Financial Markets Development
- A Road to Pacific Economic Growth

First Report of the
PECC Financial Markets Development Project

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FINANCIAL MARKETS DEVELOPMENT
A ROAD TO PACIFIC ECONOMIC GROWTH

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FEBRUARY 1997

PACIFIC ECONOMIC COOPERATION COUNCIL

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PACIFIC ECONOMIC COOPERATION COUNCIL

The Pacific Economic Cooperation Council (PECC) is an independent, policy-oriented organization devoted to promoting economic cooperation in the Pacific Rim. PECC brings together senior government, academic and business representatives from 22 Asia Pacific economies to share perspectives and expertise in search of broad-based answers to regional economic problems.

Founded in 1980, PECC now comprises member committees from the economies of Australia, Brunei, Canada, Chile, China, Colombia, Hong Kong, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Pacific Island Nations, Peru, the Philippines, Russia, Singapore, Chinese Taipei, Thailand, the United States and Vietnam. The Pacific Basin Economic Council (PBEC) and Pacific Trade and Development Conference (PAFTAD) are institutional members of PECC.

The governing body, the Standing Committee, meets several times a year and consists of the Chairs of PECC Committees in each member economy. The day to day administrative and coordinating functions are carried out by an International Secretariat based in Singapore. Each member committee sends a high-level tripartite delegation from government, business and academia to the PECC General Meeting held approximately every two years.

PECC's substantive work is carried out by a range of forums, task forces and project groups. These cover trade and investment policy, Pacific economic outlook, financial and capital markets, human resource development, small and medium enterprises, science and technology, minerals, energy, telecommunications, transport, fisheries, food and agriculture.

At the regional level, the most important link with government is through APEC. PECC is the only non-governmental organization among the three official observers of APEC. PECC representatives attend APEC Ministerial Meetings, the Senior Officials Meetings, and working group meetings. PECC also seeks to work with other international organizations such as the World Trade Organization, the OECD, the Asian Development Bank, the World Bank, and United Nations agencies.

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INTRODUCTION

This is the First Report of the PECC Financial Markets Development (FMD) Project. It spells out the objectives and approach of the project, summarizes the research and analytical work that has been conducted, and, most importantly, presents recommendations for the Asia-Pacific Economic Cooperation (APEC) Finance Ministers on steps that can be taken to improve the region's financial markets. These recommendations have evolved from the research and discussions that have been conducted in the FMD Project. This report also discusses the future work of the FMD Project.

At the PECC X General Meeting in Kuala Lumpur in March 1994, the Standing Committee endorsed the initiation of the PECC Financial Markets Development Project. The objective of the project is to support economic development by contributing to the development of financial and capital markets in the region. All 22 PECC economies have been encouraged to establish FMD committees and to participate in the project, and most have done so.

Since the Kuala Lumpur meeting, a project planning meeting was held in Shanghai, the first FMD working meeting was held in Tokyo, and subsequent working meetings were held in Chicago, Beijing (in conjunction with the PECC XI General Meeting), Hong Kong, and Singapore. Between meetings, research and analysis have been conducted by the individual FMD committees.

This report presents the work of many FMD committees and individuals over more than two years. The recommendations that are made reflect a strong consensus among the FMD committees as to the action steps indicated by the FMD Project research and analysis completed to date. While this report is the result of the cooperative efforts and input of all participants, particular note is warranted of the efforts of the Singapore, Japan, and U.S. FMD committees. Singapore organized and led the effort to produce this report and has taken the lead in defining the future work for the FMD Project. Japan took the lead in drafting and amending the recommendations presented in this report and has coordinated most of the drafting of the report. The U.S. has taken responsibility for final report drafting, editing, and production.

The work of the PECC FMD Project continues, and additional reports can be anticipated along with recommendations for further actions to be taken to develop the financial markets of the region.

EXECUTIVE SUMMARY

Part I, "Objectives of the PECC FMD Project," discusses the five basic elements of the approach that the PECC FMD Project has pursued to achieve the project's primary objective: to contribute to the development of financial and capital markets in the Asia-Pacific region. These five elements are

1. Taking advantage of the unique characteristics of the Pacific Economic Cooperation Council

2. Supporting the efforts of each member economy to achieve financial reform

3. Providing guidelines for financial reform

4. Pursuing step-by-step reforms tailored to the stage of development of each individual economy

5. Supporting voluntary, competitive adoption of liberalization measures

These elements provide the basis for mutual cooperation in the development of the economies of the Asia-Pacific region. Voluntary, competitive choices by individual economies are an effective means of deregulating and liberalizing financial and capital markets and, in an Asian environment, are more effective than demands and compromises hammered out in negotiations.

As its title suggests, Part II, "Review and Summary of Completed FMD Work," contains summaries of the research the FMD Project has completed so far.

The first section of Part II, "Financial Markets and Institutions: Guidelines for Emerging Economies," summarizes the work of the U.S. Committee. The committee's work is based on an understanding that the traditions, market practices, and stages of development of the economies of the Asia-Pacific region are so diverse that there is no single model, no single strategy for their reform. Based on this understanding, it attempts to articulate the minimum general principles necessary for financial and capital markets and develop guidelines for the extension of these general principles to individual financial and capital markets.

This work has the support of the economies participating in the PECC FMD Project. Rather than considering a specific model or strategy to be absolute, this approach takes account of the particular economic circumstances of each economy. It is a realistic, innovative, and extremely effective way to develop financial and capital markets in the Asia-Pacific region while at the same time averting friction.

The second section, "Deregulation and Liberalization of Cross-Border Capital Flows," summarizes and analyzes a survey by the Japan Committee on deregulation and liberalization of cross-border capital flows by PECC economies. The thinking that guided this work was not to present a list of existing regulations and then specify needed liberalization but rather to encourage the voluntary, self-directed efforts of each economy to reform systems governing cross-border capital flows and foreign exchange transactions. With the cooperation of the other committees, the Japan Committee conducted a survey of the deregulation and liberalization measures taken by economies over a 15-year period beginning in 1980, evaluated those efforts, and provided the information so economies could learn from each other about ways to proceed with deregulation and liberalization.

The survey benefited from the cooperation of the committees of each economy, which expresses both their desire to reform their domestic and external financial systems and the scale of the results they have achieved. A few economies were unable to check the survey prepared by the Japan Committee. For these economies, the committee merely presented the unchecked survey findings.

The third section, "Managing Financial and Exchange-Rate Stability: The Experiences of Taiwan and Korea," summarizes reports from the Chinese Taipei Committee and the Korea Committee on their experiences in stabilizing financial and capital markets and currency values. These experiences provide a valuable reference for other economies.

Section 4, "Mobilization of Financial Resources," contains summaries of the following reports:

1. "Impact of Privatizing Pension Systems on the Development of Capital Markets," by the Chile Committee

2. "A Report on China's Domestic Savings," by the China Committee

3. "The Role of Fund Management in the Development of Capital Markets in Asian Economies," by the Hong Kong Committee

4. "Lessons and Policies of the Informal Financial Markets in Chinese Taipei," by the Chinese Taipei Committee

The summaries provide insight into the reporting economies' ambitious attempts to deal with these issues and will be valuable both as a means of motivating other economies to reform their financial system and as a reference for them in doing so.

Part III, "Contributions to the APEC Finance Ministers' Action Agenda," contains recommendations for the APEC Finance Ministers as they adopt action agendas for reforming financial and capital markets in the Asia-Pacific region. These recommendations cover three broad areas:

1. Standardize requirements for disclosure of financial information

2. Diversify financing mechanisms for infrastructure development

3. Further liberalize cross-border capital flows

The first recommendation of Part III, "standardize requirements for disclosure of financial information," suggests the need to standardize financial disclosure of financial information by firms that seek to attract cross-border funding. Standardization will facilitate listing on foreign stock exchanges and fund-raising in both domestic and foreign markets. Clear disclosure of corporate information will improve transparency and is therefore vital to the development of national economies.

The second recommendation, "diversify financing mechanisms for infrastructure development," recognizes that fiscal conditions of developing countries have made public resources for infrastructure development more scarce, resulting in the need to encourage greater use of private-sector funding. This includes an overview of the United States' experiences in using the private placement bond market for "infrastructure financing" and of securitization of project finance being considered by Singapore and Malaysia.

The third recommendation, "further liberalize cross-border capital flows," builds on the results of the survey on deregulation and liberalization of cross-border capital flows (Part II, Section 2) to develop guidelines for competitive, phased-in introduction of measures to deregulate and liberalize cross-border capital flows.

Part IV, "Future FMD Work," summarizes the future work agenda for the PECC FMD Project. It was put together under the leadership of the Singapore Committee.

Two principles have been identified that will help in the selection of future work: extensiveness and usefulness. In light of these principles, issues related to financial and capital markets are identified to be covered by the FMD Project. The future agenda is structured under five broad themes:

1. Mobilizing financial resources

2. Promoting cross-border flow of funds

3. Harmonizing information disclosure

4. Developing efficient financial markets

5. Meeting the challenges of electronic commerce

Subtopics within each of the five themes are described in Part IV.

Part I

OBJECTIVES OF THE PECC FMD PROJECT

The economies of the Asia-Pacific region are enjoying strong development, but they still face many challenging problems. Governments and the private sector are now engaged in serious efforts to resolve these problems, one of which is developing and promoting reform of financial and capital markets.

The primary objective of the Pacific Economic Cooperation Council's Financial Markets Development (FMD) Project is to contribute to the development of financial and capital markets in the Asia-Pacific region.

The PECC FMD Project has defined five basic elements of its approach to meeting that primary objective:

Taking Advantage of the Unique Characteristics of the Pacific Economic Cooperation Council

Numerous international institutions and organizations have on many occasions proposed plans to reform financial and capital markets so as to contribute to the development of economies in the Asia-Pacific region. Examples include the Asia-Pacific Economic Cooperation (APEC) private-sector Financiers Group, the International Monetary Fund (IMF), the World Bank, the Asian Development Bank, The International Organization of Securities Commissions (IOSCO), other international organizations, private research institutions, and scholarly groups. Each has been effective in its own way.

The PECC FMD Project has been undertaken to take advantage of PECC's unique characteristics as an organization consisting of representatives of government, business, and academe. In other words, PECC is able to understand government guidelines through its discussions with government officials, is able to draw on the wealth of real-life experiences in the private sector, and is able to consult the insightful theoretical analyses by scholars. These advantages are fully reflected in the work of the FMD Project and in this *First Report*.

PECC also enjoys official observer status at APEC and has close ties with other international institutions, further adding to its advantages. For example, the recommendations in Part III were prepared in consultation with the Asian Development Bank.

Supporting the Efforts of Each Member Economy to Achieve Financial Reform

The PECC FMD Project recognizes that efforts to develop the economies of the Asia-Pacific region must be made essentially by the economies themselves. It presents the FMD Project as a means of supporting and cooperating with voluntary financial reforms undertaken by individual governments and the private sector.

Providing Guidelines for Financial Reform

The economies of the Asia-Pacific region are very ambitious in their efforts to develop and promote reforms in their financial and capital markets. They are trying to learn as much as possible from advanced financial and capital markets and are seeking "blueprints" for reform. In response to these needs, the PECC FMD Project will provide guidelines for the reform of financial and capital markets.

Pursuing Step-By-Step Reforms Tailored to the Stage of Development of Each Individual Economy

The traditions, market practices, and stages of development of the economies of the Asia-Pacific region are so diverse that there is no single model, no single strategy for their reform. It is more realistic that reforms of financial and capital markets be conducted in a "step-by-step" manner as warranted by each economy's stage of development. The FMD Project will organize desirable reform measures according to the stages for which they are appropriate.

Supporting Voluntary, Competitive Adoption of Liberalization Measures

The FMD Project has found that voluntary, competitive liberalization by individual economies has achieved extraordinary results. It is therefore left up to the "voluntary and competitive choice" of individual economies to select which reforms are implanted and to determine which FMD recommendations are accepted. At the same time, the FMD Project recommends that minimum common standards and harmonized actions in certain areas be adopted to enhance the efficiency of the financial and capital markets in the PECC economies. In the Asian environment in which the FMD Project is being conducted, this approach is likely to be more effective than demands and compromises hammered out in negotiations, as the results achieved in Asia make abundantly clear.

Part II

REVIEW AND SUMMARY OF COMPLETED FMD WORK

INTRODUCTION

Research and discussion are integral parts of the process by which the Financial Markets Development Project pursues its mission. The research itself informs and provides guidance to economies as they develop their financial markets. The discussions at FMD Project meetings that follow the completion of the research leads to FMD recommendations on actions that can be taken to improve the region's financial markets.

Since 1994 individual FMD committees have worked on research and analysis on a number of important issues. This part of the report presents summaries of eight of the reports produced by those efforts. This work, and the discussions that evolved from this work, led to the recommendations presented in Part III of this report.

In the future, the eight research reports may be published by the FMD Project in longer form or in their entirety. In the mean time, copies of individual reports can be obtained by contacting the FMD committee that produced the work.

Part II

Section 1

*Financial Markets and Institutions Guidelines for Emerging Economies**

* The research summarized in this section was sponsored by the United States Financial Markets Development Committee. The author is Mr. Clifford M. LEWIS, Vice President, International Relations, Chicago Board of Trade.

INTRODUCTION

What are the elements of a contemporary financial market and its supporting institutions? What determines their selection? And how should they be combined to form an effectively functioning entity that is suitable to an economy's current stage of economic and financial development, responsive to its needs, and capable of further development?

The purpose of this brief section is to summarize the answers to these questions treated at length in "Financial Markets and Institutions Guidelines for Emerging Economies." The full report provides a model by which such a financial market can be developed.

APPROACH

The report's approach is functional and oriented toward the financial markets practitioner. It accepts well-established academic work and analysis by such organizations as the World Bank, the Asian Development Bank, and the International Monetary Fund (IMF). Moreover, it is nonideological, nonpolitical, and mindful of dramatic variations in the starting points of the various emerging Pacific Economic Cooperation Council (PECC) economies. Lastly, the report recognizes that financial markets development, while differing in style and substance from one economy to another, is moving in a common direction throughout the world and may produce a globalized system of financial infrastructure in which the basic elements harmonize.

The report breaks down into three main sections: the link between financial market development and economic growth, a description of financial market functions, and a discussion of financial markets in transition and their prospects.

FINANCIAL MARKET DEVELOPMENT AND GROWTH

Financial development is an important prerequisite of sustained economic growth in today's global economy. The report discusses several factors in this connection: the global environment in which financial market development necessarily takes place as most emerging PECC economies have a robust appetite for capital imports; the role of government in providing financial infrastructure, a sustainable policy and regulatory framework, and an enabling framework of trust and contract enforcement; strategic options for government policymakers considering the best ways to promote financial market development.

Emphasizing the link between financial market development and economic growth is the fact that the *level* of financial development predicts future economic growth. No other macroeconomic indicator has this predictive power.

Developed financial markets perform several important functions. They mobilize and deploy capital efficiently and effectively; they are fundamental to facilitating commerce; they are essential to structuring and operating modern enterprises; they are now providing various mechanisms for the management of risk.

Evolutionary trends are leading to financial markets marked by scale, sophistication and a global perspective. These markets have institutional investors and international portfolios. They are efficient in their transactions and pricing and competitive with other contemporary markets. And they are now offering risk management services through derivatives.

Convergence

Policies affecting the development of financial markets in emerging-market PECC economies varied widely in the 1970s. By the late 1980s, however, they began to converge and today are moving in similar directions. This trend, marked by openness and liberalization, is in sharp contrast to the methods of the 1970s, when extensive government intervention was the norm in those economies where convergence is now taking place.

Consumers of Capital

Increasingly, emerging-market PECC economies have become consumers of capital. In 1993 these economies accounted for about 85 percent of the total capital flowing into emerging markets. In some countries, these inflows represented as much as 15 percent of gross domestic product.

This has come about as emerging-market PECC economies to a considerable extent have liberalized restrictions of inflows of foreign capital, introduced new products, brought regulation more in line with international standards, and opened their markets to multinational institutions.

Fundamental Requirements

The conditions for a basic environment for financial market development extends beyond monetary and fiscal policy to include such elements as the attitudes of civil society and reliable commercial relations. Two sets of these elements are crucial. The first is *trust and overall confidence*. These terms embrace attitudes that promote market development through a high degree of certainty as to respect for rules and regulations. The other is a *structure for enforcing contracts* in, for example, the areas of commercial law, company law, mechanisms for lenders to take control of assets pledged as collateral for loans, and bankruptcy procedures.

CORE FINANCIAL MARKET FUNCTIONS

This section of the report presents an inventory of specific value-adding functions and instruments. Some, such as the rules for international payments, are standardized. Others vary greatly because of national customs, initial conditions, and the natural diversity of financial cultures.

The analysis presents separately the supply and demand sides of the particular functions and instruments, such as, government issuance of bonds, on the one hand, and the purchase of those bonds by savers, on the other.

Payment and Transaction Processing at Retail, Wholesale, and International Levels

Specifics covered include checks, giros, automated clearinghouses, credit and debit cards, and automatic teller machines. Others covering large-value transactions include clearing, settlement, message transfer only, and net versus gross settlement. In addition, this section describes international payment systems and the mechanics of foreign exchange transfer as they vary from country to country.

Tools for Executing Monetary Policy

Monetary policy is implemented through financial functions: directly through money creation by banks or indirectly through capital markets. Discussed in this connection are the role of currency boards in limiting the issue of fiat money; the operation of direct monetary instruments such as interest rate controls; bank credit cards, and liquidity controls, and the operation of indirect monetary controls such as the rediscount window, public sector deposits, credit auctions, primary and secondary markets for debt, and the foreign exchange market.

Attracting, Aggregating, Using, and Protecting Domestic Savings

A range of institutions aggregate resources from large numbers of individual savers that can be channeled into investments. The report lists the motives for accumulation and describes the retail infrastructure for attracting and processing savings. It also reviews the mechanisms by which various savings and investment schemes are effected.

Lending to Enterprises and Individuals

Most lending is effected through intermediaries, typically commercial banks, as is the case in most PECC economies. Commercial banks offer economies of scale and the likelihood of repayment. Four activities apply equally to formal and informal credit functions: credit screening, loan pooling to reduce risk, credit monitoring, administration and documentation, and enforcement. They are designed to ensure the selection of the most creditworthy borrowers and to coerce the performance of credit contracts.

The report continues with descriptions of the various types of lending, the regulation of bank lending, direct investment in securities, credit instruments, price discovery, and infrastructure.

The Equity and Venture Capital Market

Equity is both an important source of risk capital for investments and a vehicle through which the control of enterprises is effected. It is also an important source of additional capital. The report explains methods used to finance nonfinancial enterprises and shows how these methods change as financial systems are deepened and the range of services broadened. Included in the discussion are corporate finance, which in PECC economies is changing under the influence of tax system modernization and disclosure rules, mergers, takeovers and breakups, venture capital, the mechanics of the equity market, and real estate.

Strong disclosure rules are an indispensable element of a financial market seeking growth, efficiency, and viable global connections. The report stresses the need for harmonization of disclosure rules and procedures so that investors around the world may be assured of receiving accurate and standardized information.

Insurance

Insurance, which constitutes a unique class of financial functions, is predicated on the investment portfolio insight that pooling a large number of risks can be extremely beneficial. It is, moreover, intimately associated with investment activities, as its premium income can be put to work earning a return. Insurance packages its risk management, investment, and saving functions in myriad combinations, and the industry's formation of very large pools of risk-absorbing capital led to the creation of reinsurance. Taking up the various types of insurance, the report discusses term, whole life, universal life, annuity, and variable policies.

Unbundling and Managing Risk

Risk management is an integral part of almost all financial functions. It is essential to the efficiency of any cash market. Recently research and market practice have done much to unbundle the various types of risk. This has led to the introduction of fine-tuned mechanisms for measuring and addressing individual risks and opened the way to tremendous efficiency gains by expanding the horizons of actively trading risks. In addition, markets dealing in risk provide a value-adding outlet for the purely speculative impulse that is an essential lubricant of any successful financial system.

The report discusses risk trading and cash markets, performance risk and credit enhancement, comparative advantage and risk unbundling, commodization of finance, prudential and regulatory issues, and future trends, one of which is the acceleration of the introduction of sophisticated risk management functions to emerging and transitional economies.

INSTITUTIONS IN TRANSITION AND PROSPECTS

The report establishes three categories of emerging PECC economies and, for each, discusses appropriate strategies for further development of financial markets and institutions that will advance progress toward efficiency and contemporary competitiveness.

1. **Low Income, Inadequate Financial Infrastructure**

   The first type of PECC economy discussed is characterized by low income and inadequate basic financial infrastructure. The lack of financial system capability in such an economy is a major impediment to overall economic growth. Here the developmental focus should be on basic financial infrastructure including payment systems, trade financing, and banking.

2. **Middle Income, Financial Institutions in Transition**

   The second type of economy is one with middle income and financial institutions in transition. Here the once dominant position of banks is beginning to be challenged by a range of financial services, and government is confident enough to begin liberalizing current and capital accounts. Further development should focus on increasing institutional capacity, increasing debt markets, achieving greater specialization, and using capital markets for management of monetary and governmental debt. In addition, an economy at this stage requires a reasonably complete legal and regulatory framework.

3. **Well-Developed Economy, Sophisticated Financial System**

   The third type of emerging PECC economy has a well-developed economy and fairly sophisticated financial system. It is characterized by a high degree of domestic competition and a national financial system that is well integrated with the global markets. Its monetary policy is implemented fully through indirect means.

   Further advancement of its financial system should focus on developing middle-market companies and the financial systems to support them, developing sophisticated risk management products and markets; expanding institutionally oriented products and markets and pooled investments, and expanding involvement in global markets and economy.

CONCLUSION

The study emphasizes that financial and capital markets are important to economic growth and that there is a link between these markets and economic progress. Moreover, it points out that developing economies without the drag of legacy systems may be able to achieve contemporary status very rapidly. And lastly, economies that would attain efficiency and competitiveness in their capital markets should embrace new technologies, be on the front edge of development, promote competition, encourage innovation, allow failure, and take advantage of transitional financial service organizations that bring essential expertise, technology, and capital to local markets.

Part II

Section 2

Deregulation and Liberalization of Cross-Border Capital Flows[*]

[*] The research summarized in this section was sponsored by the Japan Committee for Financial Markets Development. The author is Professor Masahiro KAWAI, Institute of Social Science, University of Tokyo.

INTRODUCTION

The Pacific Economic Cooperation Council (PECC) region is the most dynamic in the world economy. Its rapid growth has been made possible by the twin outward-oriented strategies of liberalizing international trade and capital flows and of building strong trade investment ties with the rest of the world. The expansion of both trade and inward capital flows, particularly foreign direct investment (FDI), has been a vital source of the engine of growth in the region.

Recently liberalization of financial capital flows has been the focus of much attention. Many PECC member economies have pursued policies of liberalizing domestic financial markets and opening their markets to foreign investors. At the same time, the authorities have begun to open their financial services to foreign financial institutions such as banks, securities firms, fund management firms, and insurance companies.

Capital flow liberalization and financial market opening have been driven by four factors:

1. *The need to attract foreign savings* for capital accumulation and efficient foreign technologies for rapid development, restructuring, and upgrading of the economy. Providing an open financial system enhances the credibility of a country's commitment to these aims. This credibility in turn provides a fertile environment for dynamic economic activities.

2. *Competitive pressure* on many PECC economies to open the domestic financial markets to foreign investors and institutions. Foreign manufacturing firms investing directly in a PECC economy would require high-quality financial services similar to those they enjoy in their home countries. These are often unavailable unless the home financial institutions do business in the host countries. To induce more foreign direct investment, the host countries must offer attractive financial environments to foreign financial institutions by opening their domestic markets.

3. *The de facto opening of capital accounts* in many economies as increased financial interdependence has eroded the effectiveness of capital and exchange controls. The business networks of overseas Chinese in East Asia have created tight financial linkages in the region.

4. *Bilateral and multilateral pressure on relatively advanced developing countries* to open up their financial systems. For Korea, membership of the Organization for Economic Cooperation and Development (OECD) has been contingent upon its elimination of capital and exchange controls; for Chinese Taipei, financial services liberalization has been considered as essential, apart from political factors, to World Trade Organization (WTO) membership.

Cross-border capital flow liberalization and financial market opening, thus far accomplished, have no doubt contributed to the improved allocation of financial resources internationally as well as domestically. The timing, speed, and scope of deregulation and liberalization, however, have not been uniform, reflecting the diversity of the economies in the region. The PECC economies have different sizes, per capita incomes, industrial structures, saving and investment patterns, and financial deepening indicators. The region is clearly a mixture of rich and poor economies, industrial and agricultural economies, and financially deep and shallow economies.

Capital flow liberalization and financial market opening, which have the benefit of enhanced financial efficiency, do not come without costs. Sudden inflows and outflows of capital and the consequent pressure on exchange rates, caused by the liberalization measures, have often posed serious difficulties for macroeconomic management. The sequencing of liberalization must be right, and a premature or rushed opening may entail a large cost to the economy, as the Southern Cone experiment in the 1970s showed. It is vital to find a balance between efficiency gains due to capital flow liberalization and financial opening and possible costs due to financial and macroeconomic instability.

RECENT TRENDS IN CROSS-BORDER CAPITAL FLOW LIBERALIZATION

Overall Review

The Japan PECC Committee for Financial Markets Development has compiled information on recent changes in the regulatory framework governing international capital flows in most of the PECC members, particularly in the areas of foreign direct investment, foreign securities investment, banking transactions, and foreign exchange transactions. This information is contained in "The Regulations on Cross-Border Capital Flows in the PECC Economies" (April 1996).

In recent years all the economies in the PECC community have adopted measures that encourage cross-border capital flows (both inflows and outflows), open their financial markets, and relax exchange controls. The timing, speed, and scope, however, vary significantly across economies. Given the diversity in terms of stages of economic development, industrial structures, competitiveness of financial institutions, and broad institutional frameworks, it is not surprising that the PECC member economies have taken different approaches toward capital flow liberalization and financial market opening.

Despite their remarkable accomplishments in liberalization, many PECC economies still maintain various forms of restrictions over cross-border capital flows, foreign entry into domestic financial services, and foreign exchange transactions.

Liberalization of Foreign Direct Investment (FDI)

In the 1980s, many developing PECC member economies, particularly those of East Asia, started to focus on policies to promote capital investment by domestic as well as foreign firms. This was particularly pronounced in the newly industrializing Asian economies in the first half of the 1980s and in the Association of Southeast Asian Nations (ASEAN) countries in the second half. They often changed laws to promote manufacturing sector investment and implemented numerous types of measures in favor of foreign direct investment (FDI).

The first type of measure encourages FDI inflows by offering tax and tariff incentives to foreign firms. Typical examples include establishment of export processing zones (Korea, Chinese Taipei, the Philippines), free trade zones (Malaysia), special economic zones (China), and maquiladoras (Mexico), though other countries (e.g., Thailand) offer similar incentives without setting up formal economic zones. The second type liberalizes sectors open to foreign investors by introducing a system of a negative list and reducing the number of prohibited or restricted sectors in the list (Chinese Taipei, Korea, Indonesia, the Philippines, Chile). Many manufacturing sectors are now open to FDI, in almost all PECC member economies, unless specifically prohibited. The third type encourages manufacturing FDI which contributes to the national economy by allowing substantial foreign ownership. The strategy is to set a maximum limit on foreign ownership of firms and to relax the foreign ownership limitation, depending on the firm's contribution to the national economy measured by export, employment, and regional development (Malaysia, Thailand, Indonesia). PECC economies, except China, now allow 100 percent foreign ownership in export-oriented manufacturing sectors, such as those exporting more than 80 percent of the products.

Export-oriented, pro-FDI policies adopted by many PECC member economies no doubt expanded FDI flows, especially those in manufacturing sectors. Some developing PECC economies, however, impose certain performance requirements (local contents, exports and imports, foreign exchange, domestic sales) and often restrict FDI in sensitive nonmanufacturing sectors such as banking and finance, mass media and broadcasting, airlines, real estate acquisition, and sectors affecting national security. They either prohibit such FDI or limit foreign ownership by passing specific laws or by including those sectors in the negative list. Even countries with liberal policies toward FDI sometimes require prior notification and the authorities' review for FDI in certain sectors (Japan, Australia, Canada) and the authorities' consent or approval for large-package FDI or substantial foreign ownership (Mexico).

Liberalization of Foreign Securities Investment (FSI)

Developed PECC member economies, including Singapore and Hong Kong, have maintained liberal policies toward foreign securities investment. Many PECC member developing economies began liberalization of foreigners' investment in their stock markets in the 1980s. Promotion of stock markets and liberalization of cross-border investment in shares and stocks resulted in the remarkable growth of stock markets in the PECC economies. However, foreigners' investment in fixed-income securities is still small due to the underdeveloped bond markets. This partly reflects the balanced-budget policy and the consequent lack of large-scale issues of government bonds, the lack of large institutional investors such as life insurance companies and pension funds, and the lack of basic market infrastructure such as transparent disclosure systems, effective accounting principles, credible rating agencies, and efficient payment systems.

Korea and Chinese Taipei took a cautious, step-by-step liberalization approach, first by offering international investment trust (Korea Fund and Taiwan Fund) to foreigners abroad and then by opening their stock markets to foreign institutional investors, noninstitutional firms, and individuals so that the investors could directly acquire domestic shares and stocks. These two economies still maintain upper limits on foreign investors' holdings of domestic stocks, which they have raised gradually over time.

Other PECC economies also set upper limits on foreign investors' holdings of domestic stocks, such as 49 percent for Thailand and Indonesia, 40 percent for the Philippines in the negative list, and Mexico. Although the Malaysian government does not impose any formal regulatory limit on foreign acquisition of stocks, individual firms' clauses often limit foreign ownership due to the *bumiputera* policy, and it is said to be difficult for foreigners to hold more than 30 percent of stocks outstanding. Certain firms in Singapore have foreign ownership limitation clauses in their articles of association.

Those stocks under the maximum foreign ownership are usually traded by foreigners with premiums. Thailand established an organized stock market for foreign investors, called the Foreign Board, where foreign investors trade stocks with the 49 percent limit. Firms in the Philippines in the negative list often issue two separate shares for residents and nonresidents: A-shares, with more than 60 percent of the total, are for domestic residents; B-shares, with less than 40 percent of the total, can be held by foreign investors. The Philippines issues international investment trust including A-shares, such as the Manila Fund, in London and New York for foreign investors so that they can invest indirectly in A-shares. Some Chinese firms issue A-shares (denominated and settled in the RMB) specifically for Chinese investors and B-shares (denominated in the RMB but settled in a foreign currency, such as the U.S. dollar in Shanghai and the Hong Kong dollar in Shenzhen) specifically for foreign investors. Other Chinese firms issue shares in Hong Kong called H-shares (settled in the Hong Kong dollar).

Outward foreign securities investment has been liberalized, but some economies, such as Chinese Taipei, Korea, and China, still maintain controls on domestic residents' purchases of foreign shares and stocks. Even developed economies, such as Japan and Canada, and developing economies like Singapore and Chile impose upper limits on foreign securities holdings by domestic institutional investors such as life insurance companies and pension funds.

Liberalization of Banking Transactions

Long-term bank loans have been a major vehicle of capital transfers between developed and developing countries, and short-term bank loans have frequently been used to finance trade credits and firms' current operations.

In the PECC region, cross-border bank lending and borrowing have been active since the 1980s. Tokyo, Hong Kong, and Singapore have been financial centers in Asia, intermediating cross-border banking flows. Hong Kong is unique in that it allows complete integration of the domestic and international banking markets. Singapore has an offshore banking center, which is separated from the domestic banking market (denominated in the Singapore dollar). Other East Asian economies (Chinese Taipei, Malaysia, Thailand, the Philippines) have also attempted to encourage inflows of cross-border bank loans by establishing offshore banking facilities separated from the domestic retail banking markets. This reflects a strategy of attracting cross-border banking flows and foreign banks with advanced financial technologies without exposing the domestic commercial banks to fierce international competition.

Although developed PECC members, including Hong Kong, have adopted a liberal stance toward cross-border banking transactions, many developing members retain certain regulations. They either require central bank approval, which is not always transparent, for cross-border banking transactions with large amounts (Singapore, Malaysia, Indonesia, China) or set an upper limit on volumes of such transactions (Chinese Taipei, Korea).

With regard to foreign banks' entry into the domestic retail market, many developing PECC economies have taken cautious approaches. The authorities almost always require licenses for new entry, whether by a domestic or foreign institution, and often discriminate against foreign banks by maintaining tighter entry restriction to protect, or to avoid excessive competition faced by, domestic banks. Types of restrictions vary, such as prohibiting new foreign bank entry (Malaysia), limiting form of entry (Korea as a branch or a joint venture; Indonesia and the Philippines as a joint venture), imposing upper limits on foreign equity ownership (25 percent for Thailand, 40 percent for the Philippines, Mexico), restricting the location and number of branches (Singapore, Malaysia, Thailand, Indonesia, China), and constraining types of businesses (Singapore, Korea, Malaysia, Thailand, the Philippines, China). In countries with offshore banking facilities, foreign entry into full banking is often difficult, but entry into offshore banking is easier (Singapore, Malaysia, Thailand, the Philippines). Some of these economies, however, have taken increasingly open policies; for example, Thailand announced in November

1996 that it would grant full branch licenses to seven foreign banks that have been operating in the Bangkok International Banking Facility.

Liberalization of Foreign Exchange Control

Alongside the cross-border capital flows, foreign exchange transactions have also been liberalized by PECC member economies since the 1980s. As of the end of 1996, all economies except Vietnam and Colombia have accepted their obligations under Article VIII of the IMF Agreements by establishing current account convertibility of currencies. Developed economies including Hong Kong and Singapore have completely liberalized all types of foreign exchange transactions. Malaysia, Indonesia, and Peru have relatively lax exchange controls even on capital account–related activities, though Malaysia requires central bank approval for large-amount inflows of foreign currency. Korea maintains one of the most restrictive exchange control systems; Chinese Taipei, Thailand, the Philippines, China, Mexico, Chile, and Colombia have several explicit restrictions on payments for capital account activities.

Many PECC member economies maintain the so-called foreign exchange bank system, in which specialized banks or dealers are authorized to deal in foreign exchange (Japan, Korea, Malaysia, Thailand, Indonesia, the Philippines, China, Australia). Some of these economies retain a foreign exchange concentration system by requiring export proceeds to be sold to the authorities or deposited at the authorized foreign exchange bank (Korea, Malaysia, China), and some impose position management control on the banks (Japan, Korea, Indonesia, China, Australia).

RESULTS OF CAPITAL FLOW LIBERALIZATION

Increased Financial Efficiency and Financial Linkages

One of the consequences of cross-border capital flow liberalization is an increase in efficiency of financial resource allocation. This is reflected in the trend toward equalization of rates of return on capital in the region. Research in this area has focused on the interest rate parity relationship, whether on a covered, uncovered, or real basis, which supports evidence of strengthened financial linkages in the PECC region.

Studies focusing on equity markets have also found strong correlations of equity returns among countries in the Asia-Pacific region. A significant linkage exists between the stock markets of Hong Kong, Singapore, Japan, and the United States, which is not surprising given the well-developed nature of those markets. Although markets with severe restrictions on cross-border investment in equities, notably Korea and Chinese Taipei, have been less responsive to shocks in foreign markets, even there stock market interdependence appears to have increased in recent years.

Saving-Investment Correlations and Current Account Financing

As cross-border capital flows are liberalized and the financial market is integrated with the rest of the world, the correlation between domestic saving and investment becomes weaker, and current-account imbalances are more easily financed. Essentially, with an open financial market, a country's investment does not have to be financed only by domestic savings, and a country's savings do not have to be directed only to domestic capital formation. This loosens the correlation between domestic saving and investment. Such loosening has been observed in the PECC region, whose member economies have developed significant current- account surpluses or deficits. Foreign direct investment and long-term loans have been major vehicles for financing current accounts, in addition to reserve flows.

The Danger of Sudden Capital Inflows and Outflows

Capital flow liberalization and financial market opening may induce sudden inflows and outflows of capital, posing serious difficulties for macroeconomic management. A sudden increase in capital inflows can be troublesome because it can put upward pressure on the exchange rate and/or increase foreign exchange reserves. Exchange rate appreciation can weaken the tradables sector of the country in question, and reserve accumulation and the consequent money supply increase can be inflationary. Furthermore, if the capital inflows are purely short term and easily reversed, abrupt and sudden capital outflows can occur, making macroeconomic management difficult. The damage such large inflows and outflows of capital can cause to an economy was illustrated by the 1994–95 Mexican peso crisis.

When countries liberalize international capital flows and open their financial markets to the rest of the world, they must be aware of the danger of such abrupt and sudden increases in capital inflows and outflows. PECC member economies have so far coped successfully with surges of capital inflows, because capital flows have largely been of a long-term nature and these economies have maintained sound macroeconomic fundamentals and high saving rates. But short-term capital flows have recently been rising in the region, and PECC economies must be ready to take appropriate measures to avoid the negative consequences of abrupt and sudden increases in capital inflows and outflows.

CONCLUDING REMARKS

This report has argued that all the PECC economies have persistently pursued liberalization policies, albeit with varying timing, speed, and scope. The sequencing of capital flow liberalization has by and large been well judged, and no East Asian economy's liberalization has met with a disaster such as those that befell the Southern Cone and, more recently, Mexico. Korea, Chinese Taipei, and Thailand have taken a cautious approach for fear of losing control of macroeconomic management and destabilizing their financial institutions, but Indonesia has been very bold. The recent experience in Malaysia shows that, although a sudden surge in capital inflows and outflows can cause a rapid swing in the exchange rate, it is possible to avoid a severe crisis in the tradables sector. Taken together, these experiences suggest that the PECC economies have the fundamental strength to cope with further liberalization and opening of financial markets.

At a time when the world economy appears headed toward regional arrangements, it is important for the PECC economies to maintain open economic systems. It was the liberal trading system that made the PECC region's rapid economic growth possible, and that will continue to attract global economic interests in the region and will help to expand a multilateral economic framework. Further liberalization of international capital flows and the consequent integration of this region into the world economy are vital for this purpose.

Part II

Section 3

Managing Financial and Exchange Rate Stability: The Experiences of Selected PECC Economies

*INFLOW OF FOREIGN CAPITAL AND MONETARY CONTROL: THE KOREAN EXPERIENCE**

INTRODUCTION

As globalization and opening up of markets have progressed, there has been a large increase in international commodity and capital movements in recent years. A large shift in the inflow and outflow of foreign capital resulting from this movement sends a shock to particularly the economies of developing countries where the financial sector is undeveloped. If this shock is not properly managed, various types of economic disturbances may occur, leading to macroeconomic problems. Korea had this experience during the latter half of the 1980s.

The goal of this report is to review the experience of Korea in detail and evaluate the policy response and performance of the Korean government in order to draw lessons for other developing countries, in particular, the countries that are members of Asia-Pacific Economic Cooperation (APEC).

CURRENT-ACCOUNT SURPLUS AND MONETARY EXPANSION

Since the early 1960s the Korean economy has grown very fast, at an annual rate of almost 8 percent. High economic growth until the mid-1980s was by and large government led: the government's control and intervention were especially conspicuous in the financial sector. The growth also gave birth to side effects: chronic inflation and a current-account deficit.

Around the second half of 1985, world economic conditions became unusually favorable toward the Korean economy. The best news was the collapse of oil prices, because Korea was importing 100 percent of its consumed crude oil. In 1986 the average price of imported oil fell by 47 percent from a year before and this resulted in about $2.8 billion in savings in oil import.

Another piece of good news was a decline in international interest rates. The net foreign debt had, by then, amounted to $20 billion, and the 2 percent drop in the international interest rate in 1986 resulted in a $400 million saving in interest payments.

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The third important change was that in 1986 the value of the Japanese yen against the U.S. dollar rose by almost 30 percent from the previous year. At the same time, the value of the Korean won declined vis-à-vis the U.S. dollar. Korean goods became more competitive in export markets against goods from countries with appreciated currencies.

These three blessings, as they are referred to, led to the largest current-account surplus to date in 1988. In 1986, Korea experienced its first current-account surplus of $4.62 billion. The surplus then continued to snowball, reaching $14.16 billion in 1988.

The surge in the current-account surplus posed three immediate problems for Korean policymakers: pressures for monetary expansion, pressures for appreciation of the domestic currency (won), and the possibility of trade frictions or disputes with Korea's trading partners, especially the United States.

In the case of Korea, the sharp rise in the current-account surplus automatically led to an increase in the money supply in the following way. The current-account surplus automatically led to a surplus in the overall balance of payments. This was because the capital account had been rigidly maintained in surplus to compensate for a chronic deficit in the current account. A surplus of the overall balance, in turn, was directly linked to monetary expansion, because all foreign currency was required to be sold to the central bank in exchange for the Korean won.

The ratio of the current account to high-powered money, which measures monetary expansion, jumped up from -0.2 in 1985 to 1.7 and 1.5 in 1987 and 1988, respectively.

POLICY RESPONSES

To tackle the three problems mentioned above, Korea introduced three types of policy measures.

Policies to Reduce the Current-Account Surplus

Aiming at directly reducing the current-account surplus, the authorities implemented import promotion and export restriction. First, from 1986 the Korean government implemented market opening, cuts in tariffs, and special imports as vehicles for import promotion. The government introduced several measures for import liberalization and steady deregulation of import surveillance and import diversification between 1986 and 1991. The ratio of import liberalization jumped by 7.8 percent from 87.7 percent in 1985 to 95.5 percent in 1989. Tariffs on imported goods had been reduced continuously since 1984. Korea's average tariff rates fell significantly, down from 21.3 percent in 1985 to 12.7 percent in 1989.

Second, the policy authorities reduced supports for exports and introduced self-restraints of export. Businesses eligible for receiving trade finance, which was a special privilege to exporters, had been reduced several times. Korea and the United States agreed that the growth rate of textile exports to the U.S. should be restricted to 0.825 percent per annum for four years by 1989. Export recommendation in advance began to be required for exports of items such as electronic ranges, whose exports grew at a fast pace.

Third, the Korean won was appreciated. In the beginning of the three-blessings period, the Korean government was reluctant to allow the appreciation of the Korean won. But, as the United States raised pressure for the appreciation of the Korean won from 1987, the Korean government allowed a large appreciation of the won. As a result, in 1987 and 1988 the won appreciated against the dollar 8.7 percent and 15.8 percent, respectively.

Policies to Promote Capital Outflow

Another policy to relieve the pressure of monetary expansion stemming from increases in current account surpluses was to promote capital outflows. Until the latter half of the 1980s, it was not likely that capital outflows would occur naturally through a market mechanism. This was because market interest rates in Korea remained much higher than the rates in international capital markets and also because further appreciation of the Korean won was anticipated. Therefore the government had no choice but to intervene in the foreign exchange market and implement various measures to prompt capital outflows.

Early repayment of foreign debt was made. Total repayments for foreign debts increased from $3 billion in 1985 to $6.4 billion in 1987 and declined somewhat to $5.2 billion in 1988.

Overseas investments by domestic firms were encouraged. Deregulations were introduced to simplified investment formats and relaxed approval requirements for investments. As a result, overseas investments increased from $120 million in 1985 to $570 million in 1989.

Foreign exchange control was considerably relaxed as well. All constraints on transactions in the current account were abolished in December 1988 as Korea agreed to accept the Article VIII obligation under the International Monetary Fund. The legal limits of expenses for overseas travel and sojourns and for personal remittance abroad were increased.

Measures to Control Domestic Credit Expansion

To maintain the target growth rate of M2, monetary authorities implemented four types of sterilization measures. The Bank of Korea started open market operations using self-issued monetary stabilization bonds as instruments. The volume of issuance of monetary stabilization bonds more than doubled every year between 1985 and 1988. As a result, in 1989 the volume increased to 20 trillion won, which was equivalent to 29.5 percent of M2 at the end of 1989.

The monetary authorities also employed direct control of bank credits as a means to deter monetary expansion. Credits to the government, in particular, were reduced by a large amount, from 1.44 trillion won in 1985 to -5.67 trillion won in 1990. The monetary authorities also tried hard to suppress the growth of credits to the private sector. Nevertheless, credits to the private sector nearly tripled to 122.5 trillion won between 1985 and 1991 because of strong demand and increase in policy loans. The reserve requirement ratio and the rediscount rate of commercial bills were raised.

Seemingly, the government also cooperated in tightening the money supply, because almost all balances of the consolidated budget recorded surpluses between 1986 and 1990. However, these surpluses were due not to tightened government spending but rather to the unexpected increases in tax revenues resulting from the then continued economic boom.

The authorities gradually relaxed the foreign exchange concentration system to prevent the inflow of foreign exchanges from directly linking to domestic currency expansion. Deregulation in this area largely focused on Korean firms' purchasing, carrying out abroad, and holding abroad foreign exchanges.

MACROECONOMIC PERFORMANCE

Money, Interest Rates, and Foreign Exchange Rates

The Korean monetary authorities tried to control both monetary aggregates and interest rates at the same time. But these efforts achieved only limited success in containing the pressure for monetary expansion. The authorities set up target growth rates at 15–18 percent during the 1987–89 period. The announced actual growth rates of average M2 during this period turned out to be a little over the upper limit of targets. However, the 18 percent target growth rate was too high if the potential growth rate of the Korean economy and the expected inflation rate are taken into consideration. Also, M2 balances on a year-end basis grew even faster than the average rates announced by the authorities. In addition, the growth rate of M3 grew at the annual rate of almost 30 percent during 1987–89.

Until 1987 the interest rate was fixed below market level to promote investment as well as to curb further inflow of foreign capital. As interest rate controls were relaxed at a gradual pace from 1988, however, the rates were under strong pressure to rise. Yield on corporate bonds rose from 14.2 percent in 1988 to 18.9 percent in 1991. An increase in inflation rates also contributed to the rise in interest rates during that period.

In the beginning of the three-blessings period, which was from 1985 to 1986, the domestic currency appreciated only by a small margin. This was largely due to the government's reluctance to appreciate the won. Only after policymakers saw the surplus snowballing and there was strong pressure from the United States did they allow the Korean won to appreciate. It appreciated 8.7 percent in 1987 and 15.8 percent in 1988, respectively.

Growth, Prices, and Balance of Payments

In terms of macroeconomic variables, it seems that the Korean economy showed the best possible performance, such as high economic growth, stable prices, and the current account surpluses, during 1986 to 1988.

During 1986–88, gross domestic products (GDP) grew about 11.5 percent per annum on average, far beyond the potential growth rates. Prices remained stable during 1985 to 1987, with the inflation rate below the 3 percent level in terms of the consumer price index (CPI). The Korean economy experienced unprecedented large surpluses in the current account during 1986 to 1989. Starting from $4.2 billion, the current-account surplus reached its highest in 1988, at $11.5 billion.

Since the Korean economy was not sufficiently stabilized during this period, serious side effects such as economic overheating and bubbles appeared after the period. Economic growth plummeted to the 6 percent level in 1989 as growth of facility investments and exports plunged because of a series of appreciations of won exchange rates and excessive wage increases. Price increases began to accelerate from 1988. Inflation rates of the CPI rose from 3.0 percent in 1987 to 8.6 percent in 1990. Surpluses in the current account began to contract from 1989, reverting to a deficit from 1990 and afterward, mainly due to loss of international price competitiveness. Real estate and stock markets were also overheated. Prices of real estate rose by 27.5 percent in 1988 and 32 percent in 1989, respectively, before they began to stabilize mainly due to special measures against real estate speculation from mid-1990. Stock markets were also overheated. The Korea stock price index (KOSPI) rose 151.7 percent per annum on average, up from 163.3 in the end of 1985 to 907.2 in the end of 1988. Beginning in the second quarter of 1990, the market rapidly cooled down. The KOSPI reached its bottom, 510.0, in July 1992. Side effects from bubble breakdown lingered for a long time, and the Korean stock market has not sufficiently recovered from the effects.

Overheating of the Korean economy pulled the unemployment rate down during the 1986–91 period and pushed up wage rates faster than labor productivity did. The price competitiveness of export goods weakened rapidly.

LESSONS AND POLICY RECOMMENDATIONS

The volume of foreign capital inflow into Korea during 1986–88 was not large compared with that of the Korean economy. It accounted for only 4.4 percent to 7.8 percent of the GNP during that period. Despite the sterilization efforts, however, the Korean economy failed to sufficiently absorb the inflow of foreign capital and eventually had to face economic bubbles and severe damages. The major reasons for partial failure to contain the external shocks are as follows.

First of all, the Korean economic system was rigid and therefore not ready to respond rapidly to shocks in the foreign sector. Until the three-blessings period, economic policies had focused to a large extent on protecting domestic markets because of chronic deficits in the current account. The government had maintained strong control over foreign exchange and financial markets as well. Interest rates were controlled and, as a result, financial markets were underdeveloped. In addition the authorities responsible for economic policies considered the surpluses in the current account during 1986 to 1988 as a temporary phenomenon, and did not actively prepare for reaction strategies. The above factors blocked the Korean economy from responding rapidly to shocks in the foreign sector.

Second, macroeconomic prejudice also deterred policy reaction by the authorities. They believed that the higher the economic growth and the bigger the surpluses in the current account, the better. Such prejudice led the authorities to tolerate high economic growth beyond potential unless it became an imminent threat to price stability. In the beginning years of the three-blessings period, there was no effective management of major macroeconomic variables. Such prejudice and negligence of the authorities resulted in economic bubbles. In turn, the burst of those economic bubbles caused serious damage to the economy.

Putting the above facts together, one can draw some lessons that will hopefully be of help to APEC countries, especially to developing countries.

First, the policy authorities should abstain from artificially intervening in price variables such as interest rates, foreign exchange rates, and commodity prices, as much as possible. This means liberalizing interest rates and foreign exchange rates. Such liberalization will contribute to the development of foreign exchange and financial markets. As a result, when an external financial shock comes, the markets can afford to absorb or adjust smoothly.

Second, it will be desirable to open up capital markets and liberalize capital movements steadily and cautiously step by step, not at once. The Korean economy suffered from considerable side effects when there was a small shock. If the authorities implement such measures too hastily, they may eventually have to retreat because of the side effects following the liberalization.

Third, macroeconomic policymakers should pursue a sound policy, taking potential economic growth of their countries into consideration. In general the policy authorities of developing countries tend to welcome high growth rate or more capital inflow. However, priority should be given to stabilization of the economy, which means growth within its potential, price stability, and equilibrated balance of payments.

Fourth, despite all these efforts, an individual country can hardly respond sufficiently to abrupt changes in international movement of capital and their spreading effects as capital markets open up. Therefore, each country needs to establish joint efforts with other APEC countries. It is also necessary for the monetary authorities of all member countries to conclude agreements or commitments that can curb movements of speculative capital and promote stabilization of foreign exchange rates. The idea of taxation on speculative capital inflow, the so-called Tobin tax, may be one of the options.

VOLATILE FOREIGN EXCHANGE RATE AND HOW PECC MEMBER ECONOMIES COPE WITH IT: A REVIEW[*]

INTRODUCTION

Since the breakdown of the Bretton Woods system of fixed exchange rate in the early 1970s, foreign exchange rates among major currencies have become more volatile. In the last two decades, it has been observed that a volatile foreign exchange rate dampens the expansion of world trade and slows the flow of foreign direct investment. In addition, when one country is confronted with volatile foreign exchange rate situations, it may pursue monetary policies that are harmful to other countries. Therefore, decreasing the volatility of foreign exchange rate remains at the top of each country's economic policy list.

Not only did volatile foreign exchange rate cause individual countries concern, it has also received due attention from several multilateral organizations, such as the G7 Meeting, International Monetary Fund (IMF), Asia-Pacific Economic Cooperation (APEC), Pacific Economic Cooperation Council (PECC), and many others. The Mexican peso crisis of late 1994 triggered worldwide awareness that countries are vulnerable to foreign exchange rate fluctuation, and international cooperation in terms of either harmonized domestic macroeconomic policies or concerted interventions in international markets is necessary to mitigate the ill effects. As a result, the prevention of excess foreign exchange rate volatility and the cooperation of macroeconomic policies have been major issues of various G7 meetings and APEC meetings.

As a major international economic cooperation organization, PECC also pays a great deal of attention to the consequences of volatile foreign exchange rates and methods to alleviate the ill effects. The Financial Markets Development (FMD) Project, under the supervision of PECC, has asked Chinese Taipei to investigate the reasons for and the effects of increasing foreign exchange rate volatilities and how PECC member economies cope with the problem. This study (1) discusses the reasons for increasing foreign exchange rate volatilities, (2) examines PECC member economies' foreign exchange rate arrangements, (3) reviews foreign exchange rate fluctuations of eight member economies and how individual economies cope with the problems, (4) describes the instruments employed by member economies during the observation period and the lessons drawn from sample economies' experiences, and (5) summarizes the study.

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REASONS FOR INCREASES IN FOREIGN EXCHANGE RATE VOLATILITY

There are many reasons why foreign exchange rate volatility has increased significantly over time. Four major factors that contributed to the escalation of foreign exchange rate volatility are discussed.

The Collapse of the Bretton Woods System

It is evident that the collapse of the Bretton Woods system paved the way for a more volatile foreign exchange rate market. In the Bretton Woods system, each member nation set a par value of its currency as an amount of its currency per dollar or ounce of gold. Since the U.S. government continued to sell gold to other governments at $35 per ounce, a par value referenced to gold was equivalent to one referenced to the dollar. Member governments were obliged to maintain the market values of their currencies within 1 percent of par value. Member countries were allowed to make a major change in exchange rates, but only in response to a fundamental disequilibrium and after consultation with the IMF.

In a period of 25 years, the Bretton Woods system operated without major structural changes. During this period, world trade (in real terms) expanded at a rate faster than world output. At the same time, international economic and financial integration made significant progress. From 1946 to 1971, the adjustable peg system was endorsed and implemented by member countries, and changes in par value exchange rates among major currencies were rare. During the heyday of the system, the exchange rates among major currencies were virtually fixed. The Bretton Woods system would probably have lasted a little longer than it did had it not been so dependent on a gold-convertible dollar. Its operation required increases in international reserves over time, but these increases required increasing the quantity of dollars held by foreign governments. At some point, inevitably foreign governments' accumulation of dollars exceeded the gold reserves of the U.S. government and led to a crisis that the system failed to manage.

Maintenance of the Bretton Woods system proved costly. Partly because foreign governments had accumulated quite an amount of U.S. dollars and partly because countries were reluctant to realign their parities whenever necessary, speculators waged wars against major currencies from 1967 to 1971. Never before had chances for large, low-risk speculative gains been available on such a grand scale. The first major currency to be subjected to massive speculative attacks was the pound sterling, which depreciated some 15 percent in 1967. In the next few years, gold, French francs, deutsche marks, Swiss francs, and Japanese yen were all under the attacks of speculators. Finally, in December 1971, the U.S. dollar was forced to devalue 7.9 percent by raising the official price of gold from $35 to $38 per ounce.

The speculative wave in the late 1960s led to the Smithsonian Agreement in December 1971. The architects of the Smithsonian Agreement hoped that the wider bands would deter speculation and, in combination with currency realignments, stabilize the volatile foreign exchange markets. That hope was dashed, and another speculative wave actually began revealing itself in June 1972, when the pound sterling started to float. In January 1973 the Italian government began floating lira in capital transactions. Soon afterward, the Swiss franc was floated. In February 1973 the dollar depreciated by 10 percent in terms of gold and special drawing rights (SDRs); in March the dollar became a floating currency. With the floating of the dollar, the system of fixed exchange rate ended, and an era of volatile foreign exchange rate emerged.

Economic Integration

Other things being equal, the floating-rate system tends to display higher volatility than the fixed rate. However, the collapse of the fixed-rate Bretton Woods system was merely a necessary condition for increasing foreign exchange rate volatility. The sufficient conditions rest upon the underlying economic and financial environment that has gone through fundamental changes in the last several decades. The most significant phenomena are the expansions of world trade and foreign direct investment. Because the expansion of trade and investment increases the demand for and the supply of foreign reserves, foreign exchange rates tend to fluctuate according to the flow of capital.

There is no doubt that the General Agreement on Tariff and Trade (GATT) is the largest contributor to tariff reduction, trade liberalization, and the facilitation of foreign direct investment. During its existence between 1947 and 1994, GATT successfully decreased barriers to trade and investment in eight rounds of multilateral negotiations. For example, the average of nominal tariff rates of member economies was drastically cut from nearly 40 percent in 1947 to less than 4 percent in 1994. The opening of domestic markets not only facilitates world trade but also increases foreign direct investment, and consequently both factors help world economy. According to research published by GATT in November 1994, the extra annual income brought to the world will be an estimated US$510 billion in 2005 when Uruguay-round concessions are to be totally realized.

Even world trade expanded tremendously in the last two decades; however, the volume of trade was not equally distributed among individual economies. For example, industrialized countries and developing ones that practiced export-oriented policy were most likely to benefit from trade liberalization. Since their volumes of external trade skyrocketed, its impact on foreign exchange markets soared. Countries with persistent surplus in their current account (e.g., Japan and Chinese Taipei) experienced continuous appreciation in their local currencies. In addition, countries confronted with the swings in prices of their major exporting merchandises (e.g., the oil-exporting countries) suffered irregular fluctuations in their current accounts, which in turn created an environment of volatile foreign exchange rates.

Financial Liberalization

Following trade liberalization, financial liberalization has become the top priority in the international community. Financial liberalization can take on several forms, such as foreign exchange rate deregulation, liberalization of portfolio investment, encouragement of financial innovation, and market structure change. Because of a series of deregulations in financial markets, across-border capital flows are expedited, which in turn makes financial markets more volatile.

The breakdown of the Bretton Woods system paved the way for foreign exchange rate deregulation. In addition, to facilitate world trade the IMF Article VIII requires member economies to establish current-account convertibility of currencies. In the environment of flexible foreign exchange rates, the demand for arbitrage and hedging exchange rate risk increases. As a result, currency markets have been undergoing structural changes, and financial derivatives such as forwards, futures, swaps, and options of foreign exchange rate have surfaced and become major items in markets. Furthermore, the liberalization of banking transactions and portfolio investment increases the capital flows across borders and consequently makes the foreign exchange rate more volatile as demand and supply become more difficult to predict.

Mismanaged Economic Fundamentals

To attract foreign capital as well as to keep domestic capital in the local market, host governments need to practice consistent macroeconomic policies. A country may not be able to raise its rate of return in the local market; however, a well-managed macroeconomy will most certainly decrease the investment risk. On the contrary, macroeconomy mismanaged due to either incoherent policies or the incapability of adapting to challenges can easily lose the private sector's confidence. As a result, both domestic and foreign capital will soon leave the host market.

Another problem with a mismanaged macroeconomy is that it can easily be subject to speculative attacks. It has been observed that countries that intentionally delay the pace of currency realignment will almost always need to make large adjustments. Furthermore, market participants will soon learn that these countries can no longer hold the position and hence launch speculative attacks. The monetary authorities of these countries may finally win the battle; however, the volatile swings in foreign exchange rate will definitely hurt the economies.

FOREIGN EXCHANGE ARRANGEMENTS OF PECC MEMBER ECONOMIES

Generally speaking, the foreign exchange rate arrangement of PECC member economies is the floating system. According to *International Financial Statistics* (July 1996), 17 of 22 member economies of PECC allow their currencies to float against others either independently or in a managed manner. The currencies of Australia, Canada, Japan, Mexico, New Zealand, Peru, the Philippines, Chinese Taipei, and the United States float independently; the currencies of China, Colombia, Korea, Malaysia, Russia, Singapore, and Vietnam float in a managed manner. In contrast, the Hong Kong dollar is pegged to the U.S. dollar, the Brunei dollar is pegged to the Singapore dollar, Thailand's baht is pegged to composite, and the Chilean peso is adjusted to a set of indicators. Since the U.S. dollar and the Singapore dollar are floating, the Hong Kong dollar and Brunei dollar are essentially floating.

Although the majority of PECC member economies maintain a floating-rate system, they practice different degrees of foreign exchange controls. According to the Japan Committee (Part II, Section 2), the following phenomena are found in the PECC community. First, all member economies have established current-account currency convertibility except China, Vietnam, and Colombia. Second, only Australia, Canada, Hong Kong, Japan, New Zealand, Singapore, and the United States have completely liberalized their capital-account transactions; other member economies maintain different versions of restrictions. Third, Australia, China, Indonesia, Japan, Korea, the Philippines, Malaysia, Chinese Taipei, and Thailand retain a system of foreign exchange banks in which only authorized banks or dealers are allowed to conduct foreign exchange transactions. Fourth, China, Korea, and Malaysia preserve a foreign exchange concentration system by requiring export proceeds to be sold to the authorities or deposited at the foreign exchange banks. Fifth, Australia, China, Indonesia, Japan, Korea, and Chinese Taipei impose foreign exchange position control on banks.

Facing increasing foreign exchange rate volatility, countries can certainly go back to the fixed-rate regime. However, it seems unrealistic that over the last two decades the majority of countries have adopted the floating system. According to *International Financial Statistics* (July 1996), out of 181 IMF member economies, 99 economies, or approximately 54.70 percent, adopted either managed floating or independent floating foreign exchange rate arrangements. Even in the PECC community, only 3 member economies peg their currencies to single or a composite of major currencies. Since the floating-rate system is the most commonly employed, countries need to learn how to cope with the problems brought about by the system. Based on the experiences of a number of PECC economies reviewed above, useful insights can be drawn and some policy recommendations provided.

LESSONS LEARNED FROM SELECTED PECC MEMBER ECONOMIES

To mitigate the problem of increasing foreign exchange rate volatility, certain forms of government intervention are inevitable. Confronted with the buildup of foreign reserves caused by capital inflow surge, a country can lift its restrictions on capital outflow to increase the demand for foreign currencies. For example, Chinese Taipei encouraged direct investment outward, and Thailand chose early service of its foreign debts. In addition, to avoid excess volatility in foreign exchange rate, a country can place limits on the margins of currency fluctuation. For example, the exchange rate of the new Taiwan dollar vis-à-vis the U.S. dollar was allowed to fluctuate within a 4.5 percent tunnel in the mid-1980s.

Market interventions are commonly observed in the offsetting of capital inflow surges. Among various instruments available, central banks can engage in direct purchase of foreign currency to absorb the sudden increment in the supply of foreign currency. The actions taken by the central banks of Chinese Taipei and the Philippines are two examples. Moreover, since the involuntary accumulation of foreign reserve can boost monetary aggregates and increase inflationary pressure, sterilization actions must be taken. Therefore, open market operations are frequently conducted. During the observation period, the central banks (including the monetary authorities) of Korea, Malaysia, the Philippines, Singapore, and Chinese Taipei all actively utilized this channel. Furthermore, the reserve requirements in the Philippines and Chinese Taipei were raised to sterilize the effect of increasing foreign reserves. To summarize a few important lessons learned:

- PECC member economies differ in their endowments and economic fundamentals. In addition, the reasons for and the magnitude of foreign exchange rate fluctuations are also distinct in the PECC community. Therefore, it is virtually impossible to find one instrument applicable to all member economies.

- Although a universal solution does not seem feasible, each economy needs to realize that well-managed fundamentals are imperative to economic development and hence the development of financial markets. It seems unrealistic for any country to raise the rate of return and decrease investment risk in the local market at the same time. However, a well-managed economy does decrease investment risk dramatically, which is certainly an asset in its economic and financial development.

- Since the degree of economic integration increases over time, governments need to harmonize their policies. In essence, monetary policy and fiscal policy must be consistent with economic fundamentals. Furthermore, to avoid excess volatility of foreign exchange rates, governments need to take concerted actions in international currency markets in the event of large-scale speculative attacks.

CONCLUSION

The world is perceived as becoming riskier today. Commodity prices, interest rates, and foreign exchange rates are more volatile than in the past. Economic agents, including individuals, firms, and governments, are all exposed to increasing risk. To mitigate these risks, governments need to take further responsibility in the interests of their whole economy.

The excess volatility of foreign exchange rates has occupied the attention of major multilateral organizations. For example, the G7 meetings, APEC Finance Ministers' meetings, and PECC all address the importance of establishing a stable system of exchange rates. This study reviews the experiences of eight PECC member economies (Indonesia, Korea, Malaysia, Mexico, the Philippines, Singapore, Chinese Taipei, and Thailand) where volatile foreign exchange rates were caused by current account imbalances, capital inflow surges, and political turmoil.

Valuable lessons are drawn from the review of these PECC member economies. First, it is unrealistic to propose a universal solution applicable to all PECC member economies since they are different in endowments and economic fundamentals. Second, a well-managed macroeconomy is a necessary condition for the development of financial markets. Third, harmonized actions in terms of consistent domestic macroeconomic policies and concerted foreign exchange market intervention are imperative when the world economy becomes more and more integrated.

Part II

Section 4

MOBILIZATION OF FINANCIAL RESOURCES

A REPORT ON CHINA'S DOMESTIC SAVINGS[*]

EFFECTS OF ECONOMIC REFORM ON GOVERNMENT, ENTERPRISES, AND HOUSEHOLDS

The economic reform that started in 1979 has substantially changed China's economic system and, as a result, altered the distribution of income among the central government, enterprises, and households. As tremendous changes have taken place in the composition of domestic savings, the share of household savings has significantly increased.

Under the centrally planned economy prior to 1979, the central government controlled wages and salaries as well as the production of consumer goods. State-owned enterprises had little autonomy and turned over all their profits to the central government, which then allocated funds for capital formation to various parts of the economy, according to its economic plan. This system enabled China to maintain a very high savings rate for almost three decades. Under this system, the revenue of the central government was more than 30 percent of gross national product (GNP) and as a result the share of household income remained low. Data shows that household savings accounted for only 23.5 percent of the gross domestic savings in 1979. Domestic savings were clearly characteristic of the planned economies: domestic savings and investments were primarily achieved through government planning. The government played the leading role in mobilizing domestic savings. From 1979 this situation began to change: the share of the central government steadily declined, and that of household savings rose. The share of the former in gross domestic savings dropped dramatically from 42.8 percent in 1979 to 7.25 in 1989. Household savings on the other hand, rose from 23.55 percent to 65.91 percent during the same period, an average 25.4 percent increase annually. Household savings became a crucial factor as a domestic source of investment capital.

During the course of rapid economic growth, capital shortage was alleviated by the influx of foreign capital: the total of government loans, portfolio investment, and direct investment amounted to US$89 billion by 1994. However, it is desirable to mobilize domestic savings. China's current saving rate is relatively low compared with those of the high-growth countries in the region.

In the 1980s, government revenue grew slowly; most years it grew slower than the GNP. This is a major reason why government savings fell so dramatically in proportion to the gross savings. The decrease of government revenue was due primarily to the loss of tax resulting from reforms of the financial and taxation systems. State-owned enterprises

[*] The research summarized in this section was sponsored by the Chinese Committee for Financial Markets Development.

failed in their performance during the period and particularly in the 1990s. At the same time, loopholes in tax collection also caused a reduction in taxable revenues.

In addition, government expenditures have been rising steadily in recent years. In a transition from a planned to a market economy, the Chinese government is faced with decreasing fiscal revenue and mountainous expenditures, as well as huge subsidies to enterprises and households.

Under the traditional planned economy prior to 1979, enterprises turned over all their profits to the central government. In return the government provided investments and funds needed by the enterprises. Such a system rendered most enterprises' savings into governmental savings.

Beginning in 1979 a part of enterprises' profits has been turned in as fiscal revenue in the form of tax, another part has become depreciation of fixed assets, and the rest has been turned into enterprises' net savings. Enterprises' savings increased slowly during 1979–89 because some state-owned enterprises had been running a deficit, resulting in a reduction of total enterprises' savings. Also, the enterprises have to provide social welfare benefits to employees. Furthermore, enterprises have been paying too much wages and salaries in competition with other enterprises.

Under the economic reform, the central government delegated some of its power to enterprises, which improved the efficiency of enterprises and increased profits. The savings of enterprises would increase if a legal framework for enterprises was established and the ownership of enterprises was clearly defined and if the government would establish a social welfare system and alleviate the financial burden placed on enterprises.

Household savings during 1979–88 grew steadily in proportion to the gross domestic savings, an average 25.4 percent annually. Such an increase elevated household savings to the top position in the current composition of domestic savings.

Under the centrally planned economy prior to 1979, the government controlled production, circulation, and distribution of the national economy. For nearly 30 years, household savings accounted for only a small portion of gross domestic savings.

Since 1979, household income has been increasing at a pace faster than that of GNP and household savings were in the place of the government as the main body in the domestic savings. Eventually, the change has produced a profound impact on domestic savings mobilization, the investment system, and the formation of financial markets.

The remarkable increase in household income is due mainly to the following factors: (1) the government granted enterprises more powers in distributing their profits among households, the enterprise, and the government; (2) nonstate sectors have developed rapidly since the 1980s, contributing to the rise in household income; and (3) loopholes in the taxation system result in loss of fiscal revenues, most of which end up as household income.

Under the planned economy, domestic savings mobilization was done chiefly through the government. Since 1994, China has introduced radical reform measures to its financial system in a bid to adapt to the market mechanism. In 1995, China enacted the Law of the People's Bank of China, the Law on Commercial Banks, the Law on Bills, the Insurance Law, and the Securities Law. These laws are aimed at creating a new financial system. They would pose challenges to the state-owned enterprises, whose reform would be given a high priority.

Since 1993 the revenue of the government has been rising as a result of financial and taxation reform, and it is expected that the government will collect sufficient revenue in the future. The share of household income in national income is too high at present. So long as the living condition of people is not badly affected, the share of the government and enterprises should be increased.

Since 1979, China has seen a rapid expansion in its domestic savings. Household savings, the principal body of domestic savings, will be the main target of savings mobilization for a considerable time to come. At present, household savings turn into investment mainly through purchasing financial assets, the majority of which are bank deposits. The creation of highly effective financial markets, particularly capital and securities markets, and the restructuring of the existing enterprise system are the two most important preconditions for mobilizing this part of domestic savings.

GROWTH AND DIVERSIFICATION OF FINANCIAL ASSETS

The ongoing market-oriented reform has boosted dynamic progress of financial markets, and people's financial awareness has increasingly been strengthened.

In the 1960s and 1970s, small savings of households were deposited in banks or were held in cash. When there is no alternative to bank deposits, people are wary of inflation; fear of inflation drives people to withdraw deposits from banks and spend them immediately. If there are financial assets that can be used as hedge against inflation, people would hold savings and the banking sector would not be disturbed by inflation fears.

After 1979, household income increased rapidly as a result of economic reform, and the volume as well as the composition of financial assets held by households underwent a significant change. As their financial wealth increased, people started to hold different types of assets in view of liquidity, safety, and yield differences. The holdings of securities increased from 3.2 percent of total assets in 1983 to 9.2 percent in 1992, but the share of bank deposits has remained high, rising from 65.3 percent in 1983 to 69.4 percent in 1992. This kind of diversification of financial assets is always expected in the course of the development of a market economy.

At present, bank savings remain the major channel for raising capital, and diversified instruments have emerged and developed. Stocks, financial bonds, and enterprise bonds have been issued; financial investment has kept growing. The diversification of financial assets and the growth of financial investment are significantly important to the optimal allocation and efficient use of the capital.

During 1983 and 1992 the monetary income of the Chinese residents has risen substantially, multiplying by 3.95. Along with the growth of household income, individual financial investment and bank savings (especially bank saving deposits of urban residents) have simultaneously grown.

Persistent with the strengthening financial awareness, household savings flow between various financial assets, bringing about changes in household savings and financial investment. Currently, bank savings deposits remain the main body of the financial assets formed from household savings.

In the same period (1983–92), household investment in other financial assets also increased from 3.2 percent to 10.5 percent, and the cash held by households decreased from 31 percent to 19.97 percent. The flow of household savings between different financial assets reflected households' diversified choice of financial means.

The growth of household financial investment has an impact only on the increment of bank savings, without affecting the stock of bank savings. The stock of urban savings has persistently surged. Household financial investment and bank savings have increased simultaneously.

The diversification of financial assets is an inevitable result of the development of the market economy. With the progress of a financial market, the mode of financing will increasingly get diversified. By means of diversified financial instruments, savings are linked with investment, bringing the market into full play in fund distribution and redistribution. This is conducive to the establishment of a market-oriented financing mechanism.

In China, state-owned enterprises rely heavily on loans from banks. In 1982, 36.2 percent of the total working capital came from their own funds. This figure decreased steadily to 28.5 percent in 1985 and then to 20.8 percent in 1988. The balance was borrowed from banks. The development of financial investment from domestic savings has helped relax the pressure on bank loans and promote the reform of the banking industry and enterprises.

Previously only bank savings deposits were turned into investment, putting enterprises in an unfavorable position in their monetary composition. The ongoing enterprise reform is directed to the establishment of a modern enterprise system in line with the market economy. Through more than 10 years of efforts to explore enterprise reform, by the end of 1993 there were 18,000 joint stock companies, and 182 of them were traded on the stock exchange.

The introduction of a corporate system allows the ownership of a company and management responsibility to be clearly defined and securities instruments to be sold on financial markets. The central government interferes with management and profit distribution of state-owned enterprises, and the legal status of these enterprises is too ambiguous to execute transactions of their securities on the market.

Since bonds and stocks involve greater risks than bank deposits do, investors would need more financial information to assess investment risks. The disclosure of enterprises' operations would be required, and such practices would lead to development of the market economy.

IMPORTANCE OF THE BANKING SECTOR

Bank savings are a means of indirect financing, but they play a special role in the present monetary market of China. Bank savings, as the main body of China's capital market, are a major supplier of enterprises' working capital and investment in fixed assets. China's economic facts have proven that bank savings have more advantages than direct financing.

Though per capita income is still selectively low in China, household savings have been collected by the banking sector. This is because most enterprises cannot rely on direct financing through capital markets as a major source of long-term capital.

For households, bank savings are more advantageous than purchases of securities products. Since they don't have access to necessary and reliable information, households cannot evaluate the risks of securities products by themselves; furthermore most people are not familiar with securities markets and available products are limited. Banks, on the other hand, can assess credit risks. Low-income households tend to prefer to avoid risk and choose bank deposits.

Securities markets are still underdeveloped. There have been problems with the operation of securities markets, and a modern corporate system, needed for the transaction of bonds and stocks is not well established. Direct financing is not expected to become a major source of capital for investment.

Under the planned economy, the surplus of the general accounts of the central government budget was used to finance capital formation in the public sector. However, government revenue has been declining as percentage of national income. In the 1974–78 period, fiscal revenue accounted for 33.8 percent of national income; this share declined to 24 percent in the 1979–88 period and then to 21 percent in the 1989–92 period.

In contrast, household savings have grown steadily from 7.3 percent of national income in the 1979–88 period to 14.8 percent in the 1989–92 period.

As the GNP share of central government revenue declined, capital formation financed by the central government also declined. In the 1974–78 period, capital formation of the central government accounted for 15.3 percent of national income, this shared declined to 10.3 percent in the 1979–88 period and than to 6.1 percent in the 1989–92 period.

This decline in capital formation funded by the central government was partially offset by the funds from banks deposited by the households. The share of such investments was only 2.4 percent in the 1979–88 period and rose to 8.6 percent in the 1989–92 period. Loans from banks are mainly directed to the financing of working capital of enterprises. Such loans were only 4.1 percent of the national income in the 1974–78 period; the figure rose to 9.6 percent in the 1979–88 period and then to 12.6 percent in the 1989–92 period.

Household income has been increasing rapidly, at the rate of 20 percent per year in nominal terms and 8.8 percent per annum in real terms between 1984 and 1993. The households held most of their savings at banks, and bank deposits grew accordingly.

In China, people take a second job or receive benefits in kind. The incomes from such sources amount to as much as 90 percent of the formal incomes of urban workers. These incomes, which are not taxed, end up in banks.

Besides bank deposits, other financial assets have also grown rapidly. The share of such assets was only 3.1 percent, rose to 17 percent in 1993, and is estimated to have been 25 percent in 1994. After 1993, interest in stock trading subsided because stock prices dropped and the performances of publicly traded companies did not live up to expectations. But in the second half of this year, the stock market has become active again.

Despite rapid growth in securities holdings, bank deposits are still growing, and their share has even increased. In 1992, for example, new issues of bonds and stocks totaled to 132 billion yuan whereas bank deposits increased by 255 billion yuan. It is the share of cash holdings that has declined. Cash accounted for 31.1 percent of total financial assets of the households in 1983 and declined to 19.4 percent in 1992.

As the securities markets are not standardized and people are not familiar with the markets, the share of securities in financial assets should not be raised rapidly, nor too much. In the long run, bank savings will remain the major channel for domestic savings mobilization.

There is a similarity between the economic condition of Japan in the 1960s and that of China in the 1990s. In the 1950s and 1960s, when Japan was taking off, most financial assets were held in the form of bank deposits, and bank loans were the main source of investment for Japanese enterprises. The Japanese government guided overall investment, promoted export, maintained low interest rates, and shielded its financial sector from international competition. These polices contributed to the development of Japan.

Like Japan in the 1950s and 60s, China has unbalanced economic structures, and guided investment is needed. The country needs export promotion, though it has already relied heavily on foreign capital. Since the cost of domestic savings is low, it must be increased. Under these circumstances, banks are necessary instruments to collect small savings from households with relatively low income.

CONCLUSION

Rapid growth of the Chinese economy in recent years has increased its dependence on foreign capital. Although domestic savings have kept pace with this development, effective mobilization of domestic savings will be crucial to further development of the Chinese economy.

The source of domestic savings has changed significantly since 1979. The share of the central government in domestic savings has declined steadily, and the household sector has become the major source of domestic savings.

The savings of the household sector consist mostly of bank deposits. Before the economic reforms in 1979, the savings in the government sector and in state-owned enterprises were channeled into capital formation directly. Enterprises now primarily depend on financing from banks. The financial markets in China are still underdeveloped, and enterprises cannot raise sufficient capital directly from the financial markets.

The mobilization of domestic savings now depends on the financial sector. It is expected that the diversification of financial assets will take a long time, and the banking sector is required to provide the large portion of capital needed for economic development.

LESSONS AND POLICIES OF THE INFORMAL FINANCIAL MARKETS IN CHINESE TAIPEI[*]

CHINESE TAIPEI'S INFORMAL FINANCIAL MARKETS: PAST AND PRESENT

Informal financial markets in Chinese Taipei can be classified into two categories: financial activities that violate current regulations, which could be called the black financial market, and activities that fall under no specific regulations, which could be called the gray financial market. The former refers to markets in obvious violation of the law, including, among others, underground investment companies, underground futures firms, underground securities financing companies, and money lenders. The latter includes, among others, financial lease companies, pawnshops, jewelry stores, mortgage firms, credit unions, savings clubs, and install payment firms. When compared with the mechanism of formal financial markets, these informal financial activities are not subject to specific laws and hence evade legal regulation. Generally speaking, most of them are capable of offering faster and more flexible financial services at a lower operation cost.

It is estimated that, in the 1970s, borrowing and lending outside of formal financial markets accounted for 25 percent of the external financing of Chinese Taipei's enterprises. This figure rose to 30 percent in the 1980s when the availability of loanable funds was greater. The ratio for private firms reached 40 percent in 1976. Researchers also found that the ratio increased as the size of the firm decreased. For example, the ratio hit 89.3 percent for small firms with less than 1 million new Taiwan dollars (NTD) in capital, approximately US$40,000. Furthermore, researchers estimate that underground financial income accounted for 2–3 percent of the GNP during the 1960s and 1970s. After 1973 this ratio gradually rose to reach its peak of 7.92 percent in 1980 and then declined thereafter.

The reasons behind the existence of Chinese Taipei's informal financial markets were the diversified and increased demand for financial services by the general public owing to the rising per capita income, and the inability of formal financial institutions to promptly adjust to consumers' needs. Since formal financial institutions were unable to satisfy society's needs, informal financial markets began to grow and diversify.

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[*] The research summarized in this section was sponsored by the Chinese Taipei Committee for Financial Markets Development. The author is Mr. Mu-Tsai CHEN, Director General, Bureau of Monetary Affairs, Ministry of Finance.

EFFECTS OF INFORMAL FINANCIAL ACTIVITIES ON THE ECONOMY AND SOCIETY

Positive Functions

The existence of informal financial markets is to make up for the deficiencies of formal financial markets. Therefore they play an essential role in mobilizing domestic savings and providing investment funds in Chinese Taipei. Generally speaking, these markets have a positive effect because they attract society's idle funds with their higher interest rates. Some businesses are willing to pay higher interest rates to receive funds in times of need, which puts the idle funds to effective use. These markets are also able to offer assistance to households or individuals in times of emergency, which benefits society.

Negative Results

Some informal financial institutions openly conduct illegal operations, causing obvious damage to the financial order, and are not subject to regulations created to ensure social protection. Because they are able to operate at much lower costs than formal financial institutions are and because their management is more flexible, financial disorder and unfair competition have occurred.

Since the activities of informal financial markets are not monitored by the government, their transactions are not accurately recorded. This creates significant mistakes in financial statistics and also influences the accuracy of monetary policies. As a result, it hinders the formulation of financial policy and creates obstructions to carrying out those policies.

By their nature, illegal financial institutions do not return their activities or income, allowing them to evade sales tax and income tax. In addition, because the investors do not return their capital gains, they also avoid capital gains tax.

The illegal activities of informal financial markets are mostly conducted confidentially, making it difficult to apply Chinese Taipei's Fair Trade Law, Consumer Protection Law, and other related laws. Therefore, investors are often cheated by unscrupulous operators and have difficulty recovering their money.

Due to the fact that the activities of informal financial markets are not subject to governmental regulation and instruction, the rights of investors ignorant of the law are not adequately protected. The informal financial markets offer interest rates that are generally several times higher than those of legitimate financial organizations. Investors may not be able to recover their funds in the case of legal problems, possibly inducing them to use violence against informal financial institutions found to have cheated them. This harms not only the investors but their families and society as a whole, posing a serious threat to social harmony.

GOVERNMENT POLICIES FOR HANDLING INFORMAL FINANCIAL MARKETS

Allowing the New Establishment of Financial Institutions

The opening of the financial establishment is the government's main method for pressuring underground financial activities. Examples include the 1988 opening of the securities brokering establishment, the 1991 approval of the establishment of 15 private new commercial banks, the 1992 approval of 11 securities trust corporations, the 1993 establishment of 13 new insurance companies, and the 1995 approval of new securities finance firms and bills finance firms. At the same time, the substructure of financial institutions is increasing with the opening of more branch banks and branch offices, raising the quality of services available to consumers.

These liberalization methods have two important aspects. First, those newly established companies require lots of capital, providing a long-term, stable investment opportunity for floating capital. Second, the opening of the financial institutions increases competition, raising the quality of service offered to the general public. At the same time, it can reinforce the development of the capital market, provide enterprises with convenient fund-raising capabilities, and increase the average person's capability of making profitable investments. These factors can all attract funds from the underground financial system into the legitimate financial system.

Reducing Foreign Exchange Restrictions and Promoting Financial Internationalization

During the beginning of Chinese Taipei's economic development in the 1950s and 60s, there was a severe lack of foreign reserves. Therefore, the government kept strict controls on the import and export of foreign exchange, which resulted in a lack of foreign investment services. With the development of Chinese Taipei's international trade surplus, foreign exchange flooded the island, but few investment channels existed and those that did exist were strictly regulated. This resulted in the explosive development of the underground financial institutions. In response, Chinese Taipei has loosened extensively its restrictions on foreign exchange in recent years. Currently individuals can separately remit in or out US$1 million and US$50 million annually, for any reason. Also in recent years the government has been advocating financial internationalization and encouraging financial institutions to expand internationally. Many financial institutions have opened branches overseas, and foreign financial institutions have established branch offices in Chinese Taipei, offering convenient channels for residents and nonresidents.

Adjusting Financial Supervision Philosophy and Pursuing Financial Liberalization

In recent years the government has methodically done away with restrictions of financial institutions and encouraged new financial activities, enabling the financial sector to provide even better service to the general public, to improve their function, and to try to satisfy the needs of individual and corporate investors.

The main idea of financial regulation is to protect everyone's rights. Informal financial institutions, which do not try to attract deposits or investment from the general public, now have the same effect on the entire society and economy as other industrial enterprises do. Therefore, after the effect on the entire society and economy and the protection of the interest of general public have been taken into consideration, some of those institutions can be legalized. This is also one of the ways in which the problem of underground financial institutions can be solved. In the past, leasing companies and installment companies were legalized under such a philosophy and were allowed to operate without supervision of a regulatory body. Currently Chinese Taipei is preparing to allow those companies that do not absorb capital investment to become legalized this way, which will also help in driving out illegal investment companies.

Because some financial businesses operate at greater risk and because they accept investment from clients, before legalizing them the government needs to investigate the effect they have on society and economic development. However, these businesses must be supervised. For example, futures brokerages were originally illegal in Chinese Taipei. However, foreign futures have become an extremely important financial tool, and legislation in 1993 legalized them. They now fall under the jurisdiction of the Securities and Exchange Commission.

Cracking Down on Illegal Financial Activities

Each kind of underground financial activities—for example, illegal solicitation of investment from the general public, illegal futures trading, and illegal securities investing—should be wiped out as soon as possible. Otherwise these companies will continue to conduct operations and, if they fail, can influence other, legitimate financial institutions and create a huge social problem. Despite the fact that the government has already liberalized the financial markets, the ability to evade taxes still gives operators a motivation to operate illegally, and underground financial activity will continue unabated. In order to effectively limit the function of the underground financial institutions, the government must act to further encourage the creation of safe and effective financial activities. Only with continuous effort on both fronts can the activities of underground financial institutions be curtailed.

Strengthening Consumer Education and Consumer Protection

In the process of economic development, the development of and change in financial services are extremely rapid, leaving some Chinese Taipei residents unable to handle and use the services and capabilities offered by the legal financial system, especially residents of rural areas. This presents an opportunity for underground financial institutions to expand. Therefore, aside from the above-mentioned measures, the government must also employ mass media to instruct people on financial management, how to take advantage of financial services, and how to avoid the dangers associated with illegal financial institutions (i.e., loan sharks).

On the other hand, the government has been extremely permissive where nonbank financial institutions are concerned. However, even though they are legal, the original laws are still inadequate to deal with them. Some laws have yet to be revised in light of the modern situation and require either the addition or removal of certain articles. Therefore, proper protection is still not available to some people. Chinese Taipei passed the Fair Trade Law in 1991 and passed the Consumer Protection Law in 1994, allowing legislators to revise outdated relevant laws and providing Chinese Taipei's consumers with greater access to legal redress. In the future, the government will continue to conduct research and act to improve legal protection for the society's economically vulnerable under civil law or consumer protection law. This is another way of solving the country's problem of underground financial institutions.

CONCLUSION

Before the late 1980s, Chinese Taipei's formal financial system was restricted by government policy, and government-owned banks formed the major legal financial institutions. Because these institutions were unable to meet the needs of households and firms, informal financial markets emerged and took up a relevant share of the financial market. Although these informal institutions channeled idle funds into investment, society suffered as a whole. In recent years, amid financial liberalization and internationalization, Chinese Taipei's financial system has engaged in a revolutionary opening, gradually attracting funds from the informal financial markets into legal and reasonable savings investment channels. It is hoped that Chinese Taipei's overall financial system will reach a point where the competition between the formal and informal financial markets is healthy and allows the two types of markets to aid each other.

In sum, informal financial activities contribute to some extent to the economic development of developing countries. Therefore, complete prohibition does not appear to be a constructive attitude toward the supervision of informal markets. On the contrary, in order to gradually shrink the informal financial markets, informal financial activities may be regulated by opening up the financial markets, adjusting the financial system, enlarging the size of the formal financial markets, and strictly enforcing laws that protect consumers.

*IMPACT OF PRIVATIZING PENSION SYSTEMS ON THE DEVELOPMENT OF CAPITAL MARKETS**

INTRODUCTION

During this century most countries have implemented redistributive (pay as you go) pension systems with defined retirement benefits, usually state-managed. Initially the systems could pay adequate benefits; however, most of them are now virtually bankrupt for the following reasons:

- Due to the significant increase in life expectancies, benefits are paid over a much longer period of time.

- Declining birthrates mean that there are relatively fewer active workers entering the labor force in comparison to the number of workers who have retired.

- Since the pay-as-you-go system is equivalent to a transfer tax, the current generation of retirees tries to maximize its benefits, and subsequent generations must bear the cost.

As a result of the change in demographics caused by the first two factors, the number of active workers for every retired worker has declined in many countries from more than ten 40 years ago to less than three at present.

In the case of Chile the ratio of active to retired workers dropped from 12.2 in 1955 to 2.5 in 1980.

This situation is affecting most of the pay-as-you-go pension systems throughout the globe. In 1994 a report from the World Bank titled "Averting the Old Age Crisis" stated that payroll taxes to cover pensions have reached 30 percent or higher in many eastern Europe countries and that by 2030 the ratio of workers to old persons in China will drop from 6 to 2.3 workers per retiree.

In the United States, according to the 1995 Annual Report of the Board of Trustees of the Social Security Administration, in 1950 there were 16 workers paying social security taxes for each person receiving social security benefits. By 2014 there will be only 2.7

* The research summarized in this section was sponsored by the Chile Financial Markets Development Committee.

workers paying social security taxes for each person receiving benefits, down from the current 3.3 workers.

Given this situation, an increasing number of countries are studying the reform of their pension systems to a defined contribution program in which every worker contributes to an individual retirement account that will finance his or her future pension, administered by personally selected private pension fund management companies. Upon retirement a worker may either withdraw all accumulated capital and purchase an annuity from a life insurance company or maintain the account and make monthly withdrawals based on life expectancy and other actuarial factors.

DEVELOPMENT OF CAPITAL MARKETS

The countries that have already made such reforms have experienced significant development of their capital markets for the following reasons:

- *Increased savings*: Individual saving is stimulated because a worker's future retirement benefits are directly related to the amount saved. Furthermore, contributions are invested efficiently rather than being used to pay current retirement benefits, as is done under pay-as-you-go systems.

- *Stability*: The existence of a private pension system ensures an abundant, steady flow of funds into capital markets. This flow, which in the case of Chile represents approximately 4 percent of gross domestic product (GDP), provides greater market stability and stimulates the creation of new financial institutions and instruments dedicated to maximizing investment performance.

- *Long-term investment*: The fact that both pension fund management and life insurance companies have investment horizons of several decades creates the need for such financial instruments as home mortgages and corporate bonds with terms of 12, 15, or 20 years in markets that previously operated only with short-term instruments.

- *Efficiency*: As private firms that compete by trying to maximize returns while minimizing risk, pension fund managers tend to allocate resources efficiently because they are not influenced by government budget problems or political pressures in their investment decisions.

In Chile, due to these four elements together with the implementation of market-oriented structural reforms in the economy, there has been an important increase in the level of investment to over 25 percent of GDP, but the most significant change has been that more than 90 percent of these investments are financed by domestic savings.

Additionally, the financial liabilities have grown from 64 percent of GDP in 1981 to 192 percent of GDP in 1995, and the long-term liabilities have evolved from 49 percent of the total liabilities in 1981 to 78 percent in 1995.

THE TRANSITION PROCESS

The transition between the two systems, which will take several decades, is an important factor to be considered. However, the longer the delay in making the decision, the greater the problems will be.

Another important factor is that a percentage of the pension funds can be invested in government bonds to help finance the budget deficit created by the transition; however, this should be done only at open market rates.

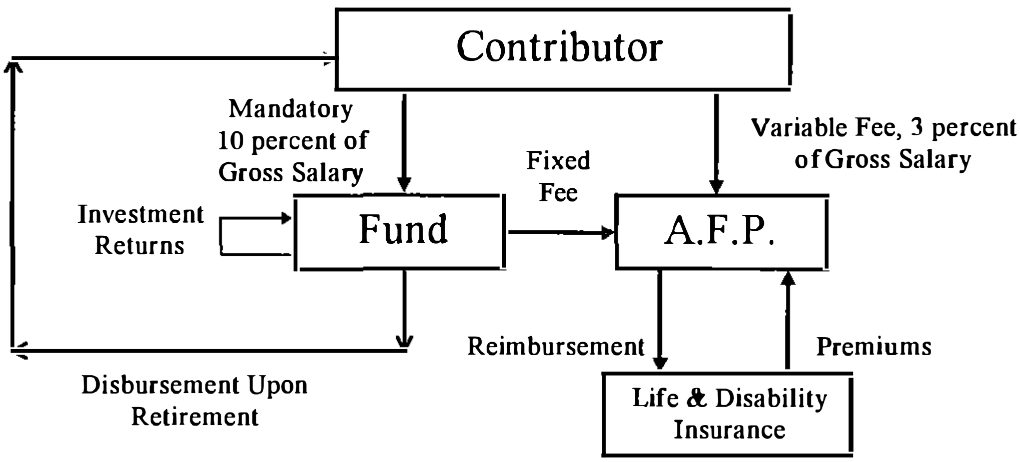
DESCRIPTION OF THE PRIVATE PENSION SYSTEM IN CHILE

The private pension system started operating in Chile in 1981 as a result of the undercapitalization of the public social security system. Its main characteristics are the following:

- A defined contribution system is based on an individual retirement account and life and disability insurance.
- Individual members select the pension fund administrators (AFP) of their choice.
- AFPs collect payments from members monthly and invest collections in a single fund.
- AFPs are privately run administrative businesses.
- Revenues are primarily based on fees charged on monthly salaries of contributing members.
- No fees are charged on funds under management.

As of December 1995, 5.2 million workers (over 90 percent of the labor force) were members of the system, of which 3 million contributed every month. Independent workers (nonemployees) are not mandated to contribute but can do so voluntarily. As a result, the funds under management have reached US$25.4 billion, equivalent to 41 percent of GDP by December 1995, managed by 16 AFPs.

The flow of funds can be observed in the following chart:



In this system the contributions are paid by the employee, as it is each worker's money that is invested in an individual retirement account to pay for his or her own pension. Ten percent of his salary is deposited monthly in this account, and all the returns generated by the investments belong to the worker, who receives the funds on retirement. The only disbursement from the account is a fixed fee of approximately US$0.50 per month.

Additionally the worker pays a variable fee, in the order of 3 percent of salary, to cover the cost of life and disability insurance as well as the AFPs' costs and profits. As an average, over the active life of the worker this fee is equivalent to 1 percent per year of the funds under management.

The AFPs compete not only in charging lower fees to the worker but also in obtaining the best possible returns on investments.

RESULTS

Chilean capital markets have experienced great change since the establishment of the private pension system 15 years ago. Financial liabilities in 1995 were 6.7 times greater in real terms than in 1980. Furthermore, market volatility has diminished significantly, as evidenced by the minimal impact in Chile of the so-called tequila effect of 1995.

As of December 1995 the 15 AFPs had US$25.143 million in assets under management, equivalent to 37 percent of GDP. Their portfolio was distributed in the following way: 39.4 percent for government bonds, 30.1 percent for stocks, 15.8 percent for mortgage bonds, 5.3 percent for corporate bonds, 6.6 percent for other financial institutions obligations, 2.6 percent for local investment funds, and 0.2 percent for foreign investments.

In addition AFPs have become important institutional investors in these financial instruments, as indicated in the following table:

Pension Funds: Share of Chilean Capital Markets (December 1995)

Government bonds	52 percent
Corporate bonds	55 percent
Mortgage bonds	56 percent
Bank certificates of deposit (CDs)	8 percent
Stocks	10 percent
Total	20 percent

Since 1986, when pension funds were authorized to invest in stocks, they have played a significant role in providing new sources of capital for companies and also in the privatization of state-owned companies, in sectors such as telecommunications, electricity generation and distribution, and nitrate production. Also, since 1987 AFPs have motivated corporations to finance themselves through issuing bonds at lower rates and longer terms than those available from banks.

At present, 38 percent of the pension funds are invested in private companies through stocks, bonds, and investment funds. This has made possible the financing of new projects or expansions that have benefited the workers, not only by generating good returns for their pension savings but also by creating new jobs and providing better salaries. Also, since 1990 part of these funds have helped local companies to expand internationally, especially to Argentina, Brazil, and Peru. In the near future it is expected that AFPs will provide financing to private companies for the development of infrastructure projects such as highways, ports, and airports.

On the other hand, mainly as a result of the annuities market generated by the pension funds, life insurance companies have also become important institutional investors, with total investments of US$6.258 million as of December 1995, equivalent to 25 percent of the investments managed by AFPs.

During the first 14 years, the private pension funds have had an average real rate of return of 12.4 percent per year. Most important, the pensions paid by the system are 50 percent higher than the pensions paid by the state-managed social security system, while the contributions are 30 percent lower in the private system.

THE PRIVATE PENSION SYSTEM IN PERU

In June 1993, Peru was the first country to establish a private pension system similar to the one previously created in Chile.

At present, there are 1.3 million affiliates in the five AFPs that operate in the private system. The public system, Instituto Peruano de Seguridad Social, is regulated by the Oficina de Normalizaci6n Previsional (ONP) and has approximately 1.3 million affiliates, a quarter of whom are already receiving a retirement pension.

It is expected that the private system will continue to grow because of the switching of people who are currently in the public system and also because of a reduction in the level of the informal workforce. The total workforce in Peru has approximately 8 million people, of which only 2 million are formally employed.

After three years the AFPs have obtained an average real rate of return of 7.1 percent and have contributed to restoring confidence in the private management of funds. As of June 1996, total investments reached US$750 million, equivalent to approximately 1.3 percent of GDP, and are invested in CDs (28.6 percent), stocks (23.1 percent), corporate bonds (11.2 percent), subordinated bonds (13.2 percent), government bonds (8.2 percent), and other financial institutions' obligations (15.7 percent).

Also, the domestic savings have shown a turnaround, especially in terms of private savings.

Before 1993 neither corporations nor financial institutions issued debt instruments for terms of over two years, as there was no demand for them. In less than three years, AFPs have become the leading buyers of these securities, which are now being issued on terms of three to five years. The AFPs have also contributed significantly to improving the situation of the banking system, investing in subordinate debt.

By June 1996, US$173 million (23 percent of the pension funds) had been invested in stocks. Even though this is only 1.2 percent of the market capitalization of the companies traded in the Lima Stock Exchange, it is expected that the presence of AFPs will help reduce the volatility of the Peruvian stock market and will bring more investors to the market, as well as motivating other companies to list their shares.

THE PRIVATE PENSION SYSTEM IN ARGENTINA

The Argentine private pension system was established in May 1994 to cover contingencies for old age, disability, and death. As in the other countries, the impetus for this reform was a significant deficit in the public system.

As of June 30, 1996, the workforce in Argentina totaled 13.7 million people. Of this total, 2.5 million were affiliated with the public system, 5.2 million were affiliated with the private system, and approximately 6.0 million were part of the Argentine informal economy.

There are currently 22 Administradoras de fondos de jubilaci6n y pensiones (AFJPs) in the Argentine private pension system, with US$3.838 million in funds under management in June 1996, equivalent to approximately 1.4 percent of GDP. The investments are distributed as follows: government bonds 47.4 percent, CDs 17.6 percent, stocks 13.5 percent, corporate bonds 10.7 percent, state bonds 4.4 percent, and other financial obligations 6.4 percent.

THE PRIVATE PENSION SYSTEM IN COLOMBIA

In Colombia the private pension funds started operating in June 1994. There are approximately 13 million workers in the Colombian labor force, out of a population of about 37 million. About 5 million workers are employees with formal labor contracts. The remaining 8 million are either self-employed, informal, or temporary workers and do not contribute to the social security system.

In June 1996, 2 million people were affiliated to one of the nine AFPs, including 100,000 self-employed workers, and about three million people are affiliated with the Instituto de Seguridad Social (ISS). The funds have now reached US$500 million, equivalent to 0.6 percent of GDP.

The AFPs are gradually consolidating their position as the leading institutional investors in the Colombian economy and are stimulating the innovation and modernization of the market, the improvement of the quality and timeliness of the information, and the creation of derivatives.

Nevertheless, there are still no market makers, there is only one rating agency, and the stock market is small with few available instruments. Also, the way the pension funds' shares are valued, marked to market on a daily basis, and the way the regulated minimum return is defined have restrained the long-term and stock investments.

SUMMARY

As we can see, the privatization of pension systems can contribute significantly to the development of capital markets, in aspects such as

- Increased savings rate

- Greater stability and steady flow of funds
- Creation of new financial institutions and instruments
- Development of long-term instruments

Improved efficiency in the allocation of resources Additionally, there are six other advantages in a private social security system:

- Pays better pensions
- Reduces economic distortions in the labor markets
- Creates new job opportunities
- Finances the development and internationalization of local companies
- Contributes to a successful privatization process
- Finances infrastructure projects

*THE ROLES OF FUND MANAGEMENT IN THE DEVELOPMENT OF CAPITAL MARKETS IN ASIAN ECONOMIES**

BACKGROUND AND MOTIVATION

During the Tokyo meeting (24–25 October 1994), it was suggested by the Hong Kong delegates that Hong Kong was interested in looking at the role of fund management in the development of domestic capital markets in the Asian-Pacific region, and the suggestion was well received by other members. In recent years the developing economies in this region have become a rich source of capital and the recipients of a large volume of capital inflows, with portfolio investment accounting for an increasingly important share. The majority of the investment activities in the emerging capital markets is carried out by international fund management houses that have tried to diversify their portfolios internationally. Fund management houses are financial intermediaries pooling surplus funds and investing them in a wide variety of securities. They can be broadly defined to include mutual funds investment companies, unit trusts, public and private pension funds, hedged funds, insurance companies, and proprietary trading by investment banks and commercial banks.

The fund management industry in emerging Asian economies has provided much-needed foreign capital, which is used to finance the rapid economic growth of these economies. However, the industry has also increased the riskiness of the domestic capital markets by opening a channel for more-volatile capital flows, which lead to problems in macroeconomic adjustments. An important issue is to what extent the fund management industry has contributed to the development of capital markets. The answer to this question can help regulators design appropriate policies to fully realize the benefits to be reaped from the industry while balancing the risks that come with it. Given that various economies in Asia are in different stages of development with respect to their capital markets and economic development, it would be extremely interesting to pursue a study of the fund management industries in these economies.

This project will study the fund management houses that manage funds invested in the Asian equity and bond markets. Of the various types of fund management houses, pension funds and insurance companies are traditionally the two most important ones in

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terms of assets under management. Pension funds, especially those from the United Kingdom, have gradually increased the share of foreign portfolio in the last two decades. However, insurance companies are not as internationally diversified as pension funds are, as they were unable to increase their global diversification during the same time period.

Mutual funds and closed-end investment companies are the fund management institutions that have become increasingly popular in recent years. Although the assets under their management are not as large as those managed by pension funds and insurance companies, their portfolios are much more internationally diversified and are growing at a much faster pace than those of other institutional investors. Since they are not subject to redemption risk, closed-end investment companies can facilitate long-term investments in more obscure, less liquid securities. Hedged funds are mostly private funds, and comprehensive data are not available.

To define the scope of the project, only pension funds, mutual funds, and closed-end funds will be studied. The Asian economies studied in this report include Hong Kong, Singapore, Malaysia, Japan, Korea, Thailand, and Taiwan. Other economies, such as Indonesia, India, and China, are also considered if relevant data are available.

OBJECTIVES

Provide an Account of the Salient Features of Fund Management in Asian Economies

Salient features include the regulatory framework, market structure, and investment criteria of the fund managers. For fund management houses to perform their functions, a sound regulatory framework is indispensable. Aspects examined include the adequacy of regulations on information disclosure, professional standards, compliance, and protection against fraud; the restrictions imposed on the launching of fund management products as well as on portfolio allocation; and the tax treatment of capital gains from fund investment and profits earned by fund management houses. An evaluation of the regulatory framework will be undertaken to assess its consistency, implementation effectiveness, and implications for competition in and development of the industry as a whole. The appropriateness of the speed of reform within the industry will also be evaluated in light of the stage of development of each individual economy.

Next, market structure and size, types of funds and products offered, locations of fund marketing and management, and asset allocation patterns by asset markets and industrial sectors are documented and the investment criteria of fund management houses studied. While the trend of globalization of fund management has brought the much needed capital to the region, the economies involved must not be complacent about these inflows. Capital can flow out of the region just as quickly as it flows in, leaving the capital markets in turmoil. For this reason, they need to understand the investment and location criteria of international fund managers. These criteria include two sets of factors: external and internal. External factors are beyond the control of the Asian economies, such as the world interest rates and the economic conditions of the Organization for Economic Cooperation and Development (OECD) economies. In contrast, internal factors are mostly related to domestic characteristics of the Asian economies. Examples of these characteristics include political risk, tax incentives, capital controls, financial infrastructure, regulatory frameworks, and macroeconomic policies.

Assess the Performance of the Fund Management Industry in Its Ability to Allocate Scarce Financial Resources to Their Most Productive Uses in These Economies

Two different approaches will each emphasize a different aspect of "performance." The first approach involves evaluating fund performance within a risk-return framework based on asset pricing models. This performance evaluation will be carried out within the individual economies as well as at the regional level. The analysis will distinguish between stock selection and the market timing abilities of fund managers. The first ability, generally viewed as desirable, is the ability to identify underpriced assets that would facilitate the flow of financial resources to their most productive uses. The second is viewed with more caution. Correct market timing can provide protection against downside risks for investors, yet such an ability might have destabilizing impacts on the capital markets during bull market periods. In the case of pension funds, the study will also determine whether they can provide a hedge against domestic inflation.

Apart from evaluating fund performance in light of modern portfolio theory, the patterns of portfolio allocation by industrial sectors and asset markets will be examined. Depending on the economic structure and the stage of development of the host countries, fund management houses can channel savings into those sectors deemed crucial in promoting economic growth. These sectors include infrastructure, telecommunications, and, for more developed economies, the financial sector. Bond markets in many Asian economies are still in their infancy. Consequently investment from fund management houses can foster the development of domestic bond markets. Finally, fund houses can encourage the development of primary markets by subscribing to initial public offerings and venture capitals and by placing local stocks in overseas markets.

Examine the Impact of Fund Management on the Development of the Infrastructure of Domestic Capital Markets

The fund management industry can promote the development of the infrastructure of a capital market through a number of means: (1) by marketing the fund management concept to the general public, (2) by training local fund managers, (3) transferring portfolio management technology and introducing innovative financial products, and (4) stimulating the growth of supporting financial services, such as custodial and accounting services. Moreover, representatives of the industry can also influence regulatory changes through their membership to the local stock exchange council. Their connections with other financial markets may facilitate the issue and trading of domestic securities overseas.

Comparison of Experiences

The final part of the analysis will be to compare the experiences of the countries in the study to draw lessons and policy implications with respect to the regulation of the fund management industry.

RESEARCH METHODOLOGY

Both statistical techniques and survey methods will be used to carry out the study. To evaluate the performance of fund managers, asset pricing models taken from finance literature will be used to assess fund performance in a risk-return framework. For instance, standard measures such as the Sharpe, Treynor, and Jensen indices will be used. The benchmarks for comparison will include the domestic stock and bond indices as well as the Morgan Stanley Capital Market Indices. Advanced statistical techniques such as the vector autoregressive model will be employed to study the causal relationship between total net asset investment, domestic stock prices, and U.S. stock prices.

The survey study will consist of two parts. The first part will be a questionnaire survey of a representative sample of fund houses that invest in the Asian capital markets. The second part of the survey study will be to interview representatives from the local fund management industry as well as the regulators. For this purpose, the project may require visits to the following Asian economies: Korea, Singapore, Taiwan, and Thailand.

PROGRESS REPORT

Design of the Fund Management Industry Questionnaire

As of November 1996, researchers had designed a questionnaire and conducted a survey of the Hong Kong fund management industry with the assistance of the Hong Kong Investment Funds Association. Endorsement for the questionnaire was being sought from the respective fund management associations in Taiwan, Singapore, Australia, and Thailand. The questionnaire covers the majority of the items stated in the first and third objectives. It has six sections. Section I covers background information such as the size of assets under management and the number and experience of staff employed. Section II identifies the sources of research support. Section III studies the investment criteria of fund managers. These criteria can be classified into three major categories: financial market infrastructure, legal and regulatory framework, and political and economic factors.

Section IV deals with the location decision of fund management houses. Finally, Sections V and VI assess the impact of the fund management industry on the training and promotion of local fund management staff and the launching of innovative financial products.

Results of the Hong Kong Survey

Several observations are worth noting from the survey of the Hong Kong fund management industry. First, most fund managers and investment analysts have university-level education and an average of eight years of relevant experience. Second, the overseas-based fund houses seem to be playing a positive role in transferring fund management technology to the local market through employing local residents as fund managers, sourcing of research support, and training of fund managers. Although over 90 percent of the fund managers and analysts from locally based fund houses are local residents, the overseas-based fund houses also employ an impressive 70 percent local residents in their fund managers/analysts teams. On average the size of the research team in overseas-based fund houses is larger than that in locally based fund houses. In terms of research support, locally based fund management houses mainly rely on outside investment advisory services, most of which are from overseas.

In contrast, overseas-based fund management houses rely more on in-house research support from both their local and overseas offices. Overseas-based fund houses also provide more training opportunities for their fund managers and analysts. Unlike locally based fund houses that rely mainly on on-the-job training, overseas-based fund houses offer formal in-house training in their local and overseas offices, as well as external training programs.

When deciding their benchmark portfolios, fund managers are most concerned about economic and political factors, followed by the legal and regulatory framework; they are least concerned about financial market structures. The three most important individual factors cited by the respondents are "market liquidity of the local stock market," "information disclosure," and "long-term economic growth." The three least important factors are "availability of derivatives," "transaction costs," and "brokerage facilities." As far as the location criteria of fund management operation are concerned, the three most important factors are "reliable legal system," "availability and quality of human resources," and "supporting financial market services." In contrast, among the least important factors are "proximity to source of funds," "proximity to derivative markets," and "simple and low tax rate systems."

Collection of Fund Management Industry Information

Some information was collected on the retirement funds, open-end funds, and closed-end funds. The retirement fund information covers Hong Kong, Japan, Malaysia, Indonesia, Korea, and the Philippines. In the case of Korea, the National Pension Fund Research Centre and National Pension Corporation provided the information. The information includes industry regulations such as restrictions on the launching of funds, portfolio restrictions, protection of investors, tax treatment, a chronology of key events in the industry, market structure, annual returns, and annual asset allocation. The asset allocation data are divided (1) between domestic assets and foreign assets and (2) between equities, bonds, and cash.

For the mutual fund industry, we have collected the information was collected on some 300 domestic and offshore open-end funds investing in China, Hong Kong, India, Indonesia, Malaysia, the Philippines, Korea, Singapore, Taiwan, Thailand, and Japan. For closed-end funds, information collected related to 183 country and regional funds that invest in Hong Kong, Taiwan, Singapore, China, Korea, Indonesia, Thailand, Japan, Malaysia, the Philippines, and the Indian subcontinent. The background information covers the names of fund management houses, fund launch dates, management fees, investment objectives, places of authorization, and listing. The numerical data include return and asset allocation by industrial sectors and, in the case of regional funds, by geographical focuses.

Study of Closed-End Country and Regional Funds

A preliminary analysis of 183 closed-end country and regional funds that have invested in the Asian capital markets during the last five years has been completed. As of 29 March 1996, these funds had a total net asset of US$23.8 billion. Contrary to the results of the mutual funds in developed economies, the closed-end country and regional funds investing in this region have outperformed the market. Even though the returns vary with the performance measures used, approximately half the country funds can beat the market, regardless of whether the Morgan Stanley Indices or the local stock indices are used as the benchmark. At the regional level, of the 25 Asian funds (excluding Japan), 16 and 15 of them have outperformed the Morgan Stanley Capital Indices according to, respectively, Jensen and Treynor measures. Therefore, the results suggest that fund managers have done a good job in improving the allocative efficiency of financial resources in individual economies and in the Asia-Pacific region as a whole.

With respect to asset allocation, the two sectors that receive the largest share in the aggregate portfolio are services (38 percent) and manufacturing (27 percent). The manufacturing sector receives a larger share in economies in earlier stages of development, such as China, India, and the subcontinent economies. Within the service sector, 87 percent of the funds are invested in the financial services sectors. By contrast, the technology and infrastructure sectors only account for 15 percent and 7 percent, respectively, in the aggregate portfolio. In view of the stage of development of some Asian economies, there is an urgent need for technological advancement and infrastructure investment. The lack of investment in these two sectors may reflect a lack of appropriate financial instruments available.

FUTURE WORK PLAN

The committee's work plan for the coming year is as follows:

- Conduct a questionnaire survey of the fund management houses located in Taiwan, Thailand, Korea, Singapore, Malaysia, Japan, the United Kingdom, and the United States.
- Analyze the asset allocation patterns of open-end funds.
- Evaluate the performance of open-end funds.
- Visit certain Asian economies to interview both representatives from the local fund management industry and regulators.

PART III

CONTRIBUTIONS TO THE APEC FINANCE MINISTERS' ACTION AGENDA

INTRODUCTION

The ultimate objective of the Pacific Economic Cooperation Council's Financial Markets Development (FMD) Project is to contribute to the development of the region's financial markets. One of the most important ways to do that is to make well-considered recommendations as to actions that can be taken by both the public and private sectors to improve financial markets.

This part of the report presents recommendations for consideration by the Asia-Pacific Economic Cooperation (APEC) Finance Ministers as they adopt action agendas for development of the region's financial markets. The recommendations fall under three main themes: standardizing requirements for disclosure of financial information, diversifying financing mechanisms for infrastructure development, and further liberalizing cross-border capital flows. These recommendations have evolved from the research and discussions that have constituted the core of the FMD Project work since 1994.

While the timing and nature of this report and the resulting recommendations are responsive to the APEC liberalization process and to the April 1997 meeting of the APEC Finance Ministers, these recommendations should be considered and acted on by all in the public and private sectors who are committed to achieving development of the region's financial markets that will make meaningful contributions to economic growth.

Part III

Section 1

Standardize Requirements for Disclosure of Financial Information

INTRODUCTION

With the growth in the number of firms in Pacific Economic Cooperation Council (PECC) member economies raising funds from foreign sources, it is becoming increasingly important to have financial information disclosure practices standardized across economies. Investors need to make a proper assessment of firms before deciding to invest in securities issued by the firms. It is imperative to provide global investors with sufficient information to meet their demands by improving the accuracy and reliability of financial information about firms, both accounting and nonaccounting. Standardized disclosure would help to reduce the cost of information collection and comparison across economies and, at the same time, to facilitate the financing of profitable and well-managed firms through capital markets.

For those firms that intend to raise funds in the foreign capital markets or from nonresident investors in their domestic capital markets, it is important that their financial statements, accounting principles, and auditing procedures be in line with those generally accepted in the global capital markets. PECC supports the efforts of the International Organization of Securities Commissions (IOSCO) and the International Accounting Standards Committee (IASC) to formulate a set of international standards for financial reporting and recommends that the firms and stock exchanges, which seek cross-border listing, in PECC member economies stand ready to adopt these standards once they are finalized. In this regard IASC and IOSCO are urged to make every effort to complete their work on international accounting standards at the earliest possible time. It might be necessary, however, to introduce such requirements in several steps since some economies may have difficulty in implementing in a single step everything that is desirable.

BENEFITS OF STANDARDIZATION

Improved Assessment of Firms' Operations and Financial Conditions

As financial activities are increasingly globalized, a wide range of investment risks are created. Disclosure of accurate, reliable information is essential for investors who assume these risks. Disclosure functions as an effective, though indirect, mechanism of investor protection in the marketplace.

Standardized disclosure of financial information enables investors to more effectively assess firms' operations and financial conditions and to compare different firms from different economies for investment purposes. This in turn makes corporate managers more disciplined and responsible for the performance of their firms.

Lowering the Cost of Raising Funds

Markets provide the mechanisms for rewarding or punishing good and bad disclosure through the pricing of securities. Well-managed and financially sound firms that provide good disclosure of accurate information are properly rewarded in the form of low costs of financing when they raise funds in the capital markets.

TARGETS OF THE STANDARDIZED DISCLOSURE REQUIREMENTS

All publicly traded firms should be required to disclose financial information in conformity with the standardized disclosure requirements in the official language of each country.

Disclosure in a common, international language is important and is advised to be phased in. In the initial stage, the international-language disclosure requirements would be realistically applied only to firms financing in foreign capital markets. Subsequently the requirements could be extended to include those raising capital from nonresident investors in the domestic markets. At the final stage, the requirements might be extended to all other firms in general whose shares are listed, issued, and traded on the domestic stock exchanges.

RECOMMENDED DISCLOSURE REQUIREMENTS AND PRACTICES

Establish the Minimum List of Disclosure Items

It is necessary to identify a minimum list of disclosure items essential for investors, one applicable to all member economies. We support the efforts of the IOSCO to draw up guidelines on nonaccounting disclosure and recommend that the PECC economies encourage and, where appropriate, assist the expeditious completion of this work.

Such a list might include the following items:

- Names of directors, company secretary, and advisers
- Names of major shareholders affecting the firms' control
- Names of major lenders
- Increases or decreases in capital, issuance of new securities, and borrowing
- Acquisition or disposition of assets and of investment in other firms
- Critical legal disputes, and disputes regarding labor, subcontracts, and suppliers,

- Essential financial information and performance
- Other important information affecting the interests of securities holders, the decision of investors, or the prices of the securities

In addition, disclosure of information about nonperforming loans and loan loss reserves should be required of commercial banks.

Unify Accounting Principles

It is advisable that accounting principles be unified along the line of the international accounting standards (IAS), which are used by an increasingly large number of firms in Asian economies. Economies that have modernized their own accounting principles have also tended to adopt an IAS-based accounting system.

Consolidated financial statements should be required. For this purpose, the concept of consolidation must be clearly defined. In particular, clear criteria must be established for consolidation of financial statements of firms whose ownerships are complex and entangled, such as groups of firms controlled by a family.

Establish External Auditing Systems

Independent auditing by internationally recognized professional accountants is highly recommended since it gives more credibility to the disclosed information. Besides, investment in a firm whose books are unaudited would not be a realistic proposition from the point of view of investors. Given the rapid changes that many firms in the Asia-Pacific region have experienced, the scope and time range of auditing must be determined by taking account of the practicality of the proposed measure.

The committee supports and encourages the work of IOSCO and the International Auditing Practices Committee (IAPC) to develop international standards of auditing, which together with mutually accepted international accounting standards should result in a coordinated package of financial reporting requirements for cross-border listing.

Use a Common International Language

It is desirable to use a common international language for information disclosure. Given the growing tendency for firms raising capital in foreign markets and those whose shares are traded by nonresident investors in the domestic markets to publish their reports in English (as well as in their local languages), it is realistic to use English as the common international language.

MEASURES TO SECURE COMPLIANCE WITH THE STANDARDIZED DISCLOSURE SYSTEM

Effective implementation of the standardized disclosure system depends on the coordinated legislative action of the member governments in each PECC economy. The authorities must make every effort to induce firms to comply with the standardized disclosure system.

The disclosure system will not function properly unless effective mechanisms of enforcement are simultaneously introduced by the member governments. It is advised that a specialized organization in each PECC economy monitor firms' disclosure systems and, if necessary, penalize firms disclosing intentionally false, misleading, or incomplete information.

Part III

Section 2

Diversify Financing Mechanisms for Infrastructure Development

INTRODUCTION AND BACKGROUND

The amount of necessary infrastructure development required in the Pacific Economic Cooperation Council (PECC) region over the next 10 years is estimated to be several trillion U.S. dollars—more than 10 percent of gross domestic product (GDP). In East Asia as well as in other developing areas of the PECC region, demand for infrastructure has been rising, especially in the areas of electric power generation, telecommunications networks, roads, and port facilities. Economies with the most urgent need for such infrastructure development are the ones with the least means of financing the development.

In the past, investment in infrastructure was made by governments or public organizations, mainly using funds from government budgets or relying on development assistance from industrial countries and multilateral development finance institutions. Recently, however, infrastructure projects are increasingly being constructed and operated by private-sector initiatives under programs such as BOT (build-operate-transfer) and BOO (build-own-operate). A number of factors have led to the use of such techniques. First, the need for private funds has risen due to the shortage of public money, caused by the burden of external debts and budget deficit reduction programs in developing economies and by the downward trend of development assistance from industrial countries. Second, it is increasingly recognized that certain infrastructure projects can be handled more efficiently by private enterprises, especially those from abroad with superior technologies and know-how, than by governments and public enterprises. Finally, it is often the case that "government failure" can be more serious than "market failure" in the provision of infrastructure.

The private sector can employ several methods to finance infrastructure projects:

- Commercial banks can extend loans to finance the purchase of equipment and construction of facilities for infrastructure projects (traditional bank loans), often supplemented by sponsors' equity participation and public export credit agencies' credit facilities.

- Commercial lenders can finance the projects themselves by backing repayment with future cash flows from the completed projects (project financing), again often supplemented by sponsors' equity participation.

- Infrastructure project companies, such as independent power producers (IPPs), can issue stocks and bonds to raise funds from private investors in capital markets. While all these financing methods will continue to play important roles, economies need to further diversify financing mechanisms for infrastructure development. It is important to have market and regulatory structures in place so that the most appropriate type of financing, as judged by the market requirements of the time and circumstances, can be chosen.

One such direction is to establish market infrastructure to promote financing of infrastructure development through securities, particularly in the form of project finance. Project finance requires participating entities to cooperate in various manners and to share the risk of and return from the project. Securitization and method 3 above require further development of capital markets in the PECC member economies. Equity participation and bank loans tied to already established projects can be securitized by converting them into stocks and bonds that are traded in organized securities markets. Or a new project can be financed completely by securities. In addition, when state-owned enterprises or public infrastructure companies are to be privatized, it is necessary to use capital markets to sell equity shares.

Both the governments of countries that receive infrastructure investment (host economies) and those that provide funds for such investment (source economies) must take steps to facilitate private investment in infrastructure projects.

RECOMMENDATIONS

Measures to Be Taken by Host Economies

- Reduce political risk to enhance the attractiveness and prospects of infrastructure projects. Maintaining transparency and consistency in reviews, procedures, and regulation concerning infrastructure projects eliminates uncertainty as to the government's future policy framework and contributes to private investment in infrastructure development.

- Reduce excessive commercial risk. Providing contingency measures to reduce excessively large commercial risks, which the private sector cannot assume in undertaking infrastructure projects, contributes to private participation in infrastructure projects.

- Mobilize domestic savings and encourage domestic institutional investors. The growth of institutional investors, such as life insurance companies and pension funds, is particularly useful to financing infrastructure projects through domestic capital markets, especially those that use long-term bonds for financing.

Measures to Be Taken by Source Economies

- Increase the cohort of private investors, who can take and diversify greater investment risks, by further deregulating capital markets. For example, to promote issuance of foreign securities in source economies as well as in international capital markets, economies can establish financial mechanisms such as Rule 144A of the Securities and Exchange Commission (SEC) of the United States. The objective of Rule 144A is to develop private placement markets for domestic and foreign securities by eliminating formal registration with the SEC and relaxing conditions for securities transactions among qualified institutional buyers. Rule 144A allows large institutional investors to freely trade nonregistered securities as if they were publicly placed.

- Relax restrictions imposed on foreign securities holdings of institutional investors in the source economies. Upper limits often imposed on foreign securities held by such institutional investors as life insurance companies and pension funds should be relaxed to encourage them to invest in host economies' infrastructure projects.

- Promote infrastructure funds. Setting up infrastructure funds—which collect funds from wide arrays of investors, invest the funds in many different infrastructure projects to diversify risks, and distribute returns to investors—can direct funds from the general public to infrastructure development.

- Develop private guarantee companies to help reduce risks involved in securitization.

Measures to Be Taken by the PECC Member Economies

- Introduce a protocol to facilitate cross-listing of stocks and bonds issued by private and public infrastructure companies. Establishing a protocol covering information disclosure, regulatory oversight, and intraregional rating is expected to promote cross-border investment in infrastructure projects. An intraregional rating agency focusing on infrastructure companies is particularly useful.

- Establish a regional arbitration mechanism to address infrastructure-related disputes. When sovereign bodies are involved in dispute settlements concerning infrastructure projects, the impartiality of local judicial decisions is often in doubt, thus posing risks to foreign investors. Establishing a regional arbitration mechanism will help to alleviate risks to overall investors.

- Use multilateral development finance institutions and the official export credit agencies of industrial countries. These can be useful bodies to help frame such regional cooperative arrangements to promote infrastructure projects.

Part III

Section 3

Further Liberalize Cross-Border Capital Flows

INTRODUCTION

Many Pacific Economic Cooperation Council (PECC) member economies have been liberalizing cross-border capital flows (both inflows and outflows), particularly in the form of *(a)* lifting regulations on foreign direct investment, securities investment, and bank loans; *(b)* opening their financial markets and services to foreign financial institutions; and *(c)* relaxing foreign exchange controls. The liberalization process has largely been unilateral, voluntary, and competitive, though international pressure played important roles in certain economies. The timing, speed, and scope of liberalization, however, vary significantly across economies. Given the diversity in the region in terms of stages of economic development, industrial structures, competitiveness of financial institutions, and broad market infrastructures, it is not surprising that the PECC member economies have taken different approaches toward capital flow liberalization and financial market opening.

Many economies, despite their remarkable accomplishments in liberalization, still maintain various forms of controls over cross-border capital flows, foreign entry into domestic financial services, and foreign exchange transactions. The existing restrictions as well as the history of liberalization are reviewed in "Deregulation and Liberalization of Cross-Border Capital Flows" (Part II, Section 2). It is in the best interest of all PECC member economies to make efforts to achieve the general principles of national treatment, most-favored-nation status, and transparency.

BENEFITS AND COSTS OF LIBERALIZING OF CROSS-BORDER CAPITAL FLOWS

Large benefits are reaped from liberalization of cross-border capital flows:

- *Diversified sources of saving for capital formation.* To meet increased demand for capital formation and infrastructure development, many developing PECC economies need not only to mobilize domestic saving but also to tap foreign saving in various forms with liberalization of cross-border capital flows. Host economies can diversify sources and types of foreign capital on which they draw, thereby reducing the need to rely on limited types of foreign capital.

- *Efficiency of financial resource allocation and financial intermediation.* Liberalization of cross-border capital flows improves the efficiency of financial resource allocation by diverting funds away from economies with low rates of return and toward economies with high rates of return. This makes both investors and recipients better off.

- *Commitment to open, outward-oriented economic regimes.* Liberalization of cross-border capital flows signifies that the economy is committed to an open, outward-oriented regime, which has been one of the vital sources of growth in the Asia-Pacific region. Such a commitment further expands foreign investment in the economy, promotes industrial growth, and raises the economic welfare of the people.

Cross-border capital flow liberalization does not come without costs. Sudden inflows and outflows of capital and the consequent pressure on exchange rates, caused by the liberalization measures, often pose serious difficulties to the country's economy and to the financial system. Exchange rate destabilization, macroeconomic instability, and a possible financial crisis are potential costs of liberalization.

Experience in the PECC region suggests that the benefits of cross-border liberalization have been far greater than the costs. To minimize costs, however, the economies in the region must establish cooperative macroeconomic-level frameworks for financial and exchange rate stabilization.

- The sequencing of liberalization of capital flows and foreign exchange transactions must be right to avoid the costs due to premature or rushed liberalization.

- Authorities must be prepared to take measures to counteract sudden capital inflows and outflows and the consequent pressure on exchange rates.

- Establishment of a cooperative framework for macroeconomic and financial crisis management is desirable. This could include exchange of macroeconomic and financial information among the authorities and efforts by the central banks to create a framework of repurchase arrangements in foreign exchange reserves at the time of crisis.

FOREIGN DIRECT INVESTMENT (FDI)

Although foreign direct investment (FDI) in the manufacturing sectors in the PECC region has been liberalized substantially, many economies impose certain performance requirements and still restrict or even prohibit FDI in certain sensitive sectors. It is in the best interest of each PECC member economy to continue to make every effort to liberalize FDI by reducing and ultimately eliminating restrictions imposed on foreign direct investment.

The PECC member economies are encouraged to adopt the nonbinding investment principles put forward in November 1994 by the Asia-Pacific Economic Cooperation (APEC). The principles put forward concern the following: transparency, nondiscrimination between source economies, national treatment, investment incentives, performance requirements, expropriation and compensation, repatriation and convertibility, settlement of disputes, entry and sojourn of personnel, avoidance of double taxation, investor behavior, and removal of barriers to capital exports.

Other international obligations are stated in trade-related investment measures (TRIMs) and general agreement on trade in services (GATS) of the World Trade Organization and the code of liberalization of capital movements of the Organization for Economic Cooperation and Development. WTO member economies and those aspiring to be members are encouraged to make every effort to accept TRIMs and GATS. OECD members and those expected to join must fulfill the liberalization code and will have to accept the more multilateral agreement on investment, which is to be reached in 1997.

If certain requirements, regulations, and restrictions concerning FDI are needed for various economic and noneconomic reasons, the authorities are advised to clearly show what they are, thus ensuring transparency, and to lay out plans for reducing impediments to FDI over time. Laying out plans for liberalization is a great benefit to foreign investors as well as to domestic industries.

When the authorities are required to review FDI applications, the review procedure and the decision criteria must be made clear and public.

When the authorities must restrict or prohibit certain types of FDI, they are advised to provide a complete list of restricted/prohibited sectors (a negative list) and to make efforts to shorten the list over time.

When the authorities impose various types of requirements on FDI activities (local contents, exports and imports, foreign exchange requirements, domestic sales, etc.), they are advised to announce them clearly, to reduce them over time, and ultimately to eliminate all the requirements.

FOREIGN PORTFOLIO INVESTMENT (FPI)

Many economies have allowed foreign (nonresident) investors to directly acquire domestic shares and stocks and to trade them. Foreign investment in equities has been a vital source of the growth of stock markets in the PECC region. The stock markets also play an essential role in the privatization of state-owned and public enterprises. However, various restrictions on FPI remain in many countries. One prominent example is limitations on foreigners' ownership of domestic shares and stocks to certain percentages of the outstanding stocks.

Reducing Foreign Shareholding Limitations

Authorities are advised to make every effort to reduce limitations imposed on foreign acquisition and ownership of domestic firms' shares and stocks and ultimately to eliminate them.

If certain ownership limitations are needed for various economic and noneconomic reasons, a market mechanism should be developed to cope with such restrictions. One way is to establish a separate foreign board for shares and stocks that have reached the prescribed upper limit, since foreigners can trade the prescribed number of shares and stocks among themselves at explicit price premiums. Such price premiums would put pressure on the authorities to relax foreign-ownership restrictions up to the point where the premiums disappear.

Another way would be for the firms to issue non–voting right stocks without imposing any foreign-ownership restrictions or to set up more country funds designed for foreign investors. Such measures can avoid the issue of foreign control over the management of the firms through capital markets and at the same time encourage foreign investment.

Establishing the Basic Market Infrastructure

To attract foreign investors to stock markets, it is essential to establish basic market infrastructure: the rules of the market, disclosure requirements, accounting principles, trading systems, reduction of the settlement risk, and so on.

- Adequate capitalization of securities firms engaged in underwriting is necessary to reduce settlement risks.

- Equal treatment of domestic and foreign stockbroking houses is desirable because that encourages further foreign investment.

- Promoting new entry of domestic and foreign fund management firms is desirable because it makes favorable contributions to capital market development.

Developing Bond Markets

To develop alternative sources of external financing, it is important to promote bond markets, particularly those for long-term instruments. Liquid debt markets help establish benchmark interest rates, which in turn will deepen the markets.

- Establishing regional rating agencies is useful for the promotion of listing of corporate bonds on securities exchanges.

- Promoting the growth of private institutional investors is essential to developing wide markets for bonds and stocks.

BANKING TRANSACTIONS

Long-Term Borrowing and Lending

Some economies adopt a cautious approach to long-term borrowing from abroad by requiring approval from the authorities. All cross-border bank borrowing and lending should be basically liberalized rather than subjected to the nontransparent approval system, which is often used to discourage cross-border borrowing.

If the authorities find it imperative to resort to controls on capital flows at a time of exceptional difficulties, such as balance-of-payments crises and excessive exchange rate fluctuations, they can do so by retaining the power to invoke "emergency measures" at the emergency time while allowing restriction-free transactions at the normal time.

Foreign Banks' Entry into the Domestic Banking Market

Several economies strictly regulate foreign banks' entry into the domestic retail market, but continuation of such a policy is not beneficial and cannot be maintained indefinitely. Relaxation of restrictions on foreign banks' entry can greatly benefit the economy in the form of increased inflows of capital and improved efficiency of financial intermediation.

- If the authorities find it necessary to regulate foreign banks' new entry in the short run, they are advised to lay out long-term plans to allow new entry.

- It is advised that the most-favored-nation (MFN) principle be applied to allow foreign banks' new entry into the domestic market.

National Treatment of Foreign Banks

- Foreign banks, even when allowed to enter in the domestic retail market, are often treated unfavorably relative to domestic banks in terms of branching, lending to domestic and/or multinational firms, and other lines of businesses. The principle of "national treatment" requires domestic and foreign banks to be treated equally.

FOREIGN EXCHANGE TRANSACTIONS

Currency Convertibility for Current Account Transactions

- Most PECC member economies have accepted the obligations of Article VIII of the IMF Agreements, thus establishing currency convertibility for current-account transactions. Economies that have yet to accomplish this, particularly economies in transition, are strongly advised to accelerate necessary liberalization on domestic and international fronts so as to establish current-account convertibility.

- Foreign exchange controls on remittance of profits and interests are detrimental to the economies' credibility as reputable recipients of foreign capital and, hence, should not be applied.

Currency Convertibility for Capital Account Transactions

- Economies with current-account convertibility are advised to introduce currency convertibility for capital account transactions. PECC member economies can benefit greatly by fully liberalizing exchange controls on capital accounts.

- To maintain financial stability, however, the authorities must pay due attention to the "sequencing" issue. Capital account currency convertibility can be successfully introduced only after ensuring macroeconomic stability, completing domestic financial liberalization, and firmly establishing free-trade/investment regimes.

Central Bank Cooperation

- The recent agreement among the East Asian central banks to create a framework of repurchase arrangements in U.S. Treasury bonds is a positive step in their attempt to reduce the possible costs of integrated money and capital markets. The authorities in the PECC economies are advised to create a region wide framework of this kind.

Part IV

FUTURE FMD WORK

INTRODUCTION

Over more than two years of research and discussion, the financial Market Development (FMD) Project has produced reports contributing to the better understanding of financial market development in the Pacific Economic Cooperation Council (PECC) community. To help focus the project on the needs of its constituents, the PECC FMD committees have agreed on several themes that will serve as agendas for future FMD work.

The agendas serve as a kind of road map for the FMD Project. Contents in the agendas reflect the interest and concerns of the project's constituents. PECC supports Asia-Pacific Economic Cooperation (APEC) and the PECC FMD Project agendas will therefore be supportive of the APEC Finance Ministers' concerns. Because such concerns change with new developments, the future agendas will evolve accordingly.

Part IV presents themes and a framework for future FMD Project work, and it suggests a number of specific studies that could lead to important recommendations for development of the region's financial markets. Future work done by the FMD Project will flow from this document, but specific studies will be determined by the individual PECC FMD member committees.

PRINCIPLES AND OBJECTIVES OF FUTURE AGENDAS

The future agendas were developed with two principles and several objectives in mind. The first principle is *extensiveness*. The tripartite nature of PECC allows for an extensive approach to financial market development. Although some agencies are partial in their perspective when making recommendations to the decision makers, the PECC approach is of a wider dimension.

The second principle is *usefulness*. The FMD Project's agendas will always be relevant to PECC's constituents. One of the objectives of the project is to provide concrete recommendations to the relevant decision makers on how financial markets can be better developed. Where appropriate, the PECC FMD Project will collaborate with other agencies with the same goals.

THEMES AND TOPICS OF FUTURE AGENDAS

Five broad future themes were identified for the FMD Project. The common thread across these themes is to promote more efficient use of financial resources within and among the PECC economies. Each theme encompasses topics that will be studied. The five broad themes are mobilizing financial resources, promoting cross-border flow of funds, harmonizing information disclosure, developing efficient financial markets, and meeting the challenges of electronic commerce.

Mobilizing Financial Resources

The need for many PECC member economies to improve the mobilization of financial resources is clear. The amount of infrastructure financing needed in Asia alone is estimated to exceed US$1 trillion. Some PECC economies have successfully improved their domestic capital formation process. Others are experimenting with innovative ways of attracting capital from abroad. The experiences and models of such successes can be distilled into useful lessons for other PECC economies.

- *Increasing domestic savings*: Increasing domestic savings can raise local private funding at more equitable financing costs without incurring large foreign financing and management fees. Models of success can be examined to study how these may be transferred to other economies.

- *Improving the investment of domestic savings*: A number of different schemes have been tried by PECC economies to tap into domestic savings to finance public projects or quicken the development of securities markets. These range from privatized management of pension funds to incentives for individual investment of pension accounts. As a number of PECC economies are beginning to rationalize their domestic savings systems, the need for productive use of these savings will have to be considered. Analysis of different approaches and models already in place will be helpful.

- *Identifying alternative forms of infrastructure financing*: The amount of capital needed for infrastructure development in many PECC economies is massive. Although there is a strong desire in the international investment community to provide the capital, the uniqueness of infrastructure projects makes it difficult for traditional forms of financing to be used. Innovative approaches have been used for some successfully completed projects. Special financial markets have been developed to meet the needs for the demand and supply of infrastructure capital. Principles can be drawn from the successful approaches for other PECC economies. In Part III of this report, the FMD Project makes recommendations on diversifying financing mechanisms for infrastructure development.

- *Securitizing financial obligations*: Securitization is one of the most innovative approaches to channeling capital to productive uses. An efficient system can effectively reduce the cost of capital and generate economic growth. Innovative methods of securitization are prevalent in western-style economies that have helped fuel growth in entrepreneurial firms, high-technology firms, creative industries, and other developed markets. These innovations have not filtered to many nonwestern PECC economies. Of the few that have, many have retained their original market form, which may be less than optimal. A project that documents such innovations and that studies how they can be adapted for PECC economies would be very beneficial to the development of the regional financial and real markets. Securitization is also possible for infrastructural projects.

Promoting Cross-Border Flow of Funds

The economic benefits from a free flow of funds across borders has been well established. Sociopolitical considerations are impediments to such a development. This, however, should not detract PECC economies from pursuing it. Given its benefits and importance, the FMD Project has already studied on how cross-border flow of funds can be further promoted and presents recommendations in Part III of this report.

- *Identifying barriers to cross-border investments*: PECC economies have policies encouraging foreign capital investment in local economies, whether they are portfolio investments (in the form of developing fund markets) or foreign direct investments (i.e., where corporate control is often an issue). Such policies, however, may exist in parallel with local market regimes that in effect hinder such foreign inflows. While the FMD Project has already done significant analysis of constraints to cross-border capital flows, additional study can be useful to provide more specifics and details on the size and nature of such barriers and how they affect cross-border investments. Such a project can also examine the size and nature of intra-PECC and international direct and securities investments.

- *Liberalizing financial services by sectors*: A study to evaluate how the PECC economies measure on a scale of liberalization by different sectors (e.g., banking, stock brokering, insurance) will be useful to policymakers and industry participants.

- *Cross-listing of securities*: More and more companies all over the world are looking toward international financial markets in order to tap a larger pool of investors. One method of achieving this is to make the company's securities available directly to the foreign investor by listing the securities on exchanges in other countries. Studies can be conducted to evaluate the following:

  - How open are member economies to listing nondomestic securities?

  - What incentives do members provide to facilitate cross-listing by foreign corporations?

  - What are the standards and the additional costs of imposing these standards on cross-listing candidates?

- *Developing a regional multilateral credit rating agency*: Moody's and Standard and Poor's are well-known American rating agencies that are increasingly penetrating regional markets. While such credit rating agencies provide an important service for fixed-income investors and foreign capital investments in the region, there may be initiatives that could be taken to spare the development of credit rating agencies in the region. A study could analyze the following issues:

- Is there a need and potential for a regional multilateral credit rating agency?

- What are the effects of credit rating agencies on trading in secondary bond markets?

- How effectively are credit rating services developing in the region?

- What are the effects of credit rating agencies on primary bond markets?

- *Strengthening financial links between PECC economies*: Growing economies have common interdependencies that help forge links between their financial markets. These dependencies and relationships exist in money markets and foreign exchange markets. Recent signings of mutual repo agreements between various Asia-Pacific central banks are an example. Studies can be done to analyze the benefits and mechanisms of such interrelationships and how they strengthen and help develop financial markets.

Harmonizing Information Disclosure

The search for risk diversification by the international investment community often hits the wall of poor or no information. This not only is a frustration to the investors but is detrimental to the investment target, which is often most in need of such investment funds. Information disclosure requirements as well as legal frameworks can vary greatly from one country to the next. Studies to analyze these differences will help increase transparency for international investors, cross-listing candidates, and fund managers. This in turn will aid cross-border flow of funds.

The FMD Project has already extensively considered this issue and makes recommendations in Part III of this report.

- *Harmonizing accounting standards*: The vast gaps in accounting treatments should be narrowed to reduce the risk to investors. PECC economies can be encouraged and helped to use international accounting standards that are most widely accepted.

- *Harmonizing the level of corporate disclosure*: Public disclosure of corporate information is essential to attracting securities investment. While stringent requirements on such disclosures have been imposed by the investment community in some PECC economies, there is much less domestic pressure in other economies.

Inadequate disclosure is, however, impeding the inflow of badly needed foreign investment. Harmonized corporate disclosure levels will certainly improve the flow of cross-border securities investment among PECC economies.

- *Harmonizing regulatory requirements and language*: The regulatory environment is a major factor in financial market development. Like other aspects of securities investment, common language and standards are much welcomed by investors.

Developing Efficient Financial Markets

- *Equity markets*: Studies will be conducted to propose further development of equity markets in terms of increasing investor protection. A study can focus on the different classes of investors (individuals or institutions) to determine how to nurture them and increase the level of sophistication.

- *Bond markets*: A common problem for fund managers is the lack of local debt markets. The size and maturity of these markets in relation to the equity markets lag behind those of mature, developed capital markets. Improvements in levels of liquidity and transparency of these markets in the Asia-Pacific region are critical to investors who seek to balance their portfolios. A complete study could be done to address the following issues:

    - Impact of inadequate debt markets on fund management and capital flows

    - Impact of debt markets on exchange rate volatility and foreign exchange rate policy

    - Measures to identify appropriate instruments and improve liquidity in debt markets

- *Derivative markets*: Emerging economies have the most urgent need for international capital to finance their high growth rates. There are sufficient international funds to fuel this growth. However, a major problem for foreign funds deciding to invest in emerging economies is the substantial risk involved and the lack of derivative markets to hedge these risks. Some products have been developed privately over the counter that cater to major investors seeking emerging-market returns but attempting to avoid excessive market risks. One project that would be beneficial to policymakers and industry alike is to identify the types of risks that exist in these markets and the kinds of financial instruments that are helpful to manage those risks. This study would contribute to efforts to

    - Reduce effects of emerging-market risks that can cause major market reverse flows

    - Avoid excessive market volatility
    - Develop efficient instruments
    - Improve understanding by corporations of their risks
    - Avoid unnecessary speculation

- *Financial intermediaries*: It would be useful to have a study on the development of financial intermediaries that are of growing importance in maturing economies, for example:
    - The insurance industry
    - The pension funds industry (private and public schemes)
    - The banking industry
    - Mutual funds
- *Benchmarking financial markets development*: A benchmark is proposed to help calibrate the level of development of PECC financial markets. This evaluation system could help identify the strengths and weaknesses of such markets and would provide an ideal platform from which to present future developments and to evaluate implications of such proposals. The FMD Project could also provide similar-style economies with a functional design of a financial system that is needed to stimulate and develop the real financial economy.

Meeting the Challenges of Electronic Commerce

The surge in the use of computing technology is rampant in financial institutions. A study can be done on

- Security of banking automation and computerization
- Standardization in the computerization of banking transactions
- Implications of the Internet and electronic cash
- Integrity of financial databases that link international banks

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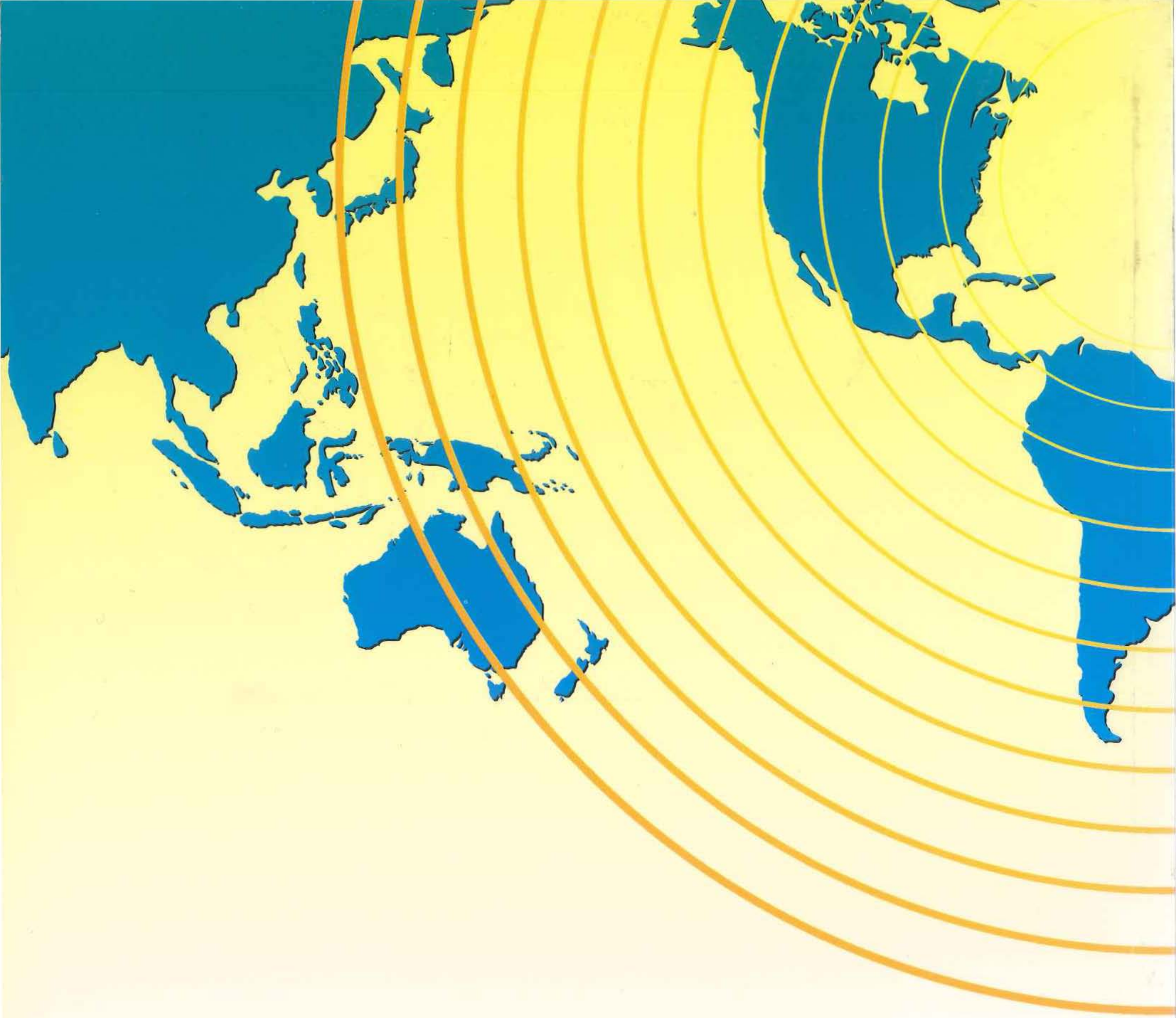

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