The Art of Reform

Applying lessons from Suntze to Asia's financial markets

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Photo above shows a collage of Xian clay warriors and Chinese checkers.

AS ONE of the fastest growing regions in the world—with the highest savings—Asia appears to have a bright future. But nine years after the East Asian crisis, the region's financial markets have not fully addressed their problems of inefficient intermediation and poor risk management. Although most of the conditions exist for Asia to move forward with the necessary reforms, progress has been slow. One reason is that Asia's subjective, relationship-based economy worked when its economies were closed, but no longer does. Globalization has changed the game: open economies are subject to transparent international standards of behavior that enhance comparability and accountability.

The decline in market capitalization triggered by the financial crisis caused a staggering loss of wealth in Asian stock markets. From its peak in 1989 to August 1998—the acknowledged trough of the crisis—the Japanese stock market declined by an estimated $2.4 trillion, or 53.3 percent of Japan's GDP in 1997. Between 1996–97 and August 1998, the other East Asian stock markets also lost $1.4 trillion, or 65.9 percent of their combined GDP, excluding losses in the banking system's write-offs of nonperforming loans and provisioning and losses caused by sharp falls in real estate prices.

The good news is that the crisis spurred major changes in Asia's financial system. But an enormous amount remains to be done for Asia to reinforce its position as a major player in the world economy. As someone who has been actively involved in financial sector reform in Asia for the past 30 years, I shall attempt to describe what the strategy for reform might look like, drawing on lessons from a fifth-century BC Chinese strategist. Such strategic tools for change management, which are common for corporate reformers, have not been applied to financial system reforms.

A snapshot of Asia's financial system

Asia accounts for 55 percent of the global population, roughly one-third of global GDP in purchasing power parity terms, and one-fourth of global exports, but only 13 percent of the global equity market. Its savings, averaging about 30 percent of GDP over the past two decades, are manifested in total Asian financial assets (defined as the sum of bank credit to the private sector, stock market capitalization, and total bonds outstanding) of about 300 percent of GDP in 2004, broadly similar to the level of European and U.S. financial assets.

But there are several ways in which Asia's financial system differs from those in Europe and the United States. (Asia here refers to Japan, China, Hong Kong SAR, India, Korea, Indonesia, Malaysia, Singapore, and Thailand.) First, ***it is dominated by banks*** (see table), with bank credit to the private sector accounting for 108 percent of GDP, only slightly less than the European Union's 125.3 percent. Although Asian stock markets, in terms of capitalization, are reasonably large and comparable in depth to European stock markets (both about 75 percent of GDP), in reality, they are considerably shallower than EU and U.S. markets. The reason is that, if Japan is excluded, Asian bond markets account for only 45 percent of GDP, half the size of EU bond markets (see chart).

Second, ***Japan's economy and financial system,*** which accounted for 52 percent of GDP and 64 percent of total Asian financial system assets in 2004, ***are dominant in Asia.*** In other words, Japan is almost twice as large as the rest of Asia combined. Because the Japanese financial market is largely domestic and also dominated by banks, even the international financial centers of Hong Kong SAR and Singapore cannot compensate for the fact that Asia is not pulling its weight globally. Japan and the larger markets of China, India, the newly industrialized Asian economies, and members of the Association of Southeast Asian Nations share responsibility for the current state of Asian financial intermediation.

Third, ***institutional development in Asia's nonbank sector is weaker than that in Europe and the United States.*** Innovative capital market and insurance skills are still tapped from London or New York. Although fund management skills are improving, the largest contractual savings institutions tend to be led by a public sector with conservative and domestic-oriented investment strategies. For example, the assets of contractual savings institutions in Malaysia and Singapore, two of the most developed contractual savings sectors in Asia, amount to only 60–80 percent of GDP, compared with over 160–180 percent in most of Europe and 100 percent in the United States (Musalem and Tressel, 2003). Even though the Japanese bond market, accounting for 190 percent of GDP, is one of the largest in the industrial countries, much of this debt is held by the Japanese Post Office and domestic financial institutions. The risk-averse buy-and-hold strategies, with home bias, mean that Asian debt and derivative markets are not as liquid or deep as other industrial country markets.

Bank heavy

Asia still depends too much on bank financing.

(percent of GDP)

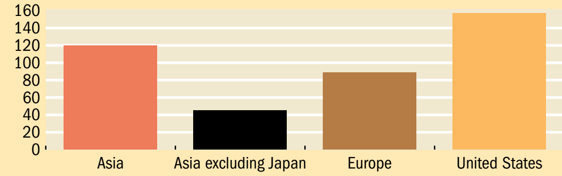
	Bank deposits		Equity market		Bond market	
	1990	2004	1990	2004	1990	2004
China	75.6	177.8	n.a.	40.3	8.5	29.4
Hong Kong SAR	205.6	299.3	107.2	486.3	1.5	28.3
India	31.4	51.1	10.4	48.4	19.9	31.7
Indonesia	29.8	38.9	4.4	24.9	0.4	24.1
Japan	100	120.5	121.7	73.2	85.9	181.6
Korea	32.6	68.8	48.2	56.1	34.1	74.9
Malaysia	52.1	88.7	100.7	152.6	69.8	89.3
Singapore	74.3	104.4	95.8	149	27.8	58.6
Thailand	56.8	79.7	29.2	72.3	9.7	38.9
Germany	53.8	96.7	21.7	42.2	51.6	80.3
United Kingdom	87.8	115.0	85.2	123	36.8	43.9
United States	59.6	58.8	57.5	131.6	122	157.2
Europe	42.1	86.8	52.3	72.1	65.9	88.8

Sources: CEIC data; World Bank, Financial Sector data set (February 2006).
Note: n.a. denotes not available.

Not pulling its weight?

Excluding Japan, Asia's bond market is still very shallow.

(bond market in percent of GDP, 2004)



Source: Authors' calculation.

Fourth, despite Asia's high savings, ***its financial system has been volatile and vulnerable to huge wealth losses,*** partly because of structural flaws. Before the Asian crisis, stock market price-earnings ratios tended to exceed developed market levels because of small public floats and the tight control that families or closely knit companies had over the markets, which prevented takeovers by outsiders or foreigners. The Asian stock markets also tended to be speculative and were used more to "double leverage" holdings of equity as collateral against bank loans to concentrate control than they were to raise funds directly from the public and spread equity ownership.

Lessons from crisis

From the 1997–98 financial crisis, Asian leaders learned the importance of sound macroeconomic policies and good risk management against currency and maturity mismatches, as well as of good corporate governance and supervision. In hindsight, they realized that capital market development was important for achieving four key policy objectives:

- ***Good resource allocation.*** The goal is to reduce reliance on the banking system, in which loans had short duration or were on foreign currency borrowing.
- ***Better price discovery.*** Risk spreads and price-earnings ratios should reflect international benchmarks. They should be neither too low nor too high, which would reflect domestic market anomalies or distortions that invite arbitrage and speculative behavior.
- ***Sound risk management and avoidance of moral hazard.*** These would enable both private and public sector participants, including financial intermediaries, to manage their risks responsibly and transparently so that market surprises can be avoided.
- ***Good corporate governance and market transparency.*** Market efficiency rests primarily on the public's belief that fund-raisers (in equity, debt, or derivatives) are worthy of their trust.

The Asian crisis also spurred massive changes on the international front, with the international financial architecture overhauled beyond recognition. The Financial Stability Forum emerged in 1999, regularly evaluating progress on monitoring financial stability and gently pushing countries, together with the international financial institutions, to implement the core international standards (accounting, corporate governance, and fiscal and monetary transparency).

The international financial institutions strengthened their capacity to deliver financial sector assessment programs and provide technical assistance. And, by 2003, leading academics and financial sector practitioners had agreed on the elements needed for capital markets to function effectively: exchanges and clearing and settlement systems to enable trading, and money market arrangements to facilitate settlement; a legal system for contract enforcement; timely information about countries' financial soundness and future prospects; and corporate governance that gives investors confidence that their funds will not be wasted or stolen.

Time to step up reform

Reform of Asia's financial markets is now urgent for both internal and external reasons. Inside Asia, policymakers recognize that the lack of deep, liquid capital markets is retarding domestic efficiency. Strong equity markets can help improve the corporate governance of many companies, particularly state-owned ones, by subjecting them to the market test. Deep and liquid bond and derivative markets are needed both to finance long-term social infrastructure and to improve monetary and exchange rate management.

The fact that Asians currently hold $2.1 trillion in foreign exchange reserves in U.S. markets testifies not only to the superior efficiency of markets outside Asia, but also to the inability of Asian markets to absorb domestic savings efficiently. Given that Asia is a relatively young economy with large pockets of poverty, the need for social infrastructure investment must be huge, but domestic capital markets and intermediaries are not equipped to finance these needs.

Externally, because of Asia's growing importance in the global economy, both the United States and Europe are exerting pressure on Asian countries to adopt more flexible exchange rate regimes to correct the global imbalances. No one wants the potential withdrawal of these huge foreign exchange reserves to destabilize global markets. No one disputes that a strong and resilient Asian capital market would be an important part of the global financial network and that a weak capital market and less robust infrastructure would pose systemic risks.

Almost all the conditions exist for Asia to move quickly on the necessary reforms. There is no shortage of savings or of the technology and skills to establish the hardware, software, and infrastructure of modern financial markets. The international financial institutions stand ready to advise, global standards have been set and disseminated, and foreign financial firms are eager to help build the financial markets. Even the sequencing of reforms is broadly understood—beginning with an active money market as the prerequisite for foreign exchange and government debt markets, followed by corporate debt, equity and asset-based securities, and complex derivative markets (see Karacadag, Sundrarajan, and Elliot, 2003). Moreover, a template exists for reformers to push through both the policy and institutional reforms needed to make domestic markets more efficient and robust.

But there is increasing awareness, including frustration, that financial sector reforms are tougher and taking longer than had been imagined. Despite initial political will, progress in Asia has slowed since the threat of crisis receded; some countries may even have rolled back some reforms.

Why is progress still so patchy and spasmodic? There are multiple reasons, including disagreement about the speed with which reforms can be implemented, conflicting policy advice, and complaints from corporations about the growing regulatory complexity and compliance costs that act as barriers to competition and entry.

A proposed reform paradigm

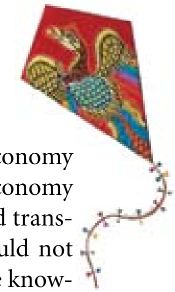
After years of struggling with reforms, including legislative changes, institution building, and restructuring, I have come to realize that it is not sufficient to address financial sector reforms on a piecemeal basis. One must take a total or even holistic political economy view. Drawing on the fifth-century BC Chinese military strategist Suntze, whose book *The Art of War* is now required reading in business schools, I would like to suggest an approach for reforming Asia's financial markets.

> "Given this emphasis on transparency and fairness, I think Asia must undergo a fundamental change in mindset."

Why would an experienced regulator turn to ancient history? In reading Suntze in the original Chinese text and applying modern concepts of governance and management, I became aware that his insights were more subtle and profound than the straightforward English translations suggest. In matters of social behavior and institutional competition or conflict, of which war is an extreme example, the quality of governance determines the outcome. Suntze considered that all matters of warfare (or decision making under conditions of uncertainty) entailed five key factors of strategic calculation: Moral order, heaven, earth, generalship/leadership, and law/discipline. How can these concepts be applied to modern markets?

First, markets compete with each other, and participants prefer one market to another on the basis of how fairly they perceive they are being treated (the morality issue). Participants drift to those markets that are transparent, protect property rights, and offer low transaction costs. It is not surprising that some emerging markets with highly protected monopolistic practices suffer from low liquidity, poor market credibility, high transaction costs, and capital flight.

Second, the concept of heaven represents the risks of timing and trends that are beyond one's control. Since all reforms carry an element of risk and uncertainty, the reformer must weigh



risks and opportunities, shaping tactics, procedures, rules, and principles to timing and conditions. Risk management, the quality of information, and an assessment of risk and opportunities are all part of project management, from the smallest project to the macromanagement of financial reforms.

Third, the concept of earth refers to the assessment of resources, logistics, and the lay of the land. Reforms must be tailored to the size of the market and the availability of resources (human, intellectual, financial, and political). Large, geographically dispersed markets and smaller, compact markets require different reform approaches. Vested interests must be strategically weighed.

Fourth, the concept of generalship, or leadership, is that amorphous quality that determines governance of social institutions. Recent reform history is replete with examples of inept leaders squandering reform opportunities, as well as of the right individuals achieving financial reform in almost impossible conditions. Often, foreign firms are useful allies that can offer the technology, skills, and market access that add to domestic market credibility and efficiency. Of course, they are also future competitors in the market game. Domestic reforms need to strike that delicate balance between indulging nationalist emotions that can block reforms and allowing in enough foreign talent and competition to keep rents accruing to existing franchises and vested interests from being exploitative. These are careful trade-offs that good leaders must negotiate.

Finally, law and discipline relate to the incentive structure of markets. The debate over corporate governance has revealed that changes of laws and codes will not necessarily change corporate behavior; laws must be enforced. In the same light, recent studies reveal that, to enforce regulatory change, bureaucracies must be able to align interests to objectives. Without the right incentives, bureaucracies may be diverted by regulatory capture, inertia, or corruption, achieving neither social nor market objectives.

Putting Suntze's lessons into practice

How would Suntze's strategic calculations apply to a modern framework? I believe that markets are social systems that must be managed. Market participants care mainly about the following issues:

- the perceived ***fairness*** of the market;
- the quality of ***transparency***: do market users have enough information to judge performance and conformance in the delivery of private and public goods that protect their property rights?
- the global standards against which performance and conformance are benchmarked to make it possible to assess the ***accountability*** of such governance; and
- governance issues that could ***bias*** performance. Distorted incentives, such as moral hazard, lack of enforcement, lack of competition, and administrative abuse, can lead to huge market losses, causing either capital flight or financial failure and crisis.

Given this emphasis on transparency and fairness, I think Asia must undergo a fundamental change in mindset. That is, it must move from a subjective, relationship-based economy to a rules-based economy. A relationship-based economy dominates when the rules of the game are unclear and transparency is absent. In the past, emerging markets could not rise to international standards because they lacked the know-how, resources, and human skills to compete internationally. When they were relatively closed economies, Asian markets could function with closed relationships and elites bolstered by large franchises.

Although Asia can blame globalization for exposing its internal weaknesses, it has only itself to blame if it does not achieve international standards of efficiency and market behavior, because the efficiency or output gap losses fall largely on its citizens. Financial crises tend to be borne by the poor and the weak; the rich can afford risk management hedges.

With globalization and the arrival of the Internet, there are now no excuses. The International Organization of Securities Commissions, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, the International Accounting Standards Board, and the OECD all provide the standards against which domestic economies will be assessed and benchmarked by the IMF as part of its Financial Sector Assessment Program. Both domestic and global investors will look to these assessments, as well as to credit-rating agencies and other international analyst publications, to judge for themselves the quality of Asia's market governance. And they might also want to remind themselves of Suntze's dictum: he who knows the competition and himself wins in the global competitive game. ■

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