How capital markets work economics essay

Economics

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To put it simply, capital market is giving a probability that savers, either individuals or organizations can put it into long-term productive use, when companies or organizations are making long-tem investments. And capital market is regulated by financial regulators. In Asia, China has China Securities Regulatory Commission (CSRC), Japan has Securities and Exchange Surveillance Commission (SESC). And others like the UK’s Bank of England (BoE) or the U. S. Securities and Exchange Commission (SEC), all oversee the capital market in their specific jurisdictions to protect investors from frauds among the transactions. Different from money market, capital markets function in the fields when companies or governments are raising long-term funds, such as individuals’ purchase of common shares or corporate bonds, or refunding because loans those are to be fully paid back for more than one year are about to . And capital markets instruments are less marketable and have variable risk levels due to different issuers. Capital market instruments have maturities from 5 to 30 years. (Kidwell, Blackwell, Whidbee & Sias, 2012)Overview of Asia Economic Conditions and Capital MarketEmerging Asia capital market shows its resilience in the last several years after the worldwide financial crisis of 2008-2009. After the financial crisis, developing Asia managed to keep a respectable pace of gross domestic product (GDP) expansion. Developing Asia is emerging as an important global consumer, which can be told from its Petroleum and copper consumption. Until the end of 2011 the developing Asia consume over 25% of petroleum of the amount of world’s production and over 50% of cooper. (ADB, 2013) The region’s energy demand also secures its growth. Developing Asia’s economies are returning to healthy growth from the 2008/09 global financial crisis. In the face of continued sluggishness in the U. S., the euro area, and Japan, Asia is finding ways to bolster its resilience. From a recent estimate report from Asian Development Bank, the regional growth will pick up to 6. 6% in 2013 and reach 2. 7 in 2014. (2013, ADB) In 2012, the growth stood at just over 6%, still far from the previous double-digit pace before the crisis. The region’s economic conditions can be described as boosting from domestic consumptions, dragging from weak export demand with varying growth prospects across subregions. From Diagram 2’s demand-side contributions to growth, with weakened demand from the Mainland China and India added to the overall demand from the major industrial economies, only domestic factors remained as drivers of growth for most areas of Asia. Among domestic factors, private consumption continued to be the key driver of growth in 2012 that contributes more than half of the growth of the economy in Asia. Investment was uneven from the diagram. While investment of Southeast Asia was generally resilient, the Republic of Korea and Taipei declined a few due to sluggish export performance. To expand varying growth prospects across subregions, we can see that positive spillover effects of more rapid expansion in Mainland China (2013, ADB) will continue to develop to more robust growth. And the higher growth in China will support growth momentum in Southeast Asia. Economies in South Asia will depend on the turnaround in India, as India is now contingent on reform. But signs hardly show recovery, and analysts expect modest growth in India. In 2012, the Pacific was the fastest-growing subregion (2013, ADB) in Asia and the Pacific. Differences in country circumstances lie behind the divergent outcomes in the region. The overall economy of Asia is getting brighter since the 2008/09 financial crisis, and it boost capital inflows into the capital markets. Asia’s overall capital market can be well described by these years’ private capital inflows to the region. Diagram 1 in the appendix shows aggregate private capital inflows since 2005 into 10 Asian economies: Mainland China; Hong Kong, China; India; Indonesia; Japan; the Republic of Korea; the Philippines; Singapore; Taipei, China; and Thailand. Diagram 1a shows the volatility of the market. Inflows rapidly increased to over $1. 4 trillion in 2007, collapsed with the 2008/09 financial crisis, sharply rebounded to pre-crisis level in 2010 and 2011 as the global economy recovered along with Quantitative Easing and then slowed after the second half of 2011, when the European crisis escalated. Diagram 2b proves that the volatility of capital inflows was perceptible in most Asian countries, although approximately half of the aggregate capital inflows were accounted for by Mainland China and Japan. In Diagram 3, the components of private capital inflows to individual countries indicate that for the two financial hubs, capital flows easily exceed 10% of GDP, mainly driven by the others. China and Japan are different in terms of the degree of financial market liberalization, so China's capital inflows are mainly smooth foreign direct investment, while Japan's main component of capital inflow seems to fluctuate as portfolio investment. Relatively open financial markets of the Republic of Korea and Taipei experienced patterns similar to Japan's. In other Asian economies, the role of portfolio investment was relatively week. China has been doing its market transformation for decades, and gradually turned from a totally closed market to a relatively open to world market. For the following years, China still has the challenge of expanding its open market in terms of both portfolio investment and foreign direct investment to a better extent, which may lead to a synonymous capital market. Different segments of Asian Capital MarketsBond MarketThere are signs that indicate that US's employment and housing are turning into a modest reviving condition, as well as the rally of US stock market since the beginning of this year. It is positive development in the US, together with the unsureness of the sustainability and the unresolved budget deadlock. Financial conditions in Europe have shown improvement and the euro has rallied against the US dollar. (2013, ADB) However, the financial conditions in Europe remain fragile together with Italy's uncertainty in politics. From a recent bond monitor report of Asian Development Bank (ADB), emerging East Asia's outlook is brightening with China's growth picking up toward the end of last year with the southeast Asian economies continue to sustain robust growth. Capital inflows have surged in recent years after the sharp drop when 2008/09's global financial crisis came. By mid-2010, gross inflows had surpassed the previous highs achieved in 2007. So it just took about two years for net capital inflows to fully recover from the crisis. This shows the Asian's economy has obtained flexibility and tenacity. The first wave of inflows into Asian area was back in the early 1990s (2013, ADB), but was disrupted by the crippling Asian financial crisis started from Japan. The second wave was in the early 2000s and ended with the onset of the global financial crisis after Lehman collapse. The recent surge, which has been characterized as the third wave of capital inflows into the region, is seen as a reversal of capitals flows balanced with the market uncertainty and increased risk perception. (2013, ADB)But what is driving these inflows? Even with the uncertainty and the risk, capital flows in recent years have been driven by both improved economic fundamentals in the region and low interest rates in advanced economies. (2013, ADB) There have been " pull factors" and " push factors" in this region attracting capital inflows. " Pull factor" can be viewed as the local domestic reforms and policies. And " push factors" can be viewed as the relatively loose monetary policies in the industrial economies and low returns (2013, ADB) in mature market. For example, in relatively mature market, high priced human labor and developed policy systems will eat up the margins that one company can obtain. The local currency (LCY) bond market in the emerging East Asia region has witnessed strong interest from foreign investors. From the historical overview of capital inflows in the last ten years (figure 1, 2), foreign direct investment (FDI) has been more stable and less prone to sudden reversals. Moreover, FDI has been relatively stable in emerging East Asia, even during the 2008/09 global financial crisis when other types of inflows dropped and fluctuated heavily and precipitously. FDI remains the largest source of capital inflows into the PRC, but portfolio investment and other investment are also growing. And we can see that capital inflows into the Republic of Korea's capital account are mostly as of portfolio investment. Although the growth in bond markets in these countries are developing and becoming increasingly attractive for foreign investors, PRC's foreign investment in debt securities remains minimal (2013, ADB). This may due to PRC's local policy for foreign investment, and the country's unclearness of governments operations to the world. It is higher yields, appreciating currencies, improved credit ratings, and lower exchange rate volatility (2013, ADB) that increase foreign participation in the region's local currency bond market. And though the world's economic integration, lower global risk perceptions and more developed domestic financial markets are contributing to higher foreign participation in Asia's bond markets. Mortgage MarketMortgage markets are the kind of market to help people, organizations and other economic units to financeToday 31% of population of Asian countries lives in urban area. However, CIA World Fact book estimated that the percentage would increase to more than 50% by 2030. (2010, EconomyWatch) Therefore, the low and middle-income families are about to move to town, with the development of housing finance. The size of Chinese and Japanese mortgage markets are small comparing with the US and European countries' mortgage markets. Moreover, China's is relatively smaller in terms of its population size and in comparison with the mortgage market in Hong Kong. Equity MarketTo see the overview of global equity market in Figure 2, US$1878 was raised through initial public offerings (IPOs) in 2011, which was a decline from 2010. The United States maintained its lead as the largest IPO market in the world in 2012, which raised 53. 34 billion USD (2012, Gan, Applegate), but there were some upsets. And capital seekers were attracted to Malaysia's economic stability, pushing it from 12th to 4th place this year. (2012, Gan, Applegate)Private EquityGlobal and Regional Environment – Changing EconomyBasel IIIBasel III, also named Third Basel Accord, is the global, voluntary regulatory standard on bank capital adequacy, stress testing and market liquidity risk. (2010, Basel Committee on Banking Supervision). It is designed as a scheduled timetable for banks to gradually implement the standard regulation. It was developed in response to the deficiencies in financial regulation revealed by the 2008/09 financial crisis, and was supposed to strength bank capital requirements by increasing bank liquidity and bank leverage. Previously, a report by Standard Chartered indicated that Asian bond issuance could triple over the five years as deleveraging and more stringent regulatory requirements stifle bank lending and make borrowers turn to alternative sources of funding(2012, Langner). From the trend of bond market's performance in Asia, the size of the AXJ (Asia ex-Japan) corporate bond market is thriving. StanChart's prediction was that Basel III and European bank deleveraging would drive the size of AXJ corporate bond market to more than USD 10trn by 2017. (2012, Langner)However, there are 2 main concerns in this region for investors. The first one is excess supply; people are concerned about supply's exceeding demand. But the developing Asia has the highest level of savings as a percentage of GDP, which is 46. 1% (2011) in Table 1. Therefore, besides the foreign inflows, Asia also has plenty of savings itself. Analysis revealed that less than 20% of investments in Asia are allocated to fixed income. European and US investors always have 33%-35% allocations (2012, Langner), meaning that Asia still has plenty of room to grow. The second one is flip risks. Demand is not the only concern. Companies in this region have to compete with banks and governments. From ADB's 2012 economy outlook report, local currency government bonds outstanding in Emerging East Asia grew 10. 1% to USD 4. 08 trn in the third quarter of 2012 versus the same period in 2011. Also, there are banks. The Basel III regulations that will curtail their lending to local companies will compel companies to raise capital by issuing bonds in local and international markets. Generally speaking, if in the following 5 years foreign inflows get weakened, funding would be quite challenging. The region has been integrated, if the expected growth in corporate bond markets does not materialize as it was said by StanChart, economic growth in some countries in the region is likely to be compromised, say, Japan as a developed country but depended on importing and exporting. However, previous rounds of large-scale asset purchases (QE1 and QE2, chart 1 and chart 2) offer important precedents for gauging the impact of QE on capital flows. Both QE1 and QE2 brought with a significant turnaround in capital flows. Global monetary policy settings are an important push factor for capital to Emerging Asia area, because lower interest rates in advanced economies increase the relative returns earned on assets in emerging economies. Asset purchases by central banks reduce yields on assets like U. S. Treasuries and the supply of such assets. It means that investors would choose other assets to hold, some of which can be assets in emerging markets. Japan's Quantitative easing planJapan's recent quantitative easing plan is to bring Japan from deflation situation back to inflation and end the vicious circle of economic growth stagnated. Japan's short-term interest rate had been decreased to nearly 0 percent, but its economy was still in trouble. Japanese preferred to keep their savings at home, rather than depositing to get it devalued in banks (2013, Wang). This had been what Japan faced in the last 15 years, which means that Japan cannot implement its conventional monetary policy any longer. Therefore, it is opportune for Japan to conduct its quantitative easing plan. On April 4th 2013, the Bank of Japan announce an extensive plan that they would expand their Asset Purchase Program by $ 1. 4 trillions USD in two year. (2013, Stewart) It shows the central bank of Japan's determination to bring Japan from deflation to inflation, aiming for 2% inflation. The amount of purchases is so large that it is expected to double the money supply. The risks associated with such monetary easing can be split into two parts. One is that rising inflation and higher interest rates will push the burden of servicing Japan's giant public-sector debt, about 240% of GDP, to perilous levels. (2013, Economist. com) Another one is that Japan's easing might lead to a lower quality of life of its workers. Wags will not rise to match inflation in the price of goods and services, meaning a squeeze on households. The small to medium-sized firms in Japan, which account for the majority of employment, haven't announced any adjustment salary increases for employees (2013, Economist. com). Japan needs to pay attention to these two kinds of problems that might eat up the advantages QE brings to it. Apparently, if Japan's easing is going to lead Japan out of its economic stagnations, it is good for world's economy especially Asia's, as a developed economic entity like Japan has its power to bring along trading partner’s economic growth." What the quantitative easing from Japan may bring to Asia is through exchange rates, reflation and portfolio inflows or hot money", from a recent released by Bank of America-Merrill Lynch. How QE impacts Asia’s capital market depends on whether Japan successfully reflates and how portfolios are adjusted. Also, similar with U. S.’s QE3, Japan’s easing influenced the Asia’s capital market by driving parts of investment outwards into other areas of Asia because of the dropping exchange rate. Trends affecting capital marketDiagram 1: Private capital inflows to AsiaMacintosh HD: Users: jonacao: Desktop: □□□□ 2013-04-30 □□ 4. 57. 20. pngMacintosh HD: Users: jonacao: Desktop: □□□□ 2013-04-30 □□ 4. 57. 40. pngMacintosh HD: Users: jonacao: Desktop: □□□□ 2013-04-30 □□ 5. 07. 40. pngDiagram 2: Demand-side Contributions to Growth, Selected Developing Asia, 2012Macintosh HD: Users: jonacao: Desktop: □□□□ 2013-04-30 □□ 7. 14. 15. pngDiagram 3: Components of private capital inflows to individual countriesMacintosh HD: Users: jonacao: Desktop: □□□□ 2013-05-01 □□ 1. 51. 12. pngMacintosh HD: Users: jonacao: Desktop: □□□□ 2013-05-01 □□ 1. 51. 48. pngMacintosh HD: Users: jonacao: Desktop: □□□□ 2013-05-01 □□ 1. 52. 04. pngFigure 1: Composition of Gross Inflows in Emerging East AsiaFigure 2: Composition of Net Inflows in Emerging East AsiaTable 1: Comparison of Developing Asia and World’s Gross domestic savings (% of GDP)Macintosh HD: Users: jonacao: Desktop: □□□□ 2013-04-29 □□ 8. 09. 03. pngSource: World Bank national accounts data, and OECD National Accounts data files. Retrieved from World Development Indicators. Chart 1 Chart 2Macintosh HD: Users: jonacao: Desktop: □□□□ 2013-04-30 □□ 4. 04. 48. png Macintosh HD: Users: jonacao: Desktop: □□□□ 2013-04-30 □□ 4. 05. 15. png