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Toward Common Financial Capital Market in East Asia


Shigehito Inukai

Director of Policy Studies and Senior
Fellow, NIRA

I am Shigehito Inukai, Senior Fellow of the National Institute for Research Advancement, Japan.

It is a great honor for me to have this opportunity to speak today at the China Economic Summit 2005. I would like to thank the sponsors of the Summit and everyone involved in its organization for giving me this opportunity.

Today I would like to offer a brief outline of issues involved in the future establishment of a common East Asian bond market as a venue for companies in East Asian countries, including China and Japan, to issue securities and for regional investors to conduct securities transactions.



The most important task for East Asia's sustainable socioeconomic growth is....

**Enhancing International
Competitiveness**
of East Asian economies and the whole regional market.

Is it proper Japan cares only about itself?

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For some time now there has been a great deal of discussion in Japan on the subject of the nation's revival. However, this discussion has generally been conducted without any awareness of the relationship between Japan's revival and development in East Asia.

In an era of increasing globalization, however, it seems unlikely that Japan could achieve revival independently of other nations. The nations of East Asia have become increasingly interdependent, and the issues of mutual cooperation in an East Asian community and the enhancement of the international competitiveness of the region's markets are now more important than ever.



1. Deeper Interdependency between East Asia and Japan

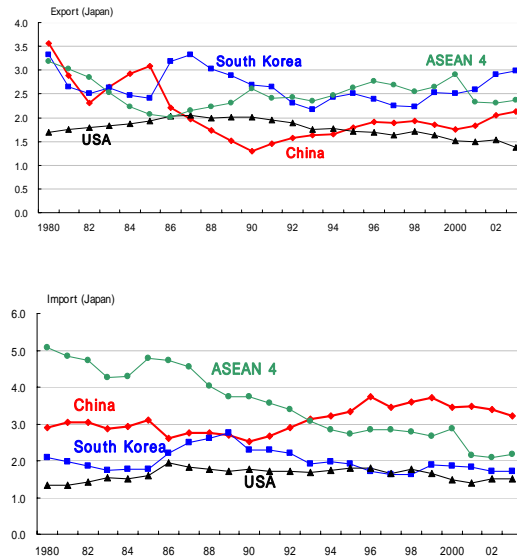
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To begin, I would like to provide some examples of the interdependence of East Asia and Japan.

Japan's Trade Intensity Index

Intensity index greater than 1 indicates relatively strong bilateral trade ties. For example, Japan's exports to ASEAN 4, South Korea and China, China's export to Japan, and South Korea's export to China have the intensity index exceeding 2. This fact indicates very strong trade ties.

Source: NIRA Challenge Book, "Progress in Direct Foreign Investments among Japan, China and South Korea"



1. South Korea
2. ASEAN 4
3. China
(2000: 1.76)
(2001: 1.84)
(2002: 2.06)
(2003: 2.13)
4. USA

1. China
2. ASEAN 4
3. South Korea
4. USA

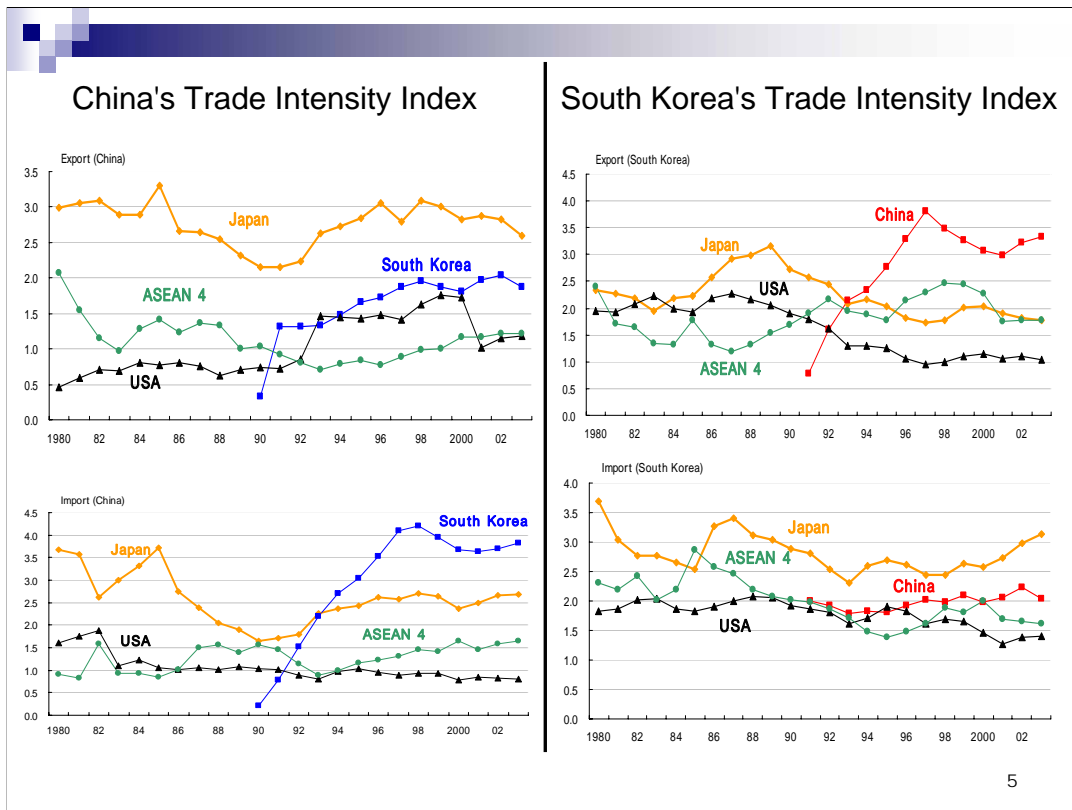
The graphs represent the data up until 2003.

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Figure 1 shows Japan's degree of trade intensity with a number of nations and groups of nations.

The bilateral export intensity index is found by adjusting a country's export ratio by means of the relative importance of its exports to the total imports of another country. When the figure is greater than 1, it indicates that the two nations have a comparatively strong export relationship; when the figure is greater than 2, it indicates an extremely strong export relationship.

In the case of Japan, the index is highest for South Korea. The next highest index is for exports to the ASEAN 4 nations, followed by China, with which Japan has rapidly established a strong export relationship in recent years. The US is ranked fourth in terms of this index. Looking at imports, the highest index is shown for China, followed by the ASEAN 4 nations, South Korea and the US.



China's bilateral export intensity index is highest for Japan, followed by South Korea and the ASEAN 4 nations. With regard to imports, the importance of South Korea has increased. It is clear that a strongly interdependent relationship exists between China, South Korea and Japan.

South Korea's export intensity with China has increased significantly, and its import intensity with Japan is high. Korea's top three partners for both imports and exports are East Asian nations: China, Japan and the ASEAN 4 nations. This demonstrates that there is a high degree of trade intensity among the nations of the region.

[Export/Import Intensity Index]

The index represents how much the two economies have strong trade ties.

Export percentage is adjusted with importing economy's total imports.

X: export; X_i : export of economy i, X_{ij} : export of economy i to economy j;

M: import; M_i : import of economy i; M_{ij} : import of economy i from economy j;

X_w : total exports in the world; and M_w : total imports in the world.

Export intensity index:

$$IEX_{ij} = \frac{X_{ij}/X_i}{M_j/M_w - M_i}$$

Import intensity index:

$$IIM_{ij} = \frac{M_{ij}/M_i}{X_j/X_w - X_i}$$

[Data source]

IMF, Direction of Trade Statistics (from around 1990 to the latest available year)

Taiwan's data come from its domestic statistics and ADB documents.

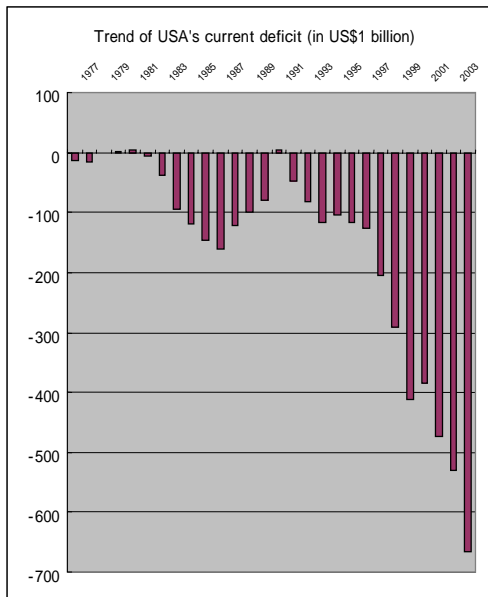
Export intensity index between Japan and China (as of 2003, \$1 million)

$(57480/473911) / (412836 / (7630000 - 383025)) = 12.129\% / 5.697\% = 2.129$

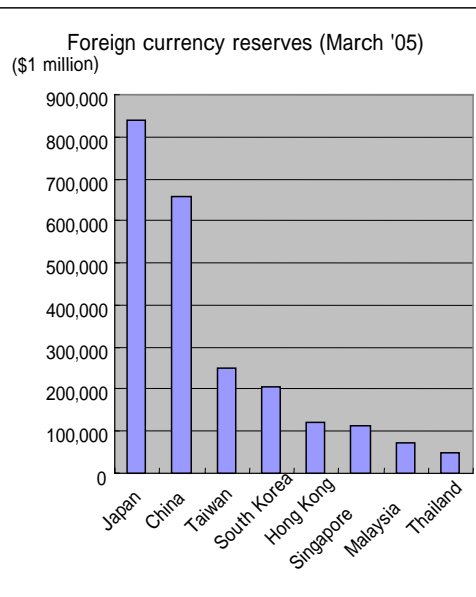
Japan's exports to China	57,480
Japan's total exports	473,911
China's total imports	412,836
Total imports in the world	7,630,000
Japan's total imports	383,025

How Long will USA's Current Deficits Keep Going?

As USA has been suffering massive current deficits, many analysts are raising questions with sustainability of financing capabilities.



(Source) US Department of Commerce, "Balance of Payments"; and Office of Management and Budget (OMB), "The Budget Message of the President (FY2005)"



<http://www.imf.org/external/np/sta/ir/colist.htm>

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The current account deficit of the U.S. has increased sharply since 2000, reaching 666 billion dollars in 2004.

More than half of the figure of over one trillion dollars in US government bonds held overseas is held in Japan, China and other East Asian nations.

As of March 31, 2005, Japan held 837.7 billion US dollars in foreign currency reserves; China took second place, with 659.1 billion dollars, Taiwan third with 251.1 billion dollars and South Korea fourth, with 205.4 billion dollars. Adding in the 122.4 billion dollars held in Hong Kong, the 112.9 billion dollars held by Singapore and the 72 billion dollars held by Malaysia gives a total of more than \$2.3 trillion dollars – that is, more than two thirds of the world's total foreign currency reserves – held by East Asian countries.

In recent years, a high percentage of the US current account deficit has been supplemented by savings held in Asian nations.

Funds accumulated in Asia flow into the US via intermediaries and a large proportion of these funds return to Asia in the form of US investment.

Intermediation of this flow of funds is largely handled by financial institutions and settlement systems outside the Asian region. This situation might lead to a hollowing-out of financial intermediation functions in East Asia.



2. Bond Capital Markets in Japan and East Asia

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Next, I would like to provide an overview of bond markets in East Asia.

Are East Asian bond markets gigantic? Otherwise, are they fragmented markets?

East Asia's Debt Securities Outstanding as a Percentage to World Total (in 2003, US\$1 billion)

	Corporate bonds	Financial institution bonds	Government / public bonds	Total domestic outstanding	Overseas/offshore outstanding
World total	5,103.8	16,113.6	19,189.2	40,406.6	11,102.5
USA	2,497.9	1,010.8	5,022.0	8,530.7	3,011.8
Japan	770.0	1,224.9	6,150.1	8,145.0	255.2
East Asia (including Japan)	1,037.2	1,696.1	6,718.3	9,451.6	461.8
East Asia as a percentage to the world total	20.3%	10.5%	35.0%	23.4%	4.2%

Source: Data except for Taiwan come from BIS Quarterly Review, June 2004.

Taiwan's data are cited from the following sources:

<http://www.tse.com.tw/docs/introduce/factbookF.htm>

<http://www.tse.com.tw/plan/factbook/2004/pdf/068.pdf>

Data on debt securities outstanding come from Central Bank of China's data

(http://www.cbc.gov.tw/economic/statistics/total_index.asp, direct finance - indirect finance).

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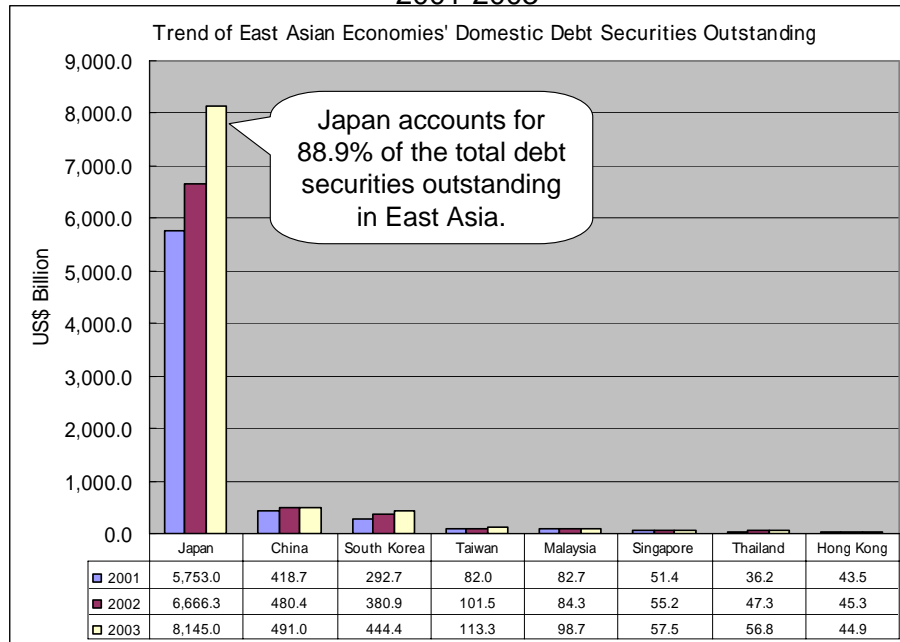
The total value of East Asian bond markets is approximately \$ 10 trillion, comprising one-quarter of the total value of world bond markets.

This figure makes East Asian bond markets collectively a close rival of US bond markets in terms of scale.

East Asia's bond markets are presently isolated in their respective countries, but we should not allow this situation to continue.

It is essential that we establish a common market to facilitate the efficient circulation and effective distribution of the long-term capital accumulated in East Asia.

Trend of East Asian Economies' Domestic Debt Securities Outstanding, 2001-2003



Source: Bank for International Settlements, Central Bank of Taiwan, etc.

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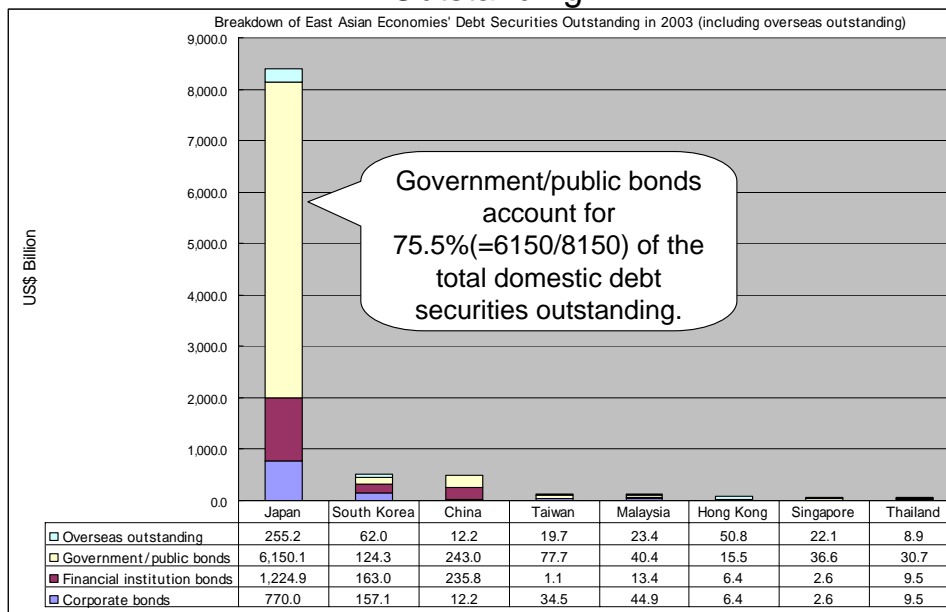
Japan has the largest bond market in the region. It is continuing to grow in scale, and has reached the 8 trillion dollar mark.

Structural reforms of both government finance and the public sector will be essential to Japan's ability to maintain financial sustainability.

The second largest bond markets in the region are those of China and South Korea, significantly smaller than the Japanese market at \$ 4000-5000 billion (equivalent to 50-60 trillion yen). The Malaysian and Thai markets are smaller again.

Dr. Mahathir, former Prime Minister of Malaysia, and Thailand's Prime Minister Thaksin have both recently advocated the establishment of an Asian bond market. I believe that this is a proposal of tremendous importance and significance from the perspective of the region as a whole.

Breakdown of East Asian Economies' Debt Securities Outstanding



Source: Bank for International Settlements, Central Bank of Taiwan, etc.

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This figure shows a breakdown of the outstanding issue balance in the bond markets of East Asian nations.

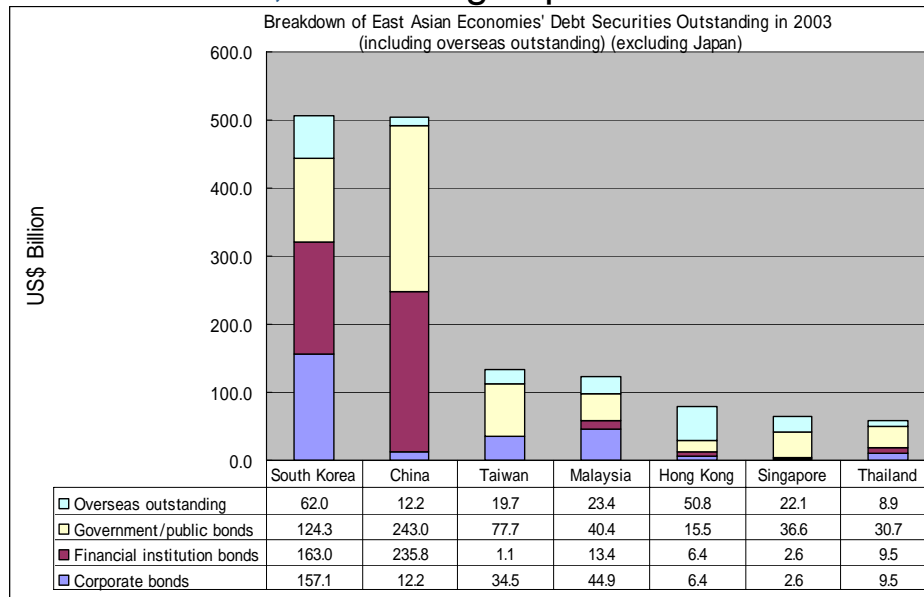
Although Japan has by far the largest outstanding issue balance, almost 80% is constituted by government and public bonds. The remaining ratio, a little over 20%, is made up of private sector bonds including financial and corporate bonds.

The size of the domestic bond markets of nations other than Japan is relatively small, but this certainly does not mean that these markets are being neglected.

In fact, all nations are aware of the importance of accumulating a certain amount of bonds issued by superior domestic companies, which are the companies in which pension funds can be invested.

The countries of East Asia have endeavored to foster their domestic markets on the basis of a medium- to long-term perspective, and have worked to establish market infrastructure, including settlement systems and relevant laws and regulations.

Total Domestic Debt Securities Outstanding at End of 2003, excluding Japan



Source: Bank for International Settlements, Central Bank of Taiwan, etc.

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This figure shows a breakdown of debt securities outstanding in East Asian nations other than Japan categorized into corporate bonds, financial institution bonds, government and public bonds, and bonds issued overseas by residents of the nations.

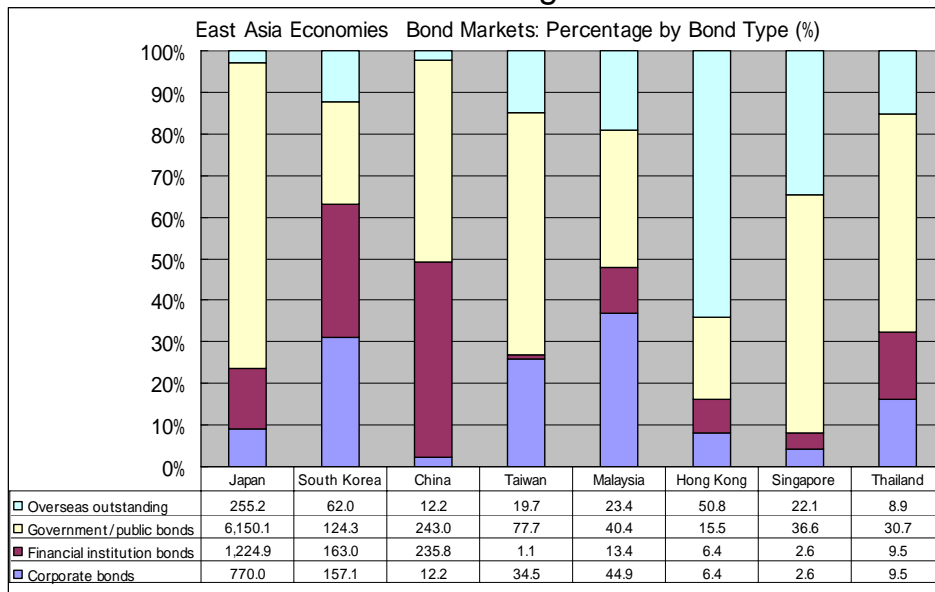
The bond market in South Korea is well-balanced among corporate bonds, financial institution bonds and government bonds and maintains a fixed size. South Korea is making tremendous efforts to develop and improve systems relevant to its domestic financial and capital markets.

The Chinese bond market is almost the same size as South Korea's in terms of transaction value. However, most bonds are issued by public organizations; the corporate bond market is expected to develop in the future.

In the case of Taiwan, in addition to listed government bonds and convertible bonds, there is considerable depth in the market for corporate bonds that are traded OTC.

In Malaysia, the nation's Securities Commission played a central role in the establishment of the Capital Market Masterplan to upgrade the level of the domestic capital market and market infrastructure.

Corporate Bonds as a Percentage to Total Domestic Debt Securities Outstanding in East Asia




Corporate bonds, financial institution bonds, government/public bonds and overseas debt outstanding as a percentage to the entire domestic bond market

Source: Bank for International Settlements, Central Bank of Taiwan, etc.

Outstanding basis, as of the end of 2003) 13

Looking at the percentage of corporate bonds in each nation's domestic bond markets, we see that figures are relatively high in Malaysia, South Korea, Hong Kong, and Taiwan.

Considering the size of the nations' domestic economies and the fact that all of them commenced with indirect financial systems centering on banks, it could be said that from the Asian Currency Crisis in 1997 up to the present private sector bonds, including corporate bonds, have made a valiant effort.



3. Establishing East Asian Financial Capital Market toward Building up Intraregional Common Market in 21st Century

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Since the Asian Currency Crisis in 1997, East Asian nations, in particular Thailand and South Korea, have made a variety of efforts to ensure that there will be no repeat of the situation.

This includes the Chiang Mai Initiative, a mutual aid network for crises, on which the ASEAN nations, Japan, China, and South Korea reached agreement in 2000.

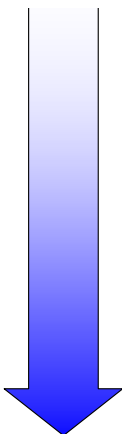
It has been pointed out that one of the causes of the Asian Currency Crisis was the fact that there was no infrastructure enabling the abundant savings of Asian nations to be circulated within the region.

From this perspective on the issues, an idea was born. To prevent a reoccurrence of the crisis it would be necessary to establish comprehensive, shared, Asian bond and financial markets in which Asian funds can be invested within the region on a long-term basis.

Establishing Common Financial Capital Market in East Asia

1997: **Asia currency crisis**

Movements toward establishing Asian bond/financial capital market



Japan plays an important role in evolving Asian bond/financial capital market

- Japan should reform its financial capital market capabilities so that Japan will be able to play a leading role in East Asian international financial markets.
- It is important to foster intraregional financial capital market as a common infrastructure and put more emphasis on improving market infrastructures.
- Through these efforts, financial institutions in East Asia must improve their financial service capabilities and profit-earning capacity, and economically contribute to the East Asia region.

Stable growth and stronger competitiveness of East Asian economies

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This concept of an Asian bond market is the first to propose the promotion of development in Asia through the circulation and reinvestment within the region of the funds accumulated in the region.

To the present, this concept has been promoted by financial authorities, central banks, and politicians in the nations concerned. Cooperation among market practitioners, financial institutions, researchers, and policymakers will be important in the future.

Given the importance of the Japanese market, market participants, including Japanese companies and institutional investors, should take the initiative in reforming the domestic financial and capital markets as the core of an East Asian financial and capital market.

Efforts to enhance Asian bond markets will be insufficient by themselves. It will also be necessary to foster financial and capital markets within the region as a common, integrated regional market infrastructure and to establish a variety of systemic foundations.

In this way, financial institutions within the region should be able to improve their ability to provide financial services and intermediation, thus increasing their profitability and the contribution they make to the East Asian economy.

This will promote the stable growth of the East Asian regional economy and enhance its competitiveness.

Setting up Financial Capital Market Principles/Rules Commonly Applicable to Entire East Asian Region

- Trade and finance are like two sides of the same coin.
- Sharing common principles to strengthen regional competitiveness
- Building up capabilities and integrity of intraregional common financial capital market
- It is necessary to innovate market soft infrastructures, such as legislation framework that will support regional financial capital markets.
(Market linkage, common securities settlement scheme, and single legal framework)
- Setting up common market governance principles "Asian Standards" suitable for East Asia

Drafting appropriate grand design and action plan on new market infrastructures

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FTAs control the movement of goods, but finance and the movement of goods are two sides of the same coin. In other words, unless both develop simultaneously, the competitiveness of East Asia as a whole will not increase.

As in the EU, it will be necessary for the relevant parties in East Asia to share principles which stress cooperation in enhancing the competitiveness of the common market within the region.

Determining how to increase the efficiency and enhance the functions of the region's markets, in addition to how to regain trust and increase market integrity, will be tasks for the future.

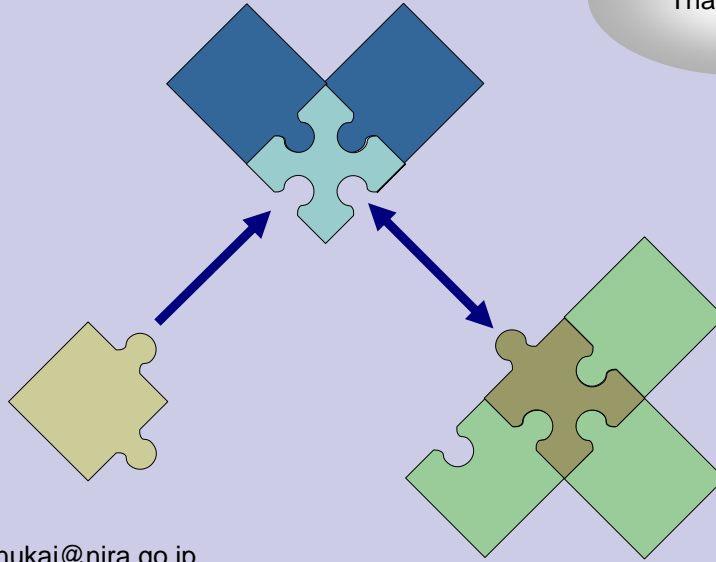
To this end, it will be necessary to establish soft infrastructure, including shared systems of laws and regulations, to support regional financial and capital markets. That is, it will be important to strengthen cooperation between domestic financial and capital markets in each of the region's nations, to establish a common regional infrastructure for the securities transfer and settlement systems in each nation and to determine, and share, common principles for financial and capital market regulatory systems.

This will lead to the establishment of common market governance principles that are appropriate to East Asia and which can truly be called an Asian standard.

<http://www.nira.go.jp/newsj/kanren/130/135/mgtindex.html>

<http://www.nira.go.jp/newsj/wp/300/302/2004-4.pdf>

Thank You!



sinukai@nira.go.jp

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From this year, NIRA intends to conduct research on the creation of a grand design for new market infrastructure and an action plan, looking towards the establishment of rules and principles for common East Asian financial and capital markets.