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FINANCIAL INSTITUTIONS AND MARKETS

FINANCIAL ASIA RISING: ASIAN STOCK MARKETS IN THE NEW MILLENNIUM

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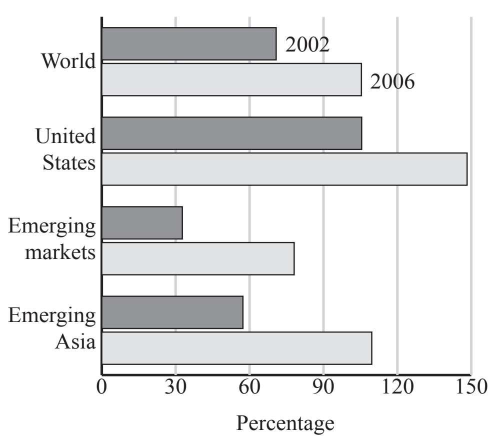
The twenty-first century has already been dubbed the Asian century. Although this nomination may be premature, it is certain that its first decade belongs to Asia. This is reflected in all the major indicators. During 2001–06, real GDP in emerging Asia (EMA) increased by an average of 8.2 percent per annum, almost twice the 4.2 percent global average. Global nominal GDP increased by about 50 percent over this period, to $48.2 billion, while EMA Asia GDP expanded by 82.6 percent, rising from 10.7 percent to 13.5 percent of global GDP.

Market Performance

The growth in Asian financial markets has been even more spectacular during this period. While the volume of the global financial markets was expanding by 78 percent, to $190 trillion, Asian financial markets were growing by 112 percent, reaching a 9.4 percent global market share. The composition of Asian financial markets also changed, with the share of equities and bonds rising from 41 percent to 58 percent. In terms of market capitalization, while global stock market capitalization rose from 70.8 percent to 105.4 percent of GDP during 2002–06, EMA market capitalization increased from 57.3 percent to 109.6 percent relative to GDP (***Figure 1***). Also in terms of market capitalization, the share of EMA in total emerging markets increased from 46.2 percent to 58.6 percent during the same period.

Figure 1: **Market Capitalization as Percentage of Gross Domestic Product, 2002 and 2006**



Source: International Monetary Fund.

Although the EMA stock markets have grown considerably during the past few years, only the Hong Kong stock market—which continues to dwarf the other EMA markets—has made it to the global top ten by capitalization. Moreover, in combination, the Hong Kong and the two Chinese main markets accounted for 47 percent of total EMA market capitalization (***Table 1***).

At the same time, liquidity increased substantially, with overall EMA dollar turnover rising by 150 percent during 2002–06, to $5.1 trillion, and a further 140 percent jump in January–November 2007 over 2006, to $12.3 trillion—with this last result owing mostly to a huge increase in trading in the three main Chinese markets (Hong Kong, Shanghai, and Shenzhen). Another measure of stock market activity, capital raised through initial public offerings (IPOs) and secondary share offerings, also registered a major jump, rising by 250 percent between 2002 and January–November 2007, to $216 billion (***Table 2***).

The price performance of Asian markets has been strong, but not as impressive, over the period. Over the five-year period, the MSCI index for EMA has been highly correlated with the overall MSCI index for emerging markets (EMs). Moreover, the five-year (annualized) performance of the MSCI indices to the end of 2006 shows that EMs in Asia came in at 19.93 percent, less than the 23.5 percent average for emerging markets as a whole and the lowest of all the

Table 1: **Emerging Asia Market Capitalization, Size, and Concentration**

Asia-Pacific	Market capitalization (billions of dollars)	No. of listed companies	Market capitalization of top 10 listed companies (percent)
Hong Kong exchanges	1,715.0	344	46.9
Shanghai + Shenzhen	1,145.5	1,287	49.7
Korea exchange	834.4	1,156	36.3
Bombay SE	818.9	4,796	32.2
Taiwan SE	594.7	518	34.7
Singapore exchange	384.3	693	37.5
Bursa Malaysia	235.6	237	36.1
Thailand SE	140.2	2,416	44.2
Jakarta SE	138.9	1,689	53.5
Philippine SE	67.9	842	56.5
Total	6,075.1	13,978	

Source: World Federation of Stock Exchanges.
Note: SE = stock exchange.

Table 2: **New Capital Raised by Shares, January–November 2007, in billions of dollars**

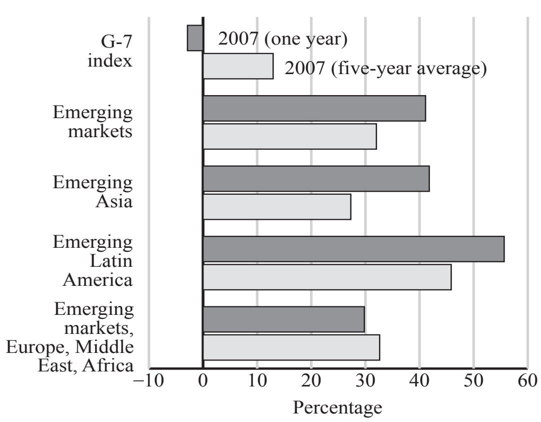
EMA	Total	IPOs	Secondary
Shanghai SE	74.8	48.6	26.2
Hong Kong exchanges	61.0	31.8	29.2
National Stock Exchange, India	30.1	7.3	22.8
Shenzhen SE	11.0	4.8	6.2
Bombay SE	10.4	9.0	1.4
Singapore exchange	8.8	4.5	4.3
Korea exchange	6.5	3.1	3.4
Jakarta SE	4.5	1.5	3.0
Bursa Malaysia	2.1	0.3	1.8
Taiwan SE Corp.	1.9	0.4	1.5
Philippine SE	1.9	0.4	1.5
Thailand SE	1.4	0.3	1.1
Colombo SE	0.4	0.0	0.4

Source: World Federation of Stock Exchanges.
Notes: EMA= emerging Asia; IPO = initial public offering; SE = stock exchange.

major EM regions. While the performance improved in 2007, Asia still came in second place after Latin America (***Figure 2***).

Price/earnings (P/E) ratios indicate that, for the period 2002–06, the EMA equity markets were not overpriced, although we saw a sharp increase in the P/E ratios for China. The stability of the P/E ratios reflects the continued strong performance of Asian corporates, with the rise in the stock prices reflecting a solid increase in corporate profits. These trends have continued in 2007, with Chinese market P/E ratios rising significantly, while other markets have exhibited some degree of stability (***Table 3***).

Figure 2: **Comparative Market Performance, 2007, percentage**



Source: MSCI Barra.

Table 3: **Price/Earnings Ratios in the Asia-Pacific, 2002–06**

Markets	2002	2003	2004	2005	2006
Shanghai	34.4	36.5	24.2	16.3	33.3
Malaysia	14.9	31.7	20.0	15.2	24.2
Singapore	21.2	24.9	16.6	15.4	19.4
Bombay	12.1	15.0	17.3	16.2	19.2
Taiwan SE	41.8	24.8	12.6	17.6	19.0
Hong Kong	15.6	19.0	18.7	15.6	17.4
Indonesia	33.1	10.8	9.7	12.5	14.7
Philippines	14.4	19.2	18.3	14.8	14.6
Korea	15.2	10.1	15.8	11.0	11.4
Thailand	7.0	13.7	9.4	9.4	8.1

Source: International Monetary Fund.
Note: SE = stock exchange.

As shown in ***Table 4,*** Asian equity markets are highly correlated, and the correlation has tended to increase over time. The correlation with the major markets is also relatively high, with the MSCI index for EM Asia showing a correlation coefficient of 0.70 over this period.

Asian Markets Come of Age

The emergence of Asian equity markets as major global players is tied in part to the continued financial globalization trends, but that is not the end of the story. We can identify the following major factors behind the rise in financial Asia:

- Financial globalization;
- The coming of age of emerging markets;
- Critical economic mass;
- Global and regional liquidity; and
- Institutional reforms.

The globalization of Asian financial markets accelerated after the regional recovery from the 1997 financial crisis. By 2000, the Asian economies were back from the brink, with strong growth, surging exports, and repaired external balance sheets. Moreover, the crisis accelerated the opening of local equity markets (initially, with the exception of China) to foreign investors, as well as the emergence of new investment vehicles (such as exchange traded funds) and new derivatives.

At the same time, on the supply side, we saw the emergence of powerful Asian financial private and government-owned players, creating a surge in new equity issuances (which increased almost fivefold during 2002–06, to $70 billion), as well as regional mergers and acquisitions and multiple listings. Furthermore, the rising reliance of Chinese state-owned companies and banks on foreign sources of funds has made Hong Kong into a major platform for Chinese IPOs.

On the demand side, the significant accumulation of foreign assets by oil exporters and EMA alike also led to the emergence of new players such as the so-called sovereign wealth funds, with assets estimated at $1.5–$2.5 trillion by 2007. These trends are likely to continue and intensify in the foreseeable future.

Emerging markets have come of age and emerged as an asset class. Since the most recent EM crisis, in Argentina in 2001, emerging markets have returned to stable and sustained growth, significantly strengthened their external balance sheets, and accumulated significant external assets. These structural economic improvements have been accompanied by a strengthening of the countries' currencies in both nominal and real terms. The sharp fall in risk perception, as measured by both the improvement in sovereign ratings and the sharp drop in EM sovereign bond yields, combined

Table 4: **Market Correlations in Asia 2002–07**

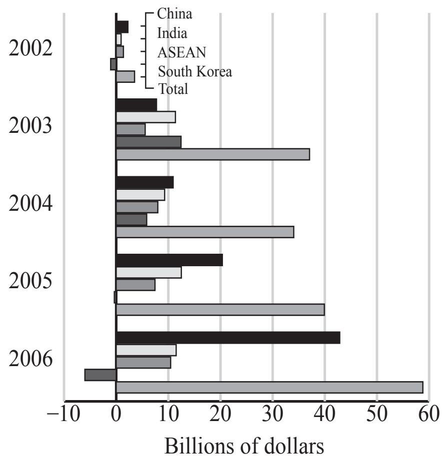
Correlation	Shanghai	Bombay	Hong Kong	Jakarta	Korea	Kuala Lumpur	Manila	Taipei	Thailand
Shanghai	1.000	0.779	0.820	0.795	0.738	0.841	0.841	0.754	0.553
Bombay	0.779	1.000	0.983	0.988	0.986	0.947	0.967	0.942	0.859
Hong Kong	0.820	0.983	1.000	0.978	0.965	0.960	0.961	0.964	0.872
Jakarta	0.795	0.988	0.978	1.000	0.968	0.968	0.983	0.953	0.855
Korea	0.738	0.986	0.965	0.968	1.000	0.928	0.955	0.936	0.827
Kuala Lumpur	0.841	0.947	0.960	0.968	0.928	1.000	0.979	0.958	0.826
Manila	0.841	0.967	0.961	0.983	0.955	0.979	1.000	0.935	0.787
Taipei	0.754	0.942	0.964	0.953	0.936	0.958	0.935	1.000	0.887
Thailand	0.553	0.859	0.872	0.855	0.827	0.826	0.787	0.887	1.000

Source: Author's derivation; data from World Federation of Stock Exchanges.
Note: Calculated on the basis of the main index for each market.

with high returns has led to a sharp increase in capital inflows to EM countries.

In the case of the EMA region, total portfolio inflows increased by a factor of 16.7 (12.5 times if we exclude China) during 2002–06, rising to $58.8 billion by the end of the period (***Figure 3***). The biggest gains have been registered by China and India, followed by the ASEAN countries, with South Korea being the only country registering net outflows.

Figure 3: **Foreign Portfolio Flows into Asia, 2002–06, billions of dollars**



Source: Institute of International Finance.

Although Asian countries form a diverse group in terms of levels of income and economic development, the EMA region has become a key factor in the global economy as a co-leader of global growth along with the United States, the euro zone, and Japan. Two developments are important in this regard. First, the breakneck speed of China's economic growth, its rapid economic transformation, and its central role in regional integration have made that country a key global player. Second, India's economic growth has significantly accelerated. On a purchasing power parity basis, the EMA region now accounts for 25 percent of global GDP. The region has also become a major importer of commodities and raw materials and has accounted in the past few years for a major portion of the increased demand for primary products.

Up to the recent subprime crisis, surging liquidity was a global trend. While liquidity seems to be drying up in the United States and Europe, it continues to be strong in EMA. The major source of liquidity in EMA is external—and is a major contributor to the global imbalances that keep the International Monetary Fund up at night. Chronic large current account surpluses (with the exception of India's) in combination with significant capital inflows (which are only partly sterilized) have complicated the conduct of monetary policy and led to double-digit growth in the money supply in EMA.

These imbalances are often blamed on the East Asian policy of maintaining undervalued exchange rates, but this is only part of the explanation. First, with the exception of the Chinese currency, most EMA currencies have significantly appreciated against the U.S. dollar in the past few years. Even the Chinese yuan is on a slow appreciating path, having gained 14.0 percent against the U.S. dollar from its revaluation in July 2005 through mid-February 2008. Second, EMA countries are facing a losing battle against squelching global liquidity, as letting their currencies appreciate faster would only attract more capital inflows. During 2002–06, the aggregate foreign exchange reserves of India, China, and Korea increased by an average of $250 billion a year.

The pace of institutional reforms in EMA equity markets has also varied by country. At one end are the world-class markets of Hong Kong and Singapore. At the other, the Chinese mainland markets remain relatively weakly regulated. In EMA excluding China, the major set of market reforms came in the wake of the 1997 Asian crisis, bringing the markets to international standards in terms of disclosure and regulation and opening the markets to foreign investors. In South Korea, a major set of reforms (the big bang) to be effective in January 2009 was enacted in 2007. Mainland China, while lagging the other markets, has instituted a number of reforms.

Challenges and Potential

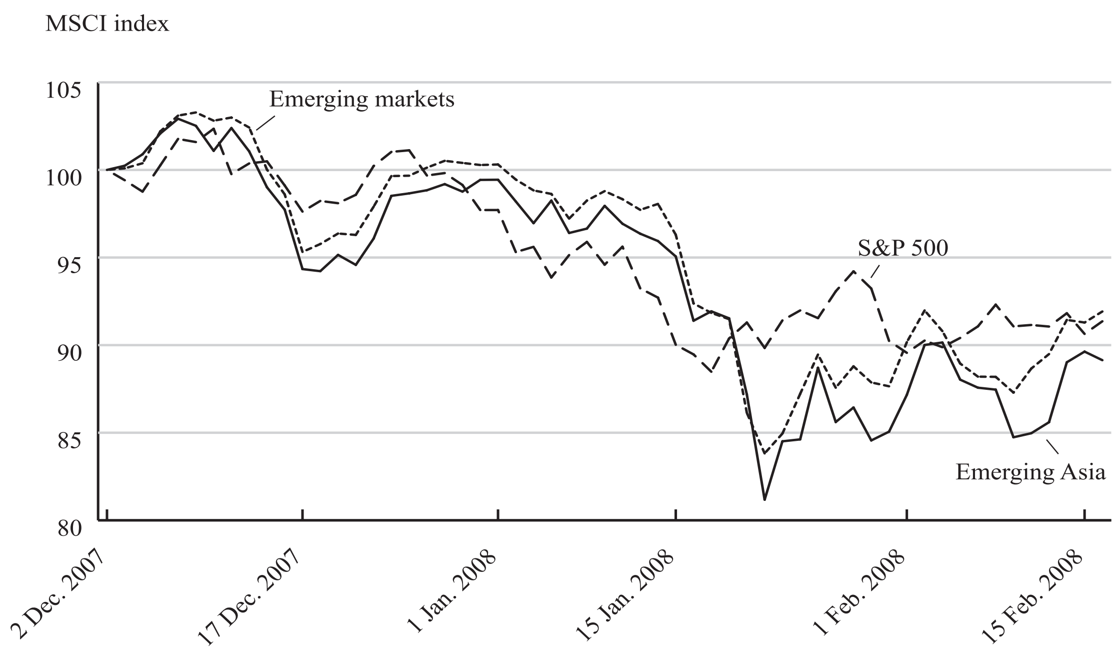
In the short term, the main challenge facing the Asian markets is the state of the global economy. After several years of steady and broad global economic growth, low inflation, and low volatility in the major financial and currency markets, the global economy faces a very different set of circumstances. The U.S. economy seems headed for a serious slowdown, if not a recession, the other major economies are losing steam, oil prices have reached all-time highs, and inflation is on the rise. The EM economies as a whole have "decoupled" and been resilient, with regional and domestic demand partly making up for the weakness in the United States and incipient problems in the other G-3 economies (euro zone countries and Japan). Nevertheless, the decoupling is expected to be tested by what is shaping up as a very difficult 2008, particularly for the EMA economies. While EMA and emerging stock markets held relatively well in the second half of 2007 in the face of the U.S. financial turmoil, they finally gave in by early December to the stream of negative news from the United States. However, there has been so far no market evidence that they have been affected more strongly than emerging markets as a whole. The EMA and overall emerging markets' performance, as measured by the MSCI, peaked in early December 2007. Since then, they have been highly correlated with the S&P 500 (a correlation of about 0.8 in each case), and lost about 15 percent through mid-February 2008, before recovering slightly (***Figure 4***). Moreover, both EMA and the overall emerging-markets stock market performance showed a sharp increase in volatility in the first few weeks of 2008, significantly higher that that of the S&P 500 (***Figure 5***). Whether these trends continue remains to be seen, as the EMA economies are highly leveraged to global trade.

In the longer term, the main challenge in Asian financial markets is institutional. While the markets in the major newly industrializing Asian countries are reasonably well regulated, the booming mainland Chinese markets require significantly improved regulation. Moreover, the performance of the Chinese stock market (with the Shanghai and Shenzhen stock market indices up by, respectively, 132 percent and 148 percent in the 12-month period to the end of November 2007) is not justified by economic or corporate fundamentals, and a sharp correction in the Chinese markets could add significantly to regional volatility.

Nevertheless, the Asian markets' prospects remain promising in the medium and long term. Here are some of the major reasons:

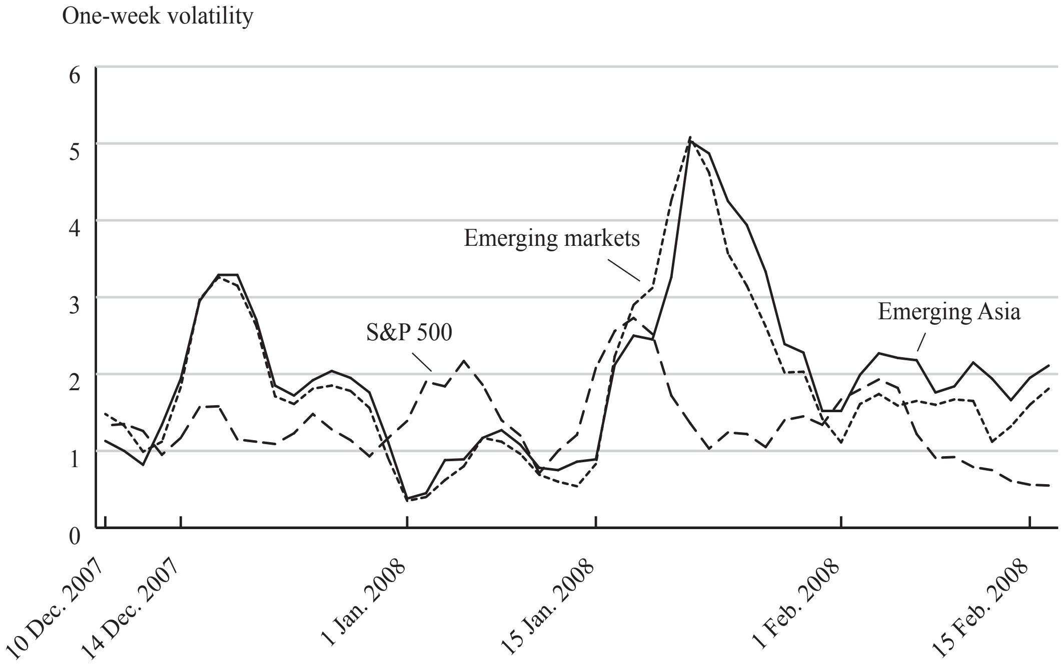
- **Economic growth.** Asia is likely to remain the fastest-growing region in the world in the foreseeable future. This should be accompanied by a ris-

Figure 4: **Recent Trends in the MSCI Index and the Standard & Poor's 500, 2 December 2007–18 February 2008**



Source: MSCI.

Figure 5: **Recent Trends in Volatility of MSCI Index and the Standard & Poor's 500, 10 December 2007–18 February 2008**



Source: MSCI.

ing tide of corporate profits, contributing to strong corporate fundamentals.

- **Wealth effect.** In parallel with the rise of a large middle class, Asia is also experiencing a sharp increase in high net worth (HNW) individuals (defined as having a net worth of $1 million or more). According to a recent estimate, the number of HNW individuals in EMA has reached almost three-quarters of a million, with assets of $2.5 trillion for just China, India, and Hong Kong.[1]

- **Sovereign wealth funds.** These institutions, which control an estimated $1.5 trillion in funds, are expected to play a major role in Asia as they diversify their assets away from the G-3 (and G-7).

- **Risk management.** The expansion (and in some cases the introduction) of derivatives in the market product mix will allow improved risk management.

At the same time, global and regional investors are likely to be increasingly sophisticated and demanding, and EMA will have to compete, not just with the G-7 markets but also with other emerging markets, to attract funds. This will require continued modernization and improved market infrastructure as well as continued integration in the global financial markets.

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1. *Financial Times,* 3 January 2008.

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