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Money and Capital Market Development in Selective Asian Countries*

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Introduction

This paper first reviews the characteristics of monetary policies under the process of economic development and the difficulties in macro-economic management of the LDCs. Then the advantages of the short-term financial markets which play an important role in the implementation of monetary policies will be discussed. Taking the cases of Korea and Taiwan, who face sharp increases in international payments surplus, I will examine the background of the establishment of the short-term financial markets, the recent situation, and problems, and then refer to the establishment of such markets in the other LDCs. The short-term financial markets are closely related to an unorganized money market on the one hand, and capital market, on the other, which developed remarkably in the Asian countries in the latter half of the 1980s. Such a development was accompanied by the relaxation of international payment constraint or a shift to payment surplus, a high level of savings rates under continued high economic growth, expansion of the size of corporations, and increase in the fund demand. However, short-term money market and capital market have just started to develop and LDCs with little experience in such a field are in the process of adjusting variouis conditions (laws

*This is a part of the work completed at the Economic Research Institute, Seoul National University with which the present writer was affiliated as a Visiting Research Fellow from March 1988 to March 1990. He would like to take this opportunity to thank the Institute for helping him in his research.

and systems) and solving problems to give full play to their function. In particular, since the capital market is quite unstable compared with financial markets, it is essential to minimize the deficiencies.

I. Characteristics of Macro-Management of LDCs and Difficulties

Difficulties in the macro-economic management of the less-developed countries (LDCs) lie fundamentally in the fact that they have to continue to invest for development. Although the LDCs must promote investment to achieve economic development, the savings, namely fund sources, are quite limited. The relation of savings and investment of the LDCs is expressed by the following function:

> gross domestic investment − gross domestic savings = corporate excess investment (fund shortage) + government excess investment (fund shortage) − household excess savings (fund surplus) = overseas excess savings (fund surplus) > 0

The LDCs, with a low national income, cannot finance excess investment (fund shortage) of the corporate sector which accounts for a major part of equipment investment. The government sector also is faced with large excess investment because public investment must encompass wide areas and the tax revenue is limited. Such excess investment in the corporate and government sectors must be financed with credits of the domestic financial sector, especially the central bank or assistance and borrowings from abroad. However, the former results in inflation and the latter in large overseas borrowings. If aggravated, the former may threaten stable economic growth and the latter may lead to default or moratorium and rescheduling of debts. This way, LDCs, structurally faced with these domestic or international problems, are in danger of experiencing economic chaos and losing their credit in international markets.

In the LDCs the government sector borrows directly from financial institutions, mainly the central bank or otherwise makes these institutions hold national bonds. The government sector borrows at the lowest cost (lowest interest rate) due to its highest credit worthiness, aiming at the lowest interest rate within the interest rate structure of the organized financial sector. In the LDCs such interest rate, which is artificially determined is not related to organized market rates.

As seen above, the authorities control the fund raising cost of financial intermediaries at low levels in order to minimize their borrowing costs. As a result, the interest rates of the organized financial market, consisting of financial intermediaries, further decrease, compared with those of the unorganized money market (black market or informal market), which is the major cause for financial repression, namely unpopularity of organized financial markets. Domestic investment fund shortage reinforced by policies promoting artificially low interest rates must be financed with the central bank credit, namely high-powered money, provided to organized financial markets, especially commercial banks, which fuels an inflationary tendency. Inflation leads to the increase of export prices as well as domestic prices, resulting in the deterioration of the international balance of payments. Rises in expected inflation rates, and prospects of a decrease in financial assets value, results in the flow of funds from financial assets to real assets, and the decrease of further assets (financial savings) of financial intermediaries.

Growth policies of the LDCs, along with the central bank credit policies and low interest rate policies, lead to inflation, increases in external deficit, rises in external debts and payment difficulties; therefore, such policies are limited from the viewpoint of international payments constraints.

On the other hand, investment fund is borrowed from abroad, with the government as borrower or with the guarantee of the government in order to acquire the credit of lenders; so that government- and public-owned corporations can enjoy a favorable status abroad as well as in the borrowing from domestic banks. As a result, these government-owned corporations are responsible for the large part of external debts and such a deficit of the public sector is obviously the major factor responsible for external debt accumulation.

As seen above, the LDCs adopted policies with artificially low interest rates in order to facilitate investment. These policies lead to the expansion of the investment-savings gap, and become inflationary policies, while policies aiming at domestic and external equilibrium to maintain price stability, or economic stabilization policies, only play a secondary role.

The difficulties in the macro-economic management of the LDCs lie fundamentally in their economic development policies which emphasize the promotion of investment. Besides, there are some restrictions resulting from the economic structure of the LDCs. In other words, as many countries depend on exports of primary commodities or labor-intensive manufactured goods, they are vulnerable to the changes of the international economic situation and affected by changes in terms of trade. Moreover, their own economic activities are quite unstable because the economic structure of these nations is immature and technology-intensive and high-value-added industries have not taken root. Such a features of real economic sectors makes macro-management more difficult. Macro-management of the LDCs cannot be conceived in terms of demand control policies, as seen in developed nations, and the implementation of flexible budgetary and financial policies, especially fine-tuning type, is not effective. However, the importance of stabilization policies came to be recognized, when inflation was fueled in the 1970s also in the LDCs. On the other hand, financial reform, implemented in many Asian countries in the 1980s resulted from the changes in the international economy and domestic macro-economy.

II. Establishment of Short-Term Financial Markets in Korea and Taiwan and Implication

In the process of economic development, the financial system must be developed to be able to adapt to economic structural changes. However, often its necessity

Table 1. Share of Fund Raising of Bank and Non-Bank Financial Institution (%)

	South Korea					Taiwan				
	1975	1980	1986	1987	1988	1975	1980	1986	1987	1988
Bank	78.9	70.2	50.2	47.6	45.7	71.9*	67.6*	62.3*	62.7*	63.7*
Non-Bank Financial Institution	21.1	29.8	49.8	52.4	54.3	28.1	32.4	37.7	37.3	36.3

Source: The Bank of Korea, "Monthly Bulletin," various issues; The Central Bank of China, "Financial Statistics Monthly," March 1989; "Flow of Funds Tables," 1988.
*Foreign banks are excluded.

cannot be recognized until the country experiences the impact of macro-economic changes.

Korea's current account has run large surplus since 1986, resulting in large fund inflow, and monetary authorities had to take various measures for absorbing such liquidity in order to prevent inflation. Such a situation, however, could not be foreseen nor was there any system to respond to it, because there was a continued fund shortage up to that time and there was even an automatical system for lending money to small- and medium-sized industries at low interest rates if they fulfilled some conditions. In other words, there was a system for providing funds but not for absorbing funds. Therefore, the authorities were compelled to issue debt certificates of the central bank, called monetary stabilization bonds.

Under such conditions, the need for promoting short-term financial markets was recognized in order to control the liquidity. Through such short-term financial markets, financial institutions were able to control the fund volume at any time, and monetary authorities to control the liquidity easily by implementing monetary policies. This way it can be said that the problem of promoting short-term financial markets was not seriously dealt with until this time. Also in Taiwan short-term financial markets were established at the time of the sharp increase in the balance of payments surplus in 1972/73.

As seen in these cases, system and market were formed in response to economic development. Developed countries show models, which may not be applicable to other countries. Besides, the most difficult problem is to react to a new situation, in harmony with the existing regulations for related fields. Here, in dealing with the financial reform implemented in Korea, I will examine such problems and then compare the conditions with those of Taiwan, which experienced a similar situation as mentioned above.

Korea implemented financial liberalization in the 1980s including relaxation of government control, privatization of commercial banks, expansion of business area of financial institutions and introduction of new financial commodities. Financial and capital markets were markedly expanded, with favorable macro-economic conditions from 1986 to the beginning of 1989. But due to the problem of excess liquidity, as mentioned before, the improvement of monetary control methods and promotion of short-term financial markets became essential.

As the current account has recorded a surplus since 1986, considerable changes of shares occurred in the financial markets; namely share decrease in the banking sector and share increase in the non-banking sector. The banking sector accounted for nearly 80% in 1970s but less than 50% in 1986 and thereafter (Table 1).

Such changes cannot be explained only by the diversification of people's preference for financial assets but mainly by the large issuance of monetary stabilization bonds. The issuance increased slightly from 1984 and conspicuously from 1986, namely, their outstanding issuance stood at 14.6% of money supply (M2) in 1986, 20.6% in 1987 and 34.7% in 1988.

In order to absorb such a large issuance of monetary stabilization bonds, new kinds of investment trust funds were introduced, with monetary stabilization bonds as the investment objective and the limit of the existing investment trust for monetary stabilization bonds was expanded. These investment funds gained popularity and sharply increased due to the high returns.

This way the share expansion of non-banking financial institutions kept pace with the large issuance of monetary stabilization bonds. On the other hand, under the pressure of these high-profit commodities, the banking sector could not increase deposits. Fund borrowing and operation activities of corporate sectors show that firms did not pay their debt to the banks in spite of favorable fund conditions under buoyant exports but that they invested funds in more profitable commodities of non-banking financial institutions. In addition, a large volume of money was invested in and supplied to the stock market and real estate, and the individual sector showed a similar behavior.

I described the changes brought about by the enormous large issuance of currency stability certificates. However wouldn't it have been possible to apply another strategy?

Monetary policy instruments include central bank rediscount rate operations, reserve requirement operations, and open market operations. But in the case of the developing countries, where an open market for national bonds for example is lacking, open market operations are carried out only in the form of negotiated transactions between the central bank and financial institutions. A similar situation exists in Korea.

It is difficult to state that in Korea bank rate operations or central bank rediscount rate operations were implemented at an appropriate time. Under the process of high economic growth, the corporate sector, which was continuously suffering from fund shortage, resorted to "over-borrowing" while in the banking sector an "over-loan" situation prevailed. The increase in interest rate, therefore, met a large resistance and was difficult to realize.

Such practices have not changed appreciably even under the favorable economic conditions since 1986. The banking sector could not improve the liquidity position as seen before. Reserve requirement operations were also restricted, to avoid a worsening of the income of banks.

Short-term financial market originally enables to adjust the shortage and surplus of funds by financial institutions, and the central bank participates directly or indirectly in the control of liquidity of the financial institutions and business sector. However, it was only a call market which consisted of an "inner" market among banks and "outer" market among other institutions, with call rates being duplicated.

In the "inner" market, fund borrowers are city banks and lenders are special banks and local banks. This market controls the requirements for reserve shortage by city banks by allocating funds from lenders. "Outer" market refers to counter dealings of discounts and sales of CP, made by investment financial companies mainly and securities firms and insurance companies. This duality of the call market results from various interest rate restrictions.

Short-term financial instruments other than call money consist of CP, CD, commercial bills, bonds with repurchase agreement, and short-term securities, but they are used only as investment object more than fund control method, which indicates that the secondary markets are immature. In order to improve the efficiency of the secondary markets, it is necessary that various interest rates change freely and that the price function operates in order to meet the demand and supply. As mentioned previously, it is apparent that there are problems in the interest rate restrictions in Korea.

Professional intermediary brokers are essential for markets to function effectively. In Korea, however, the fund adjustment function of the financial institutions of the short-term financial markets was quite limited so that professional intermediary institutions could not operate only as professional brokers. However, the monetary authorities, which have been forced to absorb the excess liquidity since 1986, designated investment financial firms as professional brokers and saw to it that deals were made only through such brokers. However they were unable to enforce the adoption of these guidelines.

Due to the presence of interest rate controls, the borrowing and lending rates of the banking sector remained disadvantageous, compared with those of the nonbanking sector. Besides there was a gap between the time structure of interest rates and the normal interest rate structure.

On the other hand, the Taiwan authorities attempted to absorb the liquidity through the issuance of short-term government securities when the current account surplus increased sharply in 1972/73. After that, the foundation of short-term financial markets was laid on the basis of the recommendations of researchers of the Central Institute in 1974 and the Bank of Taiwan eventually started BA and CD business. In the same year, "short-term security firms restrictions" were implemented, involving business areas of "short-term securities firms" which are professional brokers of short-term financial markets and a kind of "securities" which are equivalent to short-term financial systems. As a result, professional intermediary brokers were organized in 1976, totaling 3 firms with 12 branches.

One of the characteristics of Taiwan is that the business area of such brokers was limited to the transaction of short-term financial market instruments. Interest

Table 2. Comparison of Money Market Outstanding (1988)

	South Korea		Taiwan	
	billion Won	Ratio to GNP (%)	100 million of N.T. Dollars	Ratio to GNP (%)
TB	18,466.7	14.9	1,970	5.8
(Monetary Stabilization Bond)	(16,966.7)	(13.7)		
CP	12,330.7	10.0	858	2.5
CD	1,753.3	1.4	435	1.3
BA			1,536	4.5
RP	2,289.2	1.9		
Total	34,839.9	28.2	4,799	14.1

Source: Same as Table 1.

rates of short-term financial markets have been liberalized since 1980, resulting in the efficient operation of secondary markets. Also in Taiwan there is an "inner" market among domestic banks and an "outer" market between domestic banks and other financial institutions, but there is a small gap in the interest rates.

Table 2, which compares the size of the short-term financial markets of Korea and Taiwan, shows that the difference in the size is due to the large volume of monetary stabilization bonds and CP in Korea.

Table 3 shows that the system of holders of bonds for controlling money stock (TB, central bank CD, central bank savings notes), issued in Taiwan is similar to the system of monetary stabilization bonds of Korea. In Taiwan the share of banks is surprisingly high, in contrast to the situation in Korea which shows a large increase in the share of non-bank financial institutions as mentioned before.

Finally, let us compare the interest rate structure (Table 4).

Interest rate structure of Taiwan can be considered to be normal; namely, it is a structure conforming to maturity structure and liquidity premium.

bank deposits rates < call rates, short-term financial market rates < rediscount rates < bank lending rates

In the case of Korea call rates (outer) and short-term financial market rates were the highest, with a remarkable deviation from the normal yield curve. Such a situation indicates the existence of interest rate control in Korea which prevents competition and on the other hand, effective operation of market rates in Taiwan.

In the LDCs short-term financial markets in a broad sense are originally closely related to the curb market, stock market or real estate market. In Korea for example, short-term investment financial companies, which were established in 1972 in order to absorb funds in the curb market, were allowed by the act of incorporation to undertake securities business like securities companies. (Such securities business of investment financial companies, however, was suspended in 1976 by the Securities Administrative Committee, as the securities companies improved their business through the development of the security market). This way, curb market, short-term money market and security market remain undifferentiated while

Table 3. Share of Monetary Stabilization Bond by Holder (%)

	South Korea			Taiwan		
	1986	1987	1988	1986	1987	1988
Bank	27.1	14.6	9.3	90.0	83.5	—
Non-Bank Financial Institution	58.4	69.0	82.8	2.0	16.2	—

Source: Same as Table 1.

Table 4. Structure of Interest Rates (at the end of 1988) (%)

	Bank Deposit Rates	Call Rate	Money Market Rate	Rediscount Rate	Bank Lending Rates
Taiwan	Demand (3 Big Banks) 1.75 – 3.75 Time (1 month – 1 year) 4.00 – 5.25	Interbank 3.92 Other 4.21	CP (Issue Rate) 4.68 – 5.94 (1 – 30 days — 91 – 180 ays) CP (Secondary Rate) 4.15 – 5.23 (same as above)	4.50 – 5.50	Prime Rate (3 Big Banks) 7.00
South Korea	Demand 1 – 4 Time 4 – 6 Preferential Savings 5 – 11.0	Interbank 9.2 Other 10.27	CP 11.9 (Selling Rate on Average) CP 12.4 (Buying Rate on Average)	8.0	Commercial Bill Discount Rate 10.0

Source: Same as Table 1.

the economy is not yet developed; therefore often the financial institutions are not specialized due to the lack of "scale economy." In the case of Thailand, finance companies and finance and securities companies were established in 1969 as non-bank financial institutions and their business area involves money market and capital market. Fund flow often occurs between money market and capital market; for example, due to the lower interest rates in the money market, funds flow to the capital market. However the main reason is that the sizes of the money market and capital market are not large enough to allow for the specialization of non-bank financial institutions. Professional brokers playing the role of intermediate in the short-term money market do not exist in ASEAN countries except for Malaysia and Singapore.

Under the favorable conditions of money and capital markets associated with the easing of the international balance of payments in the latter half of 1980 the ASEAN countries not only liberalized financial regulations but also actively adopted financial liberalization policies such as liberalization of interest rate controls and introduction of new financial commodities, and many of them found their market mechanism beginning to work in the money market.

Table 5. Growth of the Capital Market of the Seven Asian Countries

	Market	1985	1989
S. Korea	Number of Listed Companies	342	626
	Market Value of Listed Stocks (million US$)	7,400	140,500
Taiwan	Number of Listed Companies	127	181
	Market Value of Listed Stocks (million US$)	10,400	237,000
Singapore	Number of Listed Companies	133	151
	Market Value of Listed Stocks (million US$)	12,980	42,078
Malaysia	Number of Listed Companies	222	251
	Market Value of Listed Stocks (million US$)	11,260	29,487
Thailand	Number of Listed Companies	93	170
	Market Value of Listed Stocks (million US$)	1,837	25,283
Philippines	Number of Listed Companies	137	144
	Market Value of Listed Stocks (million US$)	669	11,607
Indonesia	Number of Listed Companies	24	56
	Market Value of Listed Stocks (million US$)	117	2,566

Source: Same as Table 1.

III. Growth of Capital Market in Asian Countries and Their Problems

One of the major changes in such countries in the latter half of 1980s is the development of the capital market, especially that of the stock market. The stock market has become buoyant in the Asian countries since 1987, with notable increases in the number of listed companies, stock prices, and the number of people investing in securities (Table 5). Factors contributing to the development of the capital market are considered to be as follows. Firstly, the improvement in the macro-economic circumstances in these nations, especially the relaxation of international payment constraints, enabled funds to flow to the capital market. Secondly, under the high economic growth since the 1960s which led to the expansion of the number of corporations and modernization of corporate management, various pre-conditions of fund-raising through capital market have become mature. Thirdly, due to the foreign funds invested in such countries through the Country Fund listed on markets of the Untied States and Europe, stock prices advanced and stock dealings became buoyant.

However such a sharp increase in dealings has brought about many problems. The major problem is the lack of maturity of the bond market in the face of the rapid growth of the stock market. It is generally recognized that the existence of a mature bond market is a prerequisite in the face of the stock market to keep the stock prices steady through arbitrage between interest rates and returns on stocks. In this sense, bond markets are immature and stock markets were usually quite speculative in the Asian countries. It is essential to improve the efficiency of the settlement system at the Stock Exchange as secondary market and to accelerate the progress of dealings. Against this background, Singapore and Malaysia are scheduled to introduce a transfer settlement system which makes the transfer of stocks unnecessary when stocks are sold or purchased. In addition, they made progress in the computerization for speeding up dealings. In some countries market reform and adjustment have been planned such as the merger of the stock exchanges of Manila and Makati and privatization of the stock exchange in Indonesia. On the other hand, there is an increasing tendency to raise funds in the stock market such as privatization or listing on the stock market of government-owned corporations and listing on the stock market of large corporations.

In spite of the recent changes, common problems of the stock market are as follows: (1) large fluctuations in stock prices due to the concentration to a few influential stocks, (2) short-sighted attitude of investors, and (3) problems in securities dealings (accounting system, laws, non-modernized dealing customs) due to the inexperience or lack of specialization of the securities firms. In addition, there are other problems brought about by the concentration of dealings to a few securities brokers and the lack of professional ability. As a result the securities business is only a part of the total business of banks, merchant banks, and finance companies.

IV. Conclusion

I outlined the difficulties of macro-management in the LDCs which are mainly due to the artificial low interest rate policies adopted to reduce the borrowing cost of the government, the largest economic unit. As economic development proceeded, the economic activities of the private economic units widened, along with the expansion of the market area and increased utilization of the market function. Monetary policies began to shift their orientation from artificially low rates to market rates. The financial liberalization policies of the Asian countries, which started in the 1970s and were implemented actively in 1980, reflect such changes. These changes were promoted by the relaxation of the constraints on the international balance of payments or a shift to surplus.

The importance of short-term financial markets, which enable to adjust fund shortage and surplus of various financial institutions, increased and they also played a role in the implementation of financial policies, with the interest rates serving as a reference rate for fund-raising or yield on investment. On the other hand, as a result of the increase in the number of corporations, expansion of their size, and increase in the household income under high economic growth, the demand and supply situation of funds expanded and the fund maturity period was prolonged, leading therefore to the development of a capital market. Notably, inflow of foreign funds through Country Funds, in anticipation of the growth potential of the Asian economies, gave rise to the recent buoyancy in the capital market. However the securities business is operated in many countries by finance companies whose businesses cover curb market, short-term financial market and capital market. Since their business is undifferentiated, and small-sized securities brokers lack professional ability, it is necessary to expand the size of these financial institutions and improve their specialization. In this regard, there is a wide scope for advanced foreign securities companies to extend some technical assistance. It is also true that under the recent "stock boom," many problems must be solved for the development of a sound capital market, including the reform of the stock exchange.

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