



DOMESTIC RESOURCE MOBILIZATION

TRENDS IN SAVINGS AND INVESTMENT

The largest share of financing for development has to originate from domestic resources. This is an inescapable necessity. Official development assistance has been declining. The tremendous increase in international private capital flows has bypassed the overwhelming majority of developing countries and a significant part of such flows is highly volatile, responding to the vagaries of unpredictable market sentiment. Data on savings and investment in the ESCAP region since 1985 show that overall the ratio of savings to GDP has been on a slight upward trend from around 21 per cent in 1985 to 29 per cent in 1999. This is a very positive sign for the region. However, when the overall picture is disaggregated, it is clear that this relatively high level of the overall savings rate is mainly accounted for by the high-growth countries in East Asia and South-East Asia. Four ASEAN members (Indonesia, Malaysia, Singapore and Thailand) as well as China; Hong Kong, China; and the Republic of Korea have all had savings rates greater than 30 per cent since 1990 (except Indonesia in the last three years). Savings rates in South and South-West Asia and the new members of ASEAN have historically been and remain, with a few exceptions, below 20 per cent. Most of the Central Asian republics also have quite low savings rates, two (Armenia and Kyrgyzstan) even having negative rates.

The contribution of government savings to overall savings has been small, or even negative, in most countries in the region. Indeed, the figures prepared by countries are probably overestimates as account has not been taken of off-budget expenditures and non-transparent subsidies. Thus, it is the private sector (households and enterprises) which generates most of the savings and stores them in monetary form for intermediation to investment. However, as government savings is a net concept, it is the level of resources raised by the government

relative to its level of recurrent expenditure which actually determines its capacity to undertake investment.

For the ESCAP region as a whole there is a relatively close correspondence between the savings rate and the investment rate. This implies that the region is generating almost enough resources itself for its development purposes. However, this is not true across subregions or countries. All South and South-West Asian countries, except the Islamic Republic of Iran, have had investment rates higher than their savings rates, implying a significant inflow of external resources. Much of this has come in the form of ODA, rather than FDI. This is also true overall for many of the Central Asian republics in recent years, where the domestic savings rate is about one half of the investment rate. (As exceptions, the Russian Federation has an increasing excess of savings over investment, whereas in Kazakhstan and Uzbekistan, the two have been almost in balance.) In South-East Asia and the Republic of Korea there has generally been a close balance between the savings and investment rates, except in the heydays of high growth in the early 1990s when FDI and other private flows surged in, and in the aftermath of the recent crisis when savings considerably exceeded investment. In most of these countries, except Indonesia, savings rates have been more or less maintained whereas investment rates have fallen considerably. Among these countries Singapore appears similar to China and Hong Kong, China where the savings rate has usually been larger than the investment rate and there has been a net outflow of funds.

THE DETERMINANTS OF PRIVATE SAVINGS

Analyses of the determinants of savings have been undertaken by economists over many decades with no conclusive result. The factors which motivate households or enterprises to save are many, complex and often interrelated. Most analyses

conclude that the most important factors are those related to economic growth (lagged savings, level of per capita income and growth rates of real per capita income), demographic structures and changes therein, as well as the degree of financial sector development. The results of one recent global study provided in table V.1 strongly support similar conclusions.

The capacity of a household to hold savings voluntarily in monetary terms depends mainly on the level and growth of personal income and its sustainability. Households also often keep their savings in non-monetary forms, such as gold bars, jewellery, land and buildings, livestock or other goods kept in store at the household level. The motivation to save in monetary terms depends crucially on the credibility and convenience of access to savings

Table V.1. The determinants of savings

Determinants	National savings		Private savings	
	Global dataset	Global dataset	Global dataset	Developing countries dataset
Lagged national (private) savings rate	0.381 (6.650)	0.587 (9.254)	0.476 (17.820)	
Real per capita gross national (private) disposable income ^a	0.102 (2.685)	0.049 (2.458)	0.071 (7.473)	
Real growth rate of per capita gross national (private) disposable income ^b	0.447 (4.831)	0.450 (5.828)	0.425 (13.282)	
Real interest rate ^{a,c}	-0.136 (-1.215)	-0.253 (-5.011)	0.002 (0.084)	
M2/GNP	-0.019 (-0.410)	-0.020 (-0.562)	0.024 (1.001)	
Terms of trade ^a	0.057 (5.243)	0.078 (5.096)	0.044 (4.875)	
Urbanization ratio	-0.500 (-3.373)	-0.382 (-3.538)	-0.240 (-5.101)	
Old dependency ratio	-0.772 (-1.687)	-0.655 (-3.069)	-1.370 (-4.321)	
Young dependency ratio	-0.156 (-2.236)	-0.299 (-4.017)	-0.279 (-5.816)	
Domestic credit flow/gross national disposable income	-0.359 (-4.136)			
Government saving/gross private disposable income		-0.285 (-5.097)	-0.238 (-8.333)	
Private credit flow/gross private disposable income		-0.318 (-3.989)	-0.508 (-9.955)	
Inflation rate ^{a,c}	0.180 (2.044)	0.143 (2.034)	0.177 (4.181)	
Number of observations (number of countries)	1 640 (98)	872 (69)	475 (49)	

Source: N. Loayza, K. Schmidt-Hebbel and L. Servén, "What drives private saving across the world?", *The Review of Economics and Statistics*, vol. LXXXII, No. 2 (May 2000), pp. 165-181.

Notes: Statistical significance computed using the generalized-method-of-moments system estimator, *T*-statistics (in brackets) computed with heteroskedasticity-consistent standard errors.

^a Expressed in log form. For the real interest rate and the inflation rate, log of $[1 + x]$.

^b Measured by the first difference of the log.

^c Both the real interest rate and the inflation rate are bounded between -50 and 50 per cent.

institutions. Once the capacity to save exists, savings decisions are influenced by several other factors. High and sustained growth in per capita income tends to increase the savings rate (see, for example, the large coefficient for both the level and the growth rate of per capita income in table V.1). Once savings rates start to increase, they are usually self-sustaining (hence the significance of lagged savings). However, the propensity to save may rise even though the economic growth rate stays the same, depending, inter alia, on the tax structure and government fiscal policies. For example, fiscal stimuli, such as lowering taxes or increasing spending or subsidies, can increase the savings rate. An important consideration in this context is the level and composition of taxes; high personal income taxes tend to discourage household savings. Various cross-country and time-series studies on savings behaviour indicate that growth in real GDP and real deposit rates have positive, and growth in fiscal deficits and foreign and domestic debt have negative, impacts on savings. Expectations of high inflation or an unstable macroeconomic environment or both create uncertainty in the system, especially for future growth. Public policies that reduce economic uncertainties, including keeping the rate of inflation down, thus have a positive impact on savings.

The influence of demographics is significant. It is clear that a transition to a smaller household size (lower fertility rates) can help improve the savings rate. Several cross-country studies show that both the rate of growth of population and the share of population below 15 years of age have a negative relationship with the savings rate.¹ At the same time a growing proportion of the 60 and over appears to have a negative impact. The net effect on per capita savings depends on the initial conditions, such as the share of individual cohorts in the total population and the rate of participation in the labour force. Increasing urbanization is sometimes seen as negatively related to savings owing to the better availability of consumer and other goods in urban areas, but this is of less significance when rural and urban differences are reduced.

¹ For example, evidence from South-East Asia indicates that a reduction in population growth increases the savings rate by reducing the young dependant cohort. See Stefano Manzonchi, *Foreign Capital in Developing Economies: Perspectives from the Theory of Economic Growth* (New York, St. Martin's Press, 1999), pp. 49-51 and 123-125.

The sensitivity of national or private savings to real interest rates is ambiguous in most studies. However, there is some evidence that the significance of the interest rate on savings rises as the income level of a country increases. For the very poor developing countries, the coefficient is rather low and in most of these countries it is not even statistically significant. However, interest sensitivity for middle and upper-income groups is relatively much higher.² This is probably related to the degree of development and use of the financial sector, particularly banks and other savings institutions. It should be noted, however, that any positive relationship between the interest rate and savings can be outweighed by the negative effect of increased consumption expenditure permitted by easier consumer credit and expanded use of credit cards. In fact, as shown in table V.1, there appears to be a significantly negative relationship between flows of credit and savings, particularly in developing countries.

As mentioned earlier, the willingness of the public to save in monetary terms is influenced by the functioning of financial markets.³ For example, as financial repression forces financial institutions to pay low and often negative real interest rates, it can result in a reduction of the amount of household savings held in these institutions, and therefore makes it more difficult to intermediate savings to investment. A high level of NPLs reduces the confidence of potential depositors in the ability of banks to honour their deposits, thus inducing a lower supply of funds to them. A large share of bad loans in the portfolio also induces banks to widen the spread between borrowing and lending interest rates, and so to make the returns on savings accounts less attractive. Accordingly, reform of the financial sector of an economy in terms of improving the functioning of financial institutions and reducing

² Masao Ogaki, Jonathan Ostry and Carmen Reinhart, "Saving behaviour in low- and middle-income developing countries: a comparison", *IMF Working Paper WP/95/3*, 1995, pp. 25-26.

³ The financial sector development comprises liberalization, deepening and broadening. Liberalization implies removal of entry barriers, reduction of directed credit allocation, deregulation of interest rates and removal of controls on inflows and outflows of capital. Financial deepening involves the growth of financial instruments measured by the ratio of turnover in the financial sector to GDP. Financial broadening refers to an increase in the variety of financial institutions and instruments in a country.

NPLs can help significantly in increasing the savings rate. It appears that financial deregulation leads to higher savings mainly in the longer run. While some countries show immediate positive results from such deregulation, in others the negative short-term association which has been observed is attributed to increased consumer spending because of more liberal access to consumer credit.

Corporate savings can be important in the aggregate savings rate of an economy, but they are difficult to estimate. Many firms in Asia, particularly those that are family-owned, save in the form of retained earnings, which are then reinvested in the business. These savings are not recorded in any systematic way. In all countries the majority of firms have used only bank loans as a source of investment finance. This practice has not led to any systematic demand for corporate transparency because of client-related banking practices and so retained earnings are not properly reported. However, firms listed on stock markets or firms that issue bonds have to meet the related reporting requirements on their earnings profiles. These are the firms for which it is possible to report corporate savings. For example, in Taiwan Province of China, it is reported that they account for almost one quarter of the total savings. It is known that fiscal measures can be used to encourage corporate retention; a tax structure that creates incentives to retain profits may result in a higher level of corporate savings.

As the motivations for savings are complex, and not easy to address in a policy format, it seems preferable to concentrate the analysis of domestic resource mobilization on the instruments available to savers for storing their funds and the institutions which hold these funds and intermediate them to investors. If savers have access to a diversified array of instruments in well-regulated, supervised and sound financial institutions in their own country, they will most likely put their cash savings in these instruments. If they face a narrow range of instruments in poorly supervised and financially insecure financial firms, they would prefer to save in non-monetary terms or park their savings abroad. Therefore, the following sections review the instruments and institutions available to savers in the ESCAP region, analyse the problems being faced and the reforms under way, and suggest further actions to widen the range of attractive instruments and strengthen the institutions offering them.

INSTRUMENTS AND INSTITUTIONS

The principal instruments in the ESCAP region to attract private-sector (both households and enterprises) savings have been bank deposits of various sorts. There has been very limited diversification in most developing economies into the holding of stocks, bonds and related financial instruments, and some development of pension and insurance funds as well as postal savings or unit trust systems, provident funds and other institutional forms for holding deposits. In a large- and medium-sized economy there should be a more diverse financial system with not only banks (and equity markets) but also markets for longer-term instruments such as public and private bonds and mortgage markets, as well as institutional investment groups such as pension funds, life insurance and mutual funds and various non-bank financial institutions. There is also a need for some securitization modalities⁴ particularly for infrastructure development and real estate markets. For smaller economies, the banking structure might be better complemented with access to capital markets of larger neighbours or regional capital markets, as domestic ones would be too small, too shallow and too thin to be viable. Nevertheless, the development of a professional and modern banking system remains crucial for all countries.

The sound functioning of a financial system requires both the internal discipline provided by market forces and the external governance provided by regulation and supervision. The regulations that impinge on transactions in financial markets relate to governance arrangements, transparency requirements, financial accounting and auditing rules, debt covenants, and bankruptcy procedures. A well-functioning financial sector is one that has a transparent and efficient overall legal framework and administration, complemented by efficient and independent regulatory and supervisory institutions to reduce excessive risk-taking and moral hazard as well as an effective insolvency regime that properly balances the rights and obligations of debtors and creditors. The system should foster good corporate

⁴ Securitization is a means used by a financial institution to package a group of unrelated loans it has made (such as mortgages) into a security which can be sold to another financial institution and so clear its books of these outstanding debits.

governance, transparency by both financial institutions and enterprises, and high standards of accounting and auditing practices in private and public entities; it should also foster a competitive environment to facilitate efficiency and innovation in financial services, including the encouragement of in-country operations of foreign financial institutions. It is not obvious that these conditions are being met in the majority of ESCAP member countries.

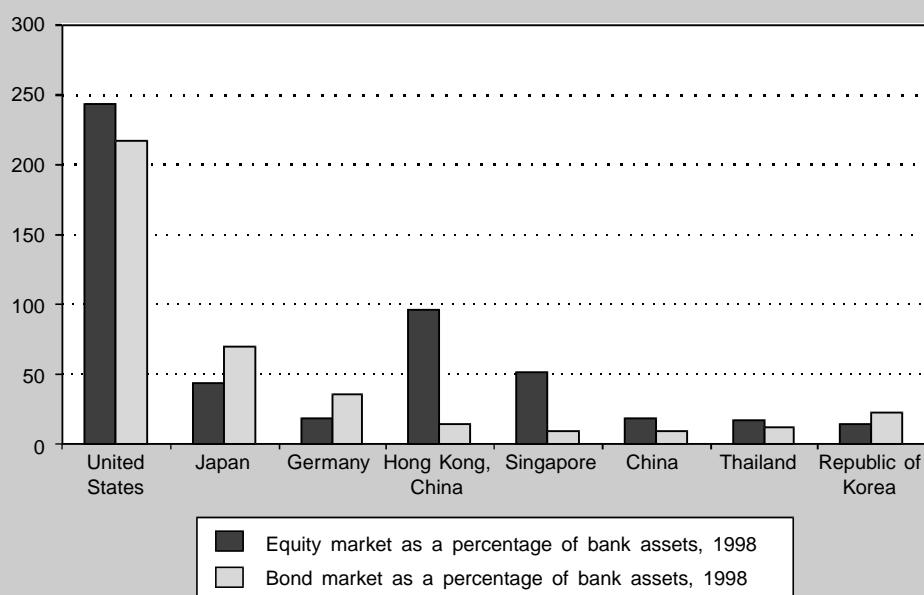
The banking sector

The banking sector continues to dominate as the major savings/investment conduit in all financial markets in the ESCAP region (see figure V.1). Except for Hong Kong, China; and Singapore, equity markets in the more advanced economies are no more than one quarter of the size of the banking sector and the bond markets in all these countries are no more than 10 to 15 per cent, except in the Republic of Korea. In other economies, capital markets are even smaller. Therefore, the health of the banking sector is central to the ability of countries to mobilize their domestic resources for

development. However, it should be noted that heavy reliance on bank financing can lead to a significant mismatch between the maturity structure of assets and liabilities of corporate entities and that of banks. Since a significant number of corporations, both public and private, require funding for long-term investments (such as infrastructure and construction or capital goods projects), a dependence on bank loans, which are short-term by definition, makes the financial viability of these corporations highly susceptible to short-term swings in the economic environment.

The banking sector in the region has undergone considerable change over the last 10 years, and even more so after the recent financial crisis. The sector has been modernized in the use of IT, liberalized in the ownership and deregulated in terms of being less a direct instrument of government economic and investment policy. There have also been regulatory and supervisory reforms and approaches to solving the NPL problems. There has been considerable progress regionwide, but there are still a number of outstanding issues to be tackled. These are described below.

Figure V.1. Diversification of financial markets



Source: Standard & Poor's, *Emerging Stock Markets Factbook 2000* (June 2000).

The structure of the banking sector varies considerably among countries. In some, including Malaysia and Thailand, there is a relatively small number of major banks, mainly private ones; in other countries, such as India and Pakistan, with a relatively small number of banks, the major ones are in the public sector. In yet others, including Indonesia and the Philippines, there is a much larger number of relatively small banks, usually private ones. The reasons for these varying structures are often historical and are directly influenced by the bank licensing policies of the government. Recent post-crisis reforms have included more stringent rules on starting up and operating banks. Thus, in several countries there have been bank closures or mergers leading to a decline in the number of banks. This should increase confidence in the banking sector and leave it with a set of more financially viable banks.

The recent financial crisis in the region exposed considerable operational weaknesses in the banking sectors of countries in East and South-East Asia, including problems with cash-flow management; risk identification and management; maturity management; project evaluation and transparency. While these areas are being addressed, much remains to be done as large segments of the banking industry remain undercapitalized and loan growth is minimal. Without further progress, the domestic mobilization of resources and the capacity of banks and the corporate sector to raise funds for investment of various sorts will remain weak.

The financial sectors of most other Asian and Pacific countries are considerably more underdeveloped and weaker than those of the crisis countries. For instance, South Asian countries are, in general, less financially developed in terms of selected quantitative indicators in comparison to both the crisis economies and to world norms (table V.2). In qualitative terms, a recent study⁵ on the financial markets of selected countries concludes that transparency and bank supervision in a large number of non-crisis countries are not in any better shape than in the crisis countries. Financial weaknesses in these non-crisis countries are due, in part, to distortions arising from the need to finance large government budget deficits (South Asia) or directed

lending to state-owned enterprises (such as in China and Viet Nam). State banks in these countries are usually afforded preferential treatment, often in terms of tax concessions and access to public-sector deposits. This can thwart competition and reduce efficient bank intermediation. The poor quality of bank supervision has also led to NPLs being understated and banks being insufficiently capitalized. Reform and liberalization of the financial systems of these countries is under way, with considerable progress noted in India,⁶ but enforcement of key legislation remains weak in many countries.

As testified by the high level of NPLs prevalent in the banking systems of almost all developing countries in the ESCAP region, most commercial banks have not followed market signals in their lending policies. Instead they have been primarily using relation-based lending practices and have been non-transparent about their financial performance. Thus, there is an urgent need to find ways of inducing banks to move towards data-based lending practices, such as credit scoring. One proposal worth considering is to increase the transparency of operations in both the banking and corporate sectors by putting pressure on the banks to improve their disclosure practices. They, in turn, would then have to demand enhanced disclosure (in terms of quantity, quality and timeliness of reports) from their clients, particularly enterprises, in order to meet their own reporting obligations. Pressure on the banks could be through domestic regulatory agencies and could, in addition, be backed up by good practices recommended by BIS or IMF. This would add weight to the regulatory authority's demands and compliance with it could form part of the BIS or IMF country reports which are available worldwide.

Most banks have used rudimentary credit assessment methodologies, when these have been applied at all. A significant improvement in their credit assessment capabilities is urgently required. The bank regulatory authorities need to verify use of these assessments for the granting of loans and impose appropriate penalties in the event of any breach. While this can be done with concerted in-house training in larger banks, it is difficult and

⁵ ADB, *Rising to the challenge in Asia: a study of financial markets*, vols. 1-12 (Manila, 2000).

⁶ See, for example, the description and analysis of these reforms in Urjit R. Patel, "Outlook for the Indian financial sector", *Economic and Political Weekly*, 4 November 2000.

Table V.2. Size of the financial sector in selected ESCAP economies (average 1998-1999)

	<i>Deposit money banks/GDP (1)</i>	<i>Stock market capitalization/GDP (2)</i>	<i>(1)+(2)</i>
Indonesia	0.36	0.35	0.71
Malaysia	0.99	1.65	2.64
Philippines	0.45	0.59	1.04
Thailand	1.11	0.39	1.50
Republic of Korea	0.76	0.56	1.32
Hong Kong, China	1.66	2.11	3.77
Singapore	1.08	1.12	2.20
Bangladesh	0.30	0.02	0.32
India	0.26	0.33	0.59
Nepal	0.28	0.06	0.34
Pakistan	0.25	0.10	0.35
Sri Lanka	0.24	0.11	0.35
World average	0.43	0.44	0.87
Average of non-Asian developing countries	0.30	0.19	0.49

Sources: World Bank, *World Development Indicators* (Washington DC), various issues; IMF, *International Financial Statistics* CD-ROM, November 2000; and World Bank web site <<http://www.worldbank.org/data/databytopic/GDP.pdf>> (28 November 2000).

expensive for smaller ones. It is necessary to devise some modalities for coping with this problem: BIS standards for data-based credit rating and assessment of risks could be a useful reference. Banks need to reduce their high percentage of NPLs before implementing improved credit assessment methods.

One of the problems facing banks is how to conduct credit assessments of SMEs, which usually have no track record and no proper financial recordkeeping. One initiative which has proved somewhat successful in Hong Kong, China is to establish an independent credit bureau, supported by an adequate legal and institutional framework, whose job it is to check the credit standing of SMEs and other firms not listed on any equity market. Such bureau could provide a useful service for banks until they can undertake such functions themselves or until firms of all sizes develop track records on loans. However, the large number and variety of SMEs make such a proposition very difficult to implement in an economy of any size.

The ownership structure of banks in some of the crisis countries has changed dramatically in the last few years. This has been due to liberalization, allowing the ownership of banks, finance and security firms by foreigners, and the consequent inflow of FDI to buy significant equity stakes in such firms.⁷ There has been a similar but slower liberalization of ownership of banks in the other economies of the region. There are arguments for and against an increase in foreign participation in the banking sector. While foreign competition can increase pressure for consolidation and modernization and for the introduction of new products and services, there can also be a flight to quality as domestic clients

⁷ In Thailand the amount of FDI inflow to the finance sector amounted to \$2.1 billion. Six banks accounting for 20 per cent of the banking sector had majority foreign ownership: Bank of Asia, Thai Dhanu Bank, Radanasin Bank, Nakornthon Bank, Bangkok Metropolitan Bank, Siam City Bank, presentation by Pisit Leeahtam, Deputy Finance Minister of Thailand at the High-level Regional Consultative Meeting on Financing for Development, Jakarta, 2-5 August 2000.

might prefer to deal with banks having foreign participation, leaving domestically owned banks to service less attractive and more risky segments of the market. This could negatively influence the financial viability of the latter institutions.

In many countries the number of finance companies, which had soared in the East Asian and South-East Asian high-growth economies in the early 1990s, has declined substantially and only the more viable firms are left in the market. Nevertheless, the importance of banks in providing commercial lending in the medium to large economies of the region is slowly declining, and capital (stock and bond) markets are of increasing importance as a modality for mobilizing domestic funds. This is partly the result of a deliberate government response, and it is expected over time to increase the stability of the economy through the diversification of modalities to finance investment. In the longer run, banks should assume a less dominant role in the financial structure and learn how to cope with competition from a more diversified set of institutions.

While banks have been the traditional modality for savings and loans for both individuals and enterprises, they have not catered well to the needs of the poor, the remote, the landless, the asset-less, or the dispersed population, nor of SMEs and the informal sector.⁸ In many countries both public and private banks have extended their geographic coverage within national borders over the past decade, thus making bank savings available to a wider proportion of the population. The increased use of information technology in the banking sector, particularly the use of ATMs (automatic teller machines), has assisted this development.⁹ However, there is still a need to expand bank networks, including taking advantage of new technologies for electronic banking, in several countries where such services are mainly urban-based. The unmet demands for service from the disadvantaged groups could then be met through the banks as well as through other means (see the next section).

⁸ For commercial banks, the costs of conducting business in their traditional format with these groups are high because of their lack of any form of recognized collateral and diseconomies associated with small volumes of individual transactions.

⁹ See *Survey 1999*, chap. VII, "Financial flows", pp. 205-209.

In most countries, irrespective of their level of development, there are public-sector specialized banks with a distinct focus on a specific sector, such as agriculture or housing. These banks often have an important role to play in mobilizing savings (and intermediating these into investment) in sectors which are of little or no interest to commercial banks, either private or public. The promotion of these specialized banks needs to be undertaken with care so that they operate as closely as possible on commercial terms and yet are able to service their particular clients. Sometimes they play an important anti-cyclical role in the economy, encouraging savings and making loans when other banks are reluctant to do so. This has been the experience, for example, in Thailand in the last couple of years with the Government Savings Bank and the Bank for Agriculture and Agricultural Cooperatives.

Policy issues

The reform of the banking sector in almost all ESCAP member countries, developed and developing alike, has been an ongoing process over many years. Much has been written about the reforms needed. IMF and the World Bank as well as ADB have been promoting reform packages and governments have taken selected reforms on board. However, much remains to be done if the banking sectors of the developing countries are to be ready and able to face the challenges of continuing to be the main conduit for the mobilization and use of domestic resources for development in an open, competitive and globalized financial system. The reforms required have several components. These include:

- (1) Increasing the **clarity of objectives** for the operation of the central bank and the lines of its reporting (accountability) to the government. Usually the central bank is responsible for the operation of the exchange rate regime and for the money supply and related monetary variables such as inflation. However, the degree of independence that the central bank enjoys in formulating and implementing policies in these two areas varies considerably. It is generally accepted that, given the inherent conflict of interest between the objectives of the central bank to keep inflation low and the exchange rate reasonably stable and those of the government in its fiscal operations, the more independent the central bank, the better

it performs in relation to its objectives. However, there are limits to this independence as it is the government which is ultimately responsible for the development policy of the country.

- (2) Clarifying the division of responsibility between various **supervisory and regulatory agencies** on the supervision and regulation of the banking sector and their relationship with supervision and regulation of other financial firms, some of which are owned at least in part by banks. Several countries have or are considering making the supervisory agencies independent of the central bank to avoid any conflict of interest between the modalities used to achieve macroeconomic policy objectives and those for the effective supervision of banks. However, there may be problems of duplicating information and reporting functions, with each agency wishing to collect its own data, as well as of coordination.
- (3) Implementing the **Core Principles for Effective Banking Supervision** developed by the Basle Committee on Banking Supervision, including a capital adequacy ratio and standards for credit/risk assessment and auditing of banks. The Core Principles are now becoming part of IMF conditionality and training on them is increasingly available from BIS, IMF and the World Bank. Being able to state that banks are supervised according to these standards would certainly increase both domestic and foreign confidence in the soundness of a country's banking sector. However, the capital adequacy ratio was constructed for more mature banking sectors and many developing countries should consider it as a minimum, preferably imposing higher ratios in their own system.
- (4) Demanding an increase in the **levels, quality and timeliness of disclosure** by banks and using BIS or IMF to back up standards of bank reporting and disclosure as discussed earlier.
- (5) Dealing with **NPL problems** in an orderly and definitive manner and implementing a legal process for intervening in, rehabilitating or liquidating banks in financial straits. Recent exchanges of experience among the crisis countries on the treatment of NPLs reveal that the responsible authorities are aware of the need to improve their handling of this problem.

However, the large volume of NPLs poses a problem for financing development in many countries in the region, not just the ones affected by the crisis.

- (6) Promoting **information-based professional credit and risk assessment procedures** in banks, including through the application of BIS standards and enhanced disclosure by banks of their operating procedures.
- (7) Promoting the **use of information technology** and new ways of conducting business to improve efficiency in the banking sector for the benefit of depositors, including the spread of ATMs and ATM pools, e-banking and new products of interest to savers supported by professional investment counselling services.
- (8) Promoting **human resources development** in the central bank and in other banking institutions in a wide variety of areas, including all those mentioned above.
- (9) Reducing the **direct use of banks** by the government as a source of funds or as a modality for directing credits, and putting public-sector and government-specialized banks progressively on the same footing as commercial banks.
- (10) Ensuring **competition** within the banking sector, including further cautious liberalization of entry by foreign banks or financial firms.

The above list should not be seen as exhaustive. Given the continuing need to rely on the banking sector as a primary engine for inter-mediating domestic resources, it requires ongoing attention to enable it to serve a country well; no country can afford to let its banking system fail as this would severely disrupt the flow of funds and development. The reform process is thus not static and its contents have to be specific to the country context and to the evolution of banking standards worldwide.

Other institutional arrangements for household savings

There are several other instruments used to raise savings from the household sector. These may be involuntary or compulsory savings by households promoted through government-sponsored instruments

or voluntary savings through pension funds, insurance schemes, microfinance arrangements etc.

Mandatory provident funds, state-sponsored unit trust schemes or fully-funded pension schemes have been employed very effectively in Japan, Malaysia and Singapore, among others. They have the potential to raise the savings rate by 3 to 4 per cent of GDP, and also to provide an ideal source of institutional finance, mainly for the public sector. However, the impact of such schemes on aggregate savings depends on the extent to which they substitute for other voluntary savings. Evidence on the fully-funded Central Provident Fund in Singapore shows that it has stimulated aggregate saving. Box V.1 provides a brief summary of the experience of the Central Provident Fund of Singapore. Nevertheless, such schemes so far have been successfully organized in countries that have a significant proportion of the labour force in the formal sector.

Pension funds add to the modalities for savings. But more importantly they provide a valuable addition to the institutional investor pool for domestic capital markets, as well as a source of social security and a safety net for the retired. In most Asian and Pacific countries, there is no universal retirement system beyond the public sector that fosters the regular contribution of funds from both employers and employees. With the increasing age of the population in many countries, pension funds could potentially be quite large. However, starting new schemes is a long-term proposition as they take years to build up a sufficient financial base; many smaller pension funds in the region have inadequate capital and high operating costs. In addition, it does not seem currently feasible to organize pension funds on a sustainable basis for the informal or unregistered sector.

Insurance schemes offer another form of savings with the funds collected being invested in various financial instruments. Life insurance, unemployment insurance and other forms of insurance in the ESCAP region exist mainly in the government sector and in the formal sectors of the economy. The coverage varies from country to country; 11 per cent of the population of Thailand have life insurance compared with 80 per cent in Japan and 70 per cent in Hong Kong, China. In India, premium payments for all forms of insurance are a tiny proportion of financial savings. However, the liberalization of this

sector is under way and a number of firms have applied to offer life and general insurance.¹⁰ In the aftermath of the recent crisis and in line with WTO agreements on services, this sector is being opened up to foreign investment. For example, in Thailand in 2000, foreign companies had stakes in 13 out of 25 life insurance companies.¹¹ One of the constraints facing expansion in this area is that many insurance schemes lack credibility because of unscrupulous brokers who deal with the individuals buying and claiming under the schemes. It appears difficult to supervise all brokers even through a viable national association of dealers which undertakes self-regulation and stresses ethical behaviour.

Using the postal system as a vehicle for collecting household savings¹² has been a modality in a number of countries for quite some time. As post offices tend to have a wide geographic distribution, they are often accessible by rural households in areas where there are no banking outlets. They have been a natural vehicle for uses beyond postal services. In addition, governments have given incentives to households to save through post offices and, with governments being the holder of the deposits, they have used the funds to invest in more projects, including social infrastructure, than they could have without access to these funds. However, as private banks and other financial institutions have improved their outreach, postal savings systems have tended to die out. There have also been problems with the viability of some of the government investments made with postal savings deposits, affecting the financial sustainability of the system. Nevertheless, there is some renewed interest in postal savings systems, especially for remote rural areas, as a modality for encouraging households to save in forms available for intermediation to government investment.

¹⁰ Patel, op. cit.

¹¹ "Insurance: Foreign connection provides stimulus", *Bangkok Post*, 10 November 2000.

¹² See ESCAP, *Domestic Resource Mobilization through Postal Savings: Experiences of Selected Asian Countries* (ST/ESCAP/1279). Japan has had a long experience with postal savings, and the funds raised have been as much as 20 per cent of total household savings. Bangladesh, India, Indonesia, Malaysia, Pakistan and Sri Lanka also have postal savings schemes. In the Lao People's Democratic Republic, Myanmar and Thailand such schemes were not viable and were closed down.

Box V.1. The role of the Central Provident Fund in promoting domestic savings and socio-economic development in Singapore^a

The Central Provident Fund (CPF) was set up in 1955 as the national pension scheme. Over the years, it has evolved into a comprehensive social security scheme to take care of a member's retirement, home ownership and health-care needs as well as to provide financial protection to its members and their families through its various insurance schemes. CPF covers all employees who are Singaporean citizens and permanent residents. All self-employed Singaporean citizens and permanent residents are required under statutory rules to contribute for health-care coverage only.

Singapore has one of the highest domestic savings rates in the world, around 50 per cent of GDP in recent years. CPF has played a major role in raising domestic savings to such a high level. Both employers and employees are required to contribute to CPF. Contributions from both were gradually raised from 5 per cent of employee wages in 1955 to 25 per cent in 1984, or 50 per cent in total by both employer and employee. This was indeed a very high rate of forced savings. In the wake of an economic recession in the country in the mid-1980s, the contributions of employers were reduced to 10 per cent in 1986 and then gradually raised to 20 per cent by 1994. In addition, from 1988 contributions by those employed were gradually reduced, reaching 20 per cent in 1994. As a result of the recent regional economic crisis, the employers' contribution was again reduced to 10 per cent in January 1999. With economic recovery, these contributions are to be increased gradually to 20 per cent, currently standing at 16 per cent. The employees continue to contribute 20 per cent.

CPF is not a conventional pension system. Through carefully timed measures, this increasingly large amount of forced savings has been used to finance the socio-economic development of the country. In 1968, CPF savings were allowed to be withdrawn by members to purchase government-built flats. The policy was a great success and today about 80 per cent of Singaporeans live in such flats. Moreover, the purchase

of a flat turned out to be a very profitable investment as most flats command a market value several times their purchase price. Later, rules were liberalized to allow the purchase of private property also. This further boosted home ownership and about 90 per cent of citizens and permanent residents now live in their own homes.

CPF members can use their CPF savings not only for old age and housing, but also for health care. A part of the CPF contribution is put into a Medisave Account. While working, a member can withdraw money from this account for approved medical treatment and for medical insurance premiums. The amount of these withdrawals is linked to a member's contribution. After retirement, Medisave savings are available for health care.

The government is conscious of the fact that an ever-growing national pension fund, unless profitably deployed, becomes an economic deadweight. As such, the government allows individual members who are not content with the minimum guaranteed tax-free return paid by the government to invest part of their pension money in pursuit of higher return. In fact, the government has tried to encourage investment in securities and other financial instruments for this purpose as well as to develop greater depth in the financial markets. In 1978 members were allowed to withdraw some of their contributions to buy shares in the Singapore Bus Services, the national public transport company, which arose from the merger of several private and public bus services. In 1986, an Approved Investment Scheme specifying financial instruments and other assets permitted for purchase was initiated. The original list of approved assets included selected blue-chip stocks, unit trusts and gold, and it has been regularly updated.

Despite the increasing liberalization of the use of CPF savings for investment, the contribution of the CPF scheme in the development of the equity market has been quite limited. At the end of 1996, only 14 per cent of the outstanding membership of CPF had made cumulative net investments of S\$15 billion, representing 21 per cent of the members' existing balance with the CPF Board. This means that almost 80 per cent of the compulsory savings were held as passive deposits. Equity investment from CPF savings accounted for only 3.4 per cent of the market capitalization on the Stock Exchange of Singapore and about 6 per cent of the total number of shares issued. This may reflect the risk-averse nature of CPF members as well as their

(Continued overleaf)

^a This box draws on Edward Ng, "A study on the Central Provident Fund (CPF) in Singapore: its contribution to the development of the capital market", a report for the Asian Development Bank, March 1998 and Central Provident Fund Board, *Annual Report 1998 and 1999*, available at <http://www.cpf.gov.sg/cpf_info/AnnRpt.asp> (26 January 2001).

(Continued from preceding page)

unfamiliarity with investment; the complicated procedures for withdrawing CPF savings for securities investments are also viewed as a major reason for the lack of enthusiasm.

Most CPF contributions are invested by the CPF Board to purchase government bonds; more than 70 per cent of government bonds are held by it. With the government running a nearly perpetual fiscal surplus, there is no need for public debt. Therefore, government bonds are issued purely to absorb the increasingly large CPF members' balances and to meet the demand by commercial banks for their statutory reserves. The CPF Board, being a passive national custodian of pension funds, is under no pressure to produce a competitive return to its members. Therefore, there is no need for it to actively maximize the yield on its funds.

The government has used the CPF system effectively as a macroeconomic tool by changing the employer's

contributions to regain cost competitiveness for businesses and the economy. As discussed earlier, the employer's contributions were reduced in 1986, which helped in the quick economic recovery at that time. Similarly, the reduction in employer's contributions in early 1999 helped to soften the impact of the recent economic crisis by reducing business costs and maintaining employment. CPF savings tapped through the issue of government bonds have certainly helped Singapore build up its foreign reserves, as the government usually invests its surpluses and other public funds overseas. CPF is an interesting model which is worth considering by other developing countries as a means of raising domestic savings. However, it may require a rethinking of the types of contributions that the funds held by a central compulsory savings scheme can make to development, without putting the contributions (or pension rights) of its members at risk.

Microfinance schemes provide savings and credit mechanisms for those beyond the reach of the formal banking system, often the poor who lack collateral. Many have been successful in inculcating the habit of savings and so provide a way to intermediate resources at a micro level. It is likely, though, that the effect on the overall savings rates in an economy is rather small. According to the World Bank,¹³ there are at least 120 microfinance institutions in East Asia and South-East Asia, and about 100 in South Asia. In East Asia and South-East Asia, about 44 per cent of the funding for microfinance comes from donors; this figure is larger, about 54 per cent, in South Asia. About 32 per cent of the funding in East Asia and South-East Asia is from deposits (savings) and only 4 per cent from governments. In South Asia, deposits contribute about 30 per cent. It is interesting that for the microfinance schemes run by banks or credit unions, around 70 per cent or more of the funding comes from savings deposits, whereas for NGO-run schemes, over 50 per cent comes from donor contributions. However, in South Asia, NGO schemes obtain about 22 per cent of funding from deposits, the highest percentage in any region.

¹³ World Bank, *An Inventory of Microfinance Institutions in South Asia*, available at <<http://www.esd.worldbank.org/sbp/MICRO/SA/soasia.HTM>> and *An Inventory of Microfinance Institutions in East Asia and the Pacific*, available at <<http://www.esd.worldbank.org/html/esd/agr/sbp/MICRO/EAP/micro2.HTM>>.

The proliferation of microfinance institutions has led to the need to reassess their role as a tool for resource mobilization and as a poverty alleviation mechanism. The question is whether users (savers and borrowers) can "graduate", that is, if people go on saving or borrowing small amounts, has their situation really changed?¹⁴ Evidence on this is very mixed as it is difficult to conduct counterfactual studies. It would appear desirable to graduate some of the users with good savings and loans track records to regular savings accounts and larger loans.

Some microfinance institutions themselves have graduated into the regular financial system. Some, including the Grameen Bank of Bangladesh, are registered banks and so follow rules on capital adequacy etc. This means that users have reduced risks in saving with and borrowing from the institution. Another option under consideration in countries with a history of microfinance is to use an apex-type organization as an intermediary between local NGO microfinance schemes and formal financial institutions. Such an organization can, as one of its functions, borrow funds from the formal institutions and lend them on to the microfinance institutions, presumably at a better rate of interest than the individual NGOs

¹⁴ Moreover, providing financial intermediation to the poor may not be enough; some form of "social intermediation" in the form of encouragement to utilize opportunities for building assets would be necessary for their graduation towards formal finance.

could. Palli Karma-Sahayak Foundation plays this role in Bangladesh and recently has provided as much as 17 per cent of the funds for NGO microfinance.¹⁵ Such an arrangement should increase the willingness of individuals to save with NGO institutions. However, when microfinance schemes are sustained by injections of funds from governments or donors, both of which may be unpredictable sources of funds, their future is quite uncertain. There is, thus, a need to increase the number of savers and the percentage of loans covered by saving deposits. All schemes should work towards being more self-supporting as a way of encouraging more micro-level domestic resource mobilization.

Policy issues

The main issues for government policy in the area of mobilizing domestic resources for development through non-bank institutions include:

- (1) Whether to create or strengthen **mandatory savings schemes**. The benefits of mobilizing funds for government investments through these modalities need to be weighed against the efficiency of the investment decisions and a judgement as to whether the savings generated are additional or a diversion from the other modes.
- (2) How to encourage **pension and insurance schemes**. The decision on whether to legislate such schemes nationwide or to leave this area to private initiatives under better developed regulation and supervision is a country-specific one. However, with an increase in the older-age population in many countries of the region, pension and life insurance schemes are definitely likely to be on the agenda. The regulatory legislation for these schemes and their effective enforcement are crucial to their being viewed as an attractive form of savings for households.
- (3) How to make **microfinance schemes** an attractive and secure modality for small-scale savings and how to provide ways and means for users to graduate to formal-sector financial

institutions. The following options need to be considered: registering microfinance institutions under banking legislation; using an apex organization to provide intermediary services between the microfinance institutions and the banking sector; and increasing the security of funding of microfinance schemes, inter alia, through increased reliance on deposits as a source of loan finance.

Capital markets

Stock markets

Stock markets have assumed, as yet a small, but increasing, role as a means of mobilizing domestic resources and providing a wider range of financial services. This has been facilitated by deregulation and liberalization measures, as well as by specific policies to foster their development. Until recently, domestic capital markets have had a rather restricted clientele, mainly urban and relatively well-off groups, and sometimes foreign investors. The robustness of these markets is thus positively associated with a widening of their participants, including through the emergence of mutual funds and provident funds which collect individual savings into funds for investment by professional managers.¹⁶

Tables V.3 and V.4 provide a perspective on the growth of equity markets in the region, table V.3 providing some statistics of the size of stock markets and table V.4 showing the level of trading activity on these markets. Except for Malaysia, all developing countries that are not financial centres have markets less than 100 per cent of GDP. The ASEAN members Indonesia, Philippines and Thailand, as well as China and India, have shown considerable growth over the last decade in both the number of companies listed and the capitalization relative to GDP; for the other countries the stock market remains small, less than 20 per cent of GDP. Table V.4 reveals a very similar trend with many countries having the value traded and turnover ratios less than 20 per cent of GDP. Consequently, their stock markets are too thin and too shallow to be a viable place for investing or raising funds. They are rather vulnerable to corners, speculative runs and other forms of manipulation. There

¹⁵ Rushidan Islam Rahman, "Poverty Alleviation and Empowerment through Microfinance: Two Decades of Experience in Bangladesh", Research monograph No. 20, Bangladesh Institute of Development Studies, Dhaka, June 2000.

¹⁶ In India, for example, the assets under the management of mutual funds currently account for about one seventh of bank deposits but resources mobilized by them are increasingly very rapidly. See Patel, op. cit.

Table V.3. Number of listed companies and stock market capitalization

	Number of companies				Stock market capitalization							
					(millions of us dollars)				(percentage of GDP)			
	1990	1995	1997	1999	1990	1995	1997	1999	1990	1995	1997	1999
Australia	1 089	1 178	1 219	1 162	107 611	245 218	311 988	874 283	36	70	177	224
Bangladesh	134	183	202	211	321	1 323	4 551	865	1	5	4	2
China	14	323	764	950	2 028	42 055	206 366	330 703	1	6	23	33
Hong Kong, China	284	518	658	658	83 397	303 705	449 381	343 394	112	211	241	217
India	2 435	7 985	5 843	5 863	38 567	127 199	128 466	184 605	12	39	34	40
Indonesia	125	238	282	277	8 081	66 585	29 105	64 087	7	34	14	45
Iran (Islamic Republic of)	97	169	263	242	34 282	6 561	17 008	14 874	28	..	7	15
Japan	2 071	2 263	2 387	2 416	2 917 679	3 667 292	3 088 850	2 495 757	98	72	53	57
Kazakhstan	..	..	..	18	..	..	..	..	..	..	..	..
Malaysia	282	529	708	757	48 611	222 729	93 608	145 445	114	261	95	195
Mongolia	..	..	434	430	..	..	..	40	..	..	6	4
Nepal	..	83	98	104	..	244	208	267	..	6	4	5
New Zealand	171	205	190	135	8 835	31 950	38 288	89 373	21	56	140	167
Pakistan	487	764	781	765	2 850	9 286	10 966	6 965	7	15	18	12
Philippines	153	205	221	226	5 927	58 859	31 361	48 105	13	79	38	64
Republic of Korea	669	721 ^a	760	725	110 594	181 955	41 881	308 534	44	40	9	76
Russian Federation	13	170	208	207	244	15 863	128 207	72 205	0	5	29	19
Singapore	150	212	303	321	34 308	148 004	150 215	94 469	94	177	110	111
Sri Lanka	175	226	239	239	917	1 998	2 096	1 584	11	16	14	10
Thailand	214	416	431	392	23 896	141 507	23 538	58 365	28	85	15	47
Turkey	110	205	257	285	19 065	20 772	61 090	112 716	13	13	32	60

Sources: World Bank, *World Development Indicators* (Washington DC), various issues; and World Bank web site <<http://www.worldbank.org/data/databytopic/GDP.pdf>> (28 November 2000).

^a 1996.

are doubts about the future of these markets unless ways can be found to increase their robustness. Another issue that needs intensive examination is whether countries without stock markets should be encouraged to develop small ones or other more viable ways of diversifying their financial sectors.

In general, almost all of the major stock markets in the region, including those that were most severely affected by the Asian currency crisis, suffered dramatic drops in size and turnover during the crisis but recovered by the end of 1999 to levels that exceeded their respective levels in 1990, then experiencing another drop in 2000. Most of these markets had opened trading to participation by foreign investors during the 1990s (the issues connected with the foreign inflows of short-term capital are dealt with in chapter VI). A few markets that were not so affected by the crisis, including China, have continued to grow. The turnover ratios in developing country markets tend to be quite variable and generally reflect both efforts to widen the inves-

tor base and investor sentiment (including sentiment by foreign investors) about the strength of the economy.¹⁷ A higher turnover reflects more confidence, but this is almost impossible to achieve in small, thin or narrow markets.

Despite signs of economic recovery and continued positive private savings behaviour, most corporations in the region are experiencing difficulties in raising funds. This is caused by three factors: (a) banks and other financial institutions have become more reluctant to approve new loans or to roll over existing credit lines; (b) alternative means of financing (for example, structured financing and syndicated loans) have become almost unavailable; and (c) the weak performance of individually listed companies on

¹⁷ It is interesting to note that the stock market in Japan declined as a percentage of GDP during the 1990s, and in terms of capitalization and turnover activity, it has declined considerably since the crisis.

Table V.4. Stock market trading volume

	Value traded (% of GDP)				Turnover ratio ^a			
	1990	1995	1997	1998	1990	1995	1997	1998
Australia	14	28	79	113	32	42	52	52
Bangladesh	0	1	1	2	2	13	24	24
China	0	7	41	30	159	116	231	130
Hong Kong, China	46	74	286	124	43	37	44	44
India	7	4	14	15	66	11	42	56
Indonesia	4	7	19	10	76	25	64	61
Iran (Islamic Republic of)	0		1	1	30	16	22	22
Japan	54	24	30	25	44	33	37	37
Malaysia	25	90	149	40	25	36	73	29
Mongolia	..	..	2	2	..	..	..	..
Nepal	..	..	..	..	..	7	2	2
New Zealand	5	15	38	96	17	28	28	28
Pakistan	1	5	19	14	9	30	104	114
Philippines	3	20	24	15	14	26	35	31
Republic of Korea	30	41	37 ^b	43	62	99	172	185
Russian Federation	..	..	4	3	..	2	19	6 ^c
Singapore	55	72	66	60	..	43	29	29
Sri Lanka	1	2	2	2	6	9	16	15
Thailand	27	34	15	19	93	42	39	71
Turkey	4	31	31	35	43	45	114	155

Sources: World Bank, *World Development Indicators* (Washington DC), various issues.

^a Turnover ratio is the value of shares traded as a percentage of capitalization.

^b 1996.

^c 1999.

stock markets makes it difficult for them to raise funds through this market. The difficulties in the financing process appear to be a manifestation of an information asymmetry problem for these corporations. As a result of the recent financial crisis, there is a general decline in the credit standing of borrowers. Given a general lack of credible information from the stock-issuing companies to investors and lenders, investors tend to focus on the larger better-known corporations with a perceived higher level of credit performance. Corporations that are unable or unwilling to demonstrate their creditworthiness, as exhibited through company financial reports, suffer from a deterioration in access to funding sources. The most seriously affected firms are those listed on stock markets with small capitalization (which suffer from a lack of investor interest) and SMEs (which suffer from the reluctance of banks to provide financing and which have limited or no access to other forms of finance).

An illustration of this phenomenon is found in Hong Kong, China, where blue chip companies have enjoyed significantly better performance than the

broad market index. The Hang Seng Stock Index comprises 33 blue chip stocks whereas the All Ordinaries Index is an aggregation of all listed companies (approximately 700 as of 1999). In terms of market capitalization, the 33 Hang Seng Stock Index constituent companies represent approximately 70 per cent of the total market size. For the period January 1997 through June 2000, the Hang Seng Stock Index increased by 52 per cent whereas the All Ordinaries Index rose by merely 22 per cent. Among the constituent stocks of the Hang Seng Stock Index, China Mobile (previously China Telecom) and Hutchison Whampoa are among the largest and highest rated companies. From 1997 through June 2000, the value of the stocks of the two companies increased by 500 and 200 per cent, respectively.¹⁸ The discrepancy in stock price

¹⁸ It should be noted that the majority of the operations of China Mobile is carried out in China rather than in Hong Kong, China. Similarly, Hutchison Whampoa has a substantial amount of investment in telecommunications and port facilities that are not in Hong Kong, China.

performance illustrates the fact that only a handful of good name companies are regarded by investors as worthy of investment; the rest of the corporations are still very constrained in their ability to raise funds on the stock market. Some governments, such as that of Thailand, have encouraged their stock market regulators to improve rules on disclosure and accounting/auditing. However, much remains to be done and it would be beneficial to Asian stock markets to promote best practices in shareholder communication and in related corporate governance.

The financial infrastructure for stock markets refers to the environment in which financial transactions are carried out; it includes the legal and regulatory framework, the financial institutions involved and the trading mechanisms. An important component of the financial infrastructure is the trading, clearing and settlement system. An efficient and effective trading environment can enhance investor (saver) participation and reduce systemic risk, such as the inability to complete a trade. These benefits are translated into a higher liquidity and a reduced cost of capital for listed companies. Improvements in the infrastructure of local stock markets can stimulate local investors (savers) to hold domestic stocks, thereby enhancing the robustness of the market. Box V.2 provides a few important ideas for improving the financial infrastructure of equity markets. In India, for example, much progress has been made recently in three areas, trading modalities, depositories and settlements. Most trading is now automated and investors should be soon reaping benefits in terms of cheaper transaction costs and better service.

Rights issues

Rights issues refer to the selling of new shares on a pro rata basis to the existing shareholders. Rights issues are usually initiated following the positive performance of a stock. However, the general impact of a rights issue announcement is that the stock price will decline significantly because there is an impression in the market that rights issues are initiated only when the stock price is overvalued. Prior to the financial crisis, rights issues contributed a major source of new equity financing for listed companies in the ESCAP

region.¹⁹ Since 1997, rights issues have almost disappeared. In several cases the information effect of a rights issue was so negative that the stock suffered a dramatic decline following the announcement of an issue. Such an effect significantly increases the risk borne by the underwriter. As a result, companies tend to refrain from rights issues, and even if a firm tries to initiate a rights issue, it is difficult to arrange a suitable underwriter. When the Asian financial markets began to recover in 1999, firms that had good stock price performance adopted alternative means of raising capital. For example, some firms chose to place new shares with a group of institutional investors. This approach appears to be more favourably accepted by the market. As institutional investors are usually better equipped than individual investors to assess the risk and return profile of the issuing firm, subscription by this group of informed investors is seen as providing certification that the issuing firm is of high quality.

Convertible bond markets

There has been limited development of convertible bond markets in Asia as a complement to equity financing. Convertible bonds provide investors with an option of exchanging these bonds for newly issued equity of the issuing company.²⁰ The

¹⁹ It should be noted, however, that rights issues virtually disappeared in the United States market during the 1980s.

²⁰ The typical features of a convertible bond can be illustrated by the following hypothetical example. Company A has its shares listed on the Stock Exchange of Hong Kong with a current market price of \$10 per share. A newly issued convertible bond carries a total issue size of \$50 million and a coupon rate of 4 per cent, payable semi-annually. Each bond has a face value of \$1,000 and a maturity of 5 years. If the investor in a bond holds the bond until maturity, A will repay the face value of \$1,000 per bond in five years. Over this period, A will also pay bondholders a total of \$40 per bond (i.e. 4 per cent of face value) each year in two equal payments of \$20 every six months. Bondholders can choose to convert their bonds into common shares of A at the (fixed) conversion price of \$13 per share. That is, the total number of shares that each bond can convert into (called the conversion ratio) is $\$1,000 \div \$13 = 76.92$ shares. Thus bondholders will gain if the stock price of A rises above \$13 because they can convert into the common shares at the lower conversion price. Conversely, bondholders will be paid a fairly steady coupon payment of 4 per cent of face value should the stock price fail to rise above the conversion price.

Box V.2. Improving the financial infrastructure of stock markets

There are several ways in which stock markets in the ESCAP region can, or are, improving their infrastructure in order to enhance investor participation and to make the markets a more durable instrument of financial intermediation. A few examples are given below.

Clearing systems

The institution of a real-time settlement system can help reduce the risk for stock market participants; the exchange can monitor the status of its clearing members and each clearing member can impose an in-house risk management system to reduce the risk to its customers. The introduction of a continuous net settlement procedure for all markets in a country would allow a clearing house to continually monitor the positions of its clearing members in and across the products in the various markets. Over time, the combining of clearing houses across often segmented securities markets will improve operations and market efficiency. Examples of the benefits include the provision of consolidated margin requirements for the cash market and its derivative products (which would reduce hedging costs and promote better risk management of traders), the implementation of net money settlement procedures, and the provision for uniformity in technical trading requirements such as collateral accepted and underlying legal documents. For example, in the case of Hong Kong, China, three separate clearing houses had been operating (one for the cash stock market and two for the derivative markets in futures contracts and options, respectively) up to March 2000. In 2000, efforts were made to merge the three clearing houses to form a unified clearing and settlement system.

Dematerialization

Many investors in Asia have the tradition of withdrawing share certificates and depositing them in their safes. This practice leads to costs, such as printing, storage and processing, and the risk of loss or theft. A solution to this problem is to “dematerialize” the securities certificates (or keeping the certificates in a scripless form). Dematerialization refers to the procedure in which the ownership interest is recorded in an electronic format and no physical certificates are issued. While dematerialization offers operational advantages and saves costs, it also raises other concerns. As investors are unable to obtain their certificates in physical form, they must rely on their financial intermediaries or have access to a centralized securities registration system to receive corporate communications or distributions, exercise voting rights or prove their ownership of such shares.

Straight-through computerized trading system

Advancements in information technologies have provided a host of solutions to improving the securities trading process. An example of such improvements is a straight-through computerized trading system. Under such a system, investors can input their buy or sell orders from an access point (computer, mobile phone or other device) and the orders are then entered directly into the trading system of the stock exchange via the securities broker's trading system. In this way the time needed for the completion of the transaction and the subsequent settlement is significantly shortened.

general belief is that the conversion option allows the issuing firm to borrow at a rate below the market interest rate. In exchange for the lower interest income, convertible bond investors enjoy an upside potential when the issuing company performs well and its stock rises above the conversion price. Finance theory suggests that convertible bonds are suitable for high growth companies because they offer a solution to the information asymmetry problem between bondholders and shareholders. In essence, convertible bond issuance allows the issuing firm to take the risk and invest in profitable investments (thus resolving the agency problem to shareholders) and, at the same time, provides adequate compensation for the bondholders (in the

form of upside potential in the convertible bond investment). From this standpoint, a convertible bond market appears to be suitable for the economies in the region which already have both stock markets and bond markets and in which there are sufficient growth opportunities.

The development of convertible bond markets in the region had begun in the 1980s. These instruments allowed foreign investors to hold equity-like securities when the local markets imposed restrictions on foreign stockholdings. As the equity markets began to open up to foreign investors, the attractiveness of issuing convertible bonds weakened. In general, convertible bonds are not popular

among domestic investors in the region.²¹ After the financial crisis, even institutional trading of convertible bonds has been reduced. The key issue, as is the case for all capital market instruments, is the lack of credible credit assessment in the region, which makes it difficult to determine a fair price for the instrument.

Bond markets

Countries in the ESCAP region are characterized by underdeveloped longer-term investment (bond) markets. With the exception of the Republic of Korea, bond markets are very small as compared with bank loan and equity markets. The lack of a functioning bond market means that a domestic economy is vulnerable to sudden and short-term changes in investor confidence. When confidence dissipates, investors (local and foreign) do not have a more secure and stable investment alternative on which to hold. The ensuing flight to quality leads to withdrawal of funds from the country. The presence of a (high quality) bond market with sufficient market depth would thus enhance long-term economic development prospects. However, the current state of capital markets in the region is not favourable to the development of such markets. Factors accounting for the slow development include poor financial infrastructure, the lack of benchmark bonds, fragmented capital markets, the lack of competitive credit markets, a general low credit standing for Asian corporations, the lack of pertinent financial information of the borrowers, and the inadequacy of investor protection. In most of the countries, in fact, the financial sector itself is the dominant holder of government debt instruments because secondary markets are not fully developed. Without secondary markets for debt instruments it is difficult to conceive that a large number of investors would be attracted.

²¹ On the one hand, investors can hold equity directly. Under normal market conditions, the trading of common shares is significantly more active than that of convertible bonds and investors find it easier and less costly to realize profits or limit losses by holding common shares rather than convertible bonds. On the other hand, investors in convertible bonds are usually subject to a sizeable minimum transaction size. Furthermore, convertible bonds are often traded over-the-counter and retail investors may find it difficult to get access to pricing information.

Table V.5 provides summary information on the market value of listed bonds in nine Asian countries. Japan has the most active bond market with a size that accounts for some 85 per cent of the entire Asian bond market. The Republic of Korea is the second largest market, approximately 6 per cent of that of Japan. Singapore is the only other major Asian debt market; all other markets in publicly listed bonds are very small. For example, in India and Pakistan, the government dominates the issuing of bonds but only a very small proportion of the stock of bonds is traded daily, most bonds being held to maturity, mainly by banks and other financial institutions to meet their statutory liquidity requirement. It should be noted, however, that in several economies (for example, Hong Kong, China; Indonesia; and the Philippines) bonds are only or mainly traded over-the-counter among investors (mainly banks and financial institutions) and as a result it is difficult to obtain reliable information on the actual size of the bond market.

In the aftermath of the 1997 crisis, bond trading and bond issuance declined significantly in the second half of 1997 and in 1998. Table V.5 suggests that the entire region (including Japan) suffered from a sharp decline in bond turnover. In particular, investors typically bought bonds with a high credit standing and refrained from investing in ones with a low credit standing, thus creating a polar development in the bond market similar to that in the stock market. Secondary market activity picked up in 1999 and the bond turnover appears to have recovered to pre-crisis levels in most developing countries, but not in Japan. Bond issuance began to pick up in 1999, but in many markets it has still not recovered to the pre-crisis levels. In addition, the bonds issued in 1997 and 1998 are of significantly shorter maturity. In other words, Asian bond markets are still unable to provide a stable source of long-term funds for corporations.

Domestic investors in the developing countries of the ESCAP region have generally exhibited a weak demand for long-term fixed income securities. This phenomenon is associated with the underdeveloped systems of institutional investors. In fact, it is often claimed that without the participation of a significant number of institutional investors, such as mutual funds, pension funds or insurance schemes which are independent of the banking sector, bond markets are not viable and their pricing is suspect. In turn, a lack of investor demand leads to illiquid markets and high transaction costs, and weakens the incentive for issuing bonds. In the case of Hong

Table V.5. Market value of listed bonds at year-end and listed bond turnover on Asian exchanges

(Millions of US dollars)

	1994	1995	1996	1997	1998	1999
Market value						
Hong Kong, China	..	..	..	..	110 438	98 910
Indonesia	444	405	339	109	50	21
Japan	3 539 282	3 886 535	3 821 540	3 600 291	4 472 648	5 263 913
Malaysia	3 865	3 497	3 444	1 788	1 310	1 753
Philippines	–	–	6	4	0	0
Republic of Korea	129 990	162 421	208 167	132 222	277 788	321 697
Singapore	153 232	150 539	161 239	171 626	182 946	198 939
Taiwan Province of China	30 320	31 813	36 750	32 919	36 578	44 284
Thailand	2 681	1 945	927	351	352	155
Turnover						
Hong Kong, China	0	47	41	23	14	18
Indonesia	–	–	–	–	–	–
Japan	167 759	260 841	206 668	155 623	72 638	53 875
Malaysia	879	375	278	908	139	1 032
Philippines	–	–	–	–	–	–
Republic of Korea	1 458	1 855	1 710	4 103	11 383	24 717
Singapore	7 003	3 977	2 840	3 883	876	3 909
Taiwan Province of China	303	70	365	683	1 227	1 683
Thailand	22	4	0	0	0	0

Source: International Federation of Stock Exchanges, available at <<http://www.fibv.com/stats/ts4.xls>> and <<http://www.fibv.com/stats/ts5.xls>> (13 November 2000).

Kong, China, for example, high-quality private bond issuers typically raise debt financing in Luxembourg where the institutional demand for fixed-income securities is comparatively high.

Thus one measure for enhancing bond market development is to adopt a nationwide retirement benefit system. For example, Hong Kong, China is launching a mandatory provident fund (MPF) scheme for all employees. Under this defined benefit scheme, employees need to contribute 5 per cent of their monthly income (subject to a certain ceiling) and the employer contributes another 5 per cent. The funds will be invested in qualified MPF programmes organized by approved MPF providers. There are investment guidelines for MPF providers, including the portion that is to be invested locally and the portion that should be invested in fixed income securities. In the long run, the funds from MPF programmes will likely increase the demand for bonds and promote bond market development. However, the MPF scheme is unlikely to show

immediate results since it will take time for MPF contributions to grow to any significant size.²²

Many governments of the crisis countries have recognized that their long-term debt markets are underdeveloped, their corporations over-leveraged, and a vicious circle of NPLs had developed. For many governments the development of a corporate bond market is a priority. For example, measures taken in Thailand have included the removal of the tax bias against bond holding and the development of a benchmark curve based on government issues. Starting from September 1999, the Bank of Thailand has been holding auctions of baht-denominated treasury bills so that yields for debt instruments of the

²² It is estimated that the annual pension fund contributions would amount to more than HK\$10 billion (\$1.3 billion), or around 1 per cent of GDP in the initial years of operation, growing to around HK\$60 billion (\$7.74 billion) when the scheme matures.

Box V.3. Development of the Philippine bond market

Starting in 1995, the Philippine Bureau of the Treasury began to introduce improvements in market infrastructure for a bond market with a view to promoting a country-wide market for treasury securities. Measures included the launch of an electronic auction system in 1995 and the introduction of scripless government securities in 1997. These improvements paved the way for an efficient and transparent trading system for treasury securities.

In 1998, the Philippine Treasury introduced the Small Investors Programme to encourage Philippine citizens to hold (and trade) local government securities. In November 1998, the denomination of the treasury bills (short-term government securities with maturities within one year) was reduced. As a result, the basic traded size of these securities was reduced from 10 million pesos to between 25,000 and 100,000 pesos. In June

1999, this programme was extended to treasury bonds (maturities from 2 to 20 years).

The trading system for the Small Investors Programme includes a settlement bank (Landmark Bank of the Philippines) as a central point of trading activities. In essence, investors deposit funds in their accounts at the settlement bank. When they buy (sell) a particular issue of securities, the funds are deducted (added) from (to) their deposit accounts and the respective securities are added (removed) to (from) their treasury securities accounts. Thus investors can trade treasury securities in small sums in an efficient, electronic trading mode with low-cost, scripless streamlined settlement procedures. The Philippine Treasury also has plans to list treasury issues on a newly established Bond Exchange in 2000 to promote this initiative further.

same or lower maturities can be determined. More auctions are planned, but the secondary market liquidity is still very small. In the Republic of Korea, measures include reform of the bond-issuing procedure, introduction of new debt products (such as repurchase agreements), and reorganization of the secondary bond market. There have also been efforts to promote participation from a wider range of retail investors. The case of the Philippine treasury securities outlined in box V.3 is an example of the promotion of a local bond market with sufficient market depth. In South Asia there is quite a lengthy, but not very positive, experience with retail bonds which are not traded (there is hardly a secondary market). This experience indicates that unless the investment of the small savers is adequately protected, it is difficult to sell them bonds. Accordingly, financial intermediaries need to be registered, regulated and provided with adequate training in order for them to be able to generate investor confidence.

The development of a risk-free benchmark yield curve as the reference for the estimated rate of return on bonds is usually done by promoting a government treasury securities market. Its risk-free yield curve facilitates private issuance as investors normally price non-government securities based on a spread over the equivalent risk-free or government security with the same maturity. Several governments have used this technique (for example,

Australia; Hong Kong, China; and Singapore)²³ and maintain benchmark curves using treasury securities even when there is no need for the government to raise funds.²⁴ Except for these economies, mid- and long-term benchmark government bonds do not exist; rather there are short-term benchmark government securities (such as the central bank issues in Thailand) or quasi-benchmark bonds such as guaranteed corporate bonds in the Republic of Korea. These are not a good substitute for longer-term government bonds which have very low risk. The Hong Kong, China case described in box V.4 provides an interesting example of the process of developing longer-term bond benchmarks.

Bond markets would clearly benefit from reforms in corporate governance, as good corporate governance enhances the protection of the legitimate interests of the holders of corporate bonds. The elements of governance requiring attention include corruption, lack of transparency in financial transactions, use of accounting methods which do not

²³ The Hong Kong treasury paper market provides a 10-year long yield curve, while the Australian Government paper market currently provides a yield curve of 12 to 13 year maturity.

²⁴ The benefits from a functioning benchmark bond market can be much larger than the costs incurred from having some government debt.

Box V.4. Development of a benchmark curve: the case of Hong Kong, China

Hong Kong, China made concerted efforts before the 1997 crisis to develop Exchange Fund Bills and Exchange Fund Notes (together termed as Exchange Fund Paper or EFP), and has significantly strengthened them in the wake of the crisis. As Hong Kong, China has had a fiscal surplus, the main objective of the EFP programme was to facilitate the development of the local debt market by increasing the supply of high-quality bonds and creating a reliable benchmark yield curve. The programme was launched in March 1990 with the issuance of 91-day bills. Over the years, the programme was expanded: 182- and 362-day bills were launched in October 1990 and February 1991, respectively, followed by two-year notes

in May 1993, three-year notes in October 1993, five-year notes in September 1994, seven-year notes in November 1995, and 10-year notes in October 1996. EFP was well received by the market and has provided a reliable Hong Kong dollar benchmark yield as a result of the regular issuing of EFP with varying maturity.

In September 1999, the Hong Kong Monetary Authority and the Stock Exchange of Hong Kong arranged to list EFN on the Stock Exchange of Hong Kong. Under this arrangement the board lot size was reduced to a face value of HK\$50,000 (\$6,410) in an effort to promote retail investor participation.

meet international standards, and unclear ownership structures. While the crisis countries have tackled some of these practices, the adoption of best practices should be expanded. Investor perceptions of intangibles such as corporate integrity, prevention of asymmetric availability of corporate information, and enforcement capabilities of securities market regulators are key determinants of an investor's interest in corporate bonds.

The "New Economy": capital markets for emerging firms

Since 1995, there has been accelerated development in the areas of technology, the media and telecommunications, principally in the developed countries. Such economic activities, which are generally described as IT-related activities, have contributed to a significant portion of economic growth in the United States and have stimulated the development of similar activities in other economies. Over the last five years the National Association of Securities Dealers Automated Quotation market (NASDAQ) has been the principal platform from which successful IT companies obtained their financing. A characteristic of NASDAQ is that a listing firm does not necessarily need to report operating profits when applying for a position. Encouraged by this development, efforts have also been made in Asia to develop NASDAQ-like markets.

The Republic of Korea was the first developing country in the ESCAP region to launch a market for emerging companies. In July 1996 KOSDAQ (Korean Securities Dealers Automated Quotation), modelled after NASDAQ, was founded. Companies listed on KOSDAQ had a dazzling performance in its first few years. The KOSDAQ index rose by about 300 per cent between the end of 1998 and the middle of 2000, outperforming the main board of the Korea Stock Exchange by a significant margin. At the same time, total market capitalization increased almost tenfold. The average daily trading value grew from KRW 5.5 billion at the end of 1998 to more than KRW 5 trillion in the first quarter of 2000. At the end of 1999 there are more than 480 registered companies on KOSDAQ, with a total market value exceeding KRW100 trillion. The Korea Securities Dealers Association reported that another 100 new firms were listed on KOSDAQ in 2000.

Three other economies (Hong Kong, China; Malaysia; and Singapore) have since introduced NASDAQ-like markets, generally known as growth enterprise markets (GEMs), and Japan launched the Mothers market with the same sort of structure. The Hong Kong GEM was established in November 1999. Eighteen companies were listed in the first three months of trading. By March 2000, market capitalization had already increased 15 times to HK\$ 86.7 billion. Of the six companies that were listed on GEM in the first two months of 2000, five were

oversubscribed with subscription ratios ranging from 1.5 times (Far Eastern Polychem Industries Ltd.) to 669 times (TOM.com). The Stock Exchange of Hong Kong had predicted that the total market capitalization of GEM would reach HK\$100 billion by November 2000. In reality, this target was achieved within four months of its launch.

It should be noted, however, that GEM markets are intrinsically much more volatile than their respective major boards. Since the listed companies do not usually have a trackable operating record or an earnings profile, the markets are susceptible to violent swings and tend to mirror the performance of NASDAQ. In addition, as there is a lack of accepted means of valuing technology shares, except based upon expectations which can change rapidly and substantially, investments in GEM stocks are generally very risky. As most of the GEM listed companies are related to the Internet market, it is also likely that a number of the companies lack the managerial capabilities, well-developed business plans or a solid revenue base to support their rapidly growing business operations.

The significant decline in NASDAQ since the second quarter of 2000 led to a sharp decline in performance and the financing activities of the GEMs. Compounding this negative factor, the winding up of some major Internet companies in the United States and Europe has made investors very cautious about holding GEM stocks. The rapid retreat of the GEM market means that firms that have to rely on accessing further equity financing may be prone to failure because of their inability to raise additional funds.

Policy issues: approaches to further capital market development

Despite the serious difficulties outlined above, establishing capital markets with sufficient depth should be achievable in several economies in the region for a variety of reasons. First, the savings rate in much of East Asia and South-East Asia has been high, at over 30 per cent. This high rate should provide sufficient funding sources to support mature capital markets. Second, economic growth is likely to continue to be significant in the region. The last two years have seen many Asian and Pacific economies demonstrating a remarkable recovery. As

the regional economies continue to grow at a respectable rate, successful firms will emerge and asset quality in general will improve. Third, many governments in the region are paying serious attention to the potential contribution of domestic capital markets in the economic development process. Such enhanced awareness provides a good foundation for governments to work towards identifying and implementing means to enhance capital market development. Outlined below are issues that are pertinent to the basic framework needed for healthy markets to thrive.

- (1) ***Coping with fragmented markets.*** The economies in the region each have their own language, culture, customs and legal framework. Hence, the market structure and its mode of functioning in one country cannot automatically be translated into that of a second country. This contributes to the existence of fragmented capital markets, making regional investment difficult and sometimes more risky than necessary. As few of the economies (notable exceptions being China, India and Japan) are large enough to provide economies of scale in information processing, capital market development will be difficult. Given this situation, it would appear more rational to work towards a common set of basic structures and standards so that the regional development of equity markets becomes possible and each economy can see the benefits from contributing to this process. However, the predominance of national interests and a view that markets in the region are competitive rather than complementary mean that this is at best a long-term proposition.
- (2) ***Dealing with the lack of disclosure.*** Both the quantity and quality of information disclosed to investors are limited in most countries of the region. The consequence is that savers inherently assume that investments are risky and demand a steep risk premium. It would be beneficial to all if sufficient relevant information were accessible to investors, either through a mandatory or a voluntary process. The proposal made above to enhance corporate disclosure through enforcing disclosure by banks would certainly benefit the capital markets as well. The standards for such disclosure could also be harmonized

among countries. As information technologies continue to improve, regulatory bodies have to constantly review the disclosure guidelines to make sure that corporate managers utilize the most efficient and effective means of communication with investors.

- (3) **Varying accounting standards** from place to place with some exceptions, such as Hong Kong, China; Malaysia; and Singapore which use British standards. It would be a very positive step if regional or subregional accounting and regulatory bodies could agree on a common set of accounting standards. Furthermore, efforts are needed to ensure that all investors have access to the same set of sensitive information at the same time.
- (4) **Reducing government intervention.** Traditionally, governments in the region tend to offer subsidies to activities that fit their policy thrust. An example is the provision of low-cost housing finance which exists in many countries. By pursuing this course, the return on the relevant capital market instrument, for example, mortgage products in the case of housing, becomes distorted and can substantially deviate from the market rate of return. When the instruments involved are suitable to be part of the development of a viable capital market, such as securitization of home mortgages, the existence of a significant distortion

in the rate of return makes this difficult. The reduction and ultimately elimination of such government intervention could contribute to the smoother development of viable capital markets.

- (5) **Developing benchmark securities.** As discussed earlier, typically the fixed income securities issued in the region are short term in nature. Therefore, it is impossible to construct a good benchmark yield curve from which efficient bond pricing can be done. It would be desirable if high-quality bonds with longer maturities were available.
- (6) **Enhancing the role of credit-rating agencies.** One solution to the information asymmetry problem affecting capital markets is to have the issuers of securities (stocks or bonds) analysed and rated by a credible credit-rating agency. The role of such an agency is to provide an objective analysis of the borrowing firm. Potential lenders can then derive valuable pricing information and assess the risk of holding the security issued by the firm. Since the early 1980s, many countries have set up their national credit-rating institutions. Table V.6 provides a listing of the domestic credit-rating agencies in South-East Asian countries. In some countries it is required by law that debt issuers be rated by a designated credit agency. However, the existing set-ups do not

Table V.6. Domestic credit-rating agencies in East and South-East Asia

	<i>Credit-rating agency</i>	<i>Year of establishment</i>
Indonesia	Pefindo Credit Rating Agency	1995
Malaysia	Rating Agency Malaysia Berhad Malaysian Rating Corporation Berhad	1990 1995
Philippines	Credit Information Bureau Inc.	1982
Republic of Korea	Korea Management Consulting and Credit Rating Corporation Korea Investors Service	1983 1985
	National Information and Credit Evaluation Corporation	1986
Thailand	Thai Rating and Information Services	1993

Source: S.G. Ree and Y. Shimimoto, *Mortgage-backed Securities Markets in Asia* (Asian Development Bank, 1999).

seem to provide sufficient information for lenders or to promote the bond and stock markets effectively. Most of the credit agencies are either government departments or affiliated to the government. Thus, when a state-owned enterprise issues a bond, the credit agency may be reluctant to give the enterprise a negative rating. In addition, the quantity and quality of financial and non-financial information may be inadequate for the credit-rating agency to provide a comprehensive and timely analysis of the borrower's situation.

In some countries borrowers tend to get around the mandatory credit-rating procedure by issuing alternative types of debt. For example, the majority of bonds issued in the Republic of Korea are guaranteed bonds backed by a holding company. In this way, the issuing (subsidiary) company need not obtain a credit rating and hence is not required to disclose the relevant pricing information.²⁵ In addition, national credit-rating agencies do not appear to provide the information on borrower quality required by international investors. In the more developed capital markets of Hong Kong, China; and Singapore, there is no local credit-rating agency and issuing firms tend to use the service of international agencies, such as Moody's or Standard and Poor's. International credit agencies actually play a significant role in the capital markets of the Asian and Pacific economies as their analyses of the risk profiles of the country, industries and specific firms²⁶ are often taken by international investors as an authoritative measure of a particular local market. In fact, a few countries have set up their domestic credit-rating agencies in collaboration with an international agency. For

instance, in Indonesia, PEFINDO was established in 1994 on the initiative of the Ministry of Finance and the Bank of Indonesia under a partnership agreement with Standard & Poor's.²⁷ PEFINDO has rated some 200 companies involving about 250 debt securities. This partnership has contributed to PEFINDO gaining international credibility.

The options for future action in this area include establishing a regional credit-rating agency or, at least, coordination among national ones to work towards common credit assessment standards pertinent to the region and performance of unbiased analysis and disclosure. In general, rating agencies should operate according to a professional code of conduct and should be financially independent from both government and corporations. It may be desirable to invite the international credit agencies as founding members so they can participate in the process of setting up the criteria and assessment standards.

- (7) **Improving the regulatory framework.** A prerequisite for both equity and debt market development is a good regulatory framework. The general framework should aim at legislating relevant laws, setting reporting and trading requirements for relevant financial institutions, and developing enforcement measures to implement the laws. Usually, a good regulatory framework should promote self-regulation and self-monitoring by financial institutions themselves; it should leave sufficient room for the market participants to act in a flexible manner. At the same time, the system should have measures to encourage good practices and punish offences. The underlying principles include increased transparency and disclosure, enhanced corporate governance and recognition of the accountability of regulators. The outcome of good regulation is a market infrastructure that promotes investor (especially creditor) protection, has an effective judicial system, and facilitates high-quality economic information. Table V.7 provides a summary of

²⁵ All publicly issued non-guaranteed bonds in the Republic of Korea are required to be rated by at least two credit-rating agencies and only those corporations rated A or higher may issue non-guaranteed bonds.

²⁶ These agencies employ both quantitative (including a set of comparative statistics of key economic variables) and qualitative measures (including openness of government policies and other non-quantitative areas) to help them arrive at a final decision on the risk profile. See *Survey 2000*, chap. V, "Review of mechanisms", pp. 190-193.

²⁷ Another new agency, Kasnik, Duff and Phelps, was licensed in 1997 but is not operational.

Table V.7. Indicators of a good financial infrastructure in East and South-East Asia

	<i>Creditor rights^a</i>	<i>Judicial system effectiveness^b</i>	<i>Quality of information^c</i>
Hong Kong, China	High	High	High
Indonesia	Low	Low	Low
Malaysia	Medium	Medium	Medium
Philippines	Low	Low	Medium
Republic of Korea	Medium	Medium	Medium
Singapore	High	High	Medium
Taiwan Province of China	Low	Medium	Medium
Thailand	Medium	Low	Medium

Source: R.J. Herring and N. Chatusritapak, "The case of the missing market: The bond market and why it matters for financial development", *ADB Institute Working Paper No. 11* (July 2000), pp. 15-17.

Notes: The original paper provides a list of indicators for each of the three criteria for good financial infrastructure. This table simplifies the entries as high (all or most of indicators are above average); medium (mixed scores of above and below average); and low (all or most scores are below average).

^a Indicators for creditor rights include: contract enforceability, automatic stay on secured assets, secured creditors paid first, restrictions on autonomous reorganization, management does not stay in reorganization, creditor rights, and legal reserve required to continue operation.

^b Indicators for effectiveness of judicial system include: efficiency of judicial system, rule of law, corruption, bureaucratic quality, risk of expropriation, and risk of contract repudiation.

^c Indicators for quality of information include: accounting standards, and index of restriction on the press.

the three areas of a good regulatory infrastructure and the rating of selected countries in the region in these areas. Other than Hong Kong, China; and Singapore, there is evidence of considerable room for improvement. As regulatory requirements vary widely in the region, closer cooperation among regional regulators is needed to work towards a common understanding on these. Such cooperative efforts will also enhance enforcement by filling the information gap, especially for cross-border transactions. It may also be possible over the longer term to explore the establishment of a common trading platform to allow investors to trade securities on a regional basis. This could especially help smaller, thinner and shallower markets to become part of a more viable market system or to allow firms from countries without markets to issue securities on the markets of neighbours rather than develop unviable markets of their own.

(8) **Investor education.** The percentage of savers (investors) holding equity is low in the Asian and Pacific region. The percentage of investors holding other types of securities is even lower. Educating potential investors is critical for increasing the general investor base and empowering investors to perform the analysis of risk and return in the investment process. Investor education is especially important for the promotion of bond markets since Asian investors exhibit a general reluctance to hold fixed-income securities. It should aim at building positive attitudes towards investing as an integral component of managing one's finances and as an important tool for planning retirement and other major consumption purchases, such as houses. It is hoped that the mutual funds being established will provide a good conduit for this exercise, and not be seen as a vehicle for cheating investors. Appropriate regulation and monitoring of mutual funds could go a long way in increasing

investor confidence. In fact, various forms of mutual funds, provident funds, insurance schemes and retirement schemes (institutional investors) can be the backbone of capital market revival or development.

- (9) **Venture capital funds.** These are sometimes used to stimulate new and riskier investments in SMEs, and sometimes for investment in a country that does not have a stock market (such as Viet Nam until very recently). Venture capital funds are viewed by investors as viable instruments as the monies are not invested in one firm but spread out over many. They can be national or they can also involve external investors. However, they are inherently risky and buyers can be misled about the returns possible, seeing only the upside. Therefore, the tradeability of venture capital shares, say on a stock market, is important in order to get a market valuation of the risk and return. An issue which arises with venture funds is the choice of regulator and the type of regulation and transparency rules to which they should be subject without stifling them.
- (10) **Increased cooperation among stock exchanges.** There is plenty of room for cooperation among both exchanges in the region and with those of the developed countries. Alliances with exchanges in the United States and Europe can form a market place for 24-hour trading. Furthermore, such alliances can promote technology innovation. For example, in 2000, seven NASDAQ listed stocks were to be listed and traded on the Stock Exchange of Hong Kong. The listing of these stocks is part of a pilot programme that will potentially develop into the linkage of the exchange with NASDAQ and other major international stock exchanges. Another notable joint venture is the alliance between Singapore International Monetary Exchange, Chicago Mercantile Exchange and the Marché à Terme Internationale de France. This alliance allows the development of joint trading and clearing systems. However, linkages among the exchanges in the region have always been weak. This may be due to differences in the cultural background. Another reason is that individual stock exchanges consider the other exchanges as competitors. One form of cooperation is to

encourage the cross-listing of Asian stocks in the region. This development would probably be a long-term goal as most Asian corporations are relatively less known to investors outside their home countries. In addition, investors have to face different disclosure and regulatory standards across countries. Nevertheless, there are already some high-quality firms from ASEAN countries which are listed on the Singaporean stock market.

- (11) **Internet trading.** The recent explosion of Internet stock trading offers opportunities for the development of and cooperation among stock markets in the region. In the United States, Internet trading has been established as an efficient and reliable means of securities trading. The emergence of Internet brokerage companies puts significant downward pressure on the commissions charged by securities brokers. The result is that more investors have the accessibility to trade and can trade at a lower cost. Such pressure can be especially intense for markets with regulated commission rates such as Malaysia or Thailand. It is expected that commission rates will ultimately be deregulated in most markets. Such a change, coupled with the increasing ease of trading using the Internet, will likely be associated with more investor participation. Table V.8 provides a profile of online trading in selected countries in the region. In most countries, personal computer ownership and Internet penetration are still at an early stage, but it is expected that the growth in Internet usage will be substantial in the next few years. The Republic of Korea is the most active Internet stock trading market, with over 50 per cent of stock transactions done over the Internet. Internet trading is also active in Taiwan Province of China, with about 15 per cent Internet trading. It is plausible that Hong Kong, China; and Singapore will also pick up the trend of Internet trading in the next two or three years. The Internet can provide a good basis on which national stock exchanges can cooperate, as investors can conveniently access pricing information in other markets. When a common trading platform across different markets is available, it can be expected that the integration of investor activities will speed up.

Table V.8. Online stockbroking, end of 1999

	<i>Internet users (millions)</i>	<i>Internet penetration as percentage of total population</i>	<i>Internet brokers</i>	<i>Commission rates</i>
Hong Kong, China	2.0	29.1	8	Regulated
Japan	14.0	11.0	33	Deregulated
Malaysia	0.8	3.7	..	Regulated
Philippines	0.6	0.8	..	Deregulated
Republic of Korea	6.7	14.3	21	Deregulated
Singapore	1.1	28.4	6	Partial
Taiwan Province of China	4.1	18.3	42	Deregulated
Thailand	0.8	1.2	..	Regulated
For reference: United States	58.0	21.0	100	Deregulated

Source: Lehman Brothers, *Asian Online Broking*, 25 October 1999.

MOBILIZATION OF GOVERNMENT FUNDS

Governments in the region have been, and still are, an important agent of development. While in most countries their role in owning and operating productive enterprises has been declining, mainly through the privatization of state-owned enterprises, they remain suppliers of crucial public goods of various sorts, of physical and social infrastructure and of law and order. The mobilization of sufficient resources for use by the government for these varied functions has always been rather problematic and many have run up sizeable fiscal deficits over several years. While countries in the region have not generally suffered prolonged bouts of hyperinflation or fiscal profligacy through the rampant printing of monies, they have not yet reached a stage where regular payment of taxes is seen as a social responsibility. This tends to complicate the task of raising resources for the government.

Basically, mobilizing funds for use by governments is undertaken in three ways: through the levying of taxes, through the generation of non-tax revenues and through government borrowing from local or international capital markets. Most of the off-market resources are raised through taxes, with non-tax revenue being less than 5 per cent of GDP in most countries. Table V.9 which reports taxes and

non-tax revenue as a percentage of GDP in selected countries, shows that in most countries taxes have been more or less the same percentage since the 1980s. Moreover, these percentages, as illustrated in table V.10, are relatively low by comparison with other countries. There is clearly room for enhanced revenue collection in almost all ESCAP members. This is also the conclusion of a recent OECD/ADB study.²⁸ However, it should be noted that the capacity of a country to raise tax revenue depends not only on tangible economic factors but also on a variety of non-economic factors, such as political will, administrative efficiency, and a culture of tax compliance, and as such it is almost impossible to prescribe a priori what proportion of GDP should be raised as taxes in any particular country.

Most tax reforms concern the simplification of tax regimes, changing the types of taxes levied towards indirect taxes and widening the taxpayer base. Other fiscal reforms include reducing fiscal deficits, privatizing some state enterprises, particularly in the countries with relatively large public sectors, making state enterprises more efficient and self-financing, and generally reducing the role of the government in the economy.

²⁸ OECD/ADB, *Sustainable Recovery in Asia; Mobilizing Resources for Development* (2000).

Table V.9. Proportion of tax and non-tax revenue in GDP

		1980	1985	1990	1995	1996	1997	1998	1999
South and South-West Asia									
Bangladesh	Tax	6.8	8.2	5.6	7.9	7.3	7.7	8.0	7.2
	Non-tax	1.1	0.6	0.9	1.9	2.1	1.8	1.4	1.8
Bhutan	Tax	5.0 ^a	5.7	4.7	6.5	7.2	6.0	7.6	8.2
	Non-tax	1.8 ^a	4.1	13.3	10.4	9.3	8.3	8.6	10.0
India	Tax	6.9	8.1	8.0	6.9	6.9	6.3	5.9	6.4
	Non-tax	2.2	2.9	2.6	2.7	2.7	2.9	3.0	3.1
Iran (Islamic Republic of)	Tax	6.9	9.1	7.2	6.9	8.3	9.4	11.3	..
	Non-tax	14.7	9.7	10.8	18.3	18.1	15.1	15.5	..
Nepal	Tax	6.5	6.8	7.0	9.0	8.7	8.7	8.6	8.5
	Non-tax	1.5	1.6	1.9	2.2	2.5	2.1	2.3	2.4
Pakistan	Tax	13.9	11.9	14.0	13.7	14.3	13.2	13.5	13.9
	Non-tax	3.1	5.1	5.4	3.5	2.9	2.4	2.8	3.7
Sri Lanka	Tax	17.8	19.3	19.3	17.9	17.0	16.0	14.5	14.9
	Non-tax	1.3	3.7	2.1	2.7	2.1	2.5	2.7	2.7
Turkey	Tax	17.3	14.5	11.6	14.0	15.2	19.1	..	..
	Non-tax	4.5	3.0	2.1	4.0	3.1	2.8	..	..
South-East Asia									
Indonesia	Tax	21.8	18.3	17.8	16.0	15.5	16.5	14.7	..
	Non-tax	0.7	1.5	1.0	1.7	2.0	1.6	1.1	..
Malaysia	Tax	22.6	21.6	17.8	18.7	18.6	19.0	15.9	15.1
	Non-tax	3.5	5.7	7.0	4.2	4.3	4.3	4.0	4.4
Myanmar	Tax	9.6	8.3	6.2	3.7	4.0	4.4	2.7	2.6
	Non-tax	6.6	5.5	3.4	2.7	2.9	3.3	3.5	2.8
Philippines	Tax	12.5	10.7	14.1	16.3	16.9	17.0	15.6	14.4
	Non-tax	1.7	1.3	2.1	1.4	1.7	2.0	1.6	1.4
Singapore	Tax	17.6	16.4	15.4	16.6	16.8	16.2	14.5	..
	Non-tax	5.9	11.2	11.5	9.9	12.7	8.4	10.3	..
Thailand	Tax	13.4	13.7	17.7	17.0	17.1	16.0	13.5	13.3
	Non-tax	1.1	1.5	1.2	1.6	1.5	1.9	2.0	1.9
Viet Nam	Tax	..	2.6	11.5	18.5	19.0	17.5	15.0	..
	Non-tax	..	13.7	3.2	3.5	3.0	2.9	3.1	..
East and North-East Asia									
China	Tax	12.7	22.8	15.2	9.8	9.7	11.0 ^b	11.8 ^b	12.4 ^b
	Non-tax	11.4	-1.9	2.6	0.5	0.9	..	..	..
Republic of Korea	Tax	15.5	14.9	15.9	16.5	17.3	17.3	17.6	17.0
	Non-tax	2.2	2.0	1.7	2.2	2.8	3.0	3.9	5.0
Pacific island economies									
Fiji	Tax	18.2	20.6	21.9	21.7	21.2	21.9	22.3	..
	Non-tax	5.5	5.1	4.8	3.0	3.1	3.6	3.0	..
Papua New Guinea	Tax	14.1	17.9	20.1	20.5	22.2	23.7	19.8	..
	Non-tax	6.1	2.4	5.2	4.7	2.9	3.0	4.1	..
North and Central Asia									
Kyrgyzstan	Tax	..	..	14.9 ^c	15.1	12.6	12.5	14.2	12.0
	Non-tax	..	..	0.6 ^c	1.6	2.2	2.8	3.3	3.1

Sources: ESCAP secretariat calculations based on ADB, *Key Indicators of Developing Asian and Pacific Countries* (Oxford University Press) various issues; IMF, *Government Finance Statistics Yearbook* (Washington DC), various issues and *International Financial Statistics* (Washington DC), various issues; and World Bank, *World Development Indicators Database*, available at <<http://www.worldbank.org/data/databytopic/GDP.pdf>> (23 January 2001).

^a 1981.

^b Preliminary.

^c 1993.

Table V.10. Selected Asian and non-Asian economies, per capita income and tax/GDP ratio

	1996		1997	
	Per capita GDP (\$)	Tax/GDP ratio	Per capita GDP (\$)	Tax/GDP ratio
India	380	6.9	397	6.3
Kenya	320	20.2	353	23.4
Indonesia	1 080	15.5	1 075	16.5
Syrian Arab Republic	1 160	19.2	1 193	16.5
Thailand	2 960	17.1	2 523	16.0
Costa Rica	2 640	23.5	3 174	23.5
Malaysia	4 370	18.6	4 476	19.0
Czech Republic	4 740	34.1	5 204	32.7
Republic of Korea	10 610	17.3	9 621	17.3
Greece	11 460	19.7	11 177	19.6
Singapore	30 550	16.8	32 106	16.2
Germany	28 870	29.4	25 516	26.8

Sources: World Bank, *World Development Indicators*, 1998 and 1999 (Washington DC) and *World Development Report 1998/99* (Washington DC); IMF, *Government Finance Statistics Yearbook 1999* (Washington DC, 1999) and *International Financial Statistics*, February 2000 (Washington DC); and ADB, *Key Indicators of Developing Asian and Pacific Countries 1999 and 2000* (Oxford University Press).

Taxation is used as the main policy instrument for transferring resources to the public sector. It can also assist in creating an atmosphere within which the private sector operates in conformity with national objectives. It has been argued by multilateral institutions, among others, that the tax system should be used only to raise finances that are sufficient for meeting the minimum necessary level of public expenditure, such as to preserve territorial integrity, to maintain law and order, to provide various public goods and to regulate undesirable activities. However, governments have traditionally used tax resources to finance some of its other development or political agenda.

The tax system favoured by multilateral organizations typically is composed of a broad-based sales tax, such as value-added tax (VAT), a relatively low level of import duties for protective purposes only, and simplified personal income and corporate profit taxes. A sales tax, being a tax on consumption of domestic and/or imported products, helps in reducing consumption and, if combined with an excise duty

on luxury goods, can also help in reducing conspicuous consumption. While direct taxes are both equitable and elastic, they can reduce incentives to work and, possibly, to save and/or invest. However, empirical evidence is not conclusive regarding their impact on either labour supply or savings. The net effect of a tax change on total savings depends on the relative marginal propensities to save of different groups on the one hand and an increase in public investment or reduction in fiscal deficit on the other. Obviously if the reduction in private savings exceeds the increase in public savings, aggregate savings will fall.

VAT has been introduced in most of the Asian and Pacific countries and usually the tax rate has been uniform, with unprocessed food and exports being exempt. The tax does not usually distinguish between domestic production and imports. VAT is considered neutral as the tax burden falls equally heavily on different products and as such avoids the cascading effects of conventional sales or turnover tax. While it is often argued that VAT is subject to

less evasion compared with income tax, various studies do not show a better compliance. Experience with VAT taxes has demonstrated that a destination- and consumption-based tax has been the easiest to administer.

Import tariffs and export duties have been a major source of government revenue for many developing countries. However, high rates of trade taxes and dispersion in the implied effective protection rates lead to production inefficiencies and can create an anti-export bias. East and South-East Asian countries have been able to reduce significantly their dependence on trade taxes, imposing VAT instead. South Asian countries have also started rationalizing their tariff structure. While some of them, such as Bangladesh, have been able to introduce VAT, others, such as Pakistan, are still struggling to do so.

It is generally believed that high income and corporate tax rates result in an adverse incentive for work effort, saving and investment. Accordingly, it is often suggested that income tax rates be reduced to improve compliance and lessen the burden of tax administration.²⁹ In most of the ESCAP members, average income and corporate tax rates have progressively fallen, taxable income slabs have been narrowed and the minimum threshold of income to be taxed, increased. Obviously if the maximum marginal tax rates have to be reduced and the total tax revenue has to be defended, then the middle rates will have to be increased. Alternatively the loss of revenue may be compensated by imposing indirect taxes.

While investors, indigenous or foreign, rely on their judgement of the fundamentals of an economy rather than on the incentives offered, most developing countries have been providing fiscal incentives, including reduction in the corporate income tax rates, tax holidays, accelerated depreciation allowances,

deduction from social security contributions, specific deduction on gross earnings for income tax purposes etc. While these may be redundant, a country that does not offer fiscal incentives may lose FDI to the countries that do. Clearly, these tax incentives should be harmonized rather than left to compete with each other.

Land and/or property taxes are levied in many countries with private ownership of land. While land taxes often include agricultural land, property taxes are mainly an urban phenomenon. In addition, the authority to set the rate and collect these taxes is sometimes delegated to local government units in order to provide them with their own revenue collection mechanism.

Two recent studies on tax reforms and their effects in India and the Republic of Korea³⁰ illustrate the enormous difficulties with implementing tax reform. They show the incentives for the government to continue to add taxes rather than rationalize when they face a resource shortage, the administrative complexities of tax collection, the problems of vested interest groups and the difficulty of balancing equity and revenue generation considerations. However, it is interesting that in India tax collection has never been more than 15 per cent of GDP, that income and profit taxes have always been less than a quarter of tax revenues and that after reform only 2 per cent of the population actually file tax returns. In the Republic of Korea, tax revenues have grown to around 20 per cent of GDP and income and corporate taxes account for just over one third of the amount raised. In India, trade-related taxes still account for almost 40 per cent of revenues; in the Republic of Korea the figure is less than 5 per cent. Both have made efforts to widen VAT-type taxes to include the service sector. The taxing of the informal or unregistered sector has proved to be a daunting task, particularly in India where the sector is quite large. The division of tax collection matters between the national government and state and local governments in both countries is a bone of contention; as in most countries, taxes on property are the main source of revenue generation at the subnational level.

²⁹ A cross-country regression over the period 1975-1995 shows that direct taxes are negatively associated with household savings, though the elasticity is only 0.09. Panel data also show the same result, though the elasticity rises to 0.16. Indirect taxes had no impact on household savings behaviour. Tim Callan and Christian Thimann, "Empirical determinants of household savings; evidence from OECD countries", *IMF Working Paper No. WP/97/181*, pp. 22-23.

³⁰ M. Govinda Rao, "Tax reform in India: achievements and challenges" and Ilho Yoo, "Experience with tax reform in the Republic of Korea", *Asia-Pacific Development Journal*, vol. 7, No. 2, December 2000.

There are government-operated lotteries in many countries of the region, mainly at the national level but also at the state level. There are also varieties of prize bonds, mainly in Islamic countries. In both, deposits for months or years can be made. This makes them a form of savings mobilization. Alternatively they may be considered a method of government fund-raising by an administrative route easier than tax collection. As governments have no way of directly taxing the informal sector, a lottery may be seen as a viable alternative. However, any type of prize scheme can be easily misused, spawning illegal and secondary markets and so diverting resources from the original intent. As lotteries and prize bonds are, in effect, an alternative to imposing taxes on the less well-to-do and informal sectors but with questionable equity implications, the use of the funds raised needs to be transparent. The funds could be earmarked for certain specified uses, such as for social development, education or health facilities, just as road taxes are often earmarked for infrastructure development and some petroleum taxes for environment protection.

As many governments in the region often run into deficit, its impact on overall national savings becomes a moot issue. However, it is difficult to ascertain the impact of a fiscal deficit on savings a priori. As long as there is slack in the economy, an increase in public expenditure through multiplier effects on national income would tend to raise aggregate savings. However, if the fiscal deficit results in inflation and destabilizes the economy, it may lead to lower private savings. The savings would fall further if interest rates were kept low with a view to reducing the cost of government borrowing. Governments in fast-growing economies have been able to devote a large part of their expenditure towards development expenditure, such as the provision of economic and social infrastructure, and this has had a positive impact on private savings.

The method of financing the fiscal deficit also has significant implications for private savings. In small countries the borrowing of a government from its domestic capital markets creates distortions in the domestic financial system and this limits its feasibility. However, in larger countries with more developed capital markets, government borrowing could help the market by setting benchmark curves for returns on bonds, for example.

While resource mobilization by the government is important, the impact on economic growth depends on how resources are used by the public sector. If the result is a higher level of unproductive expenditure, this could pull down the growth rate. If, on the other hand, there is a higher level of investment in socially desirable activities, it is likely that economic growth will be promoted.

Policy issues

On the fiscal side, there is clearly room for further reform of tax policies, to simplify the rules and the administration, to close loopholes and to encourage the general population to pay taxes. The last item would be easier to tackle if the government budget practices were transparent, if it were clear to all that the richer segments of a society were paying an equitable share of taxes and if public expenditure were perceived as visibly beneficial to the society at large. Given the comparatively low ratio of taxes to GDP in the region, there should be room for governments to raise more money.

Some of the proposals for further tax reform, which take into account the growing importance of the service and financial sectors, include:

- **Indirect taxes** to be expanded by targeting the growing services sector and socially and environmentally undesirable activities
- **Incidence of taxes to fall equitably** on labour and owners of financial capital and other assets
- **Tax base to be extended** to cover incomes from activities that are not currently taxed including innovative financial instruments, but excluding the subsistence sector

It is possible to **increase non-tax revenues** that account for a very small part of government resource mobilization. This can be done through:

- (1) **Increasing the fees for services provided**, such as those for education and medical treatment, but these may have negative equity consequences as the better-off pay for private services anyway

- (2) **Unbundling fees** and so charge the better-off full price and the poorer segments, only part, thus subsidizing their use of the service
- (3) **Privatizing state enterprises** – this is usually a one-off injection of funds and has problems in its own right
- (4) **Charging contributions** from those in the financial or commercial sector being regulated or supervised by the government, such as members of stock markets or banks, in sufficient amount to pay for the regulatory services provided. This has been done recently in the Republic of Korea and some South-East Asian countries, relieving governments of the extra financial burden needed to support better regulation/supervision or corporate governance. There are, however, inherently difficult tradeoffs between revenue yields, equity and regulatory independence.

Increasing the harmonization of tax policies between countries should be considered as part of a regional cooperation scheme. This would reduce distortions in savings and investment decisions and allow for progress in financial sector cooperation.

Fiscal policy measures that increase the transparency and clarity of budget allocations and investment decisions of the government would assist in increasing the confidence of those paying taxes that their money is being well spent. Therefore, one of the major modalities for enhancing resource generation by the government is to improve the handling of the expenditure side of its budget. These could include enhancing the transparency of budgets in line with the IMF Code of Good Practices on Fiscal Transparency, bringing extrabudgetary items into the budget and conducting regular public expenditure reviews. Improved consistency between revenue mobilization efforts and development policies would

also make an important contribution to generating the needed resources in the most efficient manner. In addition, transparency and consistency in the rules governing government borrowing from local capital markets would increase the comfort of those investing in these markets.

Governments have a direct and important responsibility to establish or modernize their *regulatory institutions for the financial sector*, to make sure that these institutions receive adequate funding and professional staff, that the staff have access to training on modern financial instruments and that they are independent enough to exercise their functions in an impartial manner. The institutions must be backed with a judicial system willing and able to enforce the penalties they impose on those breaking the regulations. Whether a country has separate regulators for the banks, stock market, bond markets, futures markets institutions, insurance sector, accountants and auditors etc. or one super-regulator is a matter of choice, but there must be good coordination among these to ensure that regulatory arbitrage is not conducted. The institutions should all be adopting modern international norms³¹ and taking advantage of regional and international meetings and training events to learn and contribute to the revision of these norms.

While governments are central to the issue of domestic resource mobilization, in fact in many countries today they are more of a facilitator of the private sector than a direct party to these efforts. In order to play their role properly, they need to keep their own house in order and use their ability to raise and use funds with discretion and a clear purpose.

³¹ See *Survey 2000*, chap. V, “Review of mechanisms”, for more on this topic.