The Integration of Capital Markets in East Asia

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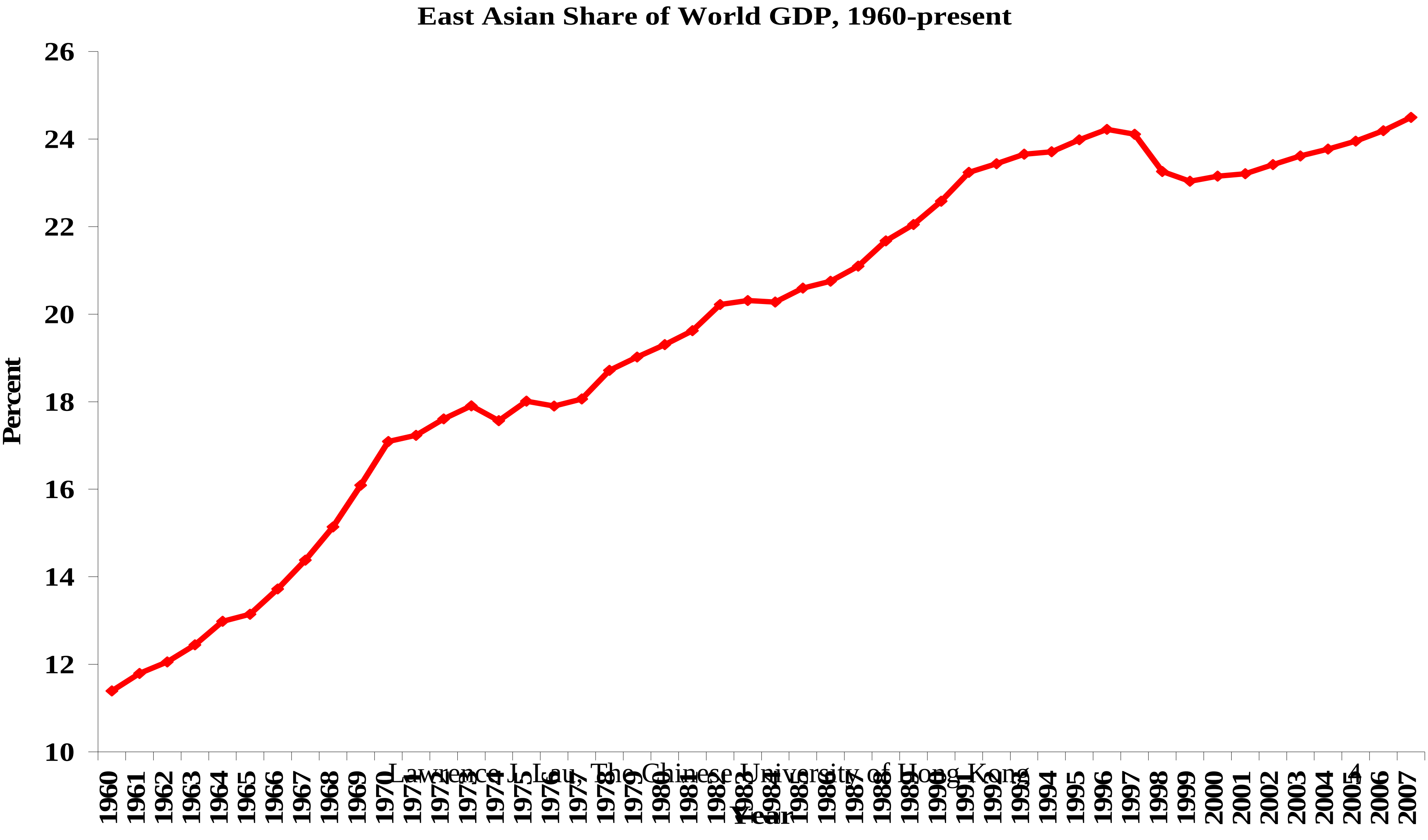
Introduction

- By East Asia, we mean the ASEAN group of countries (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) + 3 (China, Japan and South Korea). China also includes, implicitly, Hong Kong and Macao and Taiwan.
- The economic center of gravity of the world has been gradually shifting to East Asia from the United States and Western Europe and within East Asia from Japan to China.
- In 1960, East Asian GDP, was less than 12 percent of World GDP. Today, East Asian GDP accounts for approximately a quarter of World GDP, comparable to the size of the U.S. economy and that of the Euro Zone.

East Asian Share of World GDP, 1960-present



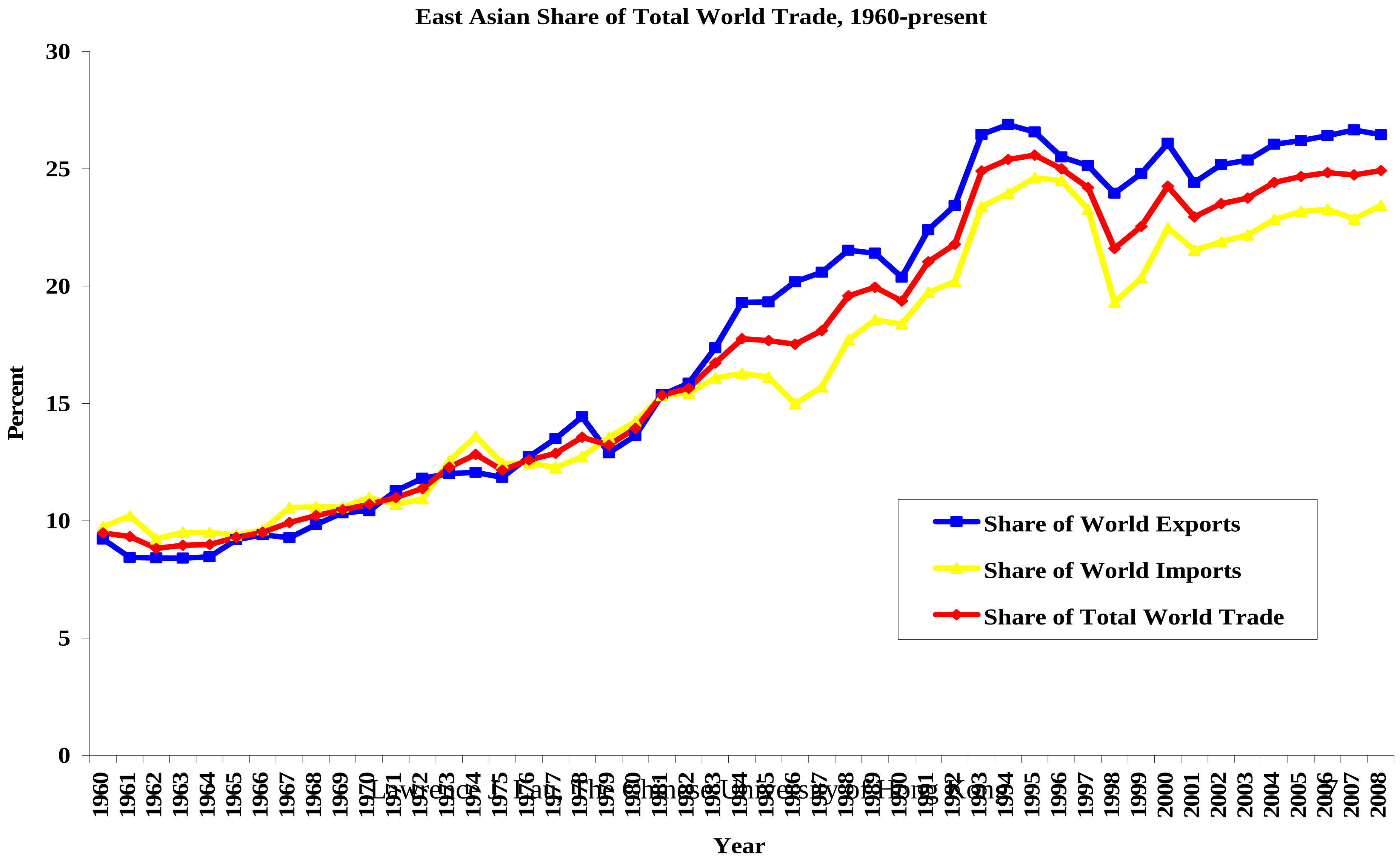
Introduction

- Capital markets considered in this lecture include both the stock markets and the bond markets. By the end of February, 2009, total market capitalization of all East Asian stock markets taken together amounts to US$7.25 trillion. By comparison, the United States stock exchanges together have a market capitalization of US$10.75 trillion. They are thus comparable in magnitude. In a few more years, the market capitalization of East Asian stock exchanges should be approximately equal to that of the United States.
- East Asian bond markets are in very early stages of development and bonds denominated in local currencies currently do not have much appeal to international investors.

The Shifting Economic Center of Gravity

- East Asian shares of world exports, imports, and international trade have also grown from approximately 10 percent in 1960 to a quarter in 2007, paralleling the growth of East Asian share of world GDP.
- Because of the rapid economic growth of China and the rest of East Asia outside of Japan, and the demand and supply that such economic growth has generated, the East Asian economies now trade more with one another than with economies outside of East Asia, including the United States. Approximately half of East Asian trade is among East Asian economies. This is a sea change compared to say thirty years ago when most of the East Asian trade was between East Asia and the United States and Western Europe.

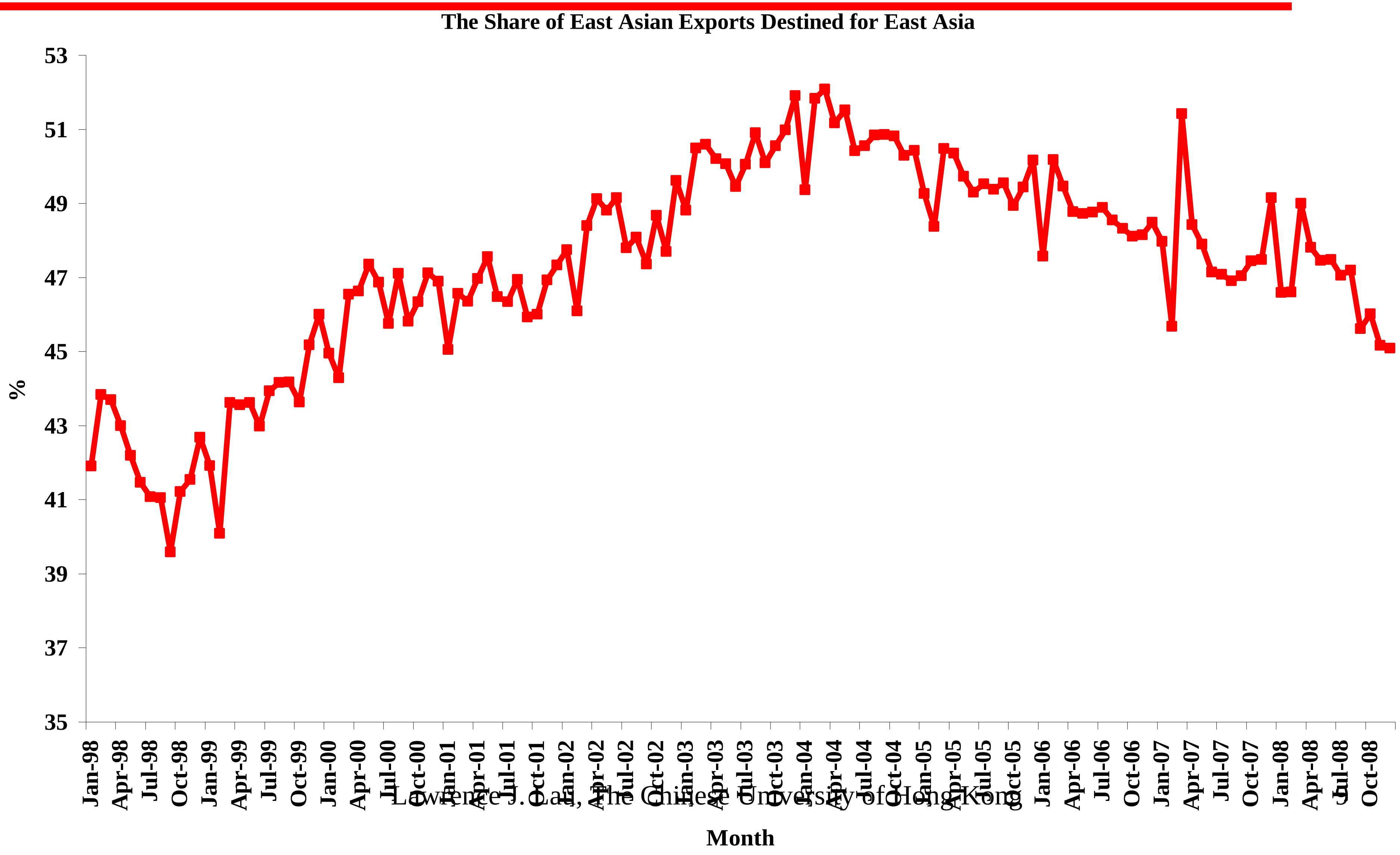
The Rising Ratio of East Asian Trade in Total World Trade, 1960-present



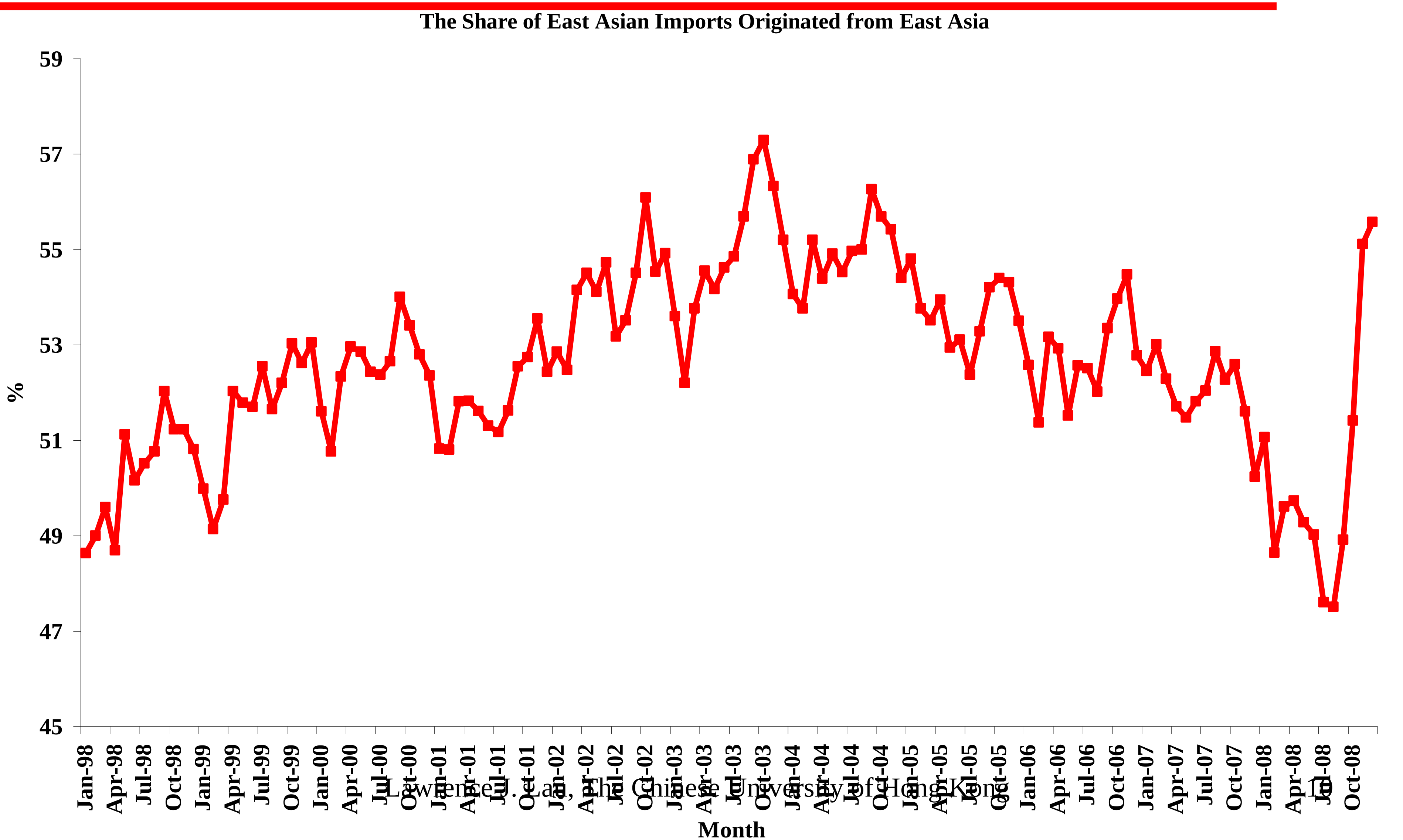
The Changing Pattern of World Trade

- Interdependence of the East Asian economies has been rising sharply over the years and East Asian dependence on the United States and Western Europe has declined.
- The ASEAN Free Trade Area as well as its variations (+1 (China); + 3 (China, Japan and South Korea)) are rapidly becoming a reality.

The Share of East Asian Exports Destined for East Asia



The Share of East Asian Imports Originated from East Asia



The Intra-East Asian Capital Flows

- Almost all of the East Asian economies, with the possible exception of the Philippines, have high national savings rates on the order of 25% or above. What this means is that East Asian economies and East Asia as a region have an adequate supply of savings to finance their own investments and do not need to rely on foreign direct or portfolio investment or loans to meet their domestic investment demands.
- East Asia has also been an attractive destination for foreign direct investment, originating from both inside and outside East Asia.
- Japan has been a major investor in East Asian economies outside of Japan for at least three decades. China has been the destination of investment, both portfolio and direct, from Hong Kong, Taiwan, Japan, South Korea, Singapore, Thailand, and many other countries outside of East Asia. It has also emerged, in recent years, as a major source of direct and portfolio investment in East Asia itself.

The Intra-East Asian Capital Flows

- Within the ASEAN Free Trade Area, cross-border investments are very common—one of the primary reasons for the formation of the ASEAN FTA is to enlarge the potential "domestic" market so as to attract more direct investment. For example, Thailand alone is too small a market to support automotive manufacturing, but the ASEAN region as a whole is large enough. Without the ASEAN FTA, Thailand is unlikely to be the location for a full-fledged automobile factory; but with the ASEAN FTA, automobile manufacturing becomes much more possible because of the market now comprises the entire ASEAN FTA.

Introduction

- All of this—significant growth in East Asian GDP and in intra-East Asian trade and investment flows—is what gives credence to the idea of partial "de-coupling" of the world economies—that the Chinese and East Asian economies can continue to do reasonably well despite the current economic problems in the U.S. and elsewhere. That is not to say they will not be affected. They are and will continue to be. But they will be able to manage and will be the first to recover economically.
- However, China and East Asia are not large enough to turn around the whole world.

The Integration of the Stock Markets

- There is at the present time no single market in which the stocks of all major firms in East Asia are traded. The result is that the markets are individually quite small and fragmented. Investors have to invest in separate national markets and in different national currencies, greatly increasing the transactions costs of cross-border investors both inside and out of East Asia.
- A unified East Asian Stock Market, in which the stocks of all major East Asian firms, such as Sony, Toyota, Samsung Electronics, LG Group, Baosteel, China Mobile, Petro-China, Taiwan Semiconductor Manufacturing Corporation, Cheung Kong, San Miguel, Siam Cement, and Singapore Airline can all be traded (possibly in the form of depositary receipts) in addition to the individual national markets, will bring significant benefits to all East Asian economies by enlarging the market, enhancing the overall liquidity and increasing the demands for the stocks of the individual firms. For example, an investor who wishes to track the MSCI East Asia Index only needs to be actively investing and trading in this one single market.

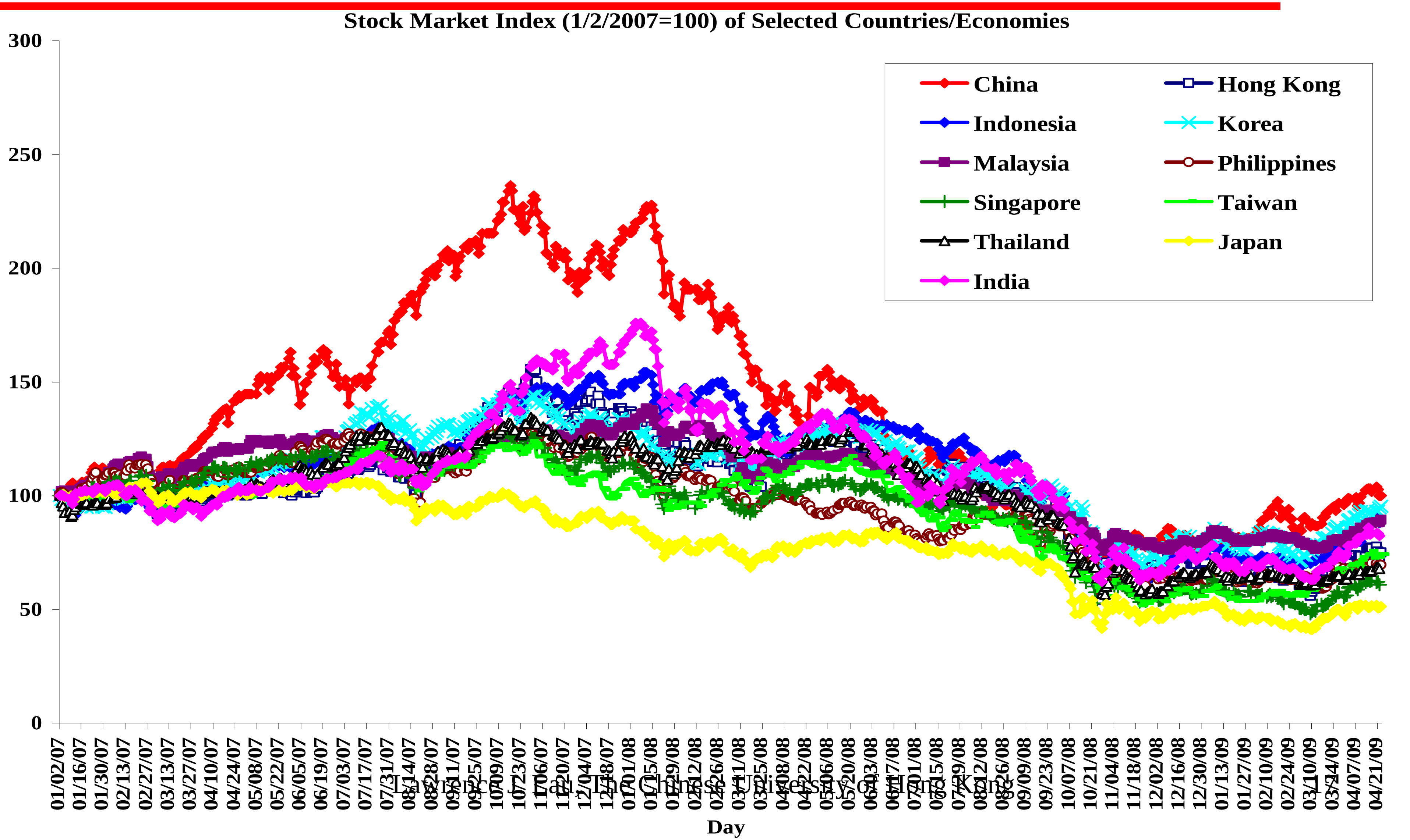
The Integration of the Stock Markets

- The trading in this unified market should probably be conducted in a single currency, e.g., the U.S. Dollar or the Renminbi, or the Yen, and in the form of "Depositary Receipts." The use of "Depositary Receipts" minimizes the frequency and volume of cross-border capital flows due to the buying and selling of the cross-listed shares. For example, someone who wishes to purchase shares in Samsung Electronics does not need to buy Korean Won but can purchase the depositary receipts in the single currency used for trading on the unified market. In fact, the investor can purchase all shares in this unified market in this single currency.

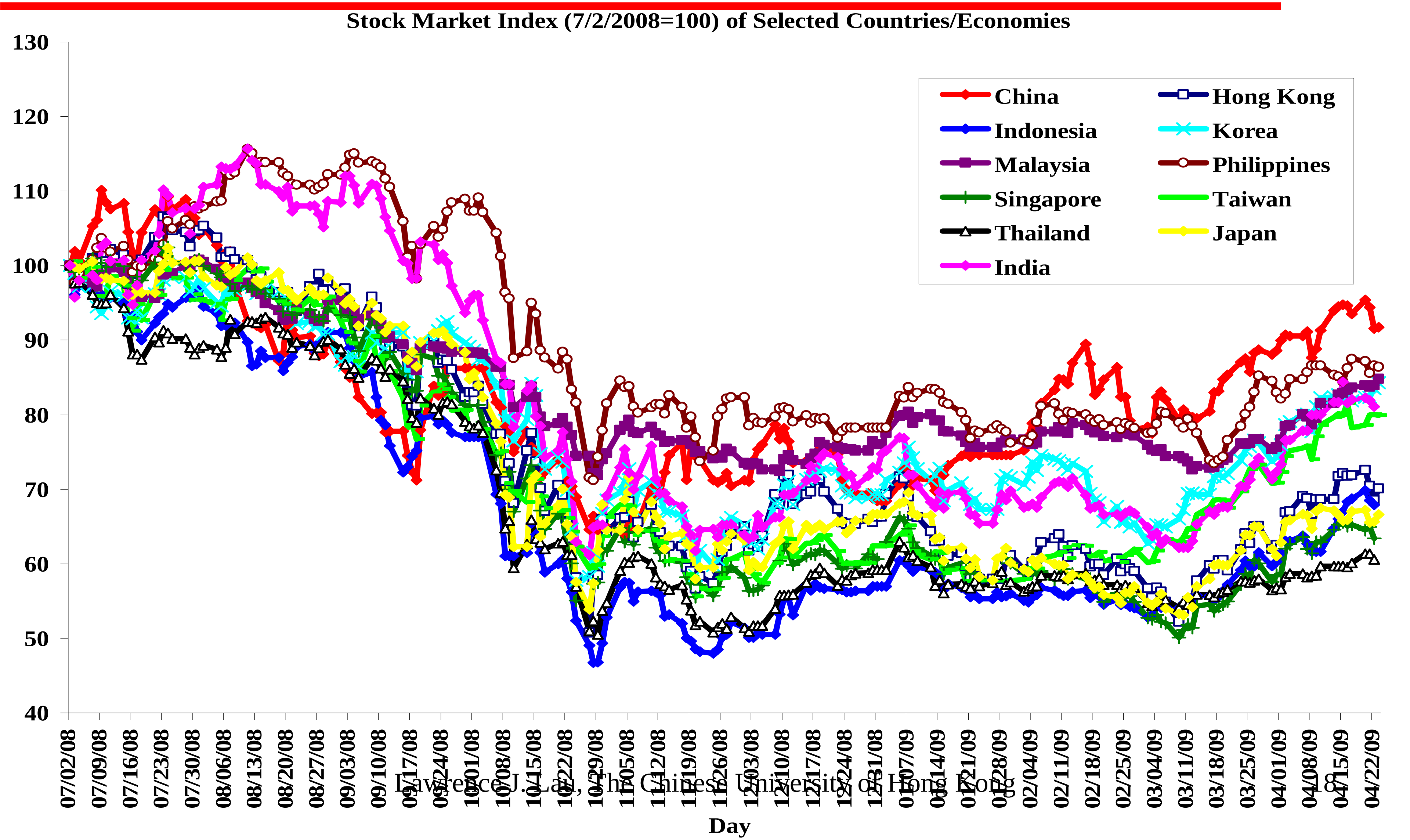
The Integration of the Stock Markets

- The existence of trading in a single international market in addition to trading in the national markets enables the gradual equalization of Price/Earning Ratios (P/Es) across national markets, enhancing the efficiency in the allocation of capital. This is especially true with the possibility of arbitrage within the same or nearly the same time zone.
- Historically, the East Asian stock markets tend to move together, more or less, so that a unified market makes sense.
- For economies that still maintain some degree of capital control, specialist firms may be authorised by governments to arbitrage between the home stock market and the unified stock market.

Stock Market Indexes of Selected East Asian Economies (1/2/2007=100)



Stock Market Indexes of Selected East Asian Economies (7/2/2008=100)



The Integration of the Stock Markets

- In order to facilitate the creation of this single unified East Asian stock market, East Asian governments will need to enter into double-tax agreements (DTAs) with the country/region in which the unified market is located. This will essentially allow the investors in the unified market at least the same tax treatment than if they invest directly in the national market concerned.
- It is not essential, but helpful, if the tax treatment of cash dividends and capital gains can be rationalized across East Asian countries and regions; but this may be too difficult to achieve.

The Integration of the Stock Markets

- Hong Kong is potentially an ideal location to host this unified stock exchange because it does not tax cash dividends nor capital gains. And if the unified market is to be located in Hong Kong, trading of the depositary receipts can be conducted in either the U.S. Dollar or the Renminbi (this will be the choice of the entire unified market—either US$ or Yuan). Hong Kong also has the further advantage that there is no restriction on the movement of capital into or out of Hong Kong. However, before Hong Kong can become the home of the unified market, it must conclude DTAs with countries/regions that are homes of enterprises that wish to be dually listed in Hong Kong.

The Integration of the Stock Markets

- What is to be done with prudential regulation and supervision? It is proposed that there be a division of labor between the national regulatory agencies and the regulatory body for the unified stock market.
- The home country regulator should continue to be responsible for the regulation and supervision of a listed firm insofar as accuracy of reporting, compliance with law, governance, disclosure, and insider trading in the home market are concerned, since the home market is the location of the primary listing of the firm. The regulator of the country or region in which the unified market is located will be responsible for any trading abuse, market manipulation, and insider trading on the unified market.
- The basic principle is that one should rely on the home country regulator exclusively when it pertains to the actual operations of the firm and the regulator of the unified market should be responsible only for maintaining a fair and open environment for the trading of the depositary receipts of that firm.

Supplementing the Existing International Clearing and Settlement Mechanism

- There is also the important question of the settlement of international trade and other current account transactions. Global trade is currently mostly denominated and settled in U. S. dollars. That is what has given rise to the huge foreign demand for U. S. dollar balances. The U. S. dollar reserves held by central banks and monetary authorities around the world provide in part the liquidity and transactions balances necessary to support the growth of world trade.
- The recent scarcity of credit in U. S. dollars and the expected decline in the U.S. trade deficit would reduce the supply of U. S. dollars to the rest of the world and ought to add impetus to the consideration of alternative ways to settle trade and other current account transactions.

Supplementing the Existing International Clearing and Settlement Mechanism

- Another consideration is the fact that the U.S. Dollar and the U.S. Treasury securities have always been considered "riskless" assets. While they are still "riskless" from the point of view of U.S. dollar-based investors and consumers, they are no longer completely riskless for investors and consumers who are not U.S. dollar-based. In what currencies should a country's foreign exchange reserves be held is a question that faces all central bankers. And that is also related to the currencies used to settle international transactions.

Supplementing the Existing International Clearing and Settlement Mechanism

- One obvious alternative would be to allow the importer of any country or region to pay for the imports in its own currency, provided that the exporter, or the exporter's country's central bank, is willing to accept and to hold the currency. For example, a Chinese exporter may be willing to accept payment in Malaysian ringgit for its exports to Malaysia, as long as he knows he can sell it to the People's Bank of China, China's central bank or to someone who needs Malaysian ringgit such as a Chinese importer importing from Malaysia. No U. S. dollar balances would then be necessary for such a transaction.
- To facilitate such a transaction, it would be helpful if the People's Bank of China could allow the Chinese exporter to sell forward the Malaysian ringgit to it at the time a firm export order is received. These forward sales can be restricted to Chinese importers of goods and services from Malaysia and only up to the value of the individual export orders.

Supplementing the Existing International Clearing and Settlement Mechanism

- Of course, one should also allow an importer to pay for the imports in the currency of the exporter. For example a Chinese importer may pay a Thai exporter for imports from Thailand in Thai Baht (or in Renminbi or in US$) so long as they can agree between them.
- All of this can and should be done voluntarily, subject to mutual agreement between the importer and the exporter, and they may well agree to continue to use the U.S. Dollar. No change in the existing system is therefore required, except for the central banks in the respective countries being willing to buy and sell these additional currencies. It is also not necessary for the central banks to buy and sell all currencies. There can simply be an eligible list.

Supplementing the Existing International Clearing and Settlement Mechanism

- In our example, the People's Bank of China may decide to hold the Malaysian ringgit as part of its foreign exchange reserves (after netting out the payments for imports from Malaysia denominated in ringgit). Eventually, the central bank may wish to consider holding the ringgit in interest-bearing assets such as bonds issued by the Government of Malaysia, preferably indexed to Malaysian inflation to preserve the purchasing power of the central bank's ringgit-denominated assets.
- Thus, gradually, and on a voluntary basis, the use of currencies other than the US$ for international trade and other transactions will rise, thus easing the demand for US$ for transaction purposes, and hence the need for the U.S. to supply such liquidity by running large trade and current account deficits.

Supplementing the Existing International Clearing and Settlement Mechanism

- The arrangement described above is not so different from what has been made possible by the Chiangmai accords and the bilateral swap agreements between many East Asian central banks and monetary authorities, except for the possibility of inflation-protection aspect of the bonds to be held as part of the foreign exchange reserves. However, given the historical rates of inflation in some of the developing economies in East Asia, the nominal rates of interest on straight, non-inflation-indexed bonds may have to be very high in order to attract buyers and holders.

Supplementing the Existing International Clearing and Settlement Mechanism

- However, the issuance of inflation-protected bonds by the governments of developing economies has many advantages, among which is the possibility of borrowing abroad in its own currency. Foreign currency borrowing by developing countries and regions frequently leads to financial crises because of currency mismatch (revenue in local currency but liabilities in foreign currency) which is often also accompanied by maturity mismatch (borrowing short-term overseas but lending long-term locally).
- Over time, the Renminbi can emerge as a currency that firms, households and central banks and monetary authorities in other East Asian economies are willing to hold both for transaction purposes and as a store of value, just like the Japanese Yen.

The Creation of a Market in Bonds Denominated in Local Currencies

- Traditionally, local currency government bonds have little appeal domestically within certain developing economies themselves because of the high rates of inflation. They also have little appeal internationally. The result is that almost all developing economies can only borrow in foreign currencies and not in their own local currencies. Sooner or later, the foreign lenders would like to get their money back and hence would not roll over the loans, and a currency crisis would then ensue. For example, this happens habitually in Latin America, which has a currency crisis every decade or so.
- If the local-currency government bonds are indexed to the local cost-of-living indexes, they will have appeal both domestically and internationally. The purchasers of the bonds will be assured that they will receive a real rate of return in the local currencies, regardless of the movements of the relative exchange rates. They will always be able to purchase the same real quantity of goods that they could have bought at the time that they first purchased the local currency bonds (plus interest).

The Creation of a Market in Bonds Denominated in Local Currencies

- For example, suppose inflation-protected bonds are issued by the Government of Malaysia. If the amount paid for the inflation-indexed bonds can purchase 20,000 tons of rubber today, the proceeds received from the bonds at maturity will still be sufficient to purchase 20,000 tons of rubber (plus interest) at that time, whatever happens to the exchange rate of the ringgit in the interim. Thus, the risk of value erosion to a foreign central bank for holding Malaysian ringgit-denominated bonds in its portfolio is greatly reduced.

The Creation of a Market in Bonds Denominated in Local Currencies

- Inflation-protected bonds can help developing economies overcome the problem of the "original sin"--that they cannot borrow in their own local currencies.
- These bonds can also be held by the local citizens, especially retirees, to preserve the purchasing power of their pensions and savings.
- They can be held by foreign central banks as part of their foreign exchange reserves, thus allowing them to diversify further the composition of their reserves and at the same time to preserve the underlying purchasing power.
- A country that issues inflation-protected government bonds has a built-in incentive to control inflation, and thus issuance of these bonds per se is an indicator of a credible commitment against high rates of local inflation.

The Creation of a Market in Bonds Denominated in Local Currencies

- A country that issues inflation-protected bonds will find that its currency will be accepted more widely. This is because, in part, those who receive their currency always has the option of using it to purchase inflation-protected bonds in the same currency, thereby protecting its purchasing power over time; and also because, in part, the issuance of inflation-protected bonds per se is perceived as a commitment not to let inflation run away.
- Thus, with the introduction of inflation-protected, or equivalently, cost-of-living indexed bonds, more and more currencies can potentially become reserve currencies and there is no need to rely on only a few major currencies. Of course, not all countries will have the required credibility to issue inflation-protected bonds.
- In the intermediate to long run, issuing bonds in one's own currency is preferred to issuing bonds in a foreign currency, be it US$, Euro, Yen or even Renminbi denominated because the exchange rate is not directly affected by whether foreign investors are willing to buy and/or hold on the bonds if they are local currency-denominated.

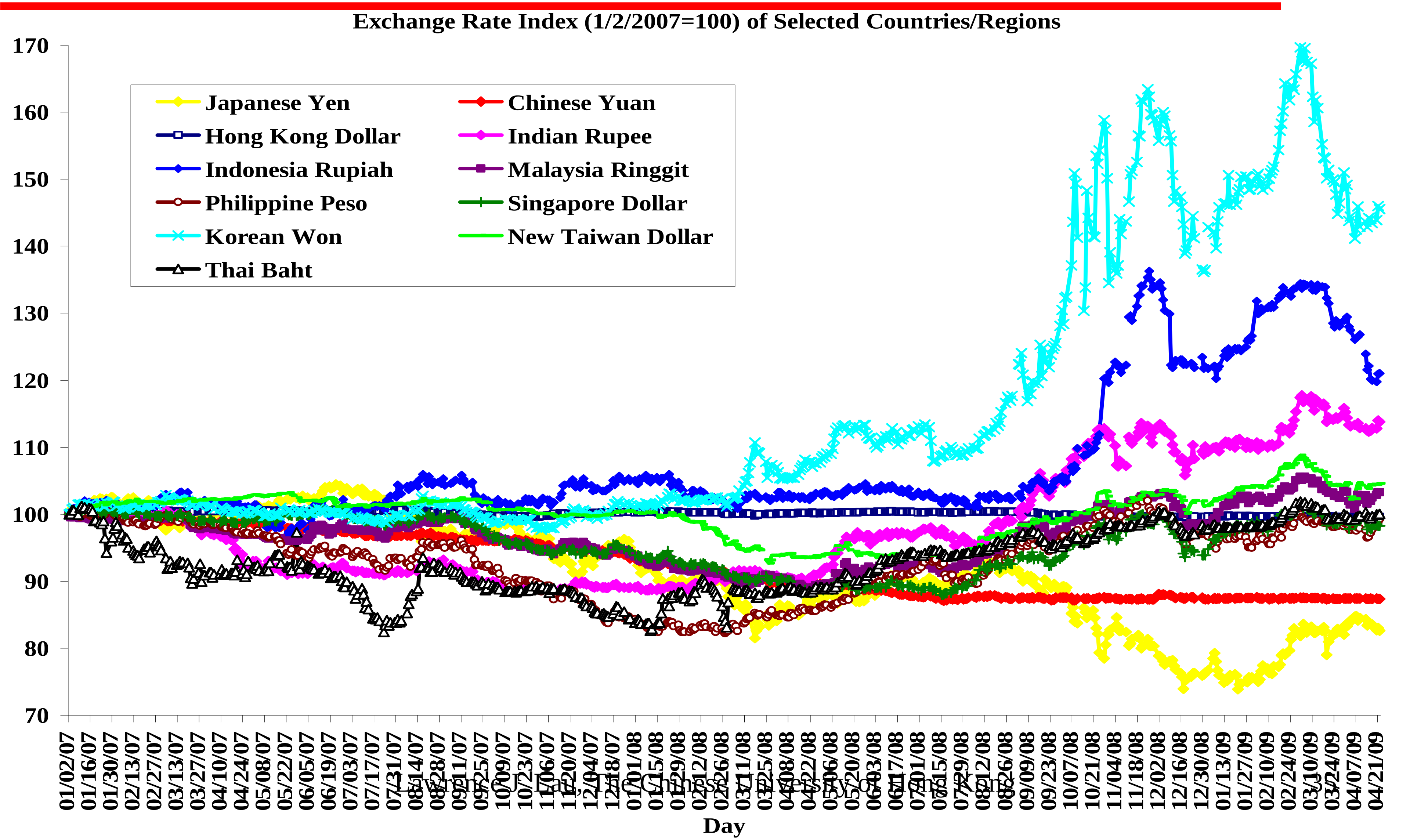
The Role of Exchange Rate Coordination

- Thus far, the central banks of East Asian economies have been content to hold on to their US$ denominated assets, mostly in the form of U.S. Treasury and Agency securities. It is in the interests of the U.S. as well as in their own self-interests to do so. A flight from US$ denominated assets by the East Asian central banks would have a disastrous impact on U.S. and world financial markets and on the realized value of their holdings. It is important that no one breaks rank at this time, or others may follow.
- The East Asian economies collectively hold so much foreign exchange reserves (on the order of US$4 trillion) that they are perfectly capable of stabilizing the relative East Asian exchange rates at reasonable, mutually beneficial and long-term sustainable levels as long as there is a common understanding and consensus.

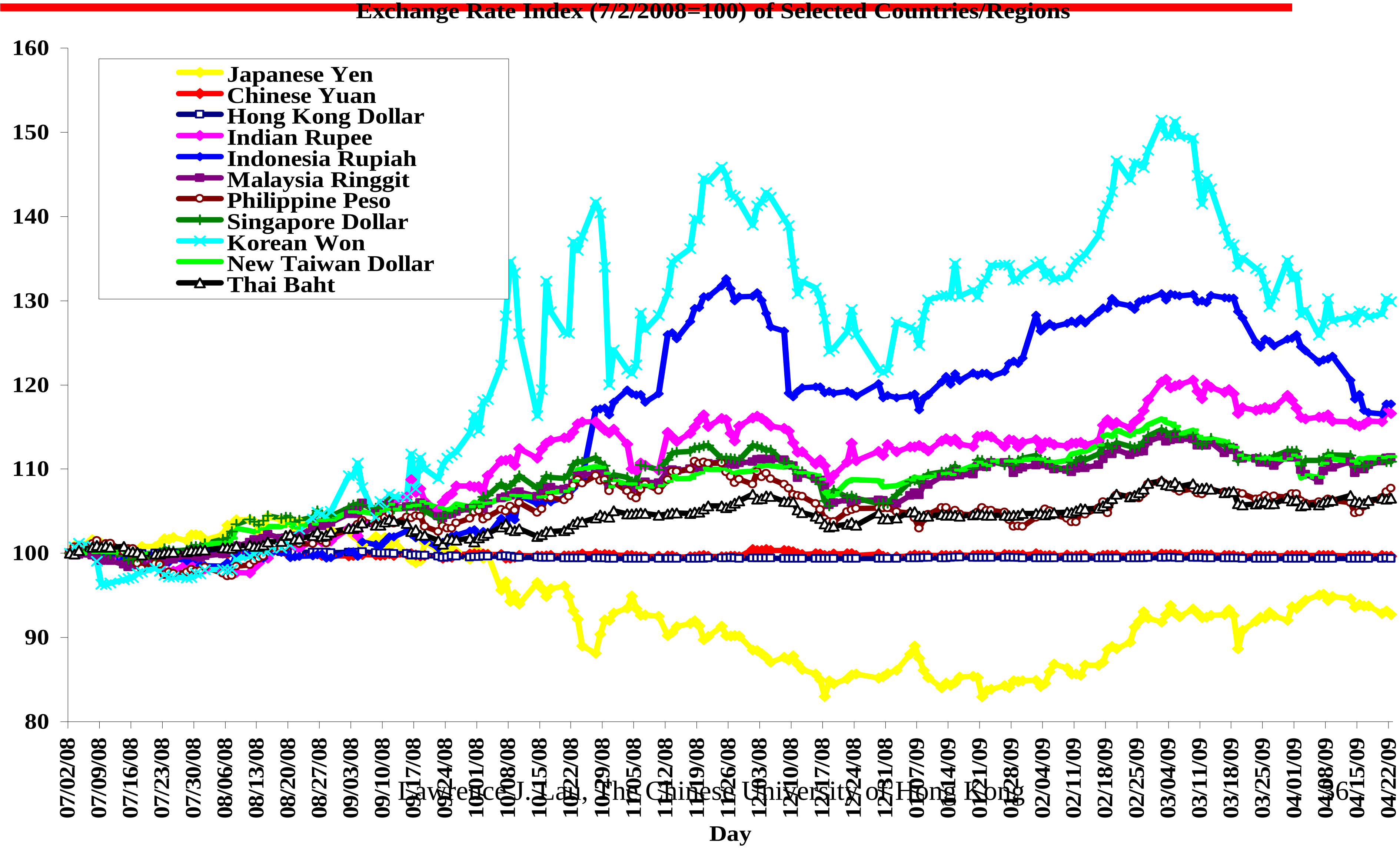
The Role of Exchange Rate Coordination

- There is also room for East Asian economies to coordinate their relative exchange rates for their long-term mutual benefits. The basic principle is to maintain relative real parities, i.e., to maintain relative exchange rate levels more or less constant after adjusting for the changes in the relative rates of inflation, so that in real terms, the relative external competitiveness remains unchanged.
- One-time adjustments in relative exchange rates that are out of equilibrium due to special unique circumstances should be permitted. There is currently too much divergence among East Asian exchange rates. Some coordination is helpful given the close interaction and interdependence among the East Asian economies.
- For example, the Japanese Yen is currently abnormally over-valued because of the unwinding of the Yen carry trade and should be allowed to be adjusted downwards. The Korean Won is currently abnormally under-valued because of the withdrawal of foreign-currency loans by foreign banks from Korea and should be allowed to be adjusted upwards.

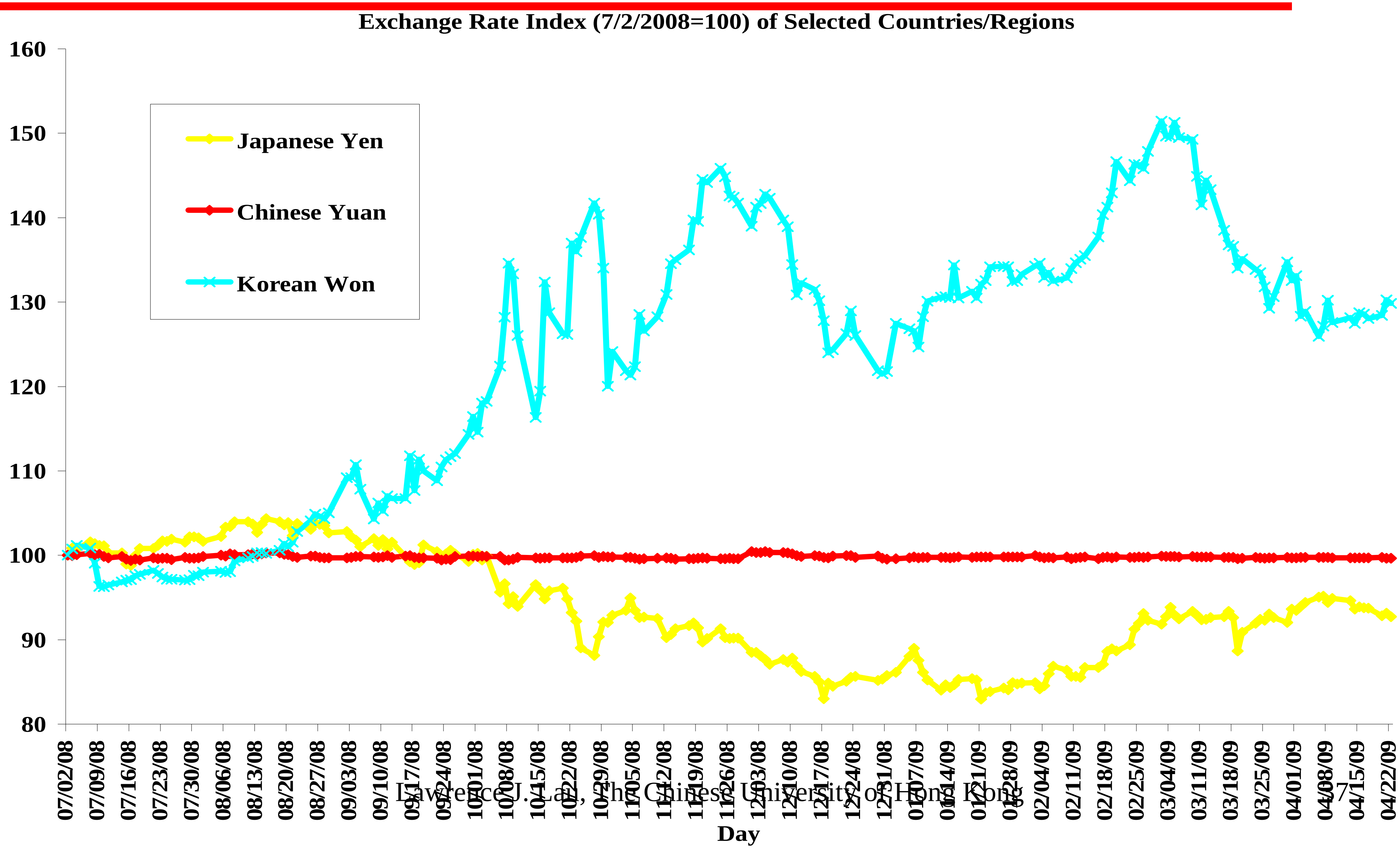
Exchange Rates of Selected East Asian Economies (1/2/2007=100)



Exchange Rates of Selected East Asian Economies (7/2/2008=100)



Exchange Rates of China, Japan and South Korea (7/2/2008=100)



The Role of Exchange Rate Coordination

- Real relative exchange rate coordination can promote and facilitate long-term region-wide development of trade in goods and services and investment. Without such coordination, it is possible for an economy to be an importer of a commodity or product in one year and an exporter in the next for the same commodity or product, leading to instability in the market and in the industry.
- Real relative exchange rate coordination also facilitates cross-border borrowing in a country or region's own domestic currency, hence greatly reducing the risk of currency-mis-match.

The Role of Exchange Rate Coordination

- Eventually, if real relative exchange rate coordination among East Asian economies becomes a reality, it may lead to an "Asian monetary snake" similar to the European monetary snake prior to the introduction of the Euro. Such an Asian monetary snake can become the precursor of an East Asian regional currency but the process is likely to take at least a decade or two.
- Real relative exchange rate coordination also facilitates the adjustment of East Asian exchange rates as a group against major reserve currencies such as the US$ and the Euro outside East Asia. This is because with real relative exchange rate coordination, no one individual economy in East Asia will gain or lose a relative comparative advantage vis-à-vis other economies in East Asia from such an adjustment whereas individual economies are predisposed not to make any adjustment on its own (if any one country revalues, no one will follow, so that it loses market share; if it devalues, everyone will follow, so that there is no net benefit—the optimal individual strategy, in the absence of coordination, is therefore to stay put.)

A Region-Wide Credit Rating Service?

- Credit rating services are supposed to fulfill a useful function by reducing the information asymmetry among participants in the capital market, thereby making the capital market more efficient. Credit reporting services in principle allows potential lenders to know the extent of the liabilities accumulated by their major borrowers and potential major borrowers.
- Enough has been said about the credibility and reliability of credit rating services, or the lack thereof, as a contributory factor to the current global financial crisis.
- There have been proposals to establish a East Asia region-wide credit rating service, which is essential to the smooth functioning of a capital market serving the region's firms.

A Region-Wide Credit Rating Service?

- But how can these new rating services be made more useful? How can one ensure that they do not repeat the same mistakes? I believe the solution lies in imposing on rating services significant monetary costs if their ratings systematically fail to reflect the true conditions of the firms being rated. In order for the costs to be meaningful, the rating services will have to be much better capitalized. Incentives must be provided so that the rating services will have a pecuniary interest in getting their ratings right.

A Region-Wide Credit Rating Service?

- For example, a crediting rating service can be required to take a significant percentage of any debt issue for which it provides a top rating (on identical terms as other purchasers of the same issue). The stake should be significant relative to the capital of the credit rating service. It is required to hold the stake till maturity, unless it changes the credit rating, and then it can sell only after it has changed its credit rating, not before. Thus, unless the credit rating service is really convinced that the debt issue should be top rated, it would not grant the top credit rating. If a credit rating service does not have enough capital, it should then refrain from providing credit ratings to new debt issues.

A Region-Wide Credit Rating Service?

- An alternative would be to institute a penalty regime for the credit rating service if it overrates debt issues, which would then act as a deterrent to over-rating. This is not unlike the situation of auditors having liabilities to shareholders if their audit results turn out not to represent the true financial picture of the firm.
- How can this be implemented in practice? One feasible way would be to compare the actual percentage frequencies of failure of the debt issues of given ratings with the expected probabilities of failure of debt issues of the same ratings. Thus, if AAA-rated bonds are expected to have a failure rate of 0.1 percent over the life of the bonds, if the actual failure rate exceeds 0.1 percent significantly, the credit rating service will have to pay a penalty to the government or an regulatory agency commensurate with the financial damages.
- If the actual failure rate is significantly less than 0.1 percent, the credit rating service is probably far too conservative in its awards of ratings. Firms that are rated lower than AAA by such a credit rating service will probably try to move to other credit rating services where they may have a better shot at achieving the top rating. This would provide incentive for the credit rating service to try to do it just right—not too conservative, not too aggressive.

A Region-Wide Credit Rating Service?

- Another alternative would be for the credit rating service to offer to sell credit default swaps (CDSs) to a significant percentage of the purchasers of the debt issue, in effect turning it into an insurance company. These credit rating services/insurance companies will be subject to capital and insurance reserve requirements. And the CDSs should be sold only to those with insurable interests, i.e., the owners of the debt instruments. The premium quoted would then have the same effect as a rating but the credit rating service stands behind its rating with its own capital.
- The existing system separates the credit rating service from the insurance company. Under this proposed alternative the two functions will be integrated into the insurance company. The price of the CDSs will then reflect the insurance company's assessment of the prospects of the debt-issuing firms and the probability of default and will in effect be a substitute for the rating.

A Region-Wide Credit Rating Service?

- Requiring credit rating services to put their money where their mouth is reduces moral hazard, which has been prevalent under the existing system. For example, credit rating agencies have been working under a system in which they are paid by the firms they are rating, but only if the firms are satisfied with the rating. This is a formula for moral hazard.
- After all, auditors have to put their money where their mouth is (remember Arthur Anderson, which failed because of the work it did (or failed to do) for Enron Corporation) (even though they do not have any upside beyond their fixed fees if they get it right). There is no reason why credit rating services, the work of which is similarly relied on by the public, should not be subject to the same standard when they get it wrong.

A Region-Wide Credit Rating Service?

- Yet another alternative is an adaptation of the Japanese "lead bank" system under which the lead bank of any loan syndicate takes an above-average share of the loan and assumes responsibility for due diligence, monitoring and enforcement. When the loan turns sour the lead bank will suffer greater loss than the other banks because of its larger share, and at the same time also will have a moral obligation to try to make good to the other banks.
- Extending this model to the issuance of debt securities, one would require the underwriter or the lead investor to take an above-average share of the debt issue and commit to holding the securities if not till maturity at least for a large number of years.

A Region-Wide Credit Rating Service?

- Having the underwriter or the lead investor make such a commitment is probably superior to having a rating at the time of issue because under the requirements of a long-term hold the underwriter or the lead investor will definitely do the due diligence very carefully. And their commitment serves as a credible signal to the other potential investors.

A Region-Wide Credit Rating Service?

- Any of these proposed alternatives will revolutionize the entire credit rating industry and will force the industry to raise capital and recruit the best talents to do the analysis.
- It will blunt the criticism that if the rating service is really good at discriminating between firms as to their true riskiness, it should be out there investing real money, rather than merely doing the rating.
- It will reduce greatly the potential moral hazard that results from the firm being rated paying the firm doing the rating.
- In the past, ratings are most typically used by asset managers to defend themselves when things turn sour—"The securities were rated AAA. What could I have done?"
- The Japanese "lead bank" model is probably the most likely alternative to work among the several. The requirement that the credit rating services put their money where their mouth is in theory a good idea but it basically turns the rating service industry into part of the insurance industry, and requires the credit rating services to raise significant amounts of capital which may not be easy to accomplish.

Concluding Remarks

- The time is ripe for the development of a unified East Asian stock market in which the shares of the major firms in every East Asian country or region can be traded in the form of depositary receipts. East Asia, with its high savings rate, is a source of surplus savings. A unified stock market allows the savings to be deployed more efficiently.

Concluding Remarks

- The introduction of inflation-protected securities to be issued by the individual East Asian developing economies can achieve several objectives: (1) It helps to develop an East Asian bond market; (2) It facilitates the diversification of the composition of foreign exchange reserves by East Asian central banks which can purchase these inflation-protected securities as potential reserve assets; (3) It enables developing countries and regions in East Asia to borrow in their own respectively domestic currencies and obviates the need for borrowing in foreign currencies; (4) It also allows developing economies in East Asia to pay for their imports in their local currencies because the recipients of their local currencies have a greater incentive to accept and to hold them; and (5) It allows the individual citizens of the respective countries an inflation hedge, which is especially critical for retirees.

Concluding Remarks

- With real exchange rate coordination, the risks of cross-border investments, whether direct or portfolio, and lending and borrowing, are greatly reduced. This allows the full realization of the benefits of a East Asian (or ASEAN + 3) Free Trade Area. Eventually, such coordination may lead to an Asian monetary snake, just as in the European case, as a precursor to an East Asian currency.
- The credit rating service industry needs to be reformed and overhauled. East Asian economies may be able to develop new models of credit rating services that are less subject to moral hazard.