information of the company’s performance for at least the past five years, to forecast on company’s performance in the next 3-5 years, to prepare company’s annual reports and prospectus and finally provide additional disclosures. The second stage involves convening management meetings between the rating agency’s analytical team and issuer representatives to review past performance, discuss strategy, goals and objectives, management philosophy and future plans. The third stage is the convening of the rating committee meeting involving the rating agency analyst to review the methodology profile and the process adopted in the assessment. The fourth stage is to give feedback to the issuer. The analyst will inform the issuer of the committee’s decision and the rationale behind the decision. The fifth stage is the appeal process. If the company disagrees with the rating decision, it can appeal the decision with the rating agency. The sixth stage is the dissemination to the public by the rating agency on the published rating with issuer’s knowledge. However, confidential information is not disclosed. The rating is then released to the public.

62. Saavedra informed the seminar participants that the rating agency applied different methodology profile for different types of clients. She explained briefly the methodology profile for sovereign ratings, financial institutions and corporations. For sovereign ratings, the methodology profile includes political risk, income and economic structure, economic growth prospects, fiscal soundness, public debt burden, price stability, balance of payments volatility, and external debt and liquidity. In the case of financial institutions, the methodology profile includes economic risk, industry risk (structure, customer base, regulation and deregulation, ownership structure), market position, diversification, management, strategy, and credit risk. It also covers market risk (structural and trading risks), funding, liquidity, capitalization, earnings, risk management (credit and market risk) and financial flexibility.

63. According to Saavedra, the methodology profile for corporate ratings includes business risk involving growth potential, capital requirements, competitive environment, company position, diversification of ownership and specific sectors. Other factors are financial risks, financial policies, profitability and earnings protection, capital structure and asset protection, cash flow adequacy, and financial flexibility. She also mentioned that there are two types of scales being used, namely, global and national. Finally, she explained that the essentials of a credit rating system must have such attributes as independence, objectivity, transparency, coverage, market validation, accuracy, relevance and supportive regulation.

64. Mr. Noritaka Akamatsu, Lead Financial Economist, Financial Sector Development Department, World Bank gave a presentation on “Capital Market Building: Managing Interdependencies”. He defined capital market as a place of interaction and mutual dependence among many participants and no single party can dictate the development process. It requires a political commitment and needs an opportunistic strategy to manage such a complex set of chicken-and-egg problems. He explained that the capital market consists of six building blocks, namely issuers, investors, intermediaries, trading and settlement infrastructure, legal and regulatory infrastructure, and financial instruments. The capital market is broken down into three market segments, consisting of equity market (the big board for blue chips) and the small capital market (for SMEs), governments (public sector) securities market, and the bond market. He also mentioned the emerging market known as the derivatives market.

65. The main focus of his presentation was on the government securities market. Akamatsu said that the government acted as the primary issuer. In order for the government securities market to exist and develop, the government must ensure the following: (i) it has a fiscal policy stance which enables sustainable issuance of government bonds; (ii) it is adequately empowered to borrow from the domestic market through legal authority; (iii) it is capable of managing the borrowing well especially with the central bank; and (iv) it is able to manage the debt efficiently. He also mentioned that government bonds are expected to be benchmarks for good reasons. To develop the government securities market, first the government should develop the primary market. There are various methods in issuing government bonds, such as auction, syndicated underwriting, tap issue and direct placement. The government must also develop the primary dealer system with some typical requirements such as: (i) always participate in primary auction; (ii) maintain price quotes for buy/or sell and a high trading volume through the prices it quotes; (iii) the trading market must be well organized to generate high trading volume through the prices it quotes.

66. Akamatsu discussed further that the government securities market must be able to generate sufficient liquidity, for this purpose there are two approaches: (i) to have investors with different investment/trading needs (banks, institutional investors, non financial companies, and individuals); and (ii) to develop the institutional investor sector, such as insurance companies, pension funds and mutual funds. The institutional investors should observe prudential regulation and introduce risk management by ensuring investment in liquid and credit-worthy instruments. Also they should diversify the investment portfolio to manage risk and provide fair market value for the beneficiaries, and evaluate their assets based on market-to-market, which requires proper accounting standards and reliable market price information.

67. In explaining the relationship between the institutional investors and the trading market, Akamatsu mentioned that if there are developed institutional investors, trading market architecture would need to accommodate their business needs. However, if the institutional investors are not well developed, the banks would act as dealers and would likely be the primary investors as well as the intermediaries. Institutional investors might wish to access the trading platform directly to avoid intermediation cost. If institutional investors trade di-
rectly with them, dealers might lose significant business. It might be good for the institutional investors but might not be good for market development, especially banks acting as dealers are discouraged to make market for bonds and a primary dealer system might not be viable. He also discussed the recent developments where the architecture of two markets, the equity and the bond markets are converging especially with respect to government securities.

68. Next, Akamatsu emphasized the importance of reliability and transparency of secondary market price for bond market development. However, in discussing the pros and cons of transparency requirement, he cautioned that not all transparencies are good. He explained some of the ways to achieve the price transparency such as standardizing the pricing formula, organizing the trade market to the extent possible, choosing the reliable private information vendors for the OTC market and standardizing the settlement system to gather trade information. He said that organized trading market might be possible and useful only for benchmarks because big players want anonymity to avoid impact cost.

69. He continued to explain the next building block, which is the trading market and settlement infrastructure. He emphasized that efficient settlement systems is important because it underpins competitiveness of the market. However, there is also an issue of trade-offs between efficiency and safety in an efficient settlement system. Moreover, to run an efficient settlement system it requires capital and liquidity. He also discussed on the type of links that exist between the trading market and the settlement systems that are being used at present in the developed countries and in the emerging markets.

70. Regarding the institutional framework, Akamatsu believed those institutions comprising the clearing house/central counter-party, transaction flow manager, central securities depository, custodians and registrars could be integrated. However, the processing should be as straightforward as possible regardless of the combination. Another important aspect of institutional integration is the governance of the body. He also discussed on money settlement by shortening the settlement cycle that would reduce systemic and market risks. He also mentioned about the difference between RTGS versus netting. The difference is between efficiency and safety trade-offs. RTGS eliminates systemic risk while requiring liquidity, which is often to be provided by the central bank. Netting reduces the liquidity requirement while accumulating systemic risk.

71. Akamatsu raised the possibility of self-regulation in the bond market and its viability. He discussed the existing market structure and the advantages and disadvantages of each. The monopoly market is good for transparency but its efficiency is questionable. In the case of competitive organized markets where they can compete with each other and with the OTC, it is difficult to enforce rules. The next market is the OTC market where there exist several bodies with no difference, such as bond dealers’ association, trade association or self regulating organizations (SRO). To ensure independence of the capital market, the following requirements should be met: (i) financial viability; (ii) competition—need many participants, sufficient business volume and require rating by regulation; (iii) “credible” owner-

72. Akamatsu also explained other important tasks in building capital market such as rationalization of trading and investment taxation in debt and equity securities and derivatives, standardization of repo transactions, establishment of derivatives market, legal and regulatory foundations, and government debt management for government securities. He recommended that the government should adopt a comprehensive approach in building a capital market by setting up a committee and task forces to develop the following areas: (i) primary market issuance; (ii) secondary market trading mechanism and architecture; (iii) delivery versus payments (DVP) and settlement systems; (iv) tax, accounting and regulatory impediments; (v) market information systems; (vi) standardization of trading practice and conventions; (vii) repurchase agreement market and bond lending; and (viii) derivatives market. For government securities market, the task force should look into the treasury and debt management.

73. Mr. Hiroshi Nakaso, Associate Director, Financial Market Department and International Department, Bank of Japan, presented his paper on “Japanese Experience: Capital Market Development and Reform”. He discussed the importance of a well-developed and sustained capital market. A well-developed government securities market would provide the basis for pricing all financial instruments. They are also essential for hedging interest rate risks. Therefore, enhancing the liquidity of such markets should be regarded as one of the most important goals in the development of capital markets. He recognized that Japan lacks behind in this area as its financial market is still dominated by the banking system. He said that Japan suffered a long economic slowdown since the early 1990s mainly because of the banking problems and the large overhang of non-performing loans. He stressed the need to develop the Japanese capital market especially the Japanese government securities market (JGSM).

74. Nakaso gave a broad overview on development of the Japanese government securities market compared with other developed countries. The gross amount of government liability relative to nominal GDP was the highest (120 per cent of GDP) among the G-7 countries in 2000 and is projected to increase further in 2001. In terms of the maturity structure of the Japanese government securities, the bulk of the maturities were concentrated in 5-10 year bonds. As at the end of December 2000, the Japanese government issued 399 trillion yen worth of government securities and 37 per cent was held by the government, compared with the US which issued 386 trillion yen (3.4 trillion dollars) during the same period and the government held 8 per cent while non-residents 35 per cent. In Germany, the German government issued 200 trillion yen (2 trillion euro) and the government held only 1 per cent while non-residents 37 per cent. In Japan, the government bond issue system is through auctions.

75. He continued his presentation by giving an overview of the Japanese secondary market compared with the G-7 countries. The liquidity of the Japanese government bonds mea-
sured by the bid-ask spread is relatively high, except the 10-
year index linked bond, which is relatively low compared with
other countries. Another indicator of market liquidity is to assess
the issue amount and the turnover. Compared with the other major
industrial countries, the Japanese secondary market was less ac-
active with relatively low turnover compared the experience in other
countries. The investors in Japan buy and hold the securities in-
stead of trading them in the secondary market. The length of the
delivery period in the US (+t1) is shorter than Japan (+t3). He
noted also that Japan was the only country where the transaction
in the futures market exceeded the cash market, which was very
liquid with the ratio below one. He recognized that the develop-
ment in the cash market was not balanced and that could lead to
potential vulnerability which should be addressed. The Japanese
government securities market tended to over depend on the fu-
tures market. He also noted that the monthly turnover volume in
the cash, futures and repo markets needed to be enhanced in a
balanced way.

76. Nakaso explained why the Japanese government
securities (JGS) market has to go through the Bank of Japan
(BOJ). The systems of JGS, the DVP and the RTGS for settle-
ment were introduced through the BOJ-net. The BOJ use the
JGS for money market operations to stabilize the financial
market and to conduct monetary policy. In essence, the JGS
is an important market for the central bank. He discussed with
the participants on the arbitrage relationships among cash,
futures and repo rates by comparing the pricing methods’ per-
formances based on prices of cash, futures, and swaps. He
continued to discuss on the postmortem of the JGS market and
the disruptions related to Y2K. He attributed the reasons
why liquidity was not sufficiently provided to the markets to
the following: (i) deteriorating risk-taking capacity by arbitragers after the Russian crisis and the near collapse of
LTCM; (ii) weakening of dealers and their exit from market-
making; and (iii) idiosyncrasies of Japanese investors. He also
highlighted the structural and institutional factors constrain-
ing liquidity as follows: (i) price discovery process overly
dependent on the futures market; (ii) inadequate development
on the repo market; (iii) unclear market practices and deliv-
ery failure; and (iv) flaws in the design of the primary mar-
ket. He went on to explain the recent reforms in the JGS
markets through the introduction of attractive financial prod-

tucts, improvement of the issue and the settlement process,
abolishment of and exemption from taxation on certain trans-
actions and introduction and improvement of new transac-
tions and practices.

77. Discussing the tasks needed to improve the JGS mar-
kets, Nakaso stressed the need on the following: (i) strength-
ening the linkage between the primary and secondary markets;
(ii) improving the secondary market by enhancing the func-
tioning of the repo markets, T+1 settlement and introduction
of electronic trading system; and (iii) reforming the account-
ing and tax rules that would avoid distorting the behavior of
market participants. He briefly discussed the development in
other Japanese stock markets such as the stock exchange, cor-
porate bonds, mutual funds insurance and pension funds cash
and deposits. Nakaso discussed the development and the re-
form process in the Japanese stock market and briefly high-
lighted the Koizumi Plan on the “Structural Reform of the
Japanese Economy: Basic Policies for Macro-Economic Man-
age ment”. The Plan consisted of seven programs designed to
enhance the individual’s ability to: (i) take risks and broaden
their frontier; (ii) reform the tax system to rebalance income,
asset and consumption; (iii) re-examine the tax related to se-
curity holdings; and (iv) strengthen the rules and bodies to
monitor fairness in the capital markets. He also discussed the
underpinnings to enhance the functioning and stability of the
Japanese stock market by allowing eligible corporates to
raise funds from the market, encouraging investors with di-
versified strategies and motivations to enter the market, pro-
vide contestable environment among intermediaries, exchange
and trading systems and having a well designed governance
system to ensure fair and transparent transactions.

78. Nakaso discussed on the development of the Commer-
cial Paper (CP) market in Japan. The amount of CP outstand-
ing in Japan was lower compared with the US. In the primary
market, banks play the dominant role in underwriting CPs as
alternative tools to loans. However, the volume of directly
issued CPs was very limited. In the secondary market, the
typical transaction form is the “gensaki” and the share of out-
right transactions is very low. Comparing the CP holders of
Japan to the US, the non-financial business was the largest
holder in Japan while in US the mutual fund is the largest
holders of CP. To develop the security settlement of the CP
market in Japan, the task ahead is to develop the multi-tier
structure, establish uniform settlement regimes in JGS, cor-
porate bonds and stocks, designating the central depository
of CPs. In addition, he discussed the need to develop the sec-
ondary market for loans by enhancing the functioning of in-
direct financing channels and more transparency in pricing
loans. At present, Japan has introduced the Syndication and
Loan-trading and has also drafted master agreements of pri-
mary and secondary transactions for loans.

79. In his concluding remarks, Nakaso said that follo-
ing were the implications drawn from the Japanese experiences
in strengthening the functions of the Japanese capital market:
(i) a well designed infrastructure including settlement, ac-
counting and taxation systems, and market practices is the
prerequisite; (ii) the momentum to improve the infrastructure
must be maintained; and (iii) the design should not distort the
functioning of the arbitrage relationships between markets,
investors’ sound and healthy risk taking, strong competition
among the financial intermediaries and the newly developed
alternative trading systems.

Part III—Strategies and Policy
Recommendations for the Development
of Capital Markets

80. Dr. Tan Khee Giap, Associate Professor, Banking and
Finance Division, Nanyang Technological University,
Singapore gave a presentation on “Strategies and Policy
Recommendations for Developing Corporate Bond Mar-
ket in Asia”. First, Tan explained the background of organ-
izing the Asian Policy Forum (APF) by the ADB Institute.
In the APF meeting, he presented a paper on “Designing a
New and Balance Financial Market Structure in Post Crisis
Asia: Policy Recommendations for strengthening the Bank-
ing Industry and Developing Corporate Bond Markets”, which was actually jointly prepared by the APF members and presented at the Annual Meeting of the ADB in Hawaii in May 2001. The APF proposed two major policy recommendations. The first recommendation was to enhance strengthening and improving the efficiency of the banking industry and the second was on development of the corporate bond market, which would be the topic of his presentation. He mentioned that the banking system is likely to continue its dominance in corporate financing. However, over-dependence on bank-based financing and the underdevelopment of bond markets in Asia may have significant adverse implications. To improve the rudimentary financial market structure and address the lopsided development over the relatively neglected financial sector and the banking system, the APF members held the view that the banking system and bond markets should be complementary to each other in the foreseeable future.

81. Tan explained that in designing a new financial market structure, a two-prong approach to deal with both strengthening the banking industry and developing the corporate bond markets would help to ensure a balanced and sustainable development of the financial markets for emerging economies. As a first priority, there was a need to strengthen the banking industry and to make the system more efficient by minimizing government interference, improving risk management capability, and harmonizing international standards and regulations in the banking industry. For this, according to Tan, there were three fundamental reasons: (i) bank loans perform many important functions which bond finance cannot substitute; (ii) a sound banking system is essential for the development of bond markets as banks inevitably become main issuers, buyers and guarantors of corporate bonds under an intermediate financial structure; and (iii) the inevitability that banks will be dominant during the intermediate stage of financial development when countries start to develop bond markets which will take a long time to develop.

82. Tan highlighted the following three proposals for enhancing the strength and efficiency of the banking industry:
- Proposal 1: Minimizing government interference and enhancing bank’s monitoring power
- Proposal 2: Strengthening prudential and supervisory regulations fitted to local conditions
- Proposal 3: Reviewing corporate structure of banks to avoid over-dominance of banks

83. To implement the first proposal the following steps were needed: (i) governments should avoid directed lending and bail-out of insolvent banks; (ii) there is a need to ensure the independence of regulatory and supervisory authorities; (iii) there is a requirement to build up sufficient budgetary resources and highly skilled human capital; (iv) banks’ position in the control chain of industrial organizations need to be enhanced, and (v) there is a need to ensure greater transparency in ownership, and in decision-making on loans and investments. For the second proposal, it needs: (i) to enhance CAMEL (capital adequacy, asset quality, management competence, earnings and liquidity); (ii) to introduce counter-cyclical, prudential regulations to use liquidity as an early warning signal for assessing the financial health of the banks; (iii) to monitor the cash flow impact of off-balance sheet liabilities; and (iv) to ensure maintenance of asset quality by introducing strict rules to reduce connected lending. The third proposal includes the need: (i) to strengthen intermediate financial market structure by enhancing bank efficiency; (ii) to prevent banks becoming too dominant and inhibit the development of bond market; and (iii) to identify an appropriate legal form for distinguishing banking from securities businesses.

84. Tan went on to explain the second part of the recommendations for developing corporate bond markets. Keeping in view the underdeveloped bond markets in the Asian region, the APF suggested that there should be a proper sequencing of capital markets development, such as establishing government bond market as a pre-condition for corporate bond markets development, so as to systematically build up the required medium-term infrastructure and thereafter prepare for the longer term regional bond market integration. Continuing, he explained that these developments could be divided into three intimately related categories. The first is an overview of sequencing capital markets development, followed by the immediate establishment of government bond market for effective benchmarking, and then proceeding with the enhancement of the depth and breadth of corporate bond markets. Thereafter, the stage would be set for the systematic build-up of corporate bond markets infrastructure and preparation for long-term regional bond market integration. Tan briefly highlighted the second part of the recommendations on sequencing bond markets development which contain the following ten proposals:

Proposal 1: Planning, prioritizing and pacing bond market activities: This involves establishing consensus on the usefulness of bond markets amongst those involved, setting up basic infrastructure, promoting primary and secondary market trading activities, encouraging corporate bond market activities, improving further bond markets infrastructure, transparency and objectivity, establishing related financial markets, reducing gradually statutory requirements and tax incentives and preparing for regional bond market development.

Proposals 2, 3 and 4 are related to the provision of effective benchmarks via government bond market issues as preconditions. Proposal 2 relates to encouraging fiscal prudence, regular issuance and well-spaced maturities mix over a longer-time horizon. Proposal 3 relates to stimulating primary and secondary markets activities with wider participation of local and foreign dealers facilitated by active market for repurchase agreements. Proposal 4 involves imposing initially statutory requirements to facilitate trading by way of competitive market-based pricing and tax incentives to promote investment in government bonds.

Proposals 5, 6 and 7 are related to overcoming the obstacles responsible for underdevelopment of corporate bond markets. In proposal 5, it involves encouraging demand for corporate bonds such as promoting institutional and retail investors as well as banks through provision of tax incentives during the infancy period. Proposal 6 requires the authorities to nurture the supply of corporate bonds by drafting legal and regulatory framework pertaining to bond issuance. Proposal 7 pertains to the need to establish related financial markets to facilitate adoption of appropriate strategies for risk management.
Proposals 8, 9 and 10 are also on overcoming obstacles responsible for underdevelopment of corporate bond markets. Proposal 8 refers to the need to improve further clearing and settlement systems to limit systemic risks so as to enhance the soundness and safety of the financial system. Proposal 9 is on encouraging transparency and objectivity from external and internal credit rating assessment. Proposal 10 is on need to prepare for regional bond markets participation and integration through a cost and benefit analysis. In the preparation for participating in regional bond market activities, each country needs to carefully evaluate the costs and benefits of local versus regional participation.

85. Professor Chong Beng Soon, Associate Professor of Banking and Finance, Nanyang Technological University, Singapore discussed his paper on “Singaporean Experience: Capital Market Development and Reform”. Chong gave an overview of the Singapore bond market development, a relatively new phenomenon and this is attributable to efforts in the past that have been mostly focused on development of other areas in the financial sector, such as the money and banking sector, equity and derivatives markets. Prior to 1997, the domestic bond market in Singapore was not well developed. Although domestic bonds have been listed on the local Stock Exchange since the 1970s, the amount outstanding and the volume traded were generally small. Singapore Government Securities (SGS) were issued on an irregular basis and there was hardly any secondary market trading as the SGS were held captive by the purchasers. The first major initiative to develop the bond market in Singapore actually started in 1987. In order to create a more active SGS market, the Monetary Authority of Singapore (MAS) embarked on several programs on restructuring the SGS market by introducing a new distribution network of primary and secondary dealers and a computerized book-entry system, increasing both the amount and the regularity of the issuance of SGS and revising the liquid asset requirements for banks and finance companies. The restructured SGS market was modeled after the US treasury bond market and was launched in 1987.

86. Even though the reform process had a good start in 1987, the programs did not have much impact on the SGS market, apart from increasing the issuance of SGS over the years and providing the necessary foundation for further reforms. Following the Asian crisis, the importance of having a sound and efficient bond market became more imperative. The Singapore government implemented a series of well-coordinated policies during 1998-1999 to promote a regional debt market. In order to broaden the bond market, liquidity needs to be improved and a reliable benchmark yield curve be created. Since 1998, the Government has embarked on a program to increase the issuance of SGS and Singapore dollar bonds.

87. Chong said that the result of 1998-1999 bond market reforms in Singapore was encouraging. It has resulted in a significant improvement in the liquidity and efficiency of the bond market. Since the Singapore government experienced large budget surplus over the years since the 1980s, the issuance of the SGS did not truly reflect the budgetary conditions or needs of the government. A majority of the SGS was held to maturity by the Central Provident Fund to meet its investment needs and by the banks to meet their minimum liquid assets requirement. As a consequence, the secondary market trading of the SGS had been rather inactive in the past. The average daily trading volume during the 1990-1997 was only 1.6 per cent of the total outstanding SGS issues. He noted that since the introduction of the bond market reforms in 1998-1999, the amount of SGS outstanding has more than doubled, and the average daily trading volume in the secondary SGS market accelerated significantly and the trading volume in the repurchase agreement (repo) market also recorded significant increases.

88. The rapid expansion in the size of the SGS market was due to MAS’s consistent effort to issue more and long-term SGS. The increase in supply of SGS had resulted in a rapid increase in trading activity. Another impact is the extension of the benchmark yield curve following the successful issue of the first 10-year bond. The impact was also observed in the corporate bond market. Since the issuance of MAS Notice 757, there has been a flurry of bond issues by supra-nationals, foreign companies and statutory boards. He noted that the impact of the 1998-1999 reforms on the issuance of Singapore Dollar bonds by the statutory boards and approved foreign entities has been significant. Following the 1998 directive from the Singapore government, the size of the statutory board bond market has increased from zero in 1997 to $4.8 billion as at Q1 of 2001. The issuances of Singapore dollar bonds were by the statutory boards. Similarly, with the approval given to foreign entities to issue Singapore dollar-denominated bonds, the amount increased from zero to $6.5 billion in 1997.

89. Chong believed that outlook for the Singapore bond market is bright based on the preliminary figures in 2001. He expected the Singapore bond market would expand further based on the following factors: (i) the Singapore government’s plan to issue S$120 billion of SGS over the next five years would provide liquidity to the market and introduction of bond futures contracts would provide additional hedging and trading opportunities to the market; (ii) 15-year bond is planned to be issued in September 2001 and the benchmark yield curve is expected to be extended further; (iii) 44 statutory boards in Singapore have the potential to issue Singapore dollar bonds since only a few had issued Singapore dollar-denominated bonds; (iv) visibility and demand for Singapore bonds will be greater with the recent inclusion of Singapore in the JP Morgan Global Bond Index; and (v) Singapore has established a well developed financial infrastructure that would provide the necessary ingredients for the development of Singapore as a regional bond center.

90. Despite the positive outlook for the Singapore bond market, Chong concluded that there remained a number of issues, which need to be addressed such as: (i) the small size of Singapore bond market by developed market standard; (ii) the need to expand investors base by including participation from retail and foreign institutional investors; (iii) the need to enhance the secondary market trading of corporate debt securities and to improve price transparency; (iv) the need to have the outstanding corporate bonds and the bonds issued by the statutory boards rated by rating agencies to increase demand from institutional investors; and (v) the need to promote the development of an asset securitization market be-
cause such a market is important for the development of the financial sector as a whole as it brings significant benefits for increasing the breadth of the bond market and providing an avenue for financial institutions to convert illiquid into liquid assets as well as to mitigate credit risks.

91. Dr. Changyong-Rhee, Associate Professor of Economics, Seoul National University, Korea, spoke on the “Korean Experience: Role of the Capital Market in Managing Financial Crisis”. Rhee identified Korea as an important case study for developing the corporate bond market. After the financial crisis of 1997/98, the corporate bond and the government securities market took a dramatic change in Korea. The measures taken by the Korean government were mainly focused on restructuring the financial system especially the banking sector but ignoring the other non-financial institutions, such as investment trust companies (ITCs) which was supervised under a relatively loose regulatory system. As a result, Chaebols could mitigate liquidity problems by issuing massive amounts of corporate bonds that bore attractive interest rates. The corporate bonds were bought by ITCs that could attract a large amount of funds from investors by offering implicitly guaranteed high rates of return. The match produced a self-fulfilling virtuous cycle: the funds kept flowing from the banking sector to the ITCs, which in turn, offered higher rates of return as the market interest rates stabilized. The market interest rates stabilized since companies avoid liquidity problems by issuing corporate bonds. Unfortunately, the mechanism that produced the virtuous cycle had inherent weaknesses. Firstly, the ITCs assumed the credit risk of corporate bonds with little discipline because they were Chaebol-affiliated and their products were not marked to the market. Second, easy financing reduced Chaebol’s incentive to restructure their businesses. When Daewoo, the second largest Chaebol, finally went bankrupt, the whole mechanism broke down.

92. Rhee showed a large proportion of corporate bonds issued in 1998 eventually defaulted, namely, 22 per cent of the total value of the corporate bonds issued from December 1997 to December 1999 had been defaulted as of October 2000. Of these defaulted bonds, 78 per cent were from the companies affiliated with the Daewoo group. This episode goes to illustrate the fact that bank-focused restructuring policy unilaterally allowed unviable firms to extend their life and thereby increased the ultimate financial costs of restructuring. To make matters worse, since the typical credit crunch problems become recurrent as the maturities of corporate bonds were three years in Korea. Currently, the credit crunch problems become recurrent which resulted from the maturities of corporate bonds issued in 1998 falling due in the first half of 2001. At the same time, the funds also flowed from the ITCs back to the banks, but the banks do not extend the credit because their capitalization was thin and they become more cautious about credit risk and less willingly to extend credit. The ITCs’ products are marked to market and cannot assume credit risk either.

93. Rhee identified the factors contributing to the roller-coaster adjustment process. One of the key factors that determined the post-crisis adjustment process in Korea was the flow of funds from the banking sector to the capital market. The factors that contributed to the rapid shift of funds from banks to capital market were the bank-focused financial restructuring policy and the fluctuation in interest rate that had risen to a historically high level and then started falling to single digit levels in mid-1998. The sharp reduction of market interest rates in mid-1998 strengthened the shift of the flow of funds. The downside trend of interest rates provided large capital gains to the funds formed by ITCs. The ITCs in turn could offer higher interest rates than the market rate. Thus more investors shifted their funds from the banks to the ITCs. In fact, both the trend of the interest rate and the pattern in the flow of funds produced a self-fulfilling virtuous cycle in the financial markets.

94. He explained further how the Korean government handled the flight-to-quality phenomenon. The government intervened in the corporate bond markets by employing two policies. The first is securitization, which helped reallocating credit risk by either slicing cash flows into senior and junior tranches, or using credit support provided by banks or the Credit Guarantee Fund. Thus, after the Daewoo crisis, structured financing, such as collateralized bond obligations and collateralized loan obligations played a pivotal role in the development of corporate bond market. The second was “An Emergency Measure for Swift Underwriting of Corporate Bonds’ through the Korea Development Bank (KDB)”. The KDB bought one-year corporation bonds issued by troubled corporations. This measure could be regarded as a tool to facilitate a private workout for troubled conglomerates before they default on corporate bonds. Rhee commented that although the effectiveness of the measure has been controversial, the government decided to intervene in corporate bond markets to cure the problems caused by its bank-focused financial restructuring policy.

95. Rhee identified some of the lessons learnt from the Korean experience in developing the corporate bond market: as: (i) loose regulation of the non-banking sector plus the bank-focused restructuring can increase ultimate costs of restructuring; (ii) mitigating credit crunch through corporate bonds can make the problem recurrent; (iii) asset-backed securities help overcome the credit crunch problem; and (iv) there are trade-offs between mitigating credit crunch and providing incentives for restructuring.

96. To conclude, Rhee expressed the view that the Korean economy would have been better off if the government restructured both banks and ITCs simultaneously. Even though the credit crunch problems might have been more painful in the beginning of the crisis, the vicious circle of credit crunch problems could have been avoided. Another lesson is that even though developing the corporate bond markets is important, but unless financial intermediaries such as ITCs are well disciplined, the negative effects may overwhelm the positive ones. For the capital market to function appropriately, investors who are compensated for credit risks should be responsible for the risks when they materialize. The simple principle, however, has not been observed well in the Korean bond markets.

97. Dr. Nik Ramlah Mahmood, Director, Market Policy and Development Division, Securities Commission of Malaysia gave a presentation on “Capital Market Development and Reform: Malaysia’s Experience”. Ramlah emphasized the important role of the Security Commissions (SC)
of Malaysia in developing the Malaysian capital market. It is a single regulatory body to promote the development of the capital market. The SC’s mission is to promote and maintain fair, efficient, secure and transparent securities and futures markets, and to facilitate the orderly development of an innovative and competitive capital market. To achieve this mission, the SC would facilitate the introduction of new products in the capital market to broaden and deepen the market, promote a fair, orderly and transparent market through efficient trading, settlement and information systems and to remove undue cost or impediments to the development of new products in the capital market.

98. Ramlah explained the various phases of capital market development in Malaysia starting from the early growth years in the 1980s. In the early years, capital-raising was rather popular through the public sector as it was a cheap source of development funding from the captive Malaysian Government Securities market. However, securities regulations were rudimentary at that time. In the mid 1980s, there were the winds of change following the severe economic recession, the government downsized public sector spending and privatized the government agencies. In 1993 the Malaysian capital market was at the watershed and the government established the SC, recognized the need to introduce the financial futures market by legislating the Futures Industry Act 1993. The focus was on institution building and strengthening the capital market. Ramlah exposed the weaknesses of the Malaysian capital market following the Asian financial crisis. The main weaknesses include inadequate disclosure and transparency, over-reliance on bank borrowings, market vulnerability to large capital outflows, relatively weak market institutions and poor risk management. The inherent weaknesses in the capital market necessitated immediate efforts in reducing systemic risk, improving transparency, enhancing enforcement, plugging the regulatory loopholes and providing flexibilities for corporate restructuring.

99. Ramlah explained that strengthening capital adequacy regulations, establishing the Kuala Lumpur Stock Exchange (KLSE) compensation fund and providing standby facility to the exchange clearing system addressed the systemic risk problem. The transparency issues were further improved by placing the central depository accounts (CDS) in the name of beneficial owner or authorized nominees. The threshold for disclosure of substantial shareholding was reduced. Also, the government introduced quarterly financial reporting requirement, due diligence by investment advisers and timely and complete dissemination of information by companies. The enforcement efforts were stepped up by bolstering SC’s supervisory and enforcement capabilities. The regulatory loopholes were plugged by strengthening the rules and interested party transactions, and by imposing a new Code on Take-Overs and Mergers.

100. She next discussed the immediate measures and comprehensive medium and long-term plans in developing corporate bond market, enhancing corporate governance, rationalizing regulatory framework, and strengthening the market institutions and intermediaries. The financial crisis underscored the need to develop a viable corporate bond market, which is regarded as the weak link in the capital market and establishment of the National Bond Market Committee. SC as a single regulatory authority could assess current impediments and incentives for market liquidity. SC also recognized the need to further enhance standards of corporate governance by establishing a high level Finance Committee. The regulatory framework was further streamlined in the corporate bond market, in transferring prospectus provisions from Companies Act to the SCA and in securities and futures licensing framework. The SC also took measures to strengthen market institutions and intermediaries. Ramlah also explained the progress in corporate governance reform effort, which was taken long before the financial crisis. The reforms focused on disclosure regulations, strengthening the laws and accounting standards, code of ethics for directors, requirements for independence directors and audit committees and establishing a Malaysian Institute of Corporate Governance. She explained that a holistic approach was adopted by forming a high level Finance Committee to establish a Malaysian code of corporate governance. Various efforts have been in place to implement it.

101. Ramlah also explained briefly the future development of the Malaysian capital market, the need to move forward, capitalize Malaysia’s strength of continued economic growth, high saving rate, growth in demand for investment products and increased investor awareness and sophistication in a challenging globalized environment and increasing competition. To take up the challenge, the government had produced the Capital Market Master Plan. The Plan identified the strategies and priorities, vision, objectives and recommended areas of action. The Plan had 24 strategic initiatives and 152 recommendations in the following areas: equity market, bond market, derivatives market, stock broking industry, market institutions, investment management, regulatory framework, corporate governance, Islamic capital market, technology and commerce and training and education. To conclude, Ramlah explained that the Master Plan will be implemented in three phases starting from 2001 until 2010. With the Master Plan in place, the SC’s mission statement to promote and maintain fair, efficient, secure and transparent securities and futures markets and to facilitate the orderly development of an innovative and competitive capital market will be achieved.

102. Dr. Yun-Hwan Kim, Senior Economist, Economic Development Resources Center, ADB, spoke about “Developing Treasury Securities Market in Asia”. He began his presentation by emphasizing the need to have a well-developed treasury bond market as a pre-requisite to develop the corporate bond market. The objectives of his paper was to discuss the significance of the treasury securities market in developing the financial sector, particularly the bond market and to learn some lessons for developing treasury securities markets in Asian developing countries (ADCs). In recent years, the significance of developing the financial sector including capital markets has been renewed. The distinctive feature of ADCs’ financial systems is bank-centered system, which contributed to the high economic growth prior to the crisis. It could more effectively mobilize and allocate financial resources and monitor financial activities of the corporate sector than the capital markets in the underdeveloped financial environment. However, it had resulted in the corporate sector’s over-reliance on short-term bank borrowing, a major cause of
the Asian financial crisis. He recognized the need to have a viable bond market, which would significantly help to diversify methods of financing industry and infrastructure.

103. The Asian bond markets are generally underdeveloped and lag much behind the banking sectors or equity markets. He noted all crisis-hit economies had substantial banking sectors and much smaller treasury and corporate debt securities markets. Among the crisis-affected economies, Korea had the most dis-intermediated debt market, whereas Indonesia had the least. Compared with the US, the outstanding bank loans were much higher in the crisis-hit economies whereas outstanding corporate bonds were much higher in the US, which has the world’s most advanced bond market.

104. Kim explained the importance of bond market development. First, it helps to diversify the sources of industrial and infrastructure financing. Such financing overly dependent on banking institutions involves a serious term mismatch between their short-term bank borrowing and long-term investments, inflexibility in financing methods, and high risks at a time when banks are reluctant to lend. Second, bond financing alleviates the uncertainties caused by the global bank dis-intermediation in the post-crisis period. The bank dis-intermediation is due to the following factors. First, because foreign banks are extremely cautious about providing new credit, the portfolio diversification and aggressive yield-seeking behavior of domestic and globalized investors have increased the opportunity cost of bank deposit. Second, East and Southeast Asian countries enjoy the world’s highest domestic saving rates. Development of the bond market will contribute to transforming these savings, which are available mostly in short-term bank deposits into long-term development resources. Third, bond market helps finance huge infrastructure development projects in ADCs and it will contribute to enhance the corporate governance standards in ADCs. Bond issuers prefer a higher credit rating to reduce interest rates and issuance costs.

105. In examining the present status of treasury markets in Asia, he noted that among the developing economies, Hong Kong, China has long been committed to preserving a liquid exchange fund paper (EFP) market, although there is no immediate funding need from the market. The Hong Kong Monetary Authority issues EFP and not the finance ministry. The EFP market provides a 10-year long yield curve. AS Hong Kong, China’s fiscal status has generally been in surplus, the EFP market is well received by the market. The EFP accounts for 23 per cent of total debt instruments. Korea and Malaysia issued treasury bonds as needs arise whereas the Philippines and Sri Lanka, despite regular issuance, did not have a liquid secondary market.

106. Kim pointed out that except for Hong Kong, China, most of other ADCs have not paid much attention to developing a long-term treasury securities market for various reasons, including concerns about accumulating government debt and lack of interest in domestic bond markets where bank loans and overseas borrowings were cheaper and easier. Only after the crisis, some ADCs have started making efforts to develop their securities markets and create a reliable long-term benchmark yield curve. Four ADCs including Korea, Malaysia, Singapore and Thailand have made efforts to develop their securities markets. The Philippines and Sri Lanka have been issuing long-term treasury bonds largely to finance fiscal deficits but their bonds are not creating any satisfactory benchmark yield curves. The PRC issues treasury bonds to finance both fiscal deficits and special projects rather than to create a benchmark curve.

107. He further explained the need for regular issuance and secondary market liquidity, which are the two key requirements for treasury securities to provide a benchmark yield curve. Regular issuance will deepen the government bond market and increase confidence of fund managers in treasury securities and enhance the liquidity in the secondary market. Treasury securities cannot be an attractive financial product without a liquid secondary market. Hong Kong, China and Singapore were satisfactory in both aspects but other ADCs did not meet one or both of the two requirements. The PRC, Korea and Malaysia issued treasury bonds as needs arise whereas the Philippines and Sri Lanka, despite regular issuance, did not have a liquid secondary market.

108. According to Kim, there are several lessons that could be drawn to develop treasury securities market and they are as follows: (i) an economy needs to have a clear and sound long-term government debt strategy and satisfactory operational capacity; (ii) a clear division of responsibility between government debt management and monetary policy to ensure a balanced fiscal and monetary policy; (iii) there is a need to minimize the debt cost, make the market more competitive, and open it to foreign investors; (iv) there is the need to have regular and substantive communication and dialogue with markets on debt management, objectives and operational strategies; (v) the rationale of debt management operations should be transparent and the operations reasonably predictable; (vi) to enhance market liquidity, treasury securities should be consolidated into a relatively small number of benchmark issues; (vii) a benchmark yield curve should cover at least 10 years; (viii) when selecting primary issue arrangements, it should consider the development stage of the treasury securities market; generally, the open auction system is preferable but smaller and less liquid markets may benefit from a dealer panel arrangement; however, a primary dealer system is essential for efficient distribution; (ix) a captive or obligatory investor arrangement is not desirable as it impedes secondary market development; (x) markets (secondary) require a steady supply of new securities to sustain liquidity; (xi) reliable and real-time clearing and settlement arrangements are both critical to efficient operations; (xii) there is a need to provide both legal certainty and a level playing field, and authorities must remain responsive to the changing requirements of the market; and (xiii) treasury securities must be attractive to investors.

Part IV—Group Work on Country Specific Issues

109. The seminar participants were divided into three groups to discuss on Financial Structure and Capital Market De-
development in their respective countries. As the participants come from countries with different stages of capital market development, they were divided into three groups in accordance with the level of capital market development in their own country: **Group A** included Hong Kong, China, Japan, Korea, Malaysia and Singapore. **Group B** included Bangladesh, India, Myanmar, Nepal, Pakistan, Sri Lanka, Kazakhstan and Uzbekistan. **Group C** included Cambodia, Indonesia, Lao PDR, Philippines, Thailand and Viet Nam.

110. A representative from **Group A** presented an overview of the development and common characteristics of capital market development of member countries in their group. Group A member countries experienced fragmented development with each country having different stages of capital market development but overall, the countries in Group A have a well developed financial market infrastructure. The uniqueness among individual markets are as follows: **Korea** has a highly liquid secondary market for government and corporate sector. The development of bond market was related to management of financial crisis and as a follow-through, create development of high-yield bond market. In the case of **Malaysia**, development of bond market was also related to management of the financial crisis. The overall development was focused on developing the breadth of the market as a cushion for handling possible future financial crisis. **Hong Kong, China and Singapore** pursued active development of their bond markets despite having fiscal surpluses. They also encouraged foreign participation in the domestic bond market. In **Japan**, the bond market development was driven by genuine need for the government to issue bonds due to large budget deficit and the need for corporations to issue bonds to replace bank lending during restructuring. On the demand side, divestment from bank deposits to investment in bond market is happening in Japan. There was over-investment in the Japan Government Securities market by the public sector. Every seminar participant in Group A was given the opportunity to give a brief presentation of their country paper on the current development of the capital market in their respective country.

111. The following are the highlights of capital market development from different countries in Group A. In **Korea**, there was active development in the issuance of corporate bonds, which increased rapidly as a percentage of GDP from 19.9 per cent in 1999 to 25.8 per cent in 2000. Rapid increase in high yield corporate bonds amounting to 13.7 trillion won which make up 55.1 per cent of all newly issued corporate bonds in 1999. Many other kinds of bonds were introduced such as ABS, CBO and CLO in the Korean capital market. The problems facing the bond market was the roll-over ratio which was 50.4 per cent from April to May 2001, the dependency upon P-CBO was too high and the number of high yielding bonds falling due has increased. The recommendations were to sustain the financial and corporate restructuring, to improve P-CBO and to foster the development of high yielding bond market.

112. In **Malaysia**, in the absence of a well-developed bond market, a significant portion of economic financing is borne primarily by the banking sector. A large financial outlay is required to fund the privatization projects, using short-term borrowing. Recognizing the importance to develop the bond market, several initiatives have been taken to develop the market, which have now increased in significance. The market for private debt securities accounts for about 28 per cent of GDP. Though the Malaysian government securities dominated the bond market, which constituted about 47.6 per cent of the total outstanding issues at end-December 2000, the development of private debt securities has increased about 84 per cent during 1995 to 2000. As part of its continuing effort to promote an active secondary market, as well as to promote a more dynamic and performance-based dealer system, several measures have been introduced for the primary and secondary market. Among the major reforms undertaken are: principal dealer system, creation of benchmark yield curve and creation of market infrastructure. The future plans would be to develop the Malaysian bond market by improving the secondary market such as repo and SBL, continuous improvement and widening of issuer and investor base, and creating the derivatives market.

113. In **Hong Kong, China**, the capital market is the most liquid and the most liberal and there was no restriction on foreign investors. The measures were taken to promote the development of the Hong Kong dollar debt market with the establishment of a benchmark yield curve and the supply of high quality paper, establishment of an appropriate and efficient market infrastructure, and through the enhancement of the liquidity and transparency of the EFP.

114. In **Singapore**, various initiatives were implemented to develop the government securities market through increased issuance program to ensure sizeable free float of bonds above MLA holdings, introducing the repo, facility available only to primary dealers to help facilitate their market making activities. MAS has executed the PSA-ISMA Master Repo Agreement with all primary dealers and MAS has worked together with the primary dealers to institute guidelines for the treatment of failed SGS outright trades. MAS has also implemented the SGS buy-back program launched in mid-November 2000, re-opening of old off-run issues, SGS issuance calendar, inclusion in JP Morgan Futures, launching SGS website on 15 May 2001 aimed to enhance transparency, and create greater awareness of the SGS market. The authority also invests in education and efficient clearing and settlement system.

115. In **Japan**, the Government is the largest holder of government bonds (40 per cent of total) followed by financial institutions (38 per cent) and central bank (11 per cent). Compared to the US, non-residents are the largest holder of government bonds accounting for 34 per cent of total, followed by financial institutions (31 per cent). The US government held only 7 per cent of the total. The ongoing reforms in the Japanese capital market are on expansion of product range, minimizing transaction costs under well-designed infrastructure and education.

116. In conclusion, **Group A** made the following recommendations to develop the capital market in Asia: (i) the pace of development and reform can vary; and (ii) there is need for continuous enhancement of capital market infrastructure; educate the investors; widen the domestic and foreign investor base; expand product range; and maintain well balanced financial innovation.
117. Group B includes Kazakhstan, Myanmar, Nepal, Pakistan, Sri Lanka and Uzbekistan. These eight countries are divided into two sub-groups since different countries have reached different levels of financial and capital market development. The first sub-group belongs to the South Asian Group consisting of countries like Bangladesh, India, Nepal, Pakistan and Sri Lanka. The second sub-group represents countries in the economic transition such as Kazakhstan, Myanmar and Uzbekistan.

118. A participant from Bangladesh spoke on the capital market development in Bangladesh. It has a small and relatively under-developed capital market, but it has great potential. At present, Bangladesh operates two stock exchanges. The size of the stock exchange is quite large compared to its initial position. As at end March 2000, the total market capitalization with the Dhaka Stock Exchange and Chittagong Stock Exchange were Tk54,004 million ($1,049 million) and Tk39,810 million ($733 million), respectively. The capital market is regulated by the following regulatory agencies: (i) the Securities and Exchange Commission; (ii) the Companies Act, 1994; and (iii) the Stock Exchange. The government has introduced several reform measures to strengthen and consolidate the development of the capital market.

119. A participant from India explained that his country has a long tradition of functioning capital markets, till the 1980s the volume of activity in the capital market was relatively limited. At present, there are 24 recognized stock exchanges. The two major stock exchanges, which account for nearly 75 per cent of the trading turnover, are the National Stock Exchange of India Ltd. and the Stock Exchange of Mumbai. The Indian securities market has seen a rapid expansion since 1990 in terms of the amount of capital raised from the primary market, the increase in the number of stock exchanges and other intermediaries, market capitalization, trading volumes, turnover on stock exchanges and investor population. In 1992, the Securities and Exchange Board of India (SEBI) was enacted to perform a dual functions of providing investor protection through regulation of the securities markets and fostering the development of securities markets. Since the 1990s, companies have been placing greater reliance on the securities market as a major source of finance.

120. According to the participant from the Kazakhstan, the capital market development in Kazakhstan is still in its infancy. The government has been active in developing its securities market. The first treasury bill was issued in 1994. In 1997, three new securities laws were adopted that establish legal regimes governing the issuance of securities, the operation of organized securities markets, the activities of securities market participants, the registration of securities and the requirements for various professionals to participate as custodians, broker-dealers, registrars, the CJSCL central depository and investment funds. A new Joint Stock Company Law came into force in August 1998. This new law was intended to modernize company law and introduce standards of corporate governance and information disclosure as well as shareholders’ protection standards. The securities market is regulated and monitored by the NSC, which was established in 1994. Currently, there is only one stock exchange in Kazakhstan.

121. A Myanmar participant explained that the capital market in Myanmar is still in its formative stage while the private banking system in its infant phase of development. Even though the stock market is said to have existed in Myanmar before the war, it is small and was established before the great depression in the 1930s, and trading is very limited. The main reasons why the stock market was not well developed in Myanmar during the pre-war period, were basically due to the fact that most European firms operating in Myanmar at that time were acting as branches for parent companies in Europe and also the Indians migrant workers remitted their earnings to India instead of investing in Myanmar. The stock market existing at that time appeared to be somewhat disorganized and undeveloped. Since late 1988, in pursuing a market-oriented economic system, Myanmar has exerted efforts to raise financial capital through various means, attracting foreign direct investment, liberalizing trade and the banking sector, encouraging private and public savings, and taking steps to create a securities market. It is possible that large sums of money have been saved but not deposited in the banks. There are sufficient grounds to believe that adequate funds exist in Myanmar for a stock market to function.

122. Capital market development is relatively new in Nepal as compared to the banking system according to the seminar participant from Nepal. The financing of the economy is heavily dependent on the banking system. The Nepalese government formulated the first comprehensive plan for capital market development while drafting the Eight Plan (1992-1997). Subsequently, the first amendment to the Securities Exchange Act in 1983 created a legal basis for implementation of the pronounced policies. With the objective of promoting and protecting the interest of investors, and regulating and developing the securities market, the Securities Board of Nepal was established in 1993 under the Securities Exchange Act 1992. The Securities Exchange center was eventually converted into the Nepal Stock Exchange Ltd. In 1993, various efforts were exerted to develop the institutional framework especially the primary market, secondary market, stockbrokers, issue managers, security dealers, and financial instruments. The progress so far has been satisfactory. Various administrative and legal measures are underway to resolve the duplications and discrepancies in terms of regulation and supervision of the capital market.

123. A participant from Pakistan gave a broad overview of capital market development in his country, the problem and measures taken. Capital market is less developed compared with the banking sector and this is taking its toll for the entire financial market. Most of the members of the stock exchanges are not disbursing dividends and 5 or 6 major corporations are controlling approximately 60 per cent of the total capitalization of the stock exchanges. This has created an environment where corporations are constrained to go highly leveraged and thus taking direct impact of interest rate volatility on their business. The main obstacle in post crisis reforms in the financial market in Pakistan can be summarized as lack of market expertise, lack of awareness on new financial products, lack of infrastructure and automation, lack of stringent regulatory policies and their enforcement, lack of self policing system in the market, lack of awareness of market ethical values, political interference in the regulatory func-
tions and lack of clear laws curtailing dual interpretations. The legal settings for financial reforms need to be improved in the areas of foreclosure laws, investor rights, settlement laws, court decisions within a short span of time, enforcement of laws and accountability proceedings. Diverse financial reforms and measures were taken to strengthen the financial system in recent years.

124. According to a participant from Sri Lanka, one of the fastest growing sectors in Sri Lanka in recent years has been the financial sector. Comprehensive financial reforms have taken place in 1977. One of the areas in which significant reforms took place was the amendments on the legislative provisions to improve the government debt securities market, create more market oriented treasury bonds and increase the efficiency of the secondary market in government securities. A system of dedicated primary dealers was established to promote the market. Many measures have been taken to develop the equity market such as allowing non-nationals to invest in the Colombo stock market, free repatriation of dividends, capital gains and sales proceeds, abolishing the capital gains tax on share investment, foreign ownership of licensed stock broking firms. Although the financial reforms in Sri Lanka has been significant in the past two decades, as conditions change and the domestic and international environment evolves, the reform process will continue to keep abreast of changes in the global environment that affects the financial sector.

125. The Republic of Uzbekistan, a transition Central Asian nation, has made good progress in the development of its capital market. A representative from Uzbekistan explained that his country has a rather short history and is still in the formative and developmental stage. The most dynamic development of the market started in 1993-1994 with the beginning of the processes of mass privatization and the sale of the securities of state enterprises. Within a short period of time, it has acquired the inherent features of advanced international stock markets but there are still a number of issues to be resolved. In recent years, the infrastructure for securities market has been created including the setting up of the stock exchange, central depository system, electronic OTC trading system, clearing and settlement chamber, electronic information analysis system and other investment institutions. The Uzbek government has also taken measures to develop and strengthen the necessary legal framework for the smooth functioning of the securities market. The performance standards for depository and register institutions were introduced. The government bond market was started in 1996 and the bonds are issued periodically. The wide-scale privatization of various state enterprises provides major potential development in the securities market of Uzbekistan.

126. Group C includes Cambodia, Indonesia, Lao PDR, Philippines, Thailand and Viet Nam. They also divided into two sub-groups on the basis of the current status of capital market development in their respective countries. Sub-group one countries consist of Thailand, Philippines and Indonesia. The countries in this sub-group experienced currency and banking crisis, and market development is in the intermediate state. Sub-group two countries are Viet Nam, Lao PDR and Cambodia, which did not experience the Asian financial crisis, and their capital market development is in their infancy.

127. A representative from Group C presented the overall current state, existing problems and future plan on capital market development in sub-groups one and two countries. The countries represented in sub-group one focused on financing problems in their countries, development of government and corporate bond and equity markets, infrastructure development, and development policies. The source of corporate financing is mainly from the banking system and offshore loans. The banks utilized offshore loans as an alternative source of funding to domestic credit needs. The countries faced the problems of currency and the maturity mismatches. With respect to the development in the government bond market, particularly in the primary market, the objective was to finance the financial institutions restructuring program and the government budgetary deficits. The investors are banks, insurance companies and institutional investors. The instruments are the treasury bills and government bonds. The government bonds were traded in the secondary market and the trading was carried out on the OTC, inactive trading due to buy and hold strategy, the market maker are primary and accredited dealers. The benchmark yield curve existed only in some countries. On the corporate bond market, the primary market exists only with a few issues from blue chip companies and investors are mainly institutional investors. The secondary market was inactive. The infrastructure has not been modernized where the clearing and settlement system is still manual, the registry system is still using the scrip and book entry and there are only one or two credit rating agencies. In the equity market, there is a wider base of investors but limited supply of new stocks. The clearing and settlement system is based on delivery versus payment (DVP).

128. A representative from sub-group two countries explained briefly the current state of capital market development in their group of countries. Their countries are heavily dependent on foreign sources of financing to fund their economic development. The loans extended by the local commercial banks to the corporate sector are limited and they have to obtain funds mainly from internal sources. The governments and the state enterprises compete for funds from the domestic market and this has crowded out private sector borrowing. The governments issued treasury bills and government bonds mainly to finance their budgetary deficits. The equity market exists only in Viet Nam, Lao PDR and Cambodia are still in the process of conducting feasibility studies in setting up the market. This group of countries which are still in the transitional stage, the capital market development policies should focus on the following: (i) removing obstacles through banking reforms and privatization exercise; (ii) having legal infrastructure in place; and (iii) establishing market infrastructure such as credit rating agency, centralize registrar, C&S system and institutional settings like securities commission and institutional investor.

129. Participants from each of the countries from Group C gave a brief presentation on the current state of capital market development in their own country, the existing problems and measures taken and the future plan to develop their capital market. In the case of Indonesia, its capital market is growing
steadily and is playing an important role in mobilizing long-term financing for the government as well as for the corporate sector. The government has established the Indonesia Blue Print Capital market 2000-2004. Various measures to improve the functioning of the market have been introduced such as improving the infrastructure, strengthening the legal framework, building up institutional framework, introducing new products and instruments and restructuring the banking system. The challenges facing the Indonesian authorities in developing its capital market are plentiful, such as for strengthening the rules, regulations and the legal framework; improving the fiscal and monetary policy to create a conducive environment for the development of the Indonesian capital market; strengthening the capital market to compete in the global market; developing the bond and derivative market; and boosting domestic investors participation in the capital market.

130. Capital market development in Thailand is progressing steadily. The equity market has become an important source of funds of private firms in the economy after the financial crisis. The secondary market for government bonds is well developed but the corporate bond market is less developed. The Thai Authority has taken various measures to develop the government bond and the corporate debt markets. To develop the equity market, the government has encouraged and expedited the privatization of state enterprises to increase trading activities and market capitalization. The government reduced corporate tax to listed companies to 25 per cent as against 30 per cent for non-listed companies. Following the global economic slowdown which affects the performance of listed companies, the Thai government and regulatory bodies implemented several measures affecting supply, demand and market infrastructure to boost the equity market development.

131. In the case of the Philippines, its capital market has grown steadily from its developmental stage after the lifting of the debt moratorium in 1993. The country has low saving rate and low earning levels, which affect the breadth of credible lenders in the capital market. While there is an adequate number of buyers/borrowers, there are not enough lenders, particularly for the long-term market. With a lack of alternative sources of funds to tap into, investors in long-term projects/investments turn to banks or to the international capital markets for their sources of financing. Despite the inadequacies, the market capitalization of the Philippines equity market has increased significantly. The domestic bond market is dominated by government securities, which may be attributed to the widening of its fiscal deficits. Compared to GS, there is a dearth of issuance of private debt instruments and this generally limited to a handful of blue-chip corporations. The derivative market is also negligible. The government is looking into various measures to establish a more vibrant and efficient capital market by imposing diverse reform measures.

132. Capital market development in Viet Nam is still in its infancy. In July 2000, the Ho Chi Minh Securities Trading Centre (STC) was launched. Stocks and bonds are issued but in the absence of an organized securities trading center, there are no secondary markets for these instruments. The debt instruments market consists mainly of a primary market in treasury and a few government and special purpose bonds. Public investors in joint stock companies and enterprises, which recently issued equities, also hold shares. In the informal market, there are 50 kinds of shares traded daily. The STC market was faced with many difficulties such as small quantity of traded securities and limited kinds of securities, unusual fluctuation of stock prices, state unsynchronized management and lack of information. In summary, the capital market in Viet Nam exists with many difficulties and obstacles.

133. Capital market development in Cambodia is in the preparatory stage. The Royal government of Cambodia has created a Securities Exchange Regulatory Working Group to prepare a feasibility study to establish a Securities and Exchange Commission at the end of 2000. There was a considerable debate, however, on the implementation and timing for developing the capital market in Cambodia. With the present weaknesses in the laws, lack of adequate accounting, legal and financial infrastructure, absence of institutional investors will hamper the development of capital market in Cambodia. Therefore, Cambodia needs to improve the basic infrastructure for the financial sector, including stronger legal rights for creditors and shareholders, better information, disclosure, and supporting public and private institutions. Nevertheless, the Prime Minister of Cambodia has established the Securities and Exchange Regulation Working Group on 5 July 2000. The working group is given the responsibility to research and draft sub-degrees and laws on stocks, bonds and securities markets for Cambodia.

134. Capital market development in Lao PDR is still in its preparatory and infancy stage. The financing of the economy is through the budgetary process and also through bilateral and multilateral loans. The government issued treasury bills to meet its short-term funding requirements. The private sector’s main source of financing is through the banking system.

Conclusion

135. Dr. Subarjo Joyosumarto, Executive Director of the SEACEN Center concluded the seminar by thanking all participants and speakers. He believed that the seminar has fully met its objectives to enhance participants’ conceptual understanding and practical skills in capital market development and at the same time provide a forum for knowledge dissemination, exchange of views and discussion on country experiences. He believed that seminar has provided an in-depth knowledge and learning experience for participants to discuss conceptual and practical policy issues involved in capital market development particularly the development of the bond market. Participants were given the opportunity to present their country reports and at the same time exchange views with one another and have interactive discussions with the resource speakers. This would sharpen participants understanding and intellectual knowledge on the subject. He thanked the resource speakers from the academia, government agencies, multilateral institutions and the private sector for imparting and sharing their valuable knowledge and expertise at the seminar. He congratulated all the participants and resource speakers for conducting a very fruitful and successful seminar, judging from the active open discussions and exchange of views during the five-day seminar. Lastly, he also thanked the ADB Institute and the SEACEN Center officials for their dedication and tireless effort in making the seminar a success.
Executive Summary Series

All these titles and much more available online and fully searchable at http://www.adbi.org/publications/

- Banking Sector Reform
  14–23 August 2000, Kuala Lumpur, ESS No. S37/01

- Pacific Public Management Executive Program (PPMEP) Module 3: Managing Programs, Projects and People
  5–13 March 2001 Brisbane, Australia, ESS No. S38/01

- Information and Communication Technology (ICT) Strategies for Developing Countries

- Public Expenditure Management:
  Local Program Conducted by Pakistan Administrative Staff College as assisted by ADB Institute
  29 January–3 February 2001, Lahore, Pakistan, ESS No. S40/01

- Information and Communication Technology and Education:
  Potential for Partnerships
  23–27 April 2001, Hong Kong, China, ESS No. S41/01

- Social Safety Nets Seminar
  19–28 March 2001, Tokyo, ESS No. S42/01

- Reforming Pension Systems in South Asia Part 1—Policy Conference
  23–25 November 2000, New Delhi, India, ESS No. S43/01

- Reforming Pension Systems in South Asia Part 2—Training Workshop
  27 November–2 December 2000, New Delhi, India, ESS No. S44/01

- Public Expenditure Management: Training-of-Trainers Program
  27 May–8 June 2001, Tokyo, ESS No. S45/01

- Trade Policy Emerging Issues
  16–24 April 2001, Singapore, ESS No. S46/01

- Urban Poverty Reduction Issues
  4–13 June 2001, Dhaka, Bangladesh, ESS No. S47/01

- 2001 Tokyo Round Table on Capital Market Reform in Asia
  10–11 April 2001, Tokyo, ESS No. S48/01

- Tokyo Seminar on Securities Market Regulation
  12–13 April 2001, Tokyo, ESS No. S49/01

- Pacific Public Management Executive Program (PPMEP) Module 4: Leadership and the Management of Change
  30 July–7 August Cairns, Australia, ESS No. S50/01

- Issues in the Social Sector
  22–28 August 2001, Tokyo, ESS No. S51/01

- 2001 Tax Conference
  5–11 September 2001, Tokyo, ESS No. S52/01

- International Finance Seminar
  17–21 September 2001 Seoul, ESS No. S53/01

- Reforming Pension Systems in the Asian Transitional Economies Part 1—Policy Conference
  5–6 July 2001, Tokyo, ESS No. S54/02

- Reforming Pension Systems in the Asian Transitional Economies Part 2—Training Workshop
  9–13 July 2001, Beijing, ESS No. S55/02

- Development of Capital Markets
  16–20 July 2001, Kuala Lumpur, ESS No. S56/02

The views expressed by presenters and speakers, and the findings, interpretations, and conclusions of authors are their own and are not necessarily endorsed by the Asian Development Bank Institute. They should not be attributed to the Asian Development Bank, its Boards, or any of its member countries. The Institute does not guarantee the accuracy or reasonableness of the contents herein and accepts no responsibility whatsoever for any consequences of its use.

ADBI Publishing 3/02