

Introduction

This book tells a simple story that has many technical components and multiple outcomes. We first describe Asia's modern economic development, then explain intermediation, and finally show and question how that process operates in important Asian settings. That anything related to modern finance can be simple seems odd in this age of financialization, especially in the wake of the global financial crisis of 2007...9, when the complexities of modern financial market practice became widely known for the first time in history, if not properly understood.

But the objective of the transformations that are central to financial activity is truly simple: to provide a means by which savings are channelled into investment in capital goods, new commercial ventures or funding for infrastructure. The complexity begins when we realize that those transformations are highly demanding in terms of risk management, and that financial intermediation can take several different elemental forms and an almost infinite number of contractual variations.

We come from three continents and three differing backgrounds and perhaps coincidentally approach our common subject from three perspectives. First, we live in a significant financial hub. Hong Kong's domestic economy is small, but as an offshore financial centre the territory is host to a large population of banks and investors, many using the city as a location for inward or outward investment with parties in Mainland China, where restrictions exist on transnational capital flows. Finance therefore has our close attention.

Second, the academic formalities and professional approaches of economics and law are unlike, even when investigating identical topics. This leads to incomplete coverage or a limited understanding of the hinterland of specialist concerns, an overall understanding of which can be extremely valuable academically and for financial practitioners. We therefore attempt a synthesis in this field that acknowledges the lack of formal demarcations in the real financial world. The value of instruments traded in one market is never wholly independent of activity elsewhere, and contractual or regulatory innovation is quickly adopted by users regardless of national borders. Copyright is almost unknown in finance. In the work that follows, we thus endeavour to assist economists and financial professionals in understanding how the law impacts their interests and to improve the familiarity of financial and commercial lawyers with finance and economics.

I.1 Finance in Asia

If this is our central objective and narrative, then the reasonable reader's thought may be to ask how this differs from many other discussions of international finance, banking or financial law and regulation? Our answer is given by the deliberate ambiguity of our title.

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Finance in Asia means at least two things. It describes the creation of modern financial markets and practice in Asia from 1949 to the immediate post-crisis period, using an explanation that specifically looks at the legal, regulatory and other institutional factors that influenced those decades of development. We set out to explain Asian financial markets, customs and outcomes, and how they may change over time. Here, our main theme is that Asian finance has its own character that is not merely a transitional phase in an inevitable global evolution towards a uniform model of finance. Nor is it a function of the urgency of its development needs, as argued by early banking scholars (Gerschenkron 1962).

Central to our view is that institutions, in the sense of rules of law, regulation or entrenched aspects of common practice, are important determinants of commercial systems and behaviour. •Institution• is used throughout the book in this sense. Unless stated, we refer to banks and similar organizations as financial intermediaries and to investors such as pension funds or insurers as non-bank intermediaries. As we will show, the bank describing itself as a •prominent financial institution• hopes to raise its reputational capital by projecting intangible ideas of safeness and stability, often with imposing headquarters to match. As we will also examine, the global financial crisis showed that the result can be a disastrous chimera.

The title's second meaning is more subtle, to illustrate the main forms of financial intermediation with Asian examples, or more accurately examples that are not predominantly European or North American and thus subject to institutional influences that are not necessarily universal. Financial intermediation and its outcomes are determined by institutional drivers such as national law, regulation and established practices, by local or transnational customs, and by supervisory rules that are adopted internationally so as to become harmonized among adopting or acceding states or territories. It has results that vary in different settings even in a highly globalized world where goods and capital flow easily across national borders.

Path dependence is especially important in finance, so that events in history bear heavily on today's outcomes. Financial systems and custom in today's markets in New Zealand, India or Colombia have certainly been affected by foreign commercial or legal influences, not least because of the impact of colonial practice and waves of globalization, but their nature and operation owe much also to local circumstances and institutions. Similarly, we believe it mistaken to identify intermediation as practised in the most sophisticated financial centres of London, New York or Hong Kong as fully representative of markets or instruments globally. In each case custom and practice is path dependent, so that the functioning of the tax-based US municipal bond market or Japan's recently privatized Kampo life insurance system, for example, are sizeable and highly significant in their respective domains but must be distinguished from comparable forms of intermediation elsewhere.

Understanding practice in the United Kingdom or United States is important from a technical perspective, but we are wary of illustrating intermediation by treating the operational quirks of those states as generic. Most writing on finance and law customarily describes intermediation using Anglo-American examples, and so neglects the extent to which US or British models are functions of local or exceptional circumstance. We see the world's leading financial markets as technically influential but not absolute precedents for systems or behaviour elsewhere, even in a highly globalized world.

intermediaries

are the technical heart of both sophisticated and emerging economies. Intermediation consists of arrays of contracts and organizations that can be simple or so complex as to be deceptive in relation to their cost or risk. We consider intermediation to be the result of generations of financial innovation and worthy of the detailed descriptions contained in this book, but we acknowledge a more cynical view expressed by an elder statesman of international finance, Paul Volcker, who in the context of the global financial crisis declared that the only valuable innovation in finance that he could recall from the previous 20 years was the automatic teller machine (Wall Street Journal 2009).

Financial intermediation more broadly, in a non-technical sense, refers to vital links between the constituent parts of every modern economy, however sophisticated and regardless of political orientation. What mechanisms connect the consumer with the saver, or the corporate sector to the state, and how does the overseas sector meld with the national economy? Without these links the adjective •modern• would be misplaced, because growth and prosperity would be limited. As the world experienced during the global financial crisis, they can be highly complex and interdependent but are often simple in construction or use. All represent processes of financial intermediation. They facilitate every aspect of commerce, trade, savings and capital formation, tax collection, foreign investment, pension provisions, gift giving, house purchase, infrastructural development, foreign aid, consumer credit, military spending, charitable donations and disaster relief, academic research, and debt and borrowing by states, companies, consumers and investors. Further, since we prepared this book during a graphic period of financial trauma, intermediation must include financial speculation, gambling and less desirable links associated with fraud, corruption or terrorism. Whether beneficial to society or individuals, all these activities require some contractual or organizational medium of financial intermediation, that is, the means by which money and credit move between participants in national economies and around the globe.

Intermediation is always a contractual process, but can be undertaken in two broad ways: through established organizations or by means of open markets or exchanges. This distinction explains the pattern of our book and is shown in simplified form in Figure I.1. A saver might choose to make a deposit with a commercial bank, or instead to buy securities such as shares or bonds in a more open arena where transactions are reported shortly after being made and are generally observable by third parties. This is a choice available in many competing ways to savers and investors, and the result is important in an institutional analysis of law and economics. Whether the saver finds the bank deposit more attractive than the

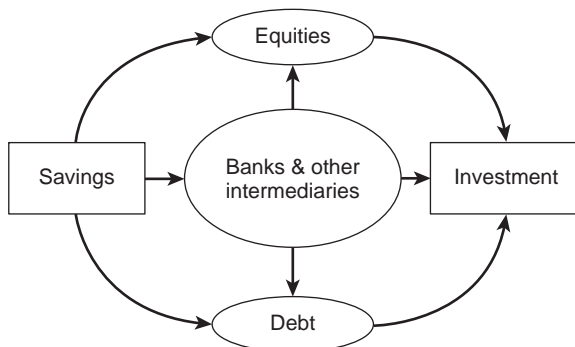


Figure I.1 Simplified financial intermediation.

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traded security is partly a matter of resources, but more importantly of personal preference as to expected risk and return. It also illustrates how transaction costs make it feasible for public markets to co-exist as alternative mediums of intermediation with financial organizations such as banks.

The real world is more complicated than our simple bifurcated model, just as the savings and investment channel works in two opposing directions to allow the proceeds of investment to return into savings. Banks intermediate between the deposits they collect and the loans they extend both as internal risk management processes and through transparent securities markets, but the contract-organization distinction is critical to our analysis.

Accordingly, our method is to describe intermediation in Asia's principal economies and try to use examples from within the region to illustrate our analysis, as well as describing non-Asian practices that indirectly impact the region, as with large-scale merger and acquisition transactions. This serves another purpose, which is to learn how “

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beyond the traditional distinction between economies of the Continental European model that depend more on banking intermediation than their Anglo-American competitors in Australia, Canada or the United States.

Our architectural analogy has a precedent among political economists. Some years ago, scholars of economic development in Asia imagined a process of take-off and eventual convergence taking place seriallyst in Japan; then in South Korea, Hong Kong, Singapore and Taiwan; next in Malaysia and Thailand; and on to the behemoths of China and later

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1.4 The future of finance in Asia

The book's third purpose is to consider how finance in Asia differs from other regions and the consequences of this for the future of finance. Our epilogue speculates on the post-crisis outcomes for finance sector behaviour and financial regulation, and asks whether the changes underway globally through the Group of 20, and regionally by members of East Asia+3, ASEAN+3, represent a cyclical downturn in financial activity or a more significant shift towards a "post-financialized" world.

This would represent a new phase of modern globalization, in which commerce and manufacturing continue to be conducted globally but finance becomes subordinate to the needs of the real economy. Such a world would allow less leverage and financial risks compared to the period of deregulation that began in the late 1970s. Can the world become simpler and less prone to systemic risks, or will it be unable to renounce those sophisticated instruments and concepts upon which the "post" many banks have been based for a generation? If the sceptical view of innovation in finance has merit, can the world's bankers, investors and traders unlearn the complex techniques that we describe in the second part of the book (Chapters 6...12)? Post-crisis re-regulation may make this inevitable unless finance can demonstrate its value in terms of economic development and general welfare.

Intermediation is not merely a process of connection or the transfer of value between parties, but is crucially about transformation, or contracts that allow the exchange of value in ways that suit the preferences of the parties involved. This applies both to instruments sold by one party to a second, and within an organizational setting when a bank elects how to apply funds amassed in the deposits of thousands of savers. Intermediation concerns transformations in the location, risk, duration and liquidity of monetary resources. In functional terms it includes money transmission, exchange and the provision of credit. All other functions are incidental to these. In many cases, the informational demands made by intermediation processes will be high, so that valuing a financial contract at any time will be complex and time sensitive, but intermediation can appear to be intuitive as with a barter or other forms of informal finance and money transmission that is conducted according to long-established but unconventional practices. One historic feature of finance in Asia is that informal banking has subsisted alongside the dominant modern forms of organization since the nineteenth century, and continues to be widely valued as a different form of money transmission.

Asia has far lesser endowments of non-renewable resources compared to Africa or the Middle East, and its renewable endowment is mixed. Some of the most successful East Asian economies have been relatively resource scarce except for human capital, including Japan, South Korea and Taiwan. How has Asian finance contributed to that broad success? To what extent is finance in Asia associated with economic development, and with crises, recoveries and general stability, either in a general way or through strong causal chains? What is Asia's financial future, and what can other regions learn from its progression? We seek to address all these questions.

1.5 Structure of the book

There are two distinct parts to the book and a short concluding chapter. Text boxes are scattered throughout to explain technical concepts or illustrate aspects of financial intermediation with local or regional examples. The first part consists of five chapters dealing with

Asia's modern economies, the nature of finance, and the virtues and challenges associated with the region's post-1949 development model. It also considers the institutional foundations of finance. We consider Asia's modern economic history to have had three major phases:

- € Serial industrialization and embedded finance, 1949...1980.
- € From economic miracle to mismanaged asset bubble, 1981...1998.
- € Post-crisis reform and risk management, 1999...2009.

At the same time, three characteristics had a consistent and regional importance:

- € State guidance of national development, even in Hong Kong and Singapore where a market orientation is assumed to prevail.
- € A strong orientation towards production for export.
- € Relatively high precautionary savings by consumers and corporations.

The narrative begins in 1949 to signify a series of sudden transformations, some of which would have financial results only decades later with the reopening of China to trade and inward investment. A narrative written in 1948 would have placed Calcutta (Kolkata), Rangoon (Yangon) and Shanghai among the region's leading commercial centres and suggest a very different modern outcome. The occupation of Japan and its forced replication of US laws and practices upon domestic industry and commerce included restrictions on monopoly that contributed to the reform of corporate governance and ownership, the adoption of finance and securities regulation similar to those instituted in the United States after 1929, and a re-orientation of the economy to export-driven manufacturing. The 1949...1980 period saw a succession of accelerated growth in per capita incomes among the industrializing states.

A second phase starts around 1980, following the end of the Bretton Woods system of capital and exchange controls and marking China's adoption of growth policies after Deng Xiaoping sanctioned economic reform. This was the beginning of Asian trade integration, with transnational capital flows becoming increasingly more prominent. Growth continued, notably with no general increase in income inequality, a mix described as the Asian economic miracle (World Bank 1993), and distinguishing the region from Africa and Latin America. The phase ended in mid-1997 with the bursting of asset prices, a rush withdrawal of capital to OECD lenders and a collapse in Asian bank balance sheets and general confidence.

The final phase, through to the global financial crisis of 2008, was notable for rapid economic recovery and a profound risk adjustment, with significant foreign reserve accumulation and decided but partial reforms in financial markets.

Within this framework, Chapter 1 describes the modern economic setting and history. We use 1949 as a starting point for our analysis since it coincides with Japan and China's transformation and predates the Korean War. Asia's development model was defined by the active and coercive functions of the state, and in a constrained model of corporate ownership. The financial sector was limited in technical and geographical scope. Both Asian and colonial banks concentrated on trade "

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To what extent was the financial sector consciously associated with Asia's post-1949 industrialization? Chapters 2 and 3 outline savings and investment intermediation and the financial links between sectors in national economies. Chapter 2 looks more closely at phases in finance and development in the region, and Chapter 3 questions the operations and risks of that model.

Chapter 4 then describes modern financial systems and regulatory practice, central banking, risk management and other institutions and customs that allow intermediation to

Table I.1 Financial intermediation: topics and arrangement of chapters

Contracts & instruments	Intermediaries	Organized markets	Supervision & regulation	Institutions & risks
Credit lines, bank loans, bonds, shares, insurance contracts, promissory notes, Islamic hance contracts, bills of exchange, guarantees	Central banks, commercial banks, investment banks, insurers, mutual funds, provident funds, hedge funds, sovereign wealth funds, private equity funds, infrastructure funds	Stock exchanges, over-the-counter derivative markets, organized futures exchanges, insurance markets, commodity markets	Securities law, stock exchange listing rules, banking regulation, "nancial disclosure law, laws on sales of investment products, laws on market manipulation	Credit risk, interest rate risks, operational risk, legal risk, foreign exchange risk, agency risk
Chapter 6 Loans & credit facilities Cash securitization Covered bonds, Contingent capital Non-recourse hance Chapter196	Chapter 4 Central banks	Chapter 8 OTC derivatives markets OTC debt capital markets	Chapter 6 Bank regulation Capital adequacy Basel Committee rules	Chapter 5 Property rights Contractual rights Collateral rights
Chapter196	Chapter116 contractA	Chapter8 Non bank private markets	Chapter8 Prudential regulation & ISDA practices	Chapter116
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Chapter 12 ends the descriptive portion of the book by tracing the recent increase in “financial” integration in Asia, partly among central banks engaging in shared or common monetary policy cooperation, and partly among intermediaries and organized exchanges through alliances and new forms of transnational intermediation.

Finally, Chapter 13 reflects on the commonalities and differences in finance in Asia, and looks forward into the future of its finance.

Parts of this book have appeared in earlier forms as journal articles and working papers, which are cited when necessary. The entire content draws on our programmes of courses given in the Faculty of Business and Economics and the Faculty of Law at the University of Hong Kong, Guanghua School of Management at Peking University, and elsewhere in the region and around the world.

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Beijing and Hong Kong, October 2012