



9th OECD-ADB Roundtable on Capital Market Reform in Asia

Ten years after the financial crisis: prospects towards the future

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Opening Remarks by Masahiro Kawai, Dean, ADB Institute

Mr. Adrian Blundell-Wignall of the OECD; Mr. Andrew Sheng, Chairman of the Roundtable; distinguished speakers, guests, participants, ladies and gentlemen: Good morning.

It is my great pleasure to welcome you to the ADB Institute for this year's OECD-ADB Roundtable on Capital Market Reform in Asia.

This is the ninth of the Roundtable series which started in 1999 as a forum for discussion on emerging and outstanding issues related to capital market reform in Asia. ADBI is privileged to have this opportunity to organize the Roundtable jointly with the OECD to further contribute to capital market development and reform in the region.

Over the past nine years I have participated in the Roundtable several times, first in an academic capacity and later as ADB staff working on Asian bond market development and regional financial integration. So I am very happy today to come back to the Roundtable as Dean of ADBI to continue to support this increasingly important forum.

The theme for this year's Roundtable: "Ten years after the financial crisis: prospects towards the future" may sound familiar to many of you since a number of workshops and conferences on this subject have been held over the past year. They have focused on lessons learned from the Asian financial crisis of 1997-98, progress made in crisis-affected countries in the past ten years, and possible new risks emerging in Asia. In fact, last year ADBI organized three conferences on this topic jointly with our partners and stakeholders—ADB HQ, the Research Institute of Economy, Trade and Industry (RIETI) of Japan's Ministry of Economy, Trade and Industry, and the Policy Research Institute (PRI) of Japan's Ministry of Finance.

Today and tomorrow, we will first look at the development and reform of capital markets in Asia—particularly national and regional efforts at enhancing market infrastructure, supervisory and regulatory frameworks, and regional financial integration and stability. Second, we will examine new emerging risks and challenges Asian capital markets are currently facing, given the potentially serious impact of the spreading US subprime loan problem and global credit market turmoil. The role of regulation and supervision over financial systems—including capital markets—is especially important with the rising risk of surges in capital inflows into Asia, as the prospect of US economic growth over the next several quarters becomes increasingly uncertain. Third, we will try to find ways to improve the region's financial intermediation capacity, particularly through capital markets, so that many more "bankable" investment projects are identified and the region's massive savings can be mobilized for these investment opportunities. This would also contribute to the resolution of global payments imbalances, at least from the Asian side.

Allow me to briefly highlight some of the progress made in capital market reform over the past decade. Both national governments and regional groups have made significant efforts to develop and deepen capital markets. Many countries have produced national "capital market master plans" and undertaken concerted initiatives to enhance market infrastructure such as regulatory frameworks, credit

rating, trading platforms, clearing and settlement, and derivatives trading to help individual national authorities create deep, liquid and more open capital markets.

Bond Market Development Initiatives

Bond markets in emerging Asia have advanced significantly since I reported on the latest progress in the previous Roundtable in October 2006. The total local currency bonds outstanding in emerging East Asia expanded from US\$400 billion in 1997 to US\$3 trillion at end-June 2007, or from 11% to 57% of the region's GDP. As of March 2007, bond financing had also outpaced equity financing with its share of total domestic financing reaching 31% compared to a mere 12% in 1997.

Corporate bond markets continued to expand in most emerging East Asian economies, registering an average of 41% share of total local currency bonds in June 2007 as opposed to 28% in 1997.

Bond market development in emerging East Asia has also benefited from regional initiatives such as the Asian Bond Markets Initiative (ABMI) and the Asian Bond Fund (ABF). The main objective of ABMI, launched by the ASEAN+3 finance ministers in August 2003, is to enhance market infrastructure for local currency bonds and facilitate market access to a diverse issuer and investor base so that robust primary and liquid secondary markets are created in the region. Under ABMI, four working groups are currently focusing on various ways to strengthen regional market infrastructure, including the establishment of new regional entities.

The objective of the ABF, initiated by the EMEAP (Executives' Meeting of East Asia-Pacific Central Banks) central bankers first in June 2003 and second in December 2004, is to help expand the bond market through the participating central banks' purchases of sovereign or quasi-sovereign bonds issued by the group's emerging economies by using central bank foreign exchange reserves. The second attempt, called ABF-2, has been particularly successful as it

involved purchases of \$2 billion equivalent of local currency-denominated bonds, and introduced a Pan-Asian Bond Index Fund and a Fund of Bond Funds.

ADB has supported Asian bond market development in many ways. ADB has issued local currency bonds to promote its member countries' national market development. A recent notable innovation is the launch of the US\$10 billion Asian Currency Note Program in September 2006, which aims to raise funds for ADB's lending operations in local currencies under a single unified framework based on United Kingdom law. In addition, ADB has been providing technical support to the ABMI working groups, some of which have made significant progress—for example, reaching an agreement on a specific modality to establish a regional credit guarantee and investment agency.

Equity Market Development

The equity markets in emerging East Asia have also expanded substantially with their market capitalization increasing more than five fold from about US\$840 billion in 1997 to US\$4.7 trillion in 2006. In 2007, the average index of Asian equity markets outperformed those of all other markets, including in the Americas and Europe, gaining by 29% in local-currency terms and 36% in US dollar terms. Access to equity markets has also improved as new capital raised through initial public offerings (IPOs) rose to US\$66 billion in 2006.

Despite these improvements, more reforms are still needed to promote greater efficiency of the equity markets in Asia's emerging economies. First, given that about three-quarters of the IPOs were concentrated in only a few advanced markets—most notably in Hong Kong's Hang Seng Stock Exchange—more efforts are needed to enlarge the number of listed companies in many other emerging economies. Second, as market liquidity, measured by the ratio of value traded to market capitalization or GDP, is relatively low in many emerging Asian markets, possibly reflecting the relatively small size of these economies, the small number of listed firms, limited accessibility by foreign investors, weak

legal and regulatory environments, or a combination of these factors, more efforts are needed to enhance liquidity.

Integration of Asia's national equity markets may help improve liquidity through cross-listing as well as cross-trading of shares. It is these potential benefits of equity market integration that led the ASEAN finance ministers to focus their cooperation on harmonizing market standards and practices and on facilitating cross-border market access in order to develop an interlinked ASEAN securities market by 2010. Progress has been made in advancing this initiative since its adoption in April 2005, particularly through the ASEAN Capital Market Forum. ADB has been providing technical support to this initiative including facilitating the dialogue among the various stakeholders concerned.

I believe this type of cooperative initiative for capital market harmonization can be expanded beyond ASEAN. We know that cross-country differences in legal and regulatory frameworks, institutional arrangements, and market practices do constrain the pace and depth of market harmonization and integration. I believe, in the long run, the adoption of core principles and common standards, based on international best practices, will contribute to much deeper integration of Asian capital markets. From this perspective, establishment of regional mechanisms to achieve common minimum standards and mutual recognition of these is a promising step toward market harmonization and integration.

The Role of Capital Markets for Infrastructure Development

Asian policy makers have increasingly recognized that capital markets can, and should, play a critical role in providing long-term investment instruments for long-term savings. The region faces the challenge of mobilizing its massive savings to finance productive investment within the region—particularly infrastructure investment such as transport, energy and telecommunications. The rapidly ageing populations in the advanced parts of Asia—like Japan, Korea, Hong Kong and Singapore—also need attractive long-term investment opportunities within Asia for their wealth diversification and post-retirement consumption.

In this context, I would like to bring to your attention the ASEAN Infrastructure Financing Mechanism that was adopted by the ASEAN finance ministers in April 2007. This mechanism aims to mobilize regional savings and international capital for ASEAN's economic development and to increase intraregional flows of capital and services in support of ASEAN infrastructure investment.

Last year, ADB launched its flagship study, "Infrastructure and Regional Cooperation." I am happy to inform you that ADBI has been tasked to take the lead in this study. One of the themes of the study is "infrastructure financing," which will identify the potential financing needs for infrastructure investment in Asia and various modalities for mobilizing funds to meet such investment needs. I expect that some of the key findings of this study can contribute to the debate on how to further deepen and integrate the region's capital markets. Just last week we held an inception workshop here at ADBI to discuss approaches and methodologies for many aspects of the study. I would be more than happy to share the outcomes and recommendations of this flagship study with you as soon as they become available.

The Subprime Loan Problem and Beyond

The latest financial market turmoil that started about a year ago with the slump in the US housing market, followed by defaults of subprime borrowers, created a ripple effect throughout the global financial community. We have found once again that prudent lending, based on the sound assessment of borrowers' ability to pay, is critically important. We have also found that the use of capital markets, the development of various new products—including structured instruments such as collateralized debt obligations—and the diversification of risks are no panacea for financial market stability if not accompanied by prudence. Capital markets need to be regulated appropriately, risks need to be assessed and priced accurately, and financial products must be marketed in a transparent manner. Of course a good balance between soundness and efficiency must be struck when pursuing regulatory reform.

While the full effects of the subprime loan crisis are still unfolding, the impact on the Asian markets so far has fortunately been limited. Despite that, the situation unveils how tightly financial markets are linked globally and how quickly financial contagion can spread across countries and across different types of markets. It clearly highlights the need for a review of existing regulatory and supervisory framework and better coordination among policymakers and regulators of various but related segments of financial markets, in order to maintain financial stability.

Being a frequent participant to this Roundtable, I have always been impressed with the depth and quality of discussions. Today and tomorrow I hope the Roundtable will come up with some good recommendations to help resolve many problems the global capital markets are currently facing—particularly the role of credit rating agencies and bond insurers, the relationship among monetary policy, asset prices and financial system soundness, and the role of supervisory and regulatory authorities. We are fortunate to have senior officials from finance ministries, central banks, and supervisory and regulatory agencies attending this year's Roundtable. I have always felt that Asia has come to the stage to develop its own financial stability forum due to the rising financial linkage and need for much more intensive cooperation in the region. Today's gathering may be a part of this process.

ADBI is proud to participate in this regional debate and effort to advance the development and integration of capital markets in the region. What we need is a competitive and safe financial system that supports Asia's sustained economic growth, efficient financial intermediation, and regional financial integration. With your cooperation, I am looking forward to very lively and in-depth discussions and debate on these issues. We are seeking your innovative ideas and thoughts.

With that, I would like to once again welcome you to ADBI and wish you all fruitful deliberations and an enjoyable stay in Tokyo.

Thank you.