YUTA SEKI

Nomura Institute of Capital Markets Research

Development of Asia's Capital Markets and Lessons to be Learned from Japan

Asia as a Center of Global Growth

Asia's presence in the global economy has been rising in recent years. Asia has been an important part of the world economy throughout most periods of history, and it has only been the past 200 years or so that Europe and the United States have dominated the world economy. However, while European and US economic growth has slowed since the latter days of the 20th Century, China and other emerging Asian nations have enjoyed conspicuously high economic growth rates. While income levels in Asian countries remain far below those in the United States and Europe, Asia has clearly become a leading driver of global economic growth since the start of the 21st Century.

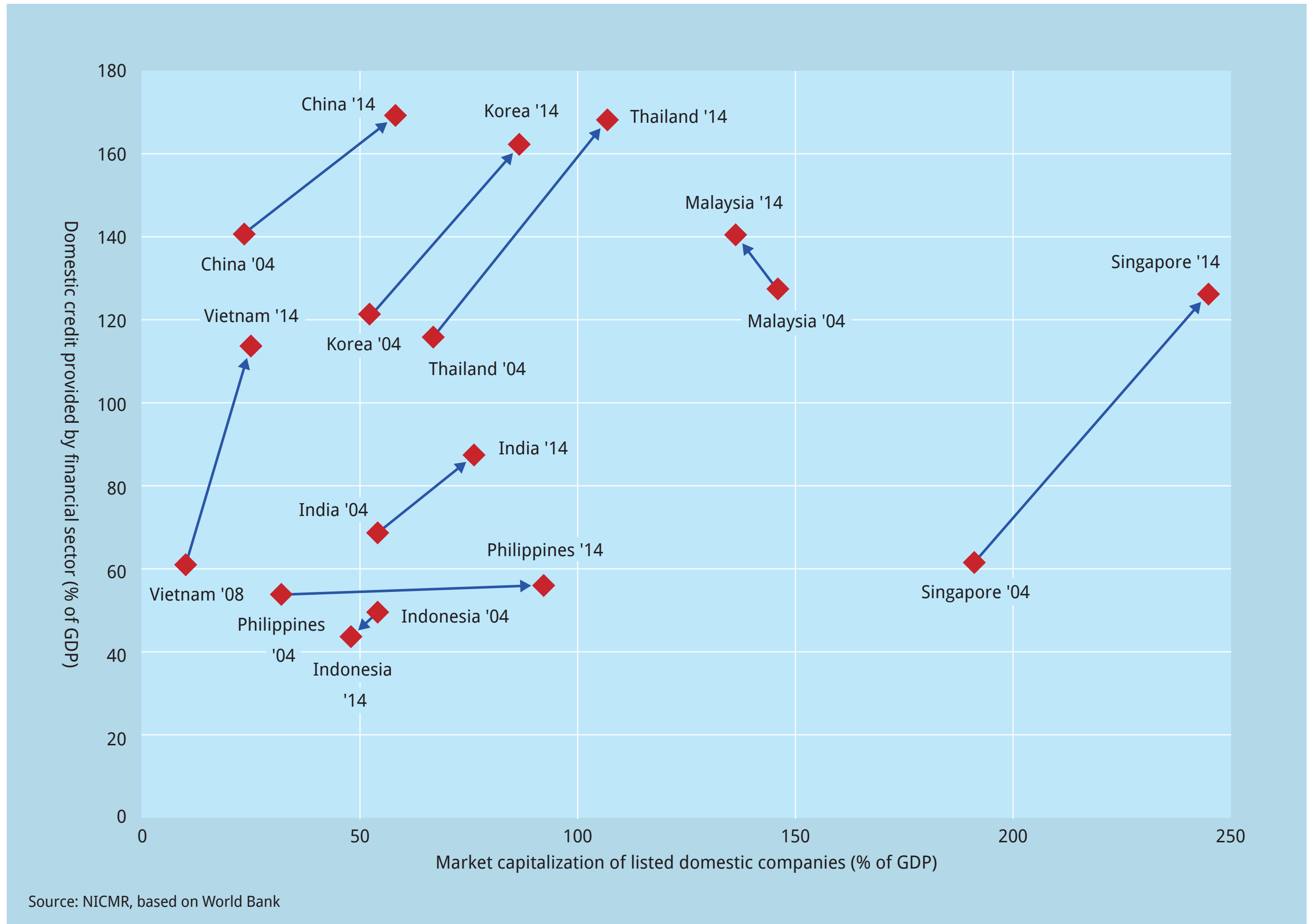
One of the distinguishing characteristics of Asia's economy is the region's large population, which amounts to more than half of the global population and is a driving force for regional economic growth. Asia's total population as of 2014 was about 3.7 billion, making Asia an economic zone more than six times larger than the three-country bloc formed by the North American Free Trade Agreement (NAFTA), with a total population of 450 million, or the European Union, with 27 countries and a total population of about 500 million. However, according to World Bank Financial Inclusion survey (2014), in such Asian countries as Indonesia, the Philippines, and Vietnam, less than 40% of their rather large populations possess accounts at a financial institution. From the perspective of financial inclusion, these countries lag far behind the developed countries.

Meanwhile, Asia accounted for about 30% of global GDP in 2015 (estimated figure). So while the region is enjoying high economic growth levels, its absolute economic scale is relatively small and is likely to remain so for the foreseeable future. In addition, income levels in Asia as measured by per-capita GDP are still low and wide disparities exist within the region. Such disparities can be readily seen if we map per-capita GDP (on a purchasing power parity basis) of major Asian nations against Japan's historical per-capita GDP growth trend. For example, a comparison of Malaysia and Vietnam reveals a rather large 20-year difference in these two countries' income growth pace from the perspective of Japan's economic history. Moreover, if we lineup the 2019 per-capita GDP forecasts for Asian countries, we notice that the relative position of each country is expected to remain the same, amounting to the perpetuation of an economic growth model that resembles the formation of a flock of flying geese. In other words, income levels in each country are expected rise steadily, increasing the likelihood that each country's economy will be greatly transfigured in the near future. A key point to observe within this growth trend will be whether or not Asian countries can achieve growth that enables them to escape from the middle-income country trap.

Asia's Financial System: Current State and Main Problems

It is often pointed out that banks (i.e., indirect financing) have traditionally been the core of Asia's financial system, and that the capital markets (direct financing) have not fully developed. However, this does not necessarily mean that Asia's financial intermediary function is highly dependent on indirect financing. To better understand the financial structure of each Asian nation, we examine the change from 2004 to 2014 in the ratio of total outstanding credit to GDP (an indicator of the scale of indirect financing) and the ratio of total market capitalization of listed companies to GDP (an indicator of the scale of direct financing) (Figure 1). This analysis shows that Singapore and Malaysia have high stock market capitalization/GDP ratios, amounting to financial structures that are very

Figure 1: Structure of Financial Systems in Asian Countries



Source: NICMR, based on World Bank

close to those of the United States and the United Kingdom. On the other hand, Thailand, Vietnam and China all have financial structures that still are fundamentally dependent on banks, even though their direct financing indicator is on a positive growth track. Vietnam, in particular, has seen a sharp increase in indirect financing in recent years. On the other hand, reliance on indirect financing in the Philippines and Indonesia has leveled off or even fallen in recent years. However, it could be that insufficient growth in bank lending has hindered economic growth in these countries.

International financial institutions, such as the Asian Development Bank (ADB) have often pointed out that the financial system of the Asian region as a whole faces many challenges and vulnerabilities that emanate directly from an overreliance on indirect financing. More to the point, because the region's financial markets have not been developed sufficiently, the growth in savings that has accompanied high economic growth is not being used to for investment opportunities in the region or to meet intra-regional demand for funds. As a result, Asian economic development has had to rely extensively on money flows from the U.S. and European markets. In addition, a lack of financial instruments that meet the asset management needs of a growing wealthy class and insufficient development of an asset management industry responsible for investing the pension-related assets of an aging population have contributed to an outflow of surplus money from the region.

Under such circumstances, changes in the flow of surplus funds from U.S. and European investors or changes in their investment stance have produced fluctuations in Asian countries' currency exchange rates and stock prices, creating conditions conducive to the generation and subsequent bursting of asset bubbles. In addition, jolts to a banking sector that lacks sufficient capital and risk management capabilities are likely to have a significant impact on the real economy. In short, the structural inadequacies of the Asian financial system that led to Asian currency crisis in the 1990s are still present today. Removing these inadequacies through the development and nurturing of capital markets that promote and facilitate the long-term re-investment of savings within the region will therefore become an increasingly important policy issue for the region's national governments and financial authorities.

The Importance of Capital Markets in Asia

In addition, we expect the four points noted below will further increase the importance of capital markets in Asia.

First, capital markets play a role in supporting economic growth and changes in industrial structure. Looking ahead,

Asian countries' economic growth rates are expected to fall as the engine of economic growth shifts from labor-intensive manufacturing industries to consumer and service industries and finally to knowledge-intensive industries. If market mechanisms are not used to effectively shift resources to growth sectors and newly emerging industries, economic and industrial vitality will be lost. Equity markets can be thought of as the heart of an economic body that effectively pumps capital to all parts of that body, from venture capital companies to mature, listed companies, providing needed financing and refinancing. The importance of equity markets in Asia can only grow stronger. In that same context, as Asian economies shift from the government-led development stage to mature free-market economies, government-controlled industrial sectors will need to be opened up to private enterprises and government-owned companies will need to be privatized. It must be emphasized that equity markets have a major role to play in this shift to a private-sector-dominated economic system.

Second, Asian infrastructure development financing needs are huge. The Asian Development Bank Institute (ADBI) estimates that from 2010 to 2020 Asian countries will need to investment a total of $8.5 trillion in infrastructure. To meet the huge demand for infrastructure development, governments will need to issue bonds to finance public works while also seeking funds and know-how from international development financial institutions, the official development assistance (ODA) programs of other countries, and the private sector. Making use of private-sector funding will be crucial to accelerating economic growth without excessively expanding the fiscal deficits of national governments. Meanwhile, huge inflows of speculative funds from domestic and overseas investors seeking to profit from infrastructure-related urban development could lead to real estate bubbles and excessive amounts of credit. To avoid these risks, infrastructure projects should be financed by long-term investment funds. Moreover, the creation of mechanisms that promote the flow of funds into highly feasible infrastructure projects while weeding out projects with low feasibility will lead to a virtuous cycle of infrastructure development followed by economic growth. A price discovery function based on the formation of interest rates and stock prices in the financial markets will be an essential part of such mechanisms.

The third reason we expect the importance of capital markets in Asia to increase is the region's growing middle class. According to the OECD, the Asia-Pacific region's middle-income population will reach 1.74 billion in 2020, accounting for more than half of the global middle-income population. In addition, PricewaterhouseCoopers forecasts that the total assets of the mass-affluent population (households with total asset values between $100,000 and $1 million) in the Asia-Pacific region will double from 2012 to 2020 to reach $43 trillion. In addition to a sudden increase in consumption by Asia's middle class, their financial needs are likely to diversify as they accumulate savings and other personal financial assets. This growth in financial assets will lead to the emergence of an investor class that will not want to put all their money in bank accounts but will also desire to own insurance products and credit cards and to build asset portfolios that include investments in marketable securities and investment trusts, which in turn will promote further development of financial markets and the financial services industry. Many Asian countries are not yet at the stage where the diversity of financial services is a priority and government policy is rather prioritizing financial inclusion. However, in such countries, financial inclusion and more sophisticated financial services are two sides of the same coin, because the household sector's asset formation could be achieved through promoting financial products and services that will have more immediate and concrete benefits, such as funding the education of children and home purchases.

The fourth factor is future demographic changes. Many Asian countries, including China and South Korea, are expected to follow Japan on the path to a rapidly aging society. Population aging will most certainly lead to increased interest in pension system reform and more sophisticated asset management using securities markets.

Capital Market Crisis and Lessons to be Learned from Japan's Experience

The financial crisis that shook the world in 2008 presented the global capital markets with a major challenge. The failure of many highly leveraged financial institutions that had aggressively pursued the securitization of risk assets and trading business and the need for publicly funded bailouts of others greatly destabilized the world economy and society at large. In addition, the unconventional monetary and fiscal policies adopted by many nations to weather the storm and put an end to the crisis are one cause of the financial market turmoil that continues to this day. The ensuing discussions about financial industry regulations that took place in international bodies, such as the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB), and regulations subsequently enacted by the advanced countries of the world have imposed heavy capital and liquidity constraints on major financial institutions' trading and securitization operations. In some cases, financial institutions are no longer allowed to engage in proprietary trading, while investment funds have had constraints imposed on their trading and other operations.

Looking solely at these trends, one could get the impression that the role of capital markets has been reduced since the global financial crisis. However, a policy that focuses excessively on the crisis that occurred in the United States and Europe and as a result downplays the role of the capital market and therefore neglects to develop its functions would be a very dangerous one, especially for countries like today's Asian countries, which are just recently entered center stage in the world economy after a period of high growth.

The validity of this statement can perhaps best be appreciated by looking back at Japan's experience. During its high-growth period after World War II, when Japan was still playing catch-up to the United States and Europe and needed to mobilize a relatively small amount of savings for capital investment in manufacturing industries, banks were the core of Japan's financial intermediary system. Then, in the 1980s, when yen appreciation and other factors led to slower growth in Japan's export industries, accommodative monetary policy was adopted as a means of supporting the economy. The banks found themselves with a huge cash surplus that they began lending for the purchase of real estate or the stock of companies that owned real estate. The result was a spectacular real estate bubble that saw the value of the land in the 23 wards of Tokyo rise to a staggering level that was said to be equal to the value of all the land in the entire United States.

Stock prices peaked at the end of 1989, followed by land prices in 1991, starting a downward spiral that burst Japan's so-called bubble economy. However, the real tragedy for Japan was the long time it took to for the commercial banking sector to dispose of the approximate ¥100 trillion yen in nonperforming loans that had accumulated on the asset side of their balance sheets. As a result, funds were not available for the industries and companies able to contribute to the growth of the Japanese economy. Moreover, declining values of real estate used as collateral on bank loans extended under bilateral agreements generated losses for banks when they revalued their loan asset to the real market value of the underlying collateral. Both lenders and borrowers therefore had an incentive to postpone disposal of their devalued assets. As a result, real estate transactions declined and real estate prices became increasingly less transparent, making it difficult for both the regulatory authorities and investors to accurately grasp the actual market conditions, which in turn fueled a vicious cycle of credit contraction and falling asset prices.

The escape route from Japanese banks' bad-debt problem was finally opened up when Japan's bank regulators implemented financial stabilization measures, including injections of public funds to boost banks' capital, issued stricter regulations on the disclosure and evaluation of nonperforming loans, and demanded that the banks reduce NPLs and increase capital. The escape route was widened by the creation of the commercial mortgage backed securities (CMBS) market and the real estate investment trust (REIT) market following enactment of the Act on Securitization of Assets and revision of the Act on Investment Trusts and Investment Corporations. The new markets increased the transparency of loans and real estate transactions and revitalized the real estate market.

In conclusion, the strengthening of the capital market framework, as noted above, was a major driving force behind the emergence of Japan's financial system from its bad-debt crisis and the subsequent recovery of the wider economy. The Japan experience therefore serves as a valuable lesson that financial intermediary systems should not become over-reliant on the commercial banking sector and that asset liquidity and the transparency of asset price formation should be maintained by enhancing the functions of the capital markets.

Japan's Effort: Formation of the Investor Base and the Role of Securities Firms

It should also be noted that Japan's capital market–related policies also emphasized the use of the securities market as a savings vehicle and the formation of a diverse investor base.

As far back as the latter half of the 1960s, when IPOs were increasing, many companies introduced employee stock ownership plans that promoted employees' asset formation while raising their interest in their company's business results by enabling them to accumulate shares of their company via regular payroll reductions. In 1980, the introduction of medium-term government bond funds contributed to diversification of the government bond market's investor base just as the Japanese government was beginning to issue a large volume of government bonds. Medium-term government bond funds became popular with individual investors because they were safe, low-risk instruments that enabled small-lot investments in fixed income securities and most often provided higher yields than bank deposits.

After the bursting of Japan's economic bubble, from 1996 the Japanese government implemented a series of reforms of the nation's securities market that came to be known as Japan's financial-sector big bang. Following these reforms, many overseas asset management companies and investment funds entered the Japan market, leading to even greater diversification of market participants. Then, in 2001 the government led by Prime Minister Junichiro Koizumi, under the slogan of "From Deposits to Investments," adopted various measures to promote investment in Japan, including temporarily lowering the income tax rate on dividends and capital gains from 20% to 10% from 2003 to 2013.

Since the end of 2012, the Abe government has implemented a series of monetary and fiscal measures that have been labeled "Abenomics". In addition, Japan introduced Nippon Individual Savings Accounts (NISA), a system of tax-free accounts used for small-lot investments by individuals, in 2014 and approved reforms to the defined contribution pension system in 2016. These ongoing reforms indicate that making greater use of individuals' financial assets and promoting the supply of risk money to corporations and industries remains a high priority in Japan's economic policy. While stock prices and economic growth in Japan might lead one to doubt the efficacy of these government policies, they have undoubtedly played a major role in securing Japan's position as Asia's largest stock market and promoting the accumulation of individual financial assets. We think Japan's efforts provide a useful reference point for the future development of capital markets in Asian countries.

Lastly, I would like to emphasize that, from the perspectives noted below, securities companies and investment banks have a major role to play in advancing the development of Asia's capital markets. The first is to support investment decision-making and facilitate investment action by distributing information to institutional and individual investors about economic trends and changes in corporate value through research analysts and financial advisors. This function will have the effect of correcting distortions and inefficiencies in the economic resource allocation. It also means that securities companies and investment banks should provide financial and investment education to individual investors through consulting services provided by competent advisors. Second, while using market mechanisms to aid in capital formation, securities and investment banks can make proposals that add to the value of existing businesses and assets, including the restructuring of mature companies and industrial sectors and the securitization of illiquid real estate assets. When the Japanese government has sought to privatize and list companies that have long enjoyed monopolies protected by government regulations—such as NTT and Japan Post—Japan's securities companies and investment banks have played crucial roles in that process. They therefore have accumulated the experience that could prove useful when Asian countries decide to implement similar policies.

The investment banking business model of advanced countries includes many aspects that should be carefully reconsidered and improved, such as the excessive leveraging and risk-taking that eventually gave rise to huge social costs. Nonetheless, it is safe to say that the functions that capital markets and securities companies are meant to perform will be important to economies, like those in Asian countries, that are shifting from a steady, high growth phase to a more moderate, stable growth trajectory.

YUTA SEKI

Managing Director, Nomura Institute of Capital Markets Research

Yuta Seki is Managing Director and Head of Research at Nomura Institute of Capital Markets Research (NICMR). He has held his current position since April 2011. He is the author of various research articles and books, and serves as advisor or guest speaker for government committees and industry group advisory panels. He joined Nomura Research Institute (NRI) in 1990. In April 2004 with the establishment of NICMR, he was appointed Chief Representative of NICMR's New York office. During seven years stationed in the U.S., he conducted research on the U.S. financial industry and capital markets, including issues related to the global financial crisis and policy responses.

He graduated from the Law Faculty of Keio University in 1990 and earned an MBA from Marshall School of Business at the University of Southern California in 1999.