Yuba Raj Khatiwada: Development of regional capital markets in Asia – issues and challenges

Speech by Dr Yuba Raj Khatiwada, Governor of the Central Bank of Nepal and Chairman of the SEACEN Board of Governors, at the 50th SEACEN Governors' Conference, Port Moresby, Papua New Guinea, 20 November 2014.

* * *

1. Asia is the fastest growing economic region of the world and the engine of global economic growth. But its growth is still dependent on (i) external demand from advanced economies and (ii) external capital and direct investment. The region has the highest saving rate and keeps on funding the fiscal deficits of many economies of the advanced world. At the same time, the region lacks sufficient long term fund for promoting investment for high economic growth. Sustaining high economic growth in the Asian region requires huge investment in both public and private sectors. Big infrastructure projects are likely to demand high amount of capital even above the capacity of domestic market; and resorting to international market for the same is not always practical. This is where the development of regional capital markets in Asia is called for.

2. A regional capital market implies that there are no barriers to the movement of capital and the provision of investment services within a geographic region. This implies that domestic savers find suitable instruments for saving in the region and investors/issuers can invest or raise capital in other countries along with domestic markets, all knowing that they will encounter broadly similar regulations, information, trading systems, settlement systems, accounting standards and governance standards throughout the region. While development of regional capital market is necessary to promote investment and economic growth in Asia, it is also instrumental to strengthen domestic capital markets and provide liquidity, scale, and capacity and ultimately put Asia in the position to integrate with global market. However, the development of capital markets in Asia has not kept pace to that of economic growth in the region relative to other regions of the world. This has led to the Asian investors' continued dependence on the markets of advanced economies for mobilizing long term capital.

3. Developing a regional capital market leads to the convergence of risk adjusted returns on financial assets of similar maturity across the region. Further, it helps the deepening of domestic capital markets, increases competition, and widens the range of instruments available for savings and investments. These changes, in turn, lead to more efficiency and innovation in the provision of services to savers, investors, and issuers. More innovation in such financial services extends the range of products to attract a wider range of participants, leading to greater financial inclusion, which is a big policy challenge at the current state of financial development.

4. There are substantial benefits to be derived from regional integration of capital markets. A regional capital market brings greater portfolio and risk diversification by providing domestic individual and institutional investors and savers a wider range of investment opportunities. As savers can diversify risk by choosing varied instruments, investors can have an optional mix of debt and equity. Besides, retail investors will benefit as costs are reduced and innovative providers compete for their business. Cross border collective investment schemes will be able to reach a wider investor base, leading to economies of scale. Increased competition will bring innovations and ensure that investment products more closely reflect the needs of retail investors.

5. Individual countries will benefit from more efficient, more liquid, broader, and cheaper capital markets. Easier, cheaper capital raisings encourage companies to raise money for investment through public issues. More public issuances reduce reliance on bank borrowing. More equity issuance develops corporate profiles so companies can further diversify their issuance. Overall, integrated capital market means better allocation of capital, enhanced portfolio diversification, more efficient sharing of risks and lower cost of capital.

6. A regional capital market also brings some substantial risks, which should not be ignored. With market integration, institutions and individuals invest in new markets and instruments across different countries. This increases the possibility of faster and multiple contagion of systemic risk. As evidenced in the Asian financial crisis of 1997 and global financial crisis of 2008, in an integrated regional capital market, shocks arising in any one economy could easily and quickly transmit to other economy. Capital market integration can lead to crises even in countries with sound fundamentals and even in the absence of imperfections in their capital markets. If a country becomes dependent on foreign capital, sudden shifts in foreign capital flows can create financing difficulties and economic downturns.

7. The development of the regional capital markets- both debt and equity- is contingent upon many factors. The depth of debt market is determined by the presence and level of transaction of convertible currency denominated long term loans and bonds market while the level of equity market is determined by the nature and volume of issues and secondary markets in convertible equity instruments. While low level of Asian financial market development is contingent on foreign exchange regulations, the low regional market integration is reflected in poor cross border presence of banks and financial institutions.

8. Along with infrastructure development and investment banks, cross border presence of commercial banks is also instrumental in the deepening of the regional capital market. Cross border banking is, of course, determined by trade and investment flows. Trade and foreign direct investment (FDI) in Asia – both intra-regional and international – is growing by more than 10 per cent, almost twice the growth in G-7 countries. But the growth of financial integration is still limited with home country banking business being more than three fourth of their services. Given the intra-regional trade flow, trade finance implies greater transaction banking opportunity, but the financial institutions have yet to grab the opportunity. As such, cross border presence and transactions of banks depends upon the size of capital and volume of transaction. Further, regulatory and supervisory issues along with growing compliance requirement on anti-money laundering, know your customer (KYC) and level of home and host authority coordination are important determinants of cross border banking presence particularly when it is the case for branch banking.

9. Asian region is the highest saver in the world and thus a potential source of capital market development from the supply side. The volume and growth of sovereign wealth funds in the public sector, provident and pension funds, insurance and corporate profit allocation funds, and high savings at the household level indicate that there is flush of funds available in the Asian market for investment in long term instruments –both debt and equity related. In the demand side, Asia requires huge investment in infrastructure projects to attain and sustain high economic growth. Such infrastructure projects suffer from both equity and debt financing challenges. Equity financing is linked to risk taking by the savers who want to invest while debt financing related to the limitations of banks and financial institutions to invest for long term. The banks which are flush with funds also often are reluctant to perform their term transformation role – converting short term savings into long term loans. Cross border financing becomes even more difficult by the restrictions on capital account transactions; and this is the reason why domestic banks are sometimes

flush with investible fund while at the same time local projects are looking for long term debt financing services. As such banks are worried about two aspects in financial dealings: (i) currency mismatch in transaction and (ii) maturity mismatch in their balance sheets – short term deposits versus long term loans. Addressing the first issue is related to currency convertibility in cross border transactions while the second is related to regulatory and macroprudential norms along with the risk taking capacities of the banks. Policy makers thinking about developing a stronger Asian regional capital market will have to assess this situation in depth.

10. Various potential barriers, which may be related to regulations, taxation, or monopoly, pose serious challenges towards the capital market integration. Regulatory barriers like exchange controls and restriction on foreign listings restrict the movement of capital towards its efficient use. Taxation barriers alter the economic comparison between different activities or participants leading to narrower markets and higher costs. Monopolistic structures like limitations on the total number of stock exchange members prevent access to particular parts of the market, reduce competition, and increase costs for all users.

11. Also important are fairness barriers and information barriers. Fairness barrier such as explicit discrimination against foreigners or a perception that such discrimination exists deter them from entering the market. Likewise information barriers could exist when there are significant differences in accounting standards or disclosure requirements, and lack of transparency of trading, which prevent nonlocals from seeing the state of the market. A multidimensional approach with strong regional cooperation is required to overcome such potential barriers and move towards the regional integration. Efforts should be directed towards harmonizing rules and practices by addressing major differences in laws, regulations, and tax treatments that prevent investors from building regional portfolios. Emphasis should be given to convergence with globally accepted standards and best practices, which will also facilitate easier global integration later.

12. A major challenge faced by Asian nations towards developing a regional capital market is the building of necessary market infrastructures. Establishing links between national clearing and payment systems, creation of regional credit rating agencies and benchmarks should be emphasized to enhance the depth and liquidity of capital markets.

13. One more challenge to the Asian capital market is the limitation of bond market. Currently, more than 80 per cent of the Asian bond market is contributed by government bonds. Corporate bonds issues are still limited and companies are often inclined to bank loan financing than resorting to the issuance of bonds. In future course of time, government bond market is expected to saturate for the reason that (i) public debts are on the rise and such debt levels do not allow governments to incur high deficits and issue bonds to finance the deficit, and (ii) the past fiscal profligacy and subsequent macroeconomic imbalances of some of the Asian countries have taught strong lessons on not incurring high fiscal deficits. Therefore, if the development of the Asian capital market in terms of bonds is concerned, there is a need to look into the corporate bonds market and that also at the cross border level. Again the provisions of currency convertibility in the capital accounts would be instrumental in this regard.

14. So far as equity markets are concerned, many larger economies of this Asian region have already been able to raise capital from the international market. Further liberalization of the foreign exchange regime and developing a regional market for the same would be instrumental to see that such capital could be mobilized at the regional level.

15. While developing the regional capital market, the Asian region would help global financial stability in three ways: (i) by promoting economic growth in the region to support the financial sector growth and eventually avoiding financial crisis as in the recent past, (ii) by retaining the savings of the region within the same region and avoiding a big vulnerability related to global capital outflows, inflows and their reversals, and (iii) by reducing the load of excess financial flows to the European and American markets and preventing the banks and financial institutions in these economies from over-leveraging with the availability of easy funds.

16. Overall, development of regional capital market in Asia has remained slow compared with the pace of economic growth. This is also because of the limited cross border presence of banks and financial institutions. As such, banks which also play a critical role in capital market development in terms of their equity trade and long term credit flows have limited cross border presence. Financial integration and the cross-border equity investment within the Asian region have grown only at a modest degree and domestic bond markets have grown considerably in some countries are dominated by government bonds. Improved macroeconomic conditions, proper credit ratings, stable exchange rates, and gradual capital account liberalization have all helped to attract foreign capital into the Asian region's domestic bond markets. However, as there are limited secondary market opportunities for the bonds, investment on bonds has been a distraction from liquidity management perspective. On the other hand, as volatile global market conditions can lead to sudden withdrawals of capital during periods of heightened global uncertainty or financial stress as witnessed in 2008 onwards, the region's policymakers require having at their disposal a broad array of policy instruments for maintaining financial stability, both at the domestic and regional levels.

17. As the global financial crisis of 2008 has shown, greater the financial integration – greater is the risk of cross-border contagion of financial distress. A strong framework for prudential regulation and supervision is thus necessary to ensure that risks arising from integration are being assessed and managed well. Move towards risk-based supervision, and changes in prudential regulation and supervisory oversight to address cross-border activities would be important steps in this regard.

18. For successful integration, economic fundamentals need to be and remain strong. Local markets need to be properly regulated and supervised. If market fundamentals deteriorate, speculative attacks will occur with capital outflows generated by both domestic and foreign investors. The benefits of integration would not be equally spread among the countries of the region. Opportunities and challenges exist for all types countries. It is likely that the more innovative and efficient countries will be most successful in the new environment. The likely impacts, both beneficial and less beneficial, will affect different countries in different ways.

19. Finally, talking about regional capital market, the presence of regional financial institutions is a must. The recent initiative for the establishment of Asian Infrastructure Investment Bank is a welcome step in this regard. Equally important will be the initiatives for higher level of capital account convertibility of the currencies of the larger economies. Besides, further financial liberalization and arrangements for cross border oversight and supervisory functions will be equally important. Harmonization of the regulations regarding AML/CFT, KYC, taxation, use of IT system, and statistical reporting are some other prerequisites for the development of an integrated regional capital market. We, the South East Asian Central Bank (SEACEN) Governors, can collectively take up such initiatives through the platform of SEACEN. Let us work together towards the evolution of the regional financial market that caters the financing need of Asia's vibrant economic growth.

Thank You.