Integrating Regional Capital Markets

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1. I must start by saying that I very much admire the immense progress of capital market development in India.The economy is very large, the country is blessed with a long history of industrialization, so there are many big companies that are qualified to list on the exchange.

2. Work by the Securities Commission in India is also very dynamic. It helps to strengthen the reputation of the Indian capital market, making it one of the markets with the most potential, along with China.

3. To make you see the perspectives, in term of market capitalization, to equal the size of India we in ASEAN have to combine all of the five biggest ASEAN stock markets together. India is therefore compared to us very big. India is definitely a laudable success.

4. The question I wish to raise though is, for a market of the size of India, how much thought should policy makers need to give to regional integration?

5. You must be aware that the countries in South East Asia and East Asia are busy working hard towards integrating our capital markets. Although it is a long-term thing, and the steps taken up so far were not dramatic, the momentum is very much kept going through various official forums.

5. These forums include the ASEAN process, the ASEAN plus three process - - which adds in China, Korea and Japan, as well as the EMEAP group - - which adds further Hong Kong, Australia and New Zealand.

6. Work programs in these processes are indeed very wide ranging - - stretching from development and technical assistance for capital market development - - out to the setting up of common financing and investing frameworks - - such as the Chiang Mai Initiative, and the Asian Bond Fund.

7. At the ASEAN level, the securities commissions have also decided for the first time to join together - - to set up the ASEAN Capital Market Forum that will meet twice a year. The first meeting was hosted by Thailand in June this year.

8. Among the ASEAN SEC's, we agreed to pursue mutual recognition of rules and standards, to help each other migrate towards international best practices, and to plan towards progressively allowing our domestic investment funds to go across our borders.

9. People outside these processes often asked why we are aiming for such regional integration. They often wonder whether it is a marketing gimmick for ASEAN to compete with capital markets elsewhere.

10. I shall spend the next few minutes examining the rationale for integration in the South East Asian context.

11. First, we have to be ready for the future growth of inter-regional trade! Trade within Asia 10 years ago was only 38 % of the total trade. Today it is 51 %, and still rising. This trend will continue. We are still quite far from the level of 70 % of Europe. As products in the region take on higher and higher value added, and as consumers can afford more high-priced items, trade within the region will expand much more. Businesses in the region will therefore more and more have to plan for marketing schemes that cover the whole region, setting up distribution centers and after sale service units throughout the region. Alternatively, some of them will set up production facilities abroad, or source materials and parts from other countries in the region. They will all need financing for these operations. They will all have to manage their temporary excess cash surpluses, or their temporary cash shortfalls, across borders. They will all have to do active risk management.

12. The most important question, therefore, is -- what can capital markets do to help facilitate these operations? What can capital markets do to make it easier for these companies when they go across national borders. The answer is, in my view, the more integrated the capital markets become the more they can offer better and more competitive services to the businesses in their regional trade expansion.

13. The second issue is the future need for wealth management. The percentage of population over the age of fifty in Asia ten years ago was at 15 %. Today it is at 18 %. But in future, the graying of population in our region will speed up, at the rates that will surprise many. The clear trend is therefore that, in this region, we are going to have many, many more retired people - - most of them with better health, living longer, requiring more money.

14. Retirement savings will therefore become big money - - not only because of the larger number of people involved, but also because they tended to have fewer children. So they will need to look after their own selves, much more than their former generations.

15. To allow better management of this money, countries in the region will have to allow more and more of their domestic savings to go across borders – especially within Asia.

16. Partly to help better diversify portfolio risks, partly to build up the skill of local fund managers to understand foreign markets! And I believe capital outflow can occur step by step - - even before a country becomes a net capital exporter.

17. In Thailand, we now allow outbound investments through collective investment schemes. Even though it is subject to well-defined yearly limits, I believe the trend towards allowing **greater capital movement** within Asia will steadily pick up speed. And in fact it is actually this trend towards greater capital movement - - in fact it is the need to manage capital inflows and the sudden outflows better - - that is the **most important consideration** for regional integration.

18. We have learnt from the Asian crisis that managing capital inflows through the banking channel was not the best way. International banks might rely on the authorities to intervene to bail out the banking sector in the event of a crisis. And past experiences have

proven them right! Hence, they may have lent too much to our local banks - - far more than they would if they had to rely on the strength of the balance sheets alone.

19. Furthermore, the bank channel, compared to the capital market channel, was also less efficient in disbursing the imported capital to productive uses, particularly when the speed of inflow was too fast.

20. Unlike the capital market, the bank channel does not require disclosure, or independent appraisals by analysts and rating agencies. As a result, local banks often ended up financing projects way into the level of excess capacity, over investment and over diversification. It quickly led to a bubble.

21. And in term of capital outflows, I can still recall, when the panic began in Thailand in 1997, that foreign banks started refusing to roll over loans to the local banks very quickly.

22. I know that I am in a seminar organized by the organization representing international bankers. And I do not try to lay the blame with anyone. But in the tight liquidity that followed, the large local banks also started to do the same to the small local banks. Eventually, it even spilled over to trade credits.

23. The final result was that non-performing loans in the Thai banking system ran up to the peak as high as 45 per cent. The hardship and the loss of livelihood that ensued in my country in the aftermath of the economic crisis were deep and painful. We have therefore learnt that we need to develop an efficient capital market, both the bond market and the equity market, to better manage capital flows than through the bank channel. And I believe that regional integration of capital markets will help towards this.

25. Let me now go back to the question of whether this is also relevant to India. Financial markets in emerging countries often have regulations and controls that prevent free movement of market forces. They are considered useful in that they can help prevent shocks from abroad from disrupting the domestic market. They also enable the authority to keep a close tap on things, allowing the domestic markets to develop at their own easy and slow paces. Some countries have tighter controls than others.

26. However, I believe that, in all emerging markets, the need for deregulation and reform will build up in the future. Particularly the more the country embraces and joins the globalization process.

27. The more open their trade, the more the trading activities will trickle down to the small and medium enterprises. The pressure to gradually relax various controls will in fact come from the need for the financial market to channel more finances to the small and medium size enterprises.

28. The SMEs usually stand at the far end in the line of credit preference. It will be only when the capital market is sufficiently developed, and the capital market is able to bid away the large customers from the banks that the banks will then have no choice but to turn to these SMEs.

29. The second pressure will come from the need to develop financial technique skills both among the local bankers and the regulators. The existence of controls and regulations naturally hampers the development of sophisticated financial instruments.

30. Controls and regulations do tend to limit development of local skills. And only by lifting controls can one really build up such skills.

31. I shall conclude therefore that even a large capital market like India would benefit from looking ahead and getting itself prepared for the days of greater liberalization.

32. In this respect, I truly believe that regional consultation and regional integration can only help.