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Chapter III Asian Growth Strategies From a Financial Perspective

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Chapter III

Asian Growth Strategies From a Financial Perspective

In the 1990s Asian economies were glutted by an inflow of global private capital. In this chapter, we will discuss the types of financial issues that face Asian economies in their attempt to maintain their status as the world's growth center in the future.

1. Changing Role of the Financial Sector

The mid-1980s was a turning point in Asia in the sense that the role played by the financial sector in economic development changed drastically. Until then, Asian governments tended to pour limited available capital into selective industries in order to achieve policy goals. Their domestic financial policies were designed to allow distribution of available governmental financial resources to designated industrial sectors or encourage private banks to disburse their capital in such way as to supplement the public policy. A large portion of the capital inflow from overseas was in the form of governmental economic cooperation or direct investment. In other words, until the mid 1980s most of the capital obtained either domestically or internationally was procured without going through financial or capital markets.

As mentioned earlier in Chapter II, Asian countries sustained high growth rates since the Plaza Accord was reached in 1985,. In the meantime, the financial or capital needs of the Asian countries grew steadily and become more diversified. A larger amount of capital was needed to finance the upgrading of infrastructure and investment in plant and machinery. Moreover, as economic activities in Asia grew more global in nature, capital transactions across national boundaries multiplied rapidly. It was no longer possible for Asian countries to acquire capital sufficient to meet their growing financial needs. Therefore, Asian economies have increasingly utilized capital markets for the procurement of capital sufficient to sustain high economic growth rates and accommodate diversifying capital needs induced by changing industrial structures.

A case of financing various projects for upgrading infrastructure is a good example for illustrating changing capital needs. In recent years, it has become a big concern among Asian countries how to procure the necessary capital for building infrastructure such as power plants, communication facilities, ports and highways. According to a World Bank projection, capital needed for building infrastructure among East Asian countries will reach US $1,500 billion in total over the ten year period extending from 1995 to 2004 (see table 3-1). Capital

Table 3-1: Indicative Investment Requirements in Infrastructure in East Asia (1995 - 2004)

(unit: $ billion dollars)

	Power (% vs. nominal GDP)	Telecom (% vs. nominal GDP)	Transport (% vs. nominal GDP)	Water and Sanitation (% vs. nominal GDP)	Total (% vs. nominal GDP)
China	200 (2.0)	141 (1.4)	302 (3.0)	101 (1.0)	744 (7.4)
Indonesia	82 (2.9)	23 (0.8)	62 (2.2)	25 (0.9)	192 (6.8)
South Korea	101 (2.1)	32 (0.7)	132 (2.7)	4 (0.1)	269 (5.6)
Malaysia	17 (1.7)	6 (0.6)	22 (2.1)	4 (0.4)	50 (4.8)
Philippines	19 (2.7)	7 (1.0)	18 (2.5)	4 (0.4)	48 (6.8)
Thailand	49 (2.4)	29 (1.4)	57 (2.8)	10 (0.5)	145 (7.2)
others	25 (3.1)	18 (2.2)	14 (1.7)	4 (0.5)	61 (7.5)
East Asia total	493 (2.2)	256 (1.2)	607 (2.7)	153 (0.7)	1,509 (6.8)

Note: 1. Only public sectors for Malaysia and Thailand.
2. Others comprise Cambodia, Fiji, Kiribati, Lao PDR, Maldives, Mongolia, Myanmar, Solomon Islands, Tonga, Vanuatu, Vietnam and Western Samoa.

Source: The World Bank, *Infrastructure Development in East Asia and Pacific: Towards a New Public-Private Partnership, September 1995.*

procured for this particular purpose must come from low interest, long-term loans, and has to be sizable. In order to secure such loans, regardless of either direct or indirect financing, a combination of various procurement means should be employed to attract capital from a wide range of financiers through capital markets.

This new trend conforms to a new financing concept that states that necessary capital will be procured by attracting private capital both domestically and globally instead of relying on governmental financing. It is therefore urgent to streamline the capital distribution function of public financing, foreign governmental economic assistance and indirect financing (banks) mechanisms so that both internal and external private capital may be distributed efficiently to borrowers.

Prospective private financiers in Asia are expected to possess the following attributes: able to accurately judge investment risks and yet be willing to bear some risk. Investors investing in infrastructure building projects such as B.O.T. (Build-Operate-Transfer) and B.O.O. (Build-Own-Operate) may possess such qualities.

One recent development in Asia that is not to be overlooked is the massive accumulation of financial assets induced by steady economic development. Asia's aggregate stock market value and foreign currency reserve levels are rising sharply in the 1990s. How well Asian economies are able to effectively utilize limited working assets to meet increasingly diversified capital procurement needs will determine whether or not Asian countries will continue to do well in the next century. To this end, Asian countries and regions are seriously attempting to improve financial intermediation systems and to restructure their own capital markets as windows for attracting global capital.

2. Current Conditions and Problems Associated with the Streamlining of Financial and Capital Markets

(1) Current Conditions

Against the above described background, Asian countries and regions began a full-scale reshaping of their respective financial and capital markets beginning in the mid-1980s. With these new developments, more diversified capital procurement means became available, and a consequent rise in savings rates is expected.

Table 3-2 depicts the size of total assets held by banks, total stock market value and bond market balance, and the shares of these three categories vis-a-vis nominal GDP for the seven Asian countries, Japan, the U.S., Germany and England. As is clear from Figure 3-1, the financial and capital markets of the Asian countries have grown rapidly, notably in stock markets, backed by the steady economic growth.

The Asian governments formulated and implemented the following policies to enable the growth of such markets: 1) the amelioration of financial infrastructure (legal framework, introduction of various computer systems); 2) de-regulation; 3) the opening of domestic markets and 4) the nurturing of local investors.

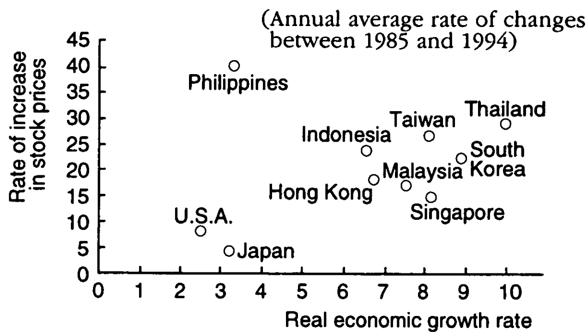
Table 3-2: Key Indicators of the East Asian Financial Markets (1994)

(unit: $ billion dollars)

	Bank Assets (% vis-a-vis nominal GDP)	Equity Market (% vis-a-vis nominal GDP)	Bond market (% vis-a-vis nominal GDP)
Hong Kong	257 (195)	270 (205)	11 (9)
South Korea	283 (75)	192 (51)	161 (43)
Singapore	115 (186)	135 (217)	45 (72)
Indonesia	90 (57)	47 (30)	9 (6)
Malaysia	70 (100)	199 (283)	40 (56)
Philippines	34 (54)	56 (87)	25 (39)
Thailand	153 (110)	132 (94)	14 (10)
Japan	7,106 (152)	3,720 (80)	3,443 (74)
U.S.A.	3,620 (54)	5,082 (75)	7,429 (110)
Germany	3,255 (169)	471 (25)	1,719 (90)
England	2,257 (216)	1,210 (116)	366 (35)

Source: The World Bank, *The Emerging Asian Bond Market, June 1995.*

Figure 3-1: Relation Between Real Economic Growth Rate and Rate of Increase in Stock Prices



Sources: Compiled from IMF, *International Financial Statistics*, and statistics from each country.

As Asia's capital markets became streamlined and mature, they have become targets for global portfolio investment by institutional investors, such as pension funds and trust investment, from industrialized countries.

Another notable change occurred in Asia with the establishment of offshore markets in Malaysia (in 1990) and Thailand (in 1993). Combined with the pre-existing offshore markets in Hong Kong and Singapore, the Asian offshore markets embarked on handling foreign currencies. Furthermore, in recent years, while the Hong Kong and Singapore markets are upgrading their market functions as international financial centers, Thailand (Bangkok), Malaysia (Rabuan Island), China (Shanghai) and Taiwan (Taipei) one after another announced their intention to turn their respective markets into international financial centers as well. It is hoped that these developments will lead to improved Asia-wide financial intermediate systems.

(2) Issues to be addressed

It is important to realize that there are a number of vexing problems to be resolved in Asia's financial and capital markets, in spite of their steady growth. The following issues need to be addressed:

1) Due to immature bond markets (for corporate bond markets in particular) in comparison with those in industrialized countries, it is difficult to consistently secure long-term loans.
2) There is a problem of insufficient capital liquidity due to the insufficient size of the short-term capital market.
3) Problems associated with transparency and efficiency in the markets as exemplified by the frequent reporting of scandalous stock market transactions.
4) Individual investors tend to seek out short-term capital gains in stock markets rather than aim for long-term benefits.
5) There is an insufficient number of institutional investors seeking long-term capital gains.
6) Development of direct financing mechanisms (such as stock markets) is too rapid while domestic indirect financing mechanisms (banking system) are not sufficiently developed.

Unless these issues and problems are either adequately addressed or resolved, financial and capital markets will not be able to perform their expected role; that is, to contribute to economic development by facilitating effective fund raising and investment.

3. Active International Flow of Private Funds Surrounding Asia

(1) Inflow of Highly Marketable Funds

Table 3-3 shows the changes in the balance of capital accounts in Asia. According to the data, the long-term capital net inflow (inflow amount minus outflow amount) rose rapidly since the end of the 1980s. While the inflow of public capital fluctuates very little, the inflow of private capital is increasing rapidly. If we take a look at the breakdown of private capital, we can see that direct investment grew most quickly. Additionally, a substantial growth in capital inflow or capital procurement through financial and capital markets in the form of portfolio equity investment or bond issuance can be observed. It should be noted that the inflow of short-term capital increased rapidly as well.

Another trend that is not to be missed is the expanded flow of capital held by ethnic Chinese in Asia. This trend is exemplified by a rapid growth of direct investment by Asian NIEs to China, and to ASEAN countries and Indochina. Moreover, the Singapore and Hong Kong markets with their enhanced capabilities as international financial centers are becoming asset management bases for regional investors.

(2) Private Capital Flow and Foreign Exchange Systems and Policies

When viewed from the perspective of the foreign investors' level of confidence in emerging markets, the co-relationship between the flow of highly marketable funds among various countries, affected by stock market investment, short-term capital, fluctuations in interest rates and stock price fluctuations, and foreign exchange systems or policies can be summarized as follows.

It is a well-known fact that foreign investors have been investing en masse in Asia's financial markets from 1990 till the present time. This is because foreign investors feel confident that their expected investment benefits outweigh investment risks, given their projected investment terms.

For foreign investors investment risks can be divided into risks associated with stock price fluctuation and foreign exchange rate fluctuation. The risks linked with stock price fluctuations can be minimal as long as Asian economies continue to sustain current growth patterns. As shown in Chapter I, the investment risks connected with exchange rate fluctuations for American investors have been minimized since Asian countries implemented their foreign exchange policies linking their currencies to the U.S. dollar. This windfall benefit for American investors was foreseen in the mid 1980s. From the view point of the monetary authorities in Asia, it is of critical importance whether or not they are able to sustain the foreign exchange systems or policies incorporated since the mid-1980s so that the inflow of highly marketable funds from overseas may be secured.

4. The Coming of an Age of Global Money and Monetary Policy

(1) The Supply of Growth Funds

Entering the 1990s, Asia was incorporated into the flow of highly marketable funds. There are emerging side effects in implementing governmental policies, both positive and negative, coupled with such developments in Asia.

As a favorable consequence, it became much easier for Asian countries to secure capital for growth purposes because of an increased inflow of highly marketable funds. This is particularly significant for the ASEAN countries suffering from current account deficits (meaning insufficient savings). For both governments and the private sector, it became increasingly possible to secure larger amounts of capital at lower costs through capital markets.

In comparison to the mid-1980s, when the inflow of highly marketable funds was not so pronounced, the Asian countries gained more room to maneuver in choosing economic tightening policy alternatives for improving their international balance of payments. It is said this positive development in Asia is one of the major reasons why the Asian countries have been able to sustain their steady economic growth over the last ten years.

On the other hand, when the inflow of capital exceeds the level of domestic supply capabilities of a given economy, such country is bound to experience macroeconomic imbalances and thus deteriorating balance of payments as well as inflationary pressure. This potential negative effect of the increased level of capital inflow is something of which each Asian nation needs to be aware.

Table 3-3: External Resource Flows to Asia

(Billions of U.S. dollars)

	1987	88	89	90	91	92	93	94
Aggregate Long-Term Net Resources Flows (1)	17.1	30.3	36.8	39.4	45.9	59.9	85.7	109.3
Official Creditors (including grants)	12.4	17.2	18.8	16.3	17.4	15.3	16.9	16.3
Total Private Creditors (2)	4.7	13.2	18.0	23.1	28.5	44.5	68.8	92.9
Foreign Direct Investment	4.9	7.9	9.6	11.6	14.4	21.5	37.3	43.6
Portfolio Equity Investment	0.4	0.8	2.8	2.4	1.1	5.5	20.1	25.3
Commercial Banks	-0.3	3.5	4.3	6.3	6.2	8.3	-0.3	n.a.
Bonds	0.9	0.1	0.9	0.7	5.0	2.7	8.7	n.a.
Short-term capital inflows	n.a.	4.3	3.6	8.8	12.0	8.6	11.9	10.9
(1)/ Nominal GNP (%)	1.8	2.8	3.2	3.1	3.5	4.2	5.7	6.6
Non-debt Inflows/ (1) (%)	31.1	28.7	33.6	35.5	33.7	45.1	67.1	63.0
(2)/ (1) (%)	27.7	43.4	48.9	58.6	62.2	74.4	80.3	85.0

Note: Data of all the member developing countries of the Asia Development Bank.
Source: Asian Development Bank, *Asian Development Outlook 1995 and 1996.*

(2) Problems in Implementing Monetary Policies

Drawn into the age of global money, Asian countries are ever increasingly being linked to the international financial and capital markets. However, at the present time none of the Asian economies are blessed with financial systems sufficiently efficient to function adequately in the new age. Specifically, when a large amount of highly marketable funds is drawn into the domestic economy, it may grow harder to control the domestic money supply. Moreover, when a massive quantity of capital is introduced to the domestic economy in a relatively short period of time, it may hamper steady procurement of capital through domestic capital and financial markets, or it may drastically amplify the level of fluctuations in foreign exchange market, or capital and financial markets.

In implementing monetary policies, the majority of the Asian countries or regions are faced with the following three vexing issues. First, there are not enough monetary policy alternatives. Even though both Asia's financial and capital markets are maturing, either the market size is still small in comparison to those of the industrialized countries, or the market is still inefficient. Therefore, it is hard to implement monetary adjustment policies such as the raising or lowering of interest rates, or the issuance of treasury bonds in short-term capital markets. Furthermore, in the face of escalating foreign exchange control liberalization, the countries with high interest rates relative to industrialized countries tend to draw a large influx of short-term capital seeking to take advantage of the interest rate differentials. For instance, this situation is causing countries such as Thailand, Malaysia, and Indonesia to expand their domestic money supply and thus suffer from high inflation rates .

Second, a country that links its currency to the U.S. dollar is limited in its ability to apply alternative monetary policies because its domestic interest rates and market conditions are strongly influenced by the market conditions or monetary policies employed by the United States. From 1993 to the beginning of 1994, the U.S. and European investors heavily invested into emerging economies of Asia and Central and South America. This was precipitated by the monetary relaxation policies implemented by the U.S. monetary authority. Conversely, since the U.S. tightened its previously loose monetary policy in February 1994, the pace of capital inflow into Asian markets slowed down significantly.

Third, there exists the increasing risk of destabilizing domestic capital markets or global capital transactions so as to trigger an overreaction on the part of market players to drastic changes in foreign exchange policy (devaluation in particular). As noted in Chapter II, there are a number of countries in Asia afflicted by high levels of current balance deficits vis-a-vis their nominal GDP. There may be cases where these countries are forced to devalue their currencies in an attempt to address this problem.

However, such foreign exchange policies are likely to result in undermining the confidence of foreign investors, and thus become a hindrance to the steady inflow of capital or end up inducing a sudden flight of short-term capital out of the country.

Looking at the present situation, it is not necessarily the case that foreign investors immediately keep the capital gains by selling stocks and change them into foreign currencies and take them out of the country. In the case of Thailand, Indonesia and the Philippines, foreign investors (non-resident) retain savings in either foreign currencies or local currency and use such savings for purchasing stocks. In other words, not all the revenue from selling stocks is turned into foreign currency and taken out of the country, and some of it is used as a domestic short-term fund for stock market investment.