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The Underlying Constraints on Corporate Bond Market Development in Southeast Asia

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Abstract

There has been little analysis on the underlying institutional constraints to corporate bond market development in Thailand, Malaysia and Indonesia. Research so far has concentrated on weaknesses in market infrastructure. This paper illustrates the interlocking relationships between corporations, banks and governments to have dissuaded bond issuance by companies and also contributed to the underdevelopment of the demand side of the market. The implication of this research is that, in addition to the oft-recommended measures to strengthen the market infrastructure, corporate bond market development in these countries is also contingent upon deep-set institutional change.

Key words: Corporate bond markets, Thailand, Malaysia, Indonesia, institutional settings.

JEL classification code: G3; 016

Introduction

Research has tended to focus on the technicalities of corporate bond market development in Southeast Asia[1]. This paper attempts to complement this work with research into the influence of more underlying institutional characteristics. Referring to the experiences of Thailand, Malaysia and Indonesia, it tries to shed light on why these markets have remained limited in size and, in comparison with equity markets, failed to expand significantly during the decade prior to the economic crisis. The paper also assesses some changes brought about by the economic crisis and suggests some broad policy preconditions for corporate bond market development.

The size and growth of corporate bond markets ultimately hinge upon the financing patterns of companies. Corporations in Thailand, Malaysia and Indonesia have relied heavily on a combination of internal earnings and bank debt to finance their fixed investments. Internal earnings became increasingly insufficient to finance the growing volume of fixed investment during the late 1980s and early 1990s and bank loans—emanating from both domestic and foreign banks—were increasingly utilized. Equity finance also grew in attraction as corporate debt/equity ratios rose and foreign portfolio capital flowed in at increasing magnitudes. In general, though bond issuance by corporations grew during the late 1980s and early 1990s, it remained limited in size and scope.

Underlying these financing patterns of companies are the institutional settings in these countries—namely the close and interlocking links between banks, companies and governments. To elaborate, there exists interlocking relationships between banks and leading companies—banks frequently tend to be a part of the major conglomerates that dominate the corporate sector in Thailand, Malaysia and Indonesia. This arrangement is underpinned by another layer of interlocking relations—this time between governments and the business families that control the conglomerates/banks—that provide the security of government support. These settings created strong incentives for companies to rely heavily on banks for their external finance. Moreover, during the decade prior to the crisis, they also generated the conditions that led to a large increase in bank borrowing. The resulting sharp rise in leverage meant that, over and above bank borrowing, companies' additional financing needs were more for instruments such as equities, that helped to cushion and diversify risks, rather than for more debt in the form of bonds.

Moreover, the inter-linkages between business and government may also have contributed to the underdevelopment of the demand side of the corporate bond market. There is evidence to suggest that issues relating to corporate transparency and the legal rights of creditors have assumed increased importance to investors, especially foreign ones, in the wake of the recent crisis. Interestingly, recent research by Claessens, Djankov and Lang (henceforth, Claessens et al, 1999) has underlined the possibility of a strong relationship between legal and judicial conditions (including factors impinging on the legal protections of creditors) and the concentration of control of the corporate sector by a few business families. The findings of this research can be interpreted to imply that the vested interests of powerful and politically-connected business families may have contributed to the legal infrastructure in these countries.

The implication of all this is that sustained corporate bond market development is contingent on deep-set institutional change, as well as the oft-recommended measures to strengthen the market infrastructure. The relevant policies include banking and legal reforms. At the same time, there is the need to tackle issues relating to the concentration of corporate wealth and the tight links between corporations and government. A start could be made in this area through measures to encourage greater competition and transparency in the corporate sector. The necessary measures are in all likelihood inter-related and may therefore need to be implemented in an integrated manner.

1 Namely, infrastructure issues such as clearing and settlement systems, the weaknesses of rating agencies, the absence of market benchmarks, the inadequacy of market makers, and so on.

In the wake of the recent economic crisis, some progress has already been made in implementing the necessary institutional reforms. Economic forces will probably ensure that reform continues, but the nature of the required change leads one to feel that corporate bond market development will take place gradually and over a number of years.

The following points need to be stressed about this paper:

- Though it points to the need for institutional change, it should not be interpreted as a critique of the entire development strategy of Thailand, Malaysia and Indonesia. Instead, it is accepted that the basic institutional arrangements in these countries may at an earlier time have been beneficial in promoting growth but later outlived their usefulness in line with the evolution in economic, political and external conditions.
- The issues here are far too complex to call this a definitive analysis—the findings of the study represent hypotheses that need to be reviewed and augmented by further research. The aim here is to provide a framework for this research and encourage discussion on a topic that has rarely been analyzed in the past. It should also be stressed that the paper contains a broad analysis rather than a detailed examination of all the relevant technical issues and experiences in Thailand, Malaysia and Indonesia. The cross-country generalizations made in this paper apply to different degree in each of the countries and the paper notes significant differences where they exist.
- As mentioned earlier, the paper concentrates on developments and data prior to the crisis and mostly during the 1980s and the first half of the 1990s. It also examines changes brought about by the crisis. However, it does not attempt to cover all the relevant developments subsequent to the crisis—other than point out some of the most important reforms.

The paper will be structured as follows: sections two and three will provide an empirical foundation by respectively describing relevant aspects of the financial systems in Thailand, Malaysia and Indonesia and illustrating the financing patterns of corporations in these countries. Section four will explore the institutional constraints on bond issuance and section five will examine the potential underlying shortcomings on the demand side. Section six will assess the likely effects of the recent economic crisis. In the context of the preceding analysis, section seven will assess the underlying preconditions for developing corporate bond markets.

The pre-crisis financial systems in Thailand, Malaysia and Indonesia

Banks play a central role in the financial systems of Thailand, Malaysia and Indonesia. The whole remit of financial institutions is illustrated in tables 1, 2 and 3[2].

In Thailand, at the end of 1996, commercial banks accounted for 63 per cent of the total assets of financial institutions. After banks come finance companies, which accounted for 20 per cent of the total assets of financial institutions during the same period (Bank of Thailand, 1999). Commercial banks and finance companies have provided finance for both short and medium-term activities. In the early 1990s commercial banks specialized in manufacturing and trade financing, while finance companies opted for consumer loans, hire-purchase lending and leasing. There are also more specialized institutions established by the Thailand government for development purposes—such as the Industrial Finance Corporation of Thailand (IFCT) which operates along the lines of a development bank. However, the share of total assets in the financial sector taken up by the IFCT (1.6 per cent in 1996), and the other specialized institutions, has been relatively small (Bank of Thailand, 1999).

The Malaysian financial system is characterized by the fact that non-bank financial institutions have played a more important role than in Thailand and Indonesia. Table 2 shows that the total size

2 The tables are not standardized since data are not defined in exactly the same way in the three countries. Nevertheless, they serve the purpose of illustrating the dominance of banks in the financial systems of all three countries.

Table 1:
Key statistics of financial institutions in Thailand at end-1996

	Assets[a]	Percentage of total
Commercial banks	5626661	62.95
Finance Companies[b]	1811938	20.27
Credit Foncier Companies	8518	0.10
Mutual Fund Management Co.	216241	2.42
Government Savings Bank	237442	2.66
Government Housing Bank	211444	2.37
Bank for Agricultural and Agricultural Cooperatives	212067	2.37
Industrial Finance Corporation of Thailand	143803	1.61
Small Industry Credit Guarantee Corporation	608	0.01
Small Industry Finance Corpn.	1888	0.02
Export-Import Bank of Thailand	34624	0.39
Savings Cooperatives[c]	254400	2.85
Agricultural Cooperatives[c]	34180	0.38
Life Insurance Companies	145173	1.62
Total	***8938986***	***100***

Source: Bank of Thailand (1999).
a Unit: Million Baht.
b Including finance and securities companies.
c Estimated.

Table 2:
Assets of the financial system in Malaysia (as at end-1996)

	Assets[a]	Percentage of total
Banking system	629.1	68.8
Monetary Institutions	458.8	50.1
Central bank	96.7	10.5
Commercial Banks	362.1	39.6
Non-monetary Institutions	170.8	18.7
Finance companies	119.6	13.1
Merchant banks	34.0	3.7
Discount houses	17.2	1.9
Non-bank financial intermediaries	285.6	31.2
Provident, pension and insurance funds	166.3	18.2
Employees provident funds	117.6	12.9
Other provident funds	18.1	2.0
Life insurance funds	20.7	2.3
General insurance funds	9.9	1.0
Development finance institutions	13.3	1.4
Savings institutions	17.3	1.9
Other financial intermediaries	88.7	9.7
Total	***915.2***	***100***

Source: Bank Negara.
a Ringgit Billion.

of pension, provident and insurance funds accounted for 18 per cent of the financial system's assets in 1996. Nevertheless, commercial banks play a key role and, at the end of 1996, accounted for 40 per cent of the financial system's assets. Banking institutions have been a major source of finance for the business community and have financed both short and medium-term projects. As in Thailand, there are more specialized development finance institutions established to provide long and medium-term financing to specific areas of the economy targeted as crucial for the development of the country. At the end of 1998, these accounted for 1.8 per cent of the financial system's assets (Bank Negara, 1996).

In Indonesia, as shown in table 3, state and private commercial banks accounted for over 70 per cent of the assets in financial institutions in 1996. An interesting characteristic in Indonesia is the larger number of banks (there were 144 private domestic commercial banks just before the crisis, compared with 23 in Malaysia and 15 in Thailand) and the greater role of state-controlled banks in comparison with the other two countries (World Bank, 1998). During the era of financial repression, state banks were the main providers of credit programs with subsidized interest rates—a large part of the credit was medium term investment finance. Each of the 27 provinces has one regional development bank, which has operated as a commercial bank and fiscal agent. However, the share of these is small and, in 1996, they accounted for 2.3 per cent of the total assets in financial institutions. (UNESCAP, 1999).

Despite the continued centrality of banks, the structure and characteristics of the financial systems in all these countries have undergone change during the last two

Table 3: Distribution of assets in financial institutions in Indonesia (percentage share)

	1994	1996
Bank of Indonesia	19.4	18.8
Deposit money banks[a]	71.1	81.2
State commercial banks	29.8	30.9
Private banks	32.4	40.2
Joint and foreign banks	6.7	7.9
Regional development banks	2.3	2.3
Savings banks	n.a.	n.a.
Insurance companies	4.1	n.a.
Finance companies[b]	5.4	n.a.
Other credit institutions[c]	n.a.	n.a.

Source: UNESCAP (1998).
a August 1996.
b Leasing, factoring, consumer, venture capital and credit card companies.
c Pawnshops, rural credit banks and rural financial institutions.

decades. This has been related to the financial reforms implemented in these countries during the 1980s and early 1990s. In all three countries, heavy state intervention and financial repression gave way to financial liberalization.

During the 1960s and 1970s, state intervention in the banking system was seen as an important tool to direct credit to certain "strategic" sectors of the economy[3]. As a result, governments either owned banks or intervened to steer the lending decisions of private banks. At the same time, the authorities subsidized loans from the banking sector to industry through heavy controls on interest rates on loans and bank deposits (Basu, 1997). Given this key policy role of the banking sector, the authorities also implemented measures to protect domestic banks from competition from foreign banks and from capital markets (Prowse, 1998).[4] Financial liberalization during the 1980s and 1990s included efforts to scale back government intervention in the financial sector through reducing directed credit and dismantling the controls on interest rates that led to subsidized loans being provided through the banking sector. Moreover, government ownership of banks was reduced, notably in Thailand and Malaysia, through privatization, and there were attempts to commercialize bank practices through exposing banks to increasing competition. The latter was to be achieved through making it easier for new banks, including foreign banks, to set-up (which was especially successful in Indonesia), and through encouraging the development of equity and bond markets (Basu, 1997). Finally, measures were undertaken to liberalize the capital account of the balance of payments.

The effect of financial liberalization varied from country to country. In general, though, the period of liberalization witnessed a growth in non-bank financial institutions and capital markets—in particular, equity markets[5]. Table 4 shows the growth in bank assets, equity and bond markets, as a percentage of GDP, between 1990 and 1995. The sharp growth in equity markets, witnessed in all three countries, was especially striking in Malaysia where, as a percentage of GDP, equity markets became larger than bank assets in 1995.[6]

The growth in bond markets was, however, far slower and they remained far smaller than equity markets and bank assets in all three countries. Their absolute size was, however, much larger in Malaysia than in Thailand or Indonesia. Moreover, within the broad category of bonds, corporate bond markets during the period prior to the crisis have been far smaller than the sovereign market in Malaysia and Indonesia—but were larger in Thailand. Table 6 shows that the size of corporate bond markets varied considerably between the three countries, ranging, in 1995, from 0.7 per cent of GDP in Indonesia to just over 10 per cent in Malaysia[7].

3 The three countries were not as active in employing directed credit schemes as were East Asian countries such as the Republic of Korea and Taiwan, Province of China (World Bank, 1993).

4 This protection was a regulatory device designed to encourage prudent behavior, but also to force banks to lend to government-favored customers (Baer, Miles and Moran, 1999).

5 Capital account liberalization led to a surge in foreign portfolio capital into equity markets and this trend was also accompanied by efforts to develop the infrastructure for these markets.

6 This is not inconsistent with the earlier analysis, illustrating the central role played by banks in the domestic financial system. The larger size of equity markets is due to the sharp inflow of foreign portfolio equity capital into Malaysia during the first half of the 1990s.

7 Another point worth stressing is that in these countries there is no proper medium-term corporate bond market. This is especially the case in Thailand where lending is still mainly 1 to 3 years and there is hardly lending for 7 to 10 year periods.

Table 4:
Bond market, equity market and bank assets as a percentage of GDP

	Equity market[a]		Bond market[b]		Bank assets	
	1990	1995	1990	1995	1990	1995
Thailand	27.7	85.6	9.9	10.1	78.4	115.1
Malaysia	113.4	264.7	63.3	52.4	95.9	114.7
Indonesia	7.2	34.2	1.6	4.3	57.8	n.a.

Source: Basu, 1997.
a Total capitalization as a percentage of GDP.
b Value of bonds outstanding in local currency as a percentage of GDP.

Table 5:
Size of bond markets in 1995 (Billion US dollars)

	Sovereign	Corporate	Total	% GDP
Thailand	1.7	5.3	17.0	10.1
Malaysia	29.2	8.8	45.0	52.4
Indonesia	5.3	1.7	9.0	4.3
United States			7429	110.2
Japan			3443	73.7
Germany			1719	89.5

Source: Basu (1997) and Dalla (1995).
Note:
1 Size of bond market is based on value of total bonds outstanding in US dollars.
2 Total includes bonds issued by State Government, State Enterprises and Central Banks.

Table 6:
Size of corporate bond market

	1990	1992	1993	1994	1995
US $ billion					
Thailand	0	0.2	1.0	3.5	5.3
Malaysia	1.1	2.5	3.4	4.9	8.8
Indonesia	0.1	0.1	0.5	0.7	1.7
% of GDP					
Thailand	0	0.2	0.8	2.5	3.2
Malaysia	2.6	4.3	5.3	7.0	10.3
Indonesia	0.1	0.1	0.3	0.4	0.7

Source: Dalla (1995) and Basu (1997).

Details on the specifics (including the historical development) of the corporate bond markets in each of the countries and the main users of these markets have been provided by authors such as Emery (1998) and Dalla (1995). These are summarized in boxes 1 and 2.

The above authors, and others, also provide comprehensive information on the infrastructure shortcomings in these markets. Perhaps the most significant of these is that in none of the three countries covered in this paper is there a well-established government benchmark against which corporate bonds can be priced. In Thailand, Malaysia and Indonesia, this has been due to the fact that the governments have not been active issuers of bonds, in view of their budget surpluses. In addition, in all these countries, the inadequate availability and quality of market makers has been a serious weakness. Thirdly, clearing, settlement and trading systems are underdeveloped to varying degrees in Thailand, Malaysia and Indonesia. Fourthly, though all three countries have an independent rating agency (Malaysia has two), most of them are still struggling to be fully established and profitable. Finally, there has been unfavorable primary market regulation stifling the issuance of, and investment in, bonds—despite an easing in regulatory policy during the era of financial liberalization.

Taken together, the above shortcomings can be said to have discouraged the issuance and purchase of bonds in the primary markets. Just as important, the low supply of issues, the limited base of institutional investors (who tend to adopt buy-and-hold strategies) and the inadequacy of market makers have together discouraged trading and investment in the secondary markets.

However, these problems do not provide a complete explanation of why corporate bond markets in these Southeast Asian countries are small and illiquid. For a start, the main infrastructure problems are as much a symptom of a lack of issuance and investment as they are

Box 1: Some specifics about the pre-crisis corporate bond markets in Thailand, Malaysia and Indonesia

Of the three countries, Malaysia has had the largest corporate bond market. This was launched in 1987 with the establishment of the Cagamas Berhad. This is the national mortgage corporation which was set up to develop a secondary mortgage market and at the same time promote the development of a private debt securities market. Apart from Cagamas bonds, there have been conventional bonds, convertible bonds, bonds with warrants and transferable subscription rights and Islamic notes. The corporate bond market grew rapidly between the late 1980s and the mid 1990s. In addition to Cagamas Berhad, the launching of the Privatization Master Plan had a major impact on the corporate bond market as did a series of measures (including the establishment of the credit rating agency RAM in 1991) to make corporate bonds more attractive to issuers and investors (Emery, 1998).

After Malaysia, Thailand's corporate bond market experienced the sharpest growth in the period prior to the crisis. The corporate bond market is relatively new but grew rapidly in the first half of the 1990s. In fact, the volume of new issues by the corporate sector rose twelve-fold over 1992-94, surpassing state enterprise bond issuance. A number of factors stimulated the growth in this market, including the enactment of the Securities and Exchange Act in 1992. Prior to this, only public companies and companies listed on the Stock Exchange of Thailand (SET) were allowed to issue bonds and consequently the number of private sector issues were limited. The Act permitted both public and private limited companies—whether listed or unlisted—to issue debentures. Other achievements included the liberalization of foreign exchange controls and interest rates, the establishment in May 1993 of TRIS, the country's first credit rating agency, the granting of new mutual fund management licenses and encouragement of state enterprises to issue bonds (Emery, 1998).

Indonesia's corporate bond market has been very compared to Thailand and Malaysia, though it also grew in the early 1990s. In fact, the first private sector bond issue was brought to the market in 1988. Since 1989, there has been an increasing trend of private bond issuance. Here too the authorities took measures to improve the attractiveness of issuing and investing in bonds. In the early 1990s, a credit rating agency, Pefindo, was established. In addition, several measures were taken to make investment in bonds more attractive and less costly—for example, bond transaction fees on the stock exchanges have been reduced to zero, the level of witholding taxes for domestic bond holders was set below the level for foreign bond holders and a clearing and settlement agency was established (Emery, 1998).

Source: Emery (1998)

Box 2: The main users of corporate bond markets

In Indonesia, private companies began to issue bonds in the late 1980s. Due to regulatory changes, there has been a change in the investor base for bonds since the late 1980s. A high proportion of bonds were placed with Taspen, the providers of pensions and insurance for civil servants, and Astek, the provider of employee social insurance for private sector companies. Since the late 1980s, the number of pension funds has grown greatly and they have generally invested in five year fixed or floating rate bonds. In addition, banks became major buyers of bonds since 1992 and insurance companies have increased their holdings of bonds. Thus, in addition to Taspen and Astek, important buyers of bonds began to include the state and private commercial banks, insurance companies, a large number of new pension funds, foundations and foreign institutional investors (Emery, 1998).

In Malaysia, privatized companies in sectors such as telecommunications, electricity supply, highways and other utility sectors have all issued bonds. The main buyers of private debt securities have been chiefly banks, insurance companies, finance companies, some government pension funds and unit trusts. Most of these hold the bonds to maturity (Emery, 1998) (Dalla, 1995).

In Thailand, since 1992, various private corporations have issued debentures or debentures with warrants. Some of the main issuers have been banks, real estate companies, finance and securities companies, industrial firms, and the Industrial Finance Corporation of Thailand, which is 31 per cent owned by the government. Most private sector debentures are held by institutional investors, particularly finance companies, banks and, most recently, mutual funds. As in Malaysia and Indonesia, the buyers of these bonds tend to hold them to maturity (Emery, 1998) (Dalla, 1995).

Sources: Emery (1998) and Dalla (1995)

a cause. To elaborate, there is an equally strong case for arguing that had there been more issuance and investment in the first place the market would have filled these infrastructure gaps. For example, with reference to market makers, a fixed income analyst interviewed by the author in Hong Kong pointed out that, *"if you have issuers and investors, you will have market makers. A market maker is just a guy in the middle, who will appear if you create the right conditions".* The greater the demand for these services, from issuers and investors, the more likely that they will appear in stronger form and then, in turn, contribute to further encouraging issuance and investment. In addition, the inadequate development of rating agencies and unfavorable primary market regulation are a function of deeper institutional features of these countries. For instance, the poor quality of corporate transparency and lack of issuance and investment have hindered the operations and profitability of rating agencies.

Thus, in order to understand why corporate bond markets in these Southeast Asian countries are underdeveloped, it is necessary to go deeper and examine the institutional factors that have determined the financing patterns of companies.

The financing patterns of corporations

The limited role of corporate bond markets is a function of how companies in Thailand, Malaysia and Indonesia have been financing their investments—especially medium to longer-term fixed investments. While it has been difficult to obtain solid data on this, it is possible to form some conclusions based on studies undertaken by Claessens, Djankov and Lang (henceforth, Claessens et al, 1998), Pomerleano (1998), UNESCAP (1999) and others. In addition, the meetings held during the author's trip to Southeast Asia during the summer of 1999 also shed some light on this issue.

During the era of heavy state intervention in finance, a combination of internal earnings and directed credit through the banking system and via development banks played a role in financing longer-term investments. Later on, as state intervention in the financial system was scaled back, internal earnings and commercial banks (and state banks, as well, in Indonesia) continued to provide the bulk of finance for fixed investments but were increasingly complemented by equity markets. Since bank loans tend to have a shorter time horizon than bond finance, projects with very long time duration appear to have been partly financed from the banking system in the expectation that the loans would simply get rolled-over. However, there was little local currency bond finance. Moreover, while some firms have accessed the international bond markets, in absolute terms this also is small relative to bank debt and equity finance[8]. Overall, to quote a fixed-income analyst interviewed by the author in Hong Kong:

> *"Businesses have been perfectly happy to start a 25 year project (say in petrochemicals) and fund it through equity, which is appropriate, and through bank loans, which is not always appropriate, since bank loans are traditionally shorter-term".*

The above is a summary of corporate finance patterns in these countries but it is nevertheless relevant to highlight some significant developments that occurred during the decade prior to the crisis. For a start, the magnitude of fixed investments undertaken by corporations increased sharply—especially in the non-tradeables sector and in areas such as real estate and infrastructure. These were increasingly financed through taking on rising amounts of bank debt and equity issuance. The increase in bank debt was sharp and reflected in the sharply rising leverage (i.e. debt to equity ratios) in the corporate sectors of the three countries (Claessens et al, 1998 and Pomerleano, 1998). Between 1992 and 1996, leverage doubled in Thailand and Malaysia and also rose sharply in Indonesia (Pomerleano, 1998). This is illustrated in table 7 below.

8 Only a selected number of companies are able to issue overseas and, in comparison with bank finance, the absolute amounts raised are limited. In Indonesia, large private companies have been the main issuers of bonds in international markets. Prior to the crisis, in the first half of the 1990s, the absolute amount of issuance has been relatively modest and not significantly greater than local currency bond issuance. A similar situation has existed in Thailand and Malaysia, where international bond issuance did increase in the mid-1990s but, in absolute terms, has been small and restricted (Emery, 1998) (Dalla, 1995).

Table 7:
The extent of leverage: total debt/equity (Percentage)

	1992	1993	1994	1995	1996
Thailand	71	81	103	135	155
Malaysia	31	29	38	45	62
Indonesia	59	54	58	81	92
Germany	61	67	61	59	58
Japan	136	139	139	135	138
USA	106	102	97	94	90

Source: Pomerleano (1998).

The increased bank debt was a function of greater borrowing from both the domestic banking system and from abroad. In Thailand, corporations borrowed from abroad through the offshore banking center established in the early 1990s. Moreover, in Thailand, banks borrowed heavily from overseas and re-lent this capital to local corporations. In Indonesia, by contrast, corporations to a larger extent borrowed directly from overseas banks. In either case, an increasing proportion of funds utilized by the corporate sector originated from abroad. Foreign borrowing was more limited in Malaysia where, following the large borrowings in the early 1980s, both financial institutions and corporations were limited in the extent to which they could take on foreign exchange exposures (World Bank, 1998).

Related to all this is another trend during the late 1980s and early 1990s—a shortening in the maturity of debt finance. In other words, companies began to take on an increasing amount of short-term debt. Now, as observed and explained by Caprio, Jr and Demirguc-Kunt (1998) and others, corporates in developing countries tend to take on a larger proportion of short-term debt than their counterparts in the industrialized world. However, what is interesting here is the sharp increase in the volume and proportion of short-term debt finance during this period, as illustrated by Claessens et al (1998). This is related to the sharp increase in foreign currency debt. A large proportion of the external funds financing corporate sector investments were short-term and often financed longer-term investments (World Bank, 1998). In Indonesia, companies increasingly borrowed short-term directly from foreign banks to finance longer-term investments. In Thailand, commercial banks tended to borrow short-term from abroad and lend this money at longer-term maturities to local companies. Even in Malaysia, where foreign borrowings were more limited, there was nevertheless an increase in the short-term foreign debt of the corporate sector (World Bank, 1998).

The absolute amounts of equity issuance also increased sharply during the decade prior to the crisis. A large proportion of the funds originated from abroad, as portfolio equity inflows. Together, these generated the sharp growth in equity markets illustrated by table 1. While bond issuance grew during the decade prior to the crisis, this was nevertheless far slower than the growth in bank borrowing and equity finance.

Underlying reasons for limited bond issuance

The financing patterns of companies can be linked to the institutional settings in these countries—namely, the close and interlocking linkages between banks, companies and governments.

To elaborate, several Asian economies have been characterized as having a system of relationship banking in which the business arrangements between banks and companies are formed on long-term partnerships based on "trust"[9]. As a consequence, banks often lent to corporations without formal reference to prudential norms or rigorous credit criteria (Basu, 1997). This relationship provided companies with secure access to the finance to undertake the large and longer-term investments necessary to build capacity and strengthen competitiveness. The nature of this relationship was to an extent influenced by the conglomerate structure of corporations in the three countries. As Backman (1999) illustrates, nearly all the private banks in Indonesia are owned by these conglomerates[10]. The interlocking links between businesses and banks are also strong in Thailand. Even

9 "Trust" refers to unwritten but mutually understood obligations between banks and borrowers.

10 This sustained the relationships between banks and corporations despite a sharp increase in the number of banks owing to financial liberalization.

in Malaysia, where these links are more limited, there are significant examples of banks being owned by major conglomerates (Backman, 1999). In other words, banks were better positioned to lend based on "trust" to other companies based in the same conglomerate.

Ultimately, though, the feasibility and sustainability of these arrangements were in all likelihood underpinned by the perception of government support for the banking system at large and for leading conglomerates. In the past, this view was probably fuelled by greater government intervention in the financial system (including greater predominance of state-owned banks) and in directing lending to specific projects, companies and sectors. Nevertheless, this perception held strong, even as state intervention was being scaled back during the era of financial liberalization. This, it has been argued, has been due to the effect of past government actions,[11] although, more importantly, they were owing to the strong less formal inter-linkages between the owners of banks and dominant corporations, on the one hand, and politicians on the other hand (World Bank, 1998; UNESCAP, 1999).

These linkages between business and politics in Thailand, Malaysia and Indonesia, are a function of the dominance and influence of a relatively small number of powerful business families. The dominance of these families is illustrated by research by Claessens, Djankov and Lang (henceforth, Claessens et al, 1999) and Backman (1999). Claessens et al (1999) show that a relatively small number of these families in fact control a large proportion of the wealth of the corporate sector in these countries. The results of this study are shown in table 8. Indonesia has the largest single number of companies controlled by a single family, more than four on average. Moreover, in Indonesia, the top family (namely the Suharto family) controlled 16.6 per cent of total market capitalization in the country. On all counts, the table shows that Indonesia has the highest concentration of family control, followed by Thailand and Malaysia.

Not surprisingly, these families are politically influential and tend to have close links to governments.

- These links have been most explicit in Indonesia where, as mentioned above, the Suharto family controlled 16.6 per cent of the total market capitalization of the entire corporate sector. According to Claessens et al, the business empire of the Suharto family controlled 417 listed and unlisted companies through a number of business groups led by children, other relatives and business partners, many of whom also served in some government functions.
- In Thailand, according to Backman (1999), *"the blurring between politics and business is such that, on occasions, Cabinet meetings might well have doubled as meetings of the Thai Chamber of Commerce. Senior executives of many of Bangkok's biggest businesses seemed to rotate between the boardrooms of Bangkok and the cabinet with astonishing regularity"*. Moreover, many of Thailand's senior businessmen sit in the Thai Senate and big businesses heavily

Table 8:
Family control of corporate sector wealth in Thailand, Malaysia and Indonesia

		Percentage of total market capitalization controlled by:			
Country	Average number of firms per family	Top family	Top 5 families	Top 10 families	Top 15 families
Indonesia	4.09	16.6	40.7	57.7	61.7
Malaysia	1.97	7.4	17.3	24.8	28.3
Thailand	1.68	9.4	32.2	46.2	53.3

Source: Claessens et al (1999).

11 Thailand (1983/87), Malaysia (1985/88) and Indonesia (1994) experienced financial crises that were resolved by partial or full bailouts. This probably reinforced the perception of a government guarantee on bank loans and deposits (World Bank, 1998).

underwrite the major political parties. There also exists an ethnic dimension to this connection, with Thais of Chinese ancestry owning the majority of big businesses. Among the main political parties, Chart Thai is the party that retains the biggest backing from big businesses (Backman, 1999).

- In Malaysia, too, links can be shown between businesses and politics—though these are nowhere near as extreme as Indonesia and Thailand. However, the ethnic dimension complicates the story in Malaysia. To elaborate, policy has been geared to maintaining the social peace between the indigenous Malays, the Chinese and the Indians. This led to the adoption of the "Bhumiputra" policy under which the ownership of many companies and banks was reserved for resident Malays. Given this, the major connections in Malaysia tend to be between political parties and powerful families within specific ethnic groups controlling companies.

Often, according to Backman (1999), *"banks, major companies and the government happen to be in the hands of the same people"*. This is most true in Indonesia, and perhaps fits less well in the case of Malaysia. Nevertheless, a common institutional characteristic in all three countries is the close and often interlocking relationship between members of government and the owners of banks and conglomerates.

Now, these links explain the heavy reliance on bank finance by corporations. Relationship banking worked well for both companies and banks. The underpinning provided by government support gave private as well as state banks the confidence to lend without much reference to prudential norms and rigorous credit criteria and it gave corporations the security to undertake longer-term strategic investments. Given this, corporations were rarely faced with the need to diversify their sources of debt finance and issue medium term instruments.

These points were brought out by several of the professionals interviewed by the author during his mission to Southeast Asia and Hong Kong. An investment banker in Hong Kong pointed out that, "r*elationship banking in these countries has meant that anything top companies or politicians ask for would be provided"*. The effect of government support in sustaining this financing system was underlined by a market participant in Bangkok who stressed that, "s*everal companies, like banks, have implicit government support that reduce the default risk". A*ccording to a fixed income analyst in Hong Kong, the need for medium-term debt securities finance was limited by the fact that local companies *"never had a problem with banks pulling credit, owing to their close connections with them. So when you do not see a problem, you do not look for a solution"*.

Now, these institutional settings not only created strong incentives for companies to rely heavily on banks for their external finance, they also limited the growth in bond finance that could have been otherwise expected from the process of financial liberalization[12].

To understand the reasons behind this, it is firstly necessary to touch on the uneven nature of financial liberalization and how this may have been influenced by the politics of the entire process. To elaborate, financial liberalization has been argued to have been characterized by excessive and unbalanced deregulation (Jomo, 1998; Robison and Rosser, 1998; Lauridsen, 1998). Measures to strengthen bank supervision and prudential regulation were not successfully applied and, moreover, the capital account liberalization accompanying the entire process has been argued to have been premature (Basu, 1997; Sharma, 1999).

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12 A major motivation behind financial liberalization was the need to mobilize additional domestic and international resources in order to meet the growing fixed investment requirements of the corporate sector. Given the policies mentioned earlier to make the banking sector more competitive and encourage the development of capital markets, it was assumed that companies' financing patterns would also broaden. Section 3 shows that this did happen in the sense that equity issuance grew significantly and, in addition, the sources of bank finance also widened—companies borrowed from a larger number of banks, including foreign banks (and finance companies in Thailand). Yet, despite rising medium-term investment needs, the utilization of local bond markets did not take off to the same extent.

Now, these characteristics of liberalization have, according to Robison and Rosser (1998) and others, been influenced by the politics of the process. In particular, the links between business and politics mentioned above have been argued to have gained greater potency during liberalization while, at the same time, the more formal government intervention in the financial sector was being scaled back. Financial liberalization saw a shift in power from state policy makers, who had supervised state intervention in the financial sector as a form of economic policy, towards coalitions between businesses and politicians geared to maximizing private interest. To quote Robison and Rosser (1998), financial liberalization in Indonesia was accompanied by *"a capture of the state by politico-business coalitions leading to a shift to unconstrained markets brought about by uncoordinated and unsystematic deregulation in particular sectors."* This issue is explained in greater detail, with examples, in box 3.

At the same time as they helped to shape deregulation, the links between banks and companies, on the one hand, and politicians, on the other hand, also (as explained earlier) generated the moral hazard perception of implicit government guarantees to the banking system and to large and well-connected conglomerates. Taken together, these two factors generated a greater willingness on the part of banks to

Box 3: The relationship between financial liberalization and the influence of business vested interests

According to Robison and Rosser (1998), financial liberalization in all three countries was accompanied with a shift in power from state authorities/bureaucrats to private business interests. In particular, there was the harnessing of state authority to private agendas that have been argued to have given rise to the problems of debt. McNeill and Bockman (1998) concisely summarize this argument by Robison and Rosser referring to,

> *"the case of Thailand, where this was facilitated by democratic reforms; to Malaysia where the new politico-business coalitions were forged within the existing dominant party as well as to Indonesia, where it occurred within the bureaucratic apparatus of the state".*

In Thailand, this shift was facilitated by increased democracy that, according to Lauridsen (1998), increased the power of special business interests as against that of macroeconomic technocrats. This led to the declining autonomy of and the increasing interference in the working of macroeconomic agencies and the Bank of Thailand. To quote Lauridsen,

> *"Parliamentary democracy with a strong influence of provincial businessmen replaced an authoritarian Bangkok-based semi-democracy.''*

In Malaysia and Indonesia, the new politico-business coalitions were forged within the existing dominant party and bureaucratic apparatus of the state as politicians and their families extended into the business world (Robison and Rosser, 1998). In Indonesia, the deregulation that occurred during financial liberalization created the opportunity for the economic dominance of large, predominantly Chinese owned conglomerates and business groups owned by powerful political families. According to the authors, what transpired in Indonesia was the influence of these businesses over state economic agendas and their wider political dominance as part of a coalition built around the Presidential family and its cronies (Robison and Rosser, 1998).

Overall, it is possible to envisage financial liberalization as a process that began with the economic intentions of more efficiently mobilizing and allocating resources. However, a combination of the nature of the process, the special circumstances accompanying it, and the existing institutional settings in all three countries strengthened the prominence of vested business interests. These, in turn, probably served to influence the nature of financial liberalization. To quote Robison and Rosser:

> *"Instead of liberal markets and regulatory frameworks within the general rule of law, there has emerged an unconstrained form of market capitalism encompassed politically within systems of money, politics and patronage."*

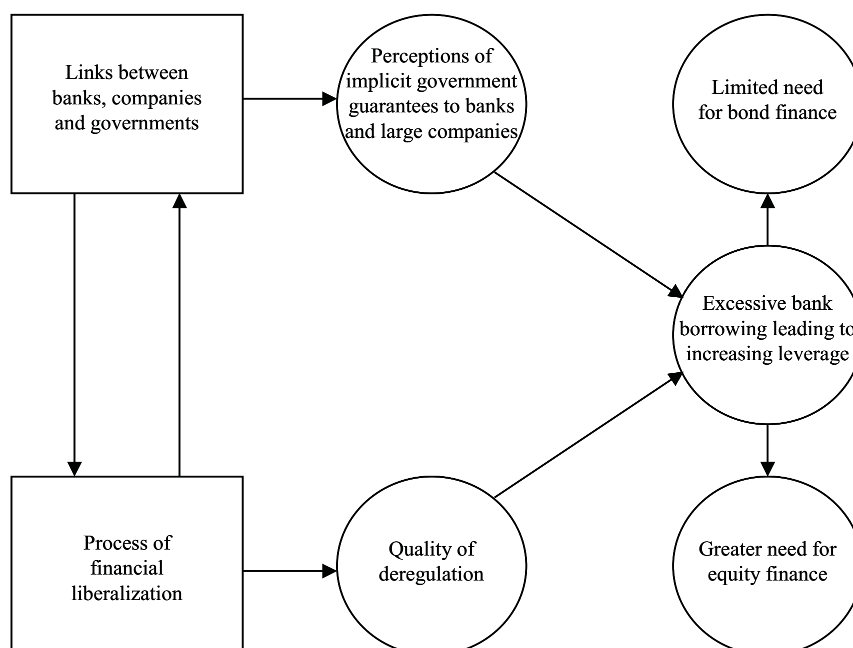
Sources: Robison and Rosser (1998), McNeill and Bockman (1998), Lauridsen (1998).

lend increasing amounts of capital on easy terms and for corporations to borrow more to finance an increasing volume of fixed investment. The result was a sharp acceleration in bank borrowing during the late 1980s and early 1990s.

The same conditions were behind the sharp increase in short-term borrowing from banks based abroad. This again was encouraged by a combination of the unbalanced deregulation that occurred as part of financial liberalization (especially, premature capital account liberalization in combination with interest rate deregulation in all three countries[13]) and moral hazard. Moral hazard was generated by the perception of implicit government guarantees backing foreign currency borrowing by local corporations and banks. In addition, excessive risk taking was also fuelled by the existence of pegged exchange rates that encouraged the discounting of currency risk. In Indonesia, corporations consequently borrowed heavily from foreign banks while, in Thailand, many domestic banks borrowed from abroad and then re-lent this money to local corporations. Foreign borrowing was more limited in Malaysia where, following the large borrowings in the early 1980s, both financial institutions and corporations were limited in the extent to which they could take on foreign exchange exposures (World Bank, 1998). The reason for the short-term nature of much of this foreign currency borrowing was a function of the lower cost of obtaining such funds which, in turn, was determined by the lower risk they entailed for the overseas lenders (Sharma, 1999).

In sum, through simultaneously generating moral hazard and influencing the nature of the financial liberalization process, the strong links between banks, companies and governments in all these countries arguably fuelled the sharp increase in companies' borrowings from domestic and foreign banks (see figure 1). These financed a significant proportion of the large increase in fixed investment—both short and

Figure 1: Institutional forces behind limited bond issuance in late 1980s and early 1990s



13 As interest rates were deregulated, the cost of domestic finance rose in these countries. For example, in Thailand, corporate borrowers discovered that they could borrow at an interest rate of 5 to 8 per cent offshore instead of paying more than 13 per cent when borrowing domestically (Lauridsen, 1998).

longer-term projects—undertaken during the late 1980s and early 1990s. The short-term loans from foreign banks in particular often went to finance longer-term investment in areas such as construction and real estate. All this meant that there was little need for companies to tap the bond market. Moreover, as corporations borrowed increasingly from local and international banks, their debt/equity ratios began to increase. Given this, the preference of companies was not to carry additional debt (such as bond finance) but for instruments such as equities that reduced their net debt exposure. To quote a leading fixed income strategist in Hong Kong, *"the last thing companies have needed is to raise their gearing ratios"*.[14]

Problems on the demand side of the market

The limited levels of bond issuance have clearly been a major constraint on the growth of the corporate bond market. At the same time, neither local[15] nor foreign investors[16] have shown a strong need for local currency bonds as a part of their portfolios.

Looking ahead, the demand side of the market for corporate bonds suffers from underlying problems, again related to the institutional settings in these countries, which could present a constraint to future growth. To elaborate, given the predominance of bank finance, there has been little perceived need to develop the governance infrastructure associated with arms-length mechanisms of finance—such as corporate transparency and the legal rights of creditors and shareholders. Even as equity markets developed rapidly during the early 1990s, there was little incentive to strengthen these areas given the lack of concern of investors (who mostly originated from overseas) who were buoyed by a sense of optimism towards the Southeast Asian countries (Sharma, 1999). These shortcomings on the legal front and in transparency are described in box 4.

In the wake of the crisis, however, investors (both local and foreign) have begun to pay increasing attention to these issues—especially given the realization that the government cannot be expected to bail out powerful conglomerates and banks (Sharma, 1999). Significant inadequacies in the areas of corporate transparency and legal protections of creditors in all three countries, if not overcome, could therefore restrain investor interest in corporate bonds in the future. This was stressed to the author by a number of interviewees during his mission to Southeast Asia. For instance, a fund manager in Singapore argued that, *" at the end of the day, for people to put their money in bonds, you will need to raise standards of governance and transparency. Otherwise, you will need to pay a huge risk premium"*.

Since a major attraction of corporate bonds is as a lower risk instrument than equities, in exchange for a lower return, investors are likely to be less tolerant of risks arising from poor legal protections and from weak transparency. Unless these risks are reduced, corporate bonds in Thailand and Indonesia, in particular, and to a lesser degree in Malaysia, are unlikely to become an attractive investment instrument—except in the case of a few well-managed and reputable blue-chip companies. To quote a foreign investor based in Singapore, *" the risk/return profile of Southeast*

14 Having said this, it is necessary to briefly point to the differences between the three countries in this respect. The above analysis fits especially well in the case of Indonesia and Thailand. In Malaysia, the interlocking relations between banks, companies and government are looser, foreign borrowing grew by less than in the other two countries and equity markets grew to a greater degree. Nevertheless, in broad terms, the above framework of the institutional influences on corporate financing patterns and how they led to limited bond issuance is applicable here too.

15 Households in the region have been content to invest a large proportion of their savings in banks and, to a lesser extent, in equity markets. There has been little investment in other asset classes such as bonds due to a lack of sophistication of the retail investor base in the region and a lack of information and supply of bond issues (be it government or corporate) in the region. Most of the purchase and holding of corporate bonds had been undertaken by institutional investors, (including banks, pension funds, insurance companies and mutual funds). The base of these investors has been growing in all three countries but, as mentioned in section 2, many of these entities tend to adopt buy-and-hold strategies rather than actively trade securities on the secondary market (Emery, 1998) (Dalla, 1995).

16 With respect to foreign investors, they poured in increasing amounts of capital in the equity markets of Thailand, Malaysia and Indonesia during the late 1980s and early 1990s. Rapidly growing emerging markets such as Asia provided a means of diversification of their investments and rapid economic growth enhanced the returns generated by equities. In this high growth environment, bonds were a less attractive instrument (Sharma, 1999)(Asian Development Bank, 1998).

Box 4: Shortcomings on the legal and transparency areas

Although creditors' rights have been well-defined in the three countries, enforcement has been problematic due to corruption, political interference and the fact that courts do not have the expertise and practical knowledge for handling proceedings like key bankruptcy cases.

Employing the methodology of Prowse (1998), the left-hand column of the table is constructed from various aspects of a country's bankruptcy law and provides a summary measure of the legal protections for creditor rights before the recent crises began to unfold. While creditor rights appear to be stronger on paper in Thailand, Malaysia and Indonesia than in the United States, it is in the degree of enforcement of these laws that the real differences have lain. The general level of enforcement of laws by the judicial system of a country is measured in the right-hand column of the table. Again employing Prowse's methodology, this summary measure is constructed from five measures of the judicial setting which rank the efficiency of the judicial system, the rule of law, the degree of corruption, the risk of expropriation by the government, and the likelihood of contract repudiation by the government. The table suggests that the overall enforcement environment has been markedly weaker in Thailand, Malaysia and Indonesia than in the developed countries. Indonesia has had, by far, the greatest problem in this respect. While Malaysia had the best record, this nevertheless fell short of the industrialized countries' standards.

***Legal protections for creditors of firms, circa 1995*[a]**

	Creditor protections	Degree of judicial enforcement
Thailand	3	5.9
Malaysia	4	7.7
Indonesia	4	4.4
United States	1	9.5
United Kingdom	4	9.4
Japan	2	9.4
Germany	3	9.4

Source: La Porta et al 1996. For creditor protection measures, the scale is from 1 to 5 with 5 representing the strongest protections and 1 the weakest. For enforcement, the scale is from 1 to 10, with 10 representing the highest degree of judicial enforcement and 1 the lowest..

a There have been recent changes to creditor protection in the aftermath of the crisis (e.g., changes to bankruptcy and foreclosure laws in Thailand). These have not been incorporated and would obviously change the figures.

There have also been numerous studies illustrating the generally poor levels of corporate transparency in all these countries. For example, Rahman (1998) made a study of accounting practices and disclosure in the East Asian countries in comparison to selected International Accounting Standards (IAS). He found that standards were clearly inadequate in all three countries. For example, none of the sample companies in the three countries disclosed information on commitments in support of off-balance sheet financing.

Sources: Prowse (1998), Rahman (1998)

Asian bonds is not attractive due to liquidity risks, legal risks and a lack of disclosure".

The legal conditions may themselves be contingent on the inter-linkages between business and government in Thailand, Malaysia and Indonesia. To elaborate, research by Claessens et al (1999) suggests that future legal reforms in these countries may not be independent of changes in ownership structures and concentration of wealth. The authors have undertaken statistical research that links legal and judicial conditions in a number of Asian countries—including Thailand, Malaysia and Indonesia—to the concentration of control in the corporate sector by a few business families. In particular, they compare the concentration of ownership in the hands of the largest fifteen families in terms of market capitalization to three indicators on legal and judicial development: the efficiency of the judicial system, the rule of law and the degree of corruption. They argue that if, "*the role of a limited number of families over the corporate sector is large and the government is heavily involved in and influenced by business, the legal system is less likely to evolve in a manner to protect minority shareholders, and more generally to promote transparent and market-based activities"*.

The study by Claessens et al shows a correlation between the share of the largest fifteen

families in total market capitalization, on the one hand, and the above-mentioned three indicators of legal and judicial development, on the other hand. According to them, this suggests that, "*...the concentration of corporate control is a major determinant in the evolution of the legal system i.e. relationships exist between the ownership structure of the whole corporate sector and the level of institutional development…"*

Table 9 illustrates the relationship between the concentration of control of the largest fifteen families in market capitalization and the indicators of judicial enforcement developed by La Porta et al (1996). The far right column is the summary measure of judicial enforcement that is contained in the table in box 4, calculated by averaging the other five indicators on enforcement. The indices run from 1 to 10 with 10 being the best i.e. least risk of contract repudiation, strongest rule of law etc. The table clearly shows the negative relationship between high concentration of family control and the value of each of the indices.

The weak legal protection of creditors and transparency standards should, in theory, affect banks as well as bond-holders. However, in practice, banks were better able to adjust to these conditions and, in fact, the model of relationship banking adopted in Southeast Asia was especially suited to it. By contrast, arms-length creditors rely to a greater degree on the courts. A finance director in a major conglomerate in Kuala Lumpur pointed out that " *banks have enormous advantages…by contrast in the debt market there is an assymetry of information….thus creditor rights need to be well-defined for the bond market to be developed"*.

The likely effect of the crisis

As mentioned in section 5, the experience of the crisis appears to have made both local and foreign investors increasingly focused on the institutional shortcomings on the demand side of the market for corporate bonds. At the same time, though, the experience of the crisis may also have increased the attractiveness of bond issuance for local corporations. With government budgets pushed into deficit by the crisis and the need for the authorities to finance the recapitalization of the banking sector, there has been some resurgence in government bond markets over the past year. This has begun to provide a benchmark to aid corporate issuers.

This has reinforced the interest of the corporate sector in accessing bond finance. Thus, in Thailand, companies such as Siam Cement PCL and Thai Military Bank PCL have each sold billions of baht of bonds in 1999. In Malaysia, too, corporate issues have taken off recently. The spurt in corporate interest in bond finance has not been apparent to the same degree in Indonesia, given that the corporate sector remains heavily distressed there. However, assuming the corporate sector recovers in Indonesia and political and social stability re-emerge, Indonesia may also experience increasing corporate interest in bond finance.

This interest could simply be a temporary phenomenon and a function of the breakdown of the banking sector that has occurred and has left companies strapped for cash. However, interviews conducted during the author's mission to Southeast Asia during the summer of 1999 (when he met senior figures in major conglomerates) suggest that the experience of the crisis

Table 9:
Relationship between concentration of family control and three indicators of judicial and legal development

Country	Concentration of family control (top 15)	Efficiency of judicial system	Rule of law	Corruption	Risk of expropriation	Risk of contract repudication	Degree of judicial enforcement
Japan	2.8	10.0	8.98	8.52	9.67	9.69	9.4
Malaysia	28.3	9.0	6.78	7.38	7.95	7.43	7.7
Korea	38.4	6.0	5.35	5.30	8.31	8.59	6.7
Thailand	53.3	3.3	6.25	5.18	7.42	7.57	5.9
Indonesia	61.7	2.5	3.98	2.15	7.16	6.09	4.4

Source: Claessens et al (1999) and La Porta et al (1996).

may also have generated some more permanent strategic changes in business attitudes that may alter financing patterns during the medium-term. In particular, the crisis has weakened perceptions of secure credit lines that had in the past increased the attractiveness of bank finance. The realization appears to have dawned in some quarters that implicit government guarantees are no guarantee against banks and companies collapsing against a mountain of bad loans and debts, respectively. The risks of undertaking foreign borrowing, especially short-term, are also more apparent, and the false security generated by pegged exchange rates has stood exposed.

Nevertheless, there are some important qualifications to be made. For a start, only a few blue chip companies in Thailand and Malaysia are presently in the position to access local currency bond markets. Economic conditions will need to improve (not least the financial position of the corporate sector) before a larger number of firms are able to partake of this activity. Most important, there is still no guarantee that these changes in strategy are not temporary. Though the perception of assured bank financing has weakened, it is still necessary to complement this by limiting the inter-locking linkages between banks, corporations and governments and encouraging banks to be more arms-length in their dealings with companies. Taken together, these should lead to a more correct pricing of the relative costs of bank loans and bond issuance.

The underlying preconditions for developing corporate bond markets

The implication of the preceding analyses is that, for corporate bond market development to take place in a sustained manner, it is necessary to implement deep-set institutional change to accompany the oft-recommended measures to strengthen the market infrastructure.

The required additional measures to reduce the constraints on bond issuance include the necessity of encouraging a greater degree of arms-length relationships between banks and companies. The required banking reforms would entail measures to strengthen competition, encouraging a change in the ownership of some banks, upgrading supervision and prudential oversight, and, in general, diluting the concentration—i.e. the oligopolistic structure—of the banking sector. To quote a bond dealer in a leading investment bank in Hong Kong, *"you cannot develop a local bond market in isolation from the banking industry"*.

At the same time, to ensure that local and foreign investors are willing to purchase the bonds issued by firms, laws need to be better enforced to protect the rights of creditors and business transparency needs to be strengthened. To an extent, achieving these objectives is dependent on human capital considerations. Upgrading business accounting and the quality of legal expertise requires substantial investment in human capital in countries such as Indonesia and technical assistance from international organizations and developed countries.

Ultimately, however, and underpinning the necessary measures on both the supply and the demand side, there is the requirement to reform the nature of the links that have existed between banks, firms and governments. For this to happen, there may need to be measures that reduce the concentration of wealth and strengthen competition in the corporate sector—such as deregulation and the encouragement of competition in sectors of the economy that have been characterized by artificial barriers to entry.

The above areas for policy consideration cannot really be separated since they are strongly inter-woven into one another. For instance, though reforms to weaken the links between banks, firms and government may ease the passage of legal and banking reform, they are in turn also influenced by the success of these very measures. Moreover, the feasibility of their implementation is inter-related with political considerations and, again, there exists a "chicken and egg" situation—reforms in the suggested areas would weaken the links between business and politics yet their passage may be blocked by these very relationships. Nevertheless, following the economic crisis, some progress has already been made in satisfying aspects of these broad preconditions.

Examples of relevant developments include the strengthening in bank supervision in all three countries. Banking sector recapitalization and restructuring has been put in place—Thailand's recapitalization has been more market-driven than that of Malaysia and Indonesia and, if

successful, should reduce the perception of state intervention in the financial sector.[17] Restructuring is, however, at a very early stage in all three countries and its direction is, as yet, somewhat unclear. Another example of policy progress is the efforts that are being made to strengthen corporate transparency. For example, in Thailand, efforts are being made to upgrade Thai Accounting Standards to International Accounting Standards by the Institute of Certified Accountants and Auditors. In Malaysia, measures have recently been passed enhancing disclosure requirements for the protection of investors[18]. Also very important is the fact that Thailand and Indonesia have introduced new bankruptcy laws that favor creditors to a greater degree than was the case in the past.

However, the process is still at a very early stage in all respects. For instance, with respect to transparency, a market participant pointed out that, *"people are ready to release information faster but the quality of figures are still suspect. But more information still helps since analysts will pick out trends with time."* Similarly, the success of bankruptcy laws is still very unclear since this depends on the ability of the courts to enforce these—at the time of writing, the results have been mixed. Moreover, the entire remit of deregulating the corporate sector and restructuring the banking sector is, at the time of writing, at an early stage and hostage to political considerations.

Conclusion

Corporate bond market development is ultimately a function of the institutional settings in Thailand, Malaysia and Indonesia. This paper points out some of the underlying reforms that may need to be implemented in this respect in order to improve the underlying attractiveness of corporate bond issuance and investment. These include corporate sector and banking reforms, the strengthening of legal processes and improvements in business transparency. All these objectives are inextricably linked and the necessary measures may therefore need to be implemented in an integrated manner. Yet the development of corporate bond markets should be viewed as an incremental process that takes place over a number of years. By their very nature, and given their social and political implications, the above reforms are likely to be implemented gradually rather than rapidly.

Moreover, efforts to resolve these underlying issues need to go hand in hand with policies to strengthen market infrastructure and make regulation favorable to both bond issuance and to the operations of local and foreign investors. In the final analysis, the "underlying" institutional and the "apparent" infrastructure-oriented preconditions for developing corporate bond markets should be viewed as complementary and mutually reinforcing.

17 Thailand's process of bank recapitalization requires a greater initiative in raising the funds from the private sector, namely bank owners.

18 This is part of a broad range of measures announced in July 2000 by the Securities Commission in Malaysia aimed at speeding the issue process for companies.

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