



## **Australian Government**

### **The Treasury**

#### **BACKGROUND NOTE PREPARED FOR THE MEETING OF APEC FINANCE MINISTERS**

**COOLUM, 2-3 AUGUST 2007**

### **Making private capital markets work better in our region**

#### **Introduction**

Private capital markets – corporate bonds, equity and derivatives markets – are important facilitators of economic growth. They are a key source of funding, help diversify financial markets, fuel private-sector growth, and can assist governments in achieving their social and economic objectives, particularly in financing infrastructure and other investment and providing tools for business and governments to manage aging, energy and climate risks.

Progress in developing these markets in the Asia Pacific has been substantial. In the aftermath of 1997 financial crisis, markets and the systems that support them have undergone important transformations. Banks have been restructured, prudential regulation and supervision strengthened, corporate governance improved, accounting and auditing standards upgraded, restrictions on capital flow gradually reduced, and regional financial cooperation boosted. Yet practical constraints and policy challenges to further market development remain, including a relatively underdeveloped supporting infrastructure, small and narrow investor base, lack of instruments, and limited compatibility in financial systems across the region.

A combination of financial-sector reform and well-targeted development initiatives is needed to overcome these constraints and challenges. APEC is well-placed to support economies in meeting these challenges.

#### **Private capital markets**

APEC emerging economies generally have underdeveloped private capital markets and are highly reliant on bank finance. Private capital markets are equivalent to less than two-thirds of GDP in emerging APEC economies but more than two and half times GDP in mature APEC economies. In emerging APEC economies, bank finance comprises 62 per cent of total private funding, compared to 29 per cent in mature APEC economies. Corporate bond and derivatives markets are particularly underdeveloped in APEC emerging market economies.

Table: Relative size of capital markets to GDP, 2005 (per cent)

	APEC <sup>1</sup>	Mature Markets	Financial Centres	Emerging Markets	World
<b>Private Funding</b>	317.2	354.8	848.3	168.2	322.1
Private Capital Markets	212.7	253.8	512.3	64.0	176.4
Corporate bonds	90.1	112.2	66.7	19.5	81.6
Stock market capitalisation	122.6	141.6	445.6	44.5	94.8
Commercial Bank Assets <sup>2</sup>	104.5 (32.9)	101.0 (28.5)	335.9 (39.6)	104.2 (61.9)	145.7 (45.2)
<b>Government Bonds</b>	58.5	70.2	21.9	22.1	52.7
<b>Derivatives Turnover<sup>3</sup></b>	1,647.6	1,763.9	22,470.2	219.6	-

Notes: 1) APEC member economies are categorised by three groups: Mature Markets – US, Canada, Japan, Australia and New Zealand; (International) Financial Centres – Hong Kong China and Singapore; and Emerging Markets – all other economies. 2) Dependence on bank financing in parentheses – share of bank (commercial) bank assets in ‘Private Funding’. 3) Annual average turnover of foreign exchange and interest rate derivatives (daily averages multiplied by 365: 2004 figures).

Sources: IMF, *Global Financial Stability Report*, September 2006; and IMF internal database. Bank of International Settlement, Triennial Central Bank Survey: Foreign exchange and derivatives market activity in 2004, March 2005.

## Practical constraints and policy challenges

### *Strengthening the underlying infrastructure for markets ...*

Private capital markets require certain infrastructure to be in place to develop fully – notably, clear and enforceable legal rights, reliable and accessible information, and an efficient supporting trading infrastructure. This underlying infrastructure for markets is sometimes also called ‘market software’ or ‘governance’.

Property rights that are well-defined, exchangeable and enforceable need to be protected with a sound legal infrastructure, including commercial law and practices, and dispute arbitration processes. This provides investors with confidence in the trading and transfer of properties or financial products in capital markets.

Markets need reliable and accessible information to function efficiently. At the most basic level, prices need to be allowed to rise and fall to reflect the most up to date information on changes in supply and demand. Market-based pricing is best supported by transparent disclosure regimes and the use of international standards to ensure companies provide sufficient and clear information that allow investors to make informed decisions. Regulation is required to ensure that such information is reliable and the integrity of markets is preserved, and prudential supervision is required to ensure that market institutions remain sound. Ratings agencies can also play an important role by helping to determine the risks of financial products; these agencies perform best if they are independent from government and other commercial interests and if they face competition.

Investment in human capital, such as education, and advances in information technology can also contribute significantly to the growth of private capital markets. The complementary benefits of a professional skill base and technology can assist in addressing the challenges and constraints to market growth and provide a solid basis for market-led growth of domestic financial institutions and innovation.

Markets need a trading, exchange, custodial and settlement infrastructure in order to function. Private capital markets need the support of a range of institutions which provide these services at least cost and reliably.

*... growing the investor base and broadening the range of instruments ...*

A strong and diversified investor base is critical for deep and liquid private capital markets. This institutional base includes not just banks but also institutions like pension funds, mutual funds, insurance companies, securitisers and hedge funds to boost the supply of capital and lower the cost of finance. Diversity of institutions is important because these institutions typically have different trading strategies, leverage, and market behaviour, which generally provides greater depth, liquidity and stability to markets. These institutions also need to be subject to appropriate regulation.

There are actions governments can take to provide greater institutional depth and diversity, even in seemingly small steps. For example, governments can allow public pension funds to invest in securities markets, which also helps improve the efficiency and stability of pension savings. There is scope in many economies to adopt more flexible regulation, without risking integrity, to encourage the development of mutual funds or remove investment restrictions to permit insurance companies to participate in the gamut of capital markets. The consolidation of small insurance companies so that they are large enough to participate in many markets can also be important.

Encouraging greater foreign participation in local securities markets can also provide depth and diversity. Increasing foreign investor participation can also lead to a broader range of innovative financial instruments or products being introduced into the market, each with different risk profiles that can be used to unlock savings and allow local firms to better manage domestic and international risks. Foreign investor participation can also help transfer knowledge (especially about financial instruments and international standards), technology, and stimulate a more vibrant and entrepreneurial domestic financial sector. The liberalisation of cross-border portfolio capital flows can provide additional funding sources for the domestic banking sector in particular.

The financial needs of local firms are becoming more complex, and firms need a broader range of financing instruments and risk-management tools. Firms do not just face ‘traditional’ finance risks – with interest rates, exchange rates and credit – but myriad risks in such diverse areas as energy, their workforce (for many of whom they provide age or sickness benefits), and climate change (both for abatement, through the adoption of corporate carbon neutrality policies and through market trading of emissions, and adaptation). By developing tradable instruments related to these risks, capital markets provide a way, albeit at a price, for individuals, firms and governments to better manage their exposure to such risks.

*... lack of financial systems compatibility*

Global and regional integration of private capital markets creates access to a wider range of saving and investment opportunities, lowers the cost of capital for borrowers, and increases risk-adjusted rates of return for lenders. The most sustainable and effective approach to integration is to focus on strengthening domestic financial systems, institutions and markets while taking into account what is going on in other economies. This, together with the adoption of international best practice and standards in financial regulation, increases compatibility of markets across the region and deep integration in the region.

### **Looking forward – strategies, frameworks and mechanisms to strengthen markets**

There is general agreement that it is important to prioritise and sequence financial sector reforms to ensure that the best policies, infrastructure and institutions are in place to support the economic, social and political objectives of each economy.

Some economies find that master plans are useful devices to set short-, medium- and long-term priorities for reform. Indonesia, Malaysia, the Philippines and Thailand, for example, are some of the economies that have adopted such plans. These long-term holistic plans can help clarify reform objectives and provide a structured approach to reform implementation.

Master plans also communicate the government's commitment and priorities for reform to stakeholders including both the finance sector itself and the general public. When designed with wide consultation, reforms can attract greater stakeholder support and reduce the resistance of vested interests. Similarly, master plans impose greater accountability and discipline on governments.

In practice, however, a carefully programmed process of reform is often not possible. Reforms are commonly opportunistic and so reform plans need to be sufficiently robust and flexible to accommodate changing priorities or opportunities to address particular issues as they arise. One approach can be to implement reforms which have expected dynamic flow-on effects across the financial sector which are themselves a catalyst for further reform.

A range of domestic, regional and global mechanisms are available to help economies undertake reforms and develop initiatives that support private capital market development. These resources and tools include independent external reviews, such as the IMF/World Bank Financial Sector Assessment Program, or domestic reviews. Many economies find such reviews a useful mechanism to engage with both the public in general and interested parties in particular.

The implementation of targeted capacity building and the sharing of practical experience and information are also important, particularly to promote sustainable integration. The APEC Catalogue of Policy Experience and Choice currently being developed draws together the practical experience of member economies and international agencies, and is a resource which can provide assistance for governments seeking to progress financial market development.