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Toyoo Gyohten*

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**Abstract**

Speech given at Session 1: The Global Capital Market: What's Next. Toyoo Gyohten discussed observations on the problems and future prospect of the Asian capital market. He describes the growth of the East Asian markets and measures to strengthen the systems.

# EAST ASIAN CAPITAL MARKETS

*Toyoo Gyohten**

First of all, I am very honored to be asked to speak to this audience this morning. I must confess though that I am a bit nervous because I know when I talk to lawyers I have to be very careful. Since I am one of the few non-lawyers here, and also one of the few Asian participants, I thought I might present you with some brief observations on the problems and the future prospect of the Asian capital market.

I don't think I need to repeat the importance of the phenomenal growth of East Asian economies since the 1970s. Following the Japanese example, the so-called Asian Tigers, the ASEAN[1] member countries, and China have led this advancement successively. East Asia emerged as the fastest-growing and the most-vibrant region in the world economy today. It is growing as one of the most important centers of production, trading, and consumption in the world.

Naturally, many factors contribute to this dynamic growth. The ample supply of productive capital, both domestic and foreign, is certainly one of them. It seems quite likely now that the East Asian economies will continue their broad development through the early part of the twenty-first century. There is every necessity and possibility for East Asia to become a gigantic international capital market. It is indisputable that the high level of investment has supported the rapid growth of East Asia. The average investment ratio is running at thirty-two percent of GDP in recent years in that region. According to the estimate made by the Asian Development Bank in Manila, the gross domestic investment needed to maintain the current level of the East Asian economic growth will be US$1 trillion in the year 2000, investment for infrastructure development alone requiring US$200 billion.

On the other hand, the combined East Asian nations' savings ratio is close to thirty percent, the highest in the world.

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* Senior Advisor, Bank of Tokyo-Mitsubishi, Ltd.; President, Institute for International Monetary Affairs.

1. The Association of South-East Asian Nations Declaration (Bangkok Declaration), Aug. 8, 1967, 6 I.L.M. 1233 (1967).

Also, attracted by the high investment return, more than US$100 billion of foreign capital is flowing into the region every year, resulting in the active movement of a huge amount of capital within East Asia. Furthermore, the total foreign exchange reserves of the East Asia nations, including Japan, amount to US$700 billion, more than half of the world total.

Prior to the 1980s, most of the foreign capital flowing into the East Asian countries came from the United States and Europe, while Japanese investment became more important soon after. A significant change, however, has taken place during the last ten years in this respect, with intra-regional investment between East Asian nations becoming more significant. Overseas Chinese investors have been the greatest contributors to the enhancement of intra-regional capital flows. Today, overseas Chinese capital from such locales as Hong Kong, Taiwan, Singapore, and Malaysia is pouring into mainland China and other East Asian countries. Of the total direct investment into East Asian countries in 1995, about two-thirds, or US$50 billion, was intra-regional. It is very clear that East Asia is developing as an active, self-reliant economic region.

Yet, while the quantitative flow of capital in East Asia is certainly large, it should not be forgotten that East Asia still has many problems to solve before it is equipped with full-fledged capital markets. As I mentioned, direct investments have been by far the most important form of foreign capital entering East Asia. During the period from 1990 to 1995, direct investment accounted for forty-five percent of total capital flowing into East Asia, while the comparative figure for Latin America was around thirty percent. Indeed, direct investment is a desirable form of capital flow. It is non-debt in nature, and it is also usually accompanied by a transfer of technology. When such investment is export-oriented, it contributes to the strengthening of the host country's foreign currency-earning capacity in a relatively short span of time.

Excessive reliance, however, on direct investment has the unfavorable side effect of delaying the development of the domestic long-term capital market. In many East Asian economies this problem is already apparent. For economic development, and particularly for the betterment of socio-economic infrastructures, a stable, long-term investment of capital, both domestic and foreign, is absolutely necessary, for which it is essential to establish a strong financial system. Frankly speaking, the current situation in East Asian economies in this respect is far from satisfactory. Specifically, many economies do not have primary and secondary markets yet for equity and long-term bonds, nor have stable banking systems been established. Already, such deficiencies have turned out to be a cause of financial instability and an obstacle to economic growth in certain economies.

Several problems emerge in the context of the equity and long-term bond market. Due to a lack of disclosure of reliable information, the market is not transparent. This, in turn, has made investment decisions very difficult. Insider trading and other such illegal activities manipulate market prices. Uncertainty in clearing and settlement processes increases investment cost. Furthermore, a limited number of equities and bonds accounts for a large percentage of total trading volume, while family holdings and cross-holdings of equity restrict the volume of shares available for market trading. A secondary market of government deals and bonds, which can function as benchmark securities, is almost nonexistent. In addition, there is an absence of independent regulatory and supervisory systems with full authority to monitor and regulate those markets.

Much needs to be done to improve the banking system as well. Prices of funds and services do not reflect market mechanisms. Banking is still a public industry and government habitually allocates funds. Competition among banks is also restricted, and this has resulted in a concentration of allocated credit in a limited number of traditional and privileged industries.

In my view, East Asian governments need to take the following measures to strengthen their banking systems. The governments should facilitate the privatization of state-owned banks and the entry of new domestic and foreign banks into the market; reduce their intervention in bank lending; strengthen banks' capital base so that they can better manage risk; improve the countries' legal and fiscal systems so that banks may expedite the disposition of bank loans and not have to bear the burden of related budget deficits; encourage mergers and alliances between banks to increase the efficiency of their management; and implement an independent regulatory and supervisory system.

It goes without saying that the institutional build-up as such can produce the desired result only when sound fiscal and managerial policies support it. Establishing an infrastructure which includes clear and efficient legal, accounting, and taxation systems and standardized legal practices is not only necessary for a stable inflow of foreign capital, but is also the very basis of the healthy development of a market economy.

While it is true that East Asian economies are making strenuous efforts, it is imperative that they not merely introduce new systems perfunctorily, but allow these systems to actually function. In this regard, the current situation of many economies in that region is as yet unsatisfactory. When these challenges are not adequately met, the economy turns vulnerable to inflation, volatile capital flow, financial instability, and currency turmoil. The risk of financial instability in East Asia has increased due to the greater interdependence between national markets as the result of the active interregional investment flows and the vulnerable external position due to heavy reliance on imported capital products.

While the East Asian economies need to continue their efforts to improve their internal conditions, international cooperation is indispensable to prevent and manage any possible financial crisis. To this end, regulatory authorities in East Asia need to agree to set up an effective cooperation mechanism. First of all, governments should establish a system through which regulatory authorities can share accurate information promptly, to enable them to properly assess the situation. Secondly, the regulatory authorities need to agree to introduce standardized and fair rules of supervision of financial institutions, with a view to enhanced soundness and credibility of their markets. Thirdly, it would be highly desirable to create a regional trading facility to provide necessary liquidity in the case of an emergency. Such a facility would supplement the role of larger, multilateral institutions, such as the International Monetary Fund ("IMF")[2] and the Bank for International Settlements ("BIS").[3]

Let me add a few words about the role of Japan in the development process and the strengthening of the East Asian capital market. It is clear that the financial capacity of Japan is enor-

2. Articles of Agreement of the International Monetary Fund, July 1-22, 1944, 60 Stat. 1401.

3. Convention Respecting the Bank for International Settlements, Jan. 20, 1930, 104 L.T.S. 441.

mous. Although the East Asian economies are growing rapidly, their total GDP accounts for seven percent of the world total, while Japan's accounts for seventeen percent. In other words, all of East Asia — namely, the Asian Tigers, ASEAN countries, and China — accounts for forty percent of the Japanese economy. In contrast to the growing current account deficit registered by many East Asian countries, Japan is still running a US$100 billion surplus every year. Japan's net foreign assets are now over US$1 trillion, including a currency exchange surplus of US$230 billion. The total household financial assets in Japan have exceeded ¥12 trillion (US$86.6 billion).

Japan is already exporting a large amount of capital to East Asia in various forms, such as official development assistance, direct investment, portfolio investment, and bank lending. From such a vantage position Japan can play a leading role in the financial activities of East Asia. In practice, however, this has yet to be the case. Excessive regulation, lack of transparency, high cost of business in the Tokyo market, and the lack of international competitiveness of Japanese financial institutions have discouraged Japan from playing the role of a global financial center.

The sweeping financial reform which has just started will bring about a fundamental change in the Tokyo market and the Japanese financial industry. Complete abolition of foreign exchange control, removal of barriers between different types of financial industries, deregulation of the production and the sale of new financial commodities and services, reduction of related taxes, liberalization of fees and commissions, setting up holding companies, introduction of the market accounting principles, just to name a few, are items to be implemented.

When completed, the reform will make the Tokyo market a highly competitive and attractive market for all participants, domestic and foreign. As the reform hopefully reinvigorates the Tokyo market, it will offer more diversified and attractive business opportunities to neighboring markets. Japanese investors will also seek their opportunities in these markets, and this will, in turn, stimulate the environment and work as a plus-sum game. Increased competition will provide incentives to offer even more attractive products and services among these markets. In other words, it is our great hope and belief that Japan's reform will stimulate a similar effort in other East Asian economies to liberalize and reform their own capital markets.