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Capital Market Development and Emergence of Institutional Investors in the Asia-Pacific Region

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CAPITAL MARKET DEVELOPMENT AND EMERGENCE OF INSTITUTIONAL INVESTORS IN THE ASIA-PACIFIC REGION

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1. INTRODUCTION

It is generally agreed that capital markets has an important role to play in the intermediation of funds from savers and investors. While banks have traditionally been a mains source of finance for investments in developing and emerging markets, it is recognized that active bond and equity markets serve an important complementary role. The view that a vibrant financial sector has a positive effect on economic growth and development has long been uncontroversial. Recently, however, and as a reaction to the financial crisis in the United States and Euro Area, some economists have argued that if it grows beyond a certain size, the financial sector may become so large that its marginal contribution to growth is negative.[1] The size at which this occurs appears relevant mostly for advanced economies and is far beyond the current state of financial development in developing and emerging markets in general and in the Asia-Pacific region in particular.

This paper thus proceeds on the premise that further development of capital markets in developing and emerging markets is beneficial, and asks what can be done to encourage growth in bond and equity markets. Particular emphasis is put on what measures might be taken induce financial markets to channel funds to infrastructure and sustainable development investments and on the role that institutional investors may play in this process.

The next section of the paper reviews the current structure of financial markets in the Asia-Pacific region. Recognizing that the vast diversity of financial development in the region makes it near impossible to draw general conclusions, most of the discussion therefore focuses on emerging markets with nascent financial markets. The section also reviews what is known about the economic and institutional reasons behind observed differences in financial development across countries.

Section 3 looks specifically at the role of institutional investors in financial intermediation and capital market development. It notes that institutional investors, particularly pension funds and insurance companies, have an incentive to be long-term investors since their liabilities have long terms to maturity. By taking on liquidity risk they can add to their return performance. The section also notes that there are reasons to believe that long-term investors can have a stabilizing effect on financial markets, and that policy makers may for this reason consider ways to encourage the growth of the institutional investor base in their financial markets. How to do so is discussed with reference to international experiences.

Special characteristics of infrastructure and sustainable development projects and the implications for public policy vis-à-vis financial markets are discussed in Section 4. An important characteristic of such projects is that they typically entail significant spill-over effects, or ‘externalities’ to use the technical economic term. The presence of such spill-overs introduces a wedge between private and social returns which implies a role for public policy. The section discusses what role policies aimed particularly at financial aspects of infrastructure and sustainable development projects can play.

[1] Cecchetti and Kharroubi (2015) and Arcand, Berkes and Panizza (2012).

Section 5 contains a discussion of a new class of investors and investment approaches which may have the promise to reduce the wedge between social and private costs and benefits inherent in environmental and sustainable development investments. The new approach goes under the name of impact investment. Impact investment is generally defined as the provision of capital that expects to generate both a financial return, usually in line with the market but not necessarily, as well as a social or environmental return. As such it internalizes the externalities associated with economic activities that have environmental and social impact. The section points to actions policy makers may take to promote this kind of investments.

The penultimate sector of the paper briefly takes up a trade-off identified with an aspect of financial development that involves the liberation of international flows of capital. Opening domestic capital markets to foreign investors and removing restrictions on outward financial investments by domestic residents has been advocated, inter alia, as a way to permit greater risk diversification and increased competition in the domestic market, thereby supporting economic development. At the same time, however, it has been noted that greater international financial openness makes the economy vulnerable to volatile international capital flows that may threaten domestic financial stability. The section discusses the extent to which regional financial integration may help improve the terms of the trade-off.

The final section lists some of the key policy messages that emerge from the paper.

2. THE CURRENT STATE OF CAPITAL MARKET DEVELOPMENT

This section reviews the basic characteristics of the financial sectors in the economies of the Asia-Pacific region, focusing first on the size and evolution of capital markets and then on what is known about the determinants of the structure of capital markets across economies.

2.1. The size and evolution of the banking sector and capital markets

2.1.1. Diversity in economic structure and financial development

The Asia-Pacific region is diverse in terms of most indicators of economic development: GDP, industrial structure, commodity dependence, size of primary vs. tertiary sectors, etc. Data from the UN ESCAP show that Gross National Product per capita differs by a factor of one hundred between the poorest and the wealthiest economies.[2] The size of the agricultural sector varies between essentially 0% of GDP in some economies to close to 60% in others. Industrial sector value added accounts for less than 10% of GDP in the least industrialized economies to between 40 and 50% in the most industrialised ones, and the size of the service sector varies between 30 and 90%. One common characteristic of the region's economies is that most are highly open to foreign trade as measured by standard criteria such as exports/GDP or imports/GDP.

2 ESCAP, *Statistical Yearbook for Asia and the Pacific 2014*, Table 24 in the on line version at www.unescap.org/resources/statistical-yearbook-asia-and-pacific-2014. The statements refer to the year 2011.

In view of the diversity in economic development and economic structures it is not surprising that significant diversity also characterises financial sectors. One indicator given in Table 1 shows the domestic credit provided by the banking sector to the economy as a percentage of GDP, a common indicator of the size of the banking sector.[3] The variation across countries is large at about a factor of thirty. There is a notable increase , 28% on average, in the importance of bank credit in most countries from before the Great Financial Crisis (GFC) attesting to the continued special role of bank credit in the region. The diversity remains, however, as shown by the coefficient of variation across countries which is high before the crisis and remains so after.

Table 1: Domestic Credit Provided by the Banking Sector (% of GDP)

	2000	Average of 2010 and 2012*
Solomon Islands	26.5	12
Brunei Darussalam	38.6	19.7
Myanmar	31.2	24.8
Lao PDR	9	26.5
Cambodia	6.4	33.9
Papua New Guinea	28.2	37
Indonesia	60.7	42.6
Kazakhstan	12.3	43.3
Sri Lanka	43.7	44.4
Pakistan	41.6	46
Philippines	58.3	50.1
India	51.2	73.9
Singapore	77.9	91
Viet Nam	32.6	114.8
Malaysia	138.4	130.5
China, People's Rep. of	119.7	150.7
Australia	93.2	154.5
Thailand`	138.3	156.2
Korea, Rep. of	74.7	165.8
Hong Kong, China	134	198
Japan	304.7	335.4
Average	72.4	92.9
Coefficient of variation	0.94	0.87
* 2011 for Lao PDR and Myanmar		

Source: ADB Key Indicators for Asia and the Pacific 2014.

Similar diversity is found in terms of capital market development as illustrated in Table 2 by the size and evolution of stock market capitalization. The gap between the least and most developed markets is large as expected. As in the case of bank lending, there is a notable increase in the size of stock markets (relative to GDP) in the past decade

[3] The average of 2010 and 2012 is taken as the latest observation (data for 2011 is not presented in the source) in order to be comparable to stock market capitalization data presented in Table 2. The latter are from 2011.

attesting to the ongoing financial deepening in the region. In fact when the comparison is made for the group of countries for which data on stock market capitalization is available, the size increase from 2000 is almost the same for the two measures. It is noteworthy that the diversity in both measures, even though high, has been declining somewhat over time as measured by the coefficient of variation.

Given that some economies in the region are at the very early stages of financial development and only have rudimentary capital markets, a discussion in following sections of the potential role of institutional investors in Asia's capital market will focus on the economies with more developed markets.

Table 2: Stock Market Capitalization (% of GDP)

	2000	2005	2011
Viet Nam		1	15
Pakistan	9	34	17
Kazakhstan	9	13	28
Sri Lanka	8	19	34
Indonesia	27	26	45
China, People's Rep. of	38	32	59
Japan	84	91	69
India	34	57	69
Philippines	38	34	74
Papua New Guinea	46	63	81
Thailand`	35	69	82
Korea, Rep. of	55	71	96
Australia	97	118	103
Malaysia	140	132	144
Singapore	182	243	145
Hong Kong, China	366	374	396
Average	77.9	86.1	91.1
Coefficient of variation	1.21	1.13	0.99

Source: World Bank, Global Financial Development Database.

2.2. Emerging Asia's capital markets in the global context

In a recent comparative study of financial systems in emerging Asian economies and emerging and developed economies in other regions Didier and Schmukler (2014) provide a broad perspective on capital market developments. The study compares the state of markets in the 2000s with that in the 1990s and focuses on seven Asian economies - People's Republic of China, India, Indonesia, Republic of Korea, Malaysia, the Philippines, and Thailand – while the comparison groups are G7 economies, seven other advanced economies, and seven emerging market economies in each of Latin America and Eastern Europe.[4] Among the authors' findings the following seven are particularly relevant for this paper:

[4] See Didier and Schmukler (2014), pp. 202-203 for a full list.

(1) Financial systems in Asia have grown over the past two decades and are generally more developed than in Eastern Europe and Latin America. They remain less developed than in advanced countries, however. This suggests that there is scope for further growth in Asian markets, and that they appear to have attributes that make them more attractive than emerging markets in other regions as a destination for investment allocation. It is important to note, however, that even among the restricted group of Asian emerging markets considered in the Didier-Schmukler paper there is considerable diversity in terms of the size of capital markets. This is illustrated in Table 3 for stock markets and in Table 4 for bond markets. Malaysia and Korea stand out as having markets with the greatest depth, while those in Indonesia are still in relatively early stages of development. The Philippines and Thailand occupy the middle.

(2) The role played by bond and stock markets has increased over time, both in absolute terms and relative to the role played by the banking sector.[5]

(3) The nature of bond financing is changing, though slowly. For example, private sector bond issues in the domestic market have longer maturity. The increased role of bond and stock markets and the ability of debtors to place longer maturity issues are also attributes that contribute to the attractiveness of the region as an investment destination. This appears to be supported by conclusion.

(4) Institutional investors have gained importance, and Sovereign Wealth Funds are also growing rapidly.

A further positive development is finding (5) that institutional investors are moving toward environmentally and socially responsible investment strategies, a topic that will be covered in some detail in Section 3 below.

Not all findings in the study are positive, however, (6) Capital raising activity has often not expanded beyond a few large companies that continue to capture most of the issuances suggesting that small and medium-sized enterprises may have difficulties in financing expansion with debt instruments. The public sector also captures a significant share of the bond market raising concerns that the private corporate sector may be crowded out. As illustrated in Table 4, corporate bond markets in Asia are small relative to government bond markets