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SessionⅢ: Developing Regional Bond Markets in East Asia: Issues and Proposals

The ABC of Asian Bonds

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1. Background of Asian Bond proposals

The Asian currency crisis of 1997-98 seems to be far distant in our memory, as many Asian countries have experienced robust growth since 1999. However, just when you are safe out of dangerous water, the perils may sneak up to you, again. Some countries, such as Thailand and Indonesia, experience strong capital inflows and the currencies may be appreciating beyond the fundamentals may justify.

We have not implemented many of the lessons we identified after the crisis. Three of the many lessons are the topic of this paper. First, it was found important to reduce vulnerability is to avoid the "double mismatch" problem, namely currency and maturity mismatches of borrowers in emerging market companies. Borrow short in the US dollar and lend long in the local currency is dangerous. Second, to avoid over-reliance on the banking sector is important, since the "twin crisis", that is, a simultaneous currency and banking crisis, is quite damaging to the economy. Third, to avoid the dollar peg is important both from the viewpoint of maintaining price competitiveness of imports and of discouraging too much short-term capital inflows.

In order to reduce reliance on the banking system, to promote bond financing is important. If the government and corporations can issue bonds for long-term projects, then they can reduce borrowing from banks. Banks also benefit from avoiding maturity mismatch. One of the problem is that the bond market in an emerging market countries in Asia has not been developed in terms of the market institutions. The bond market in emerging market may benefit from broadening the market to the region, since inviting foreign investors will deepen the market. However, in order to lure investors into the bond market, transparency may have to be enhanced. Therefore, it is desirable to establish a region-wide bond market.

Asian bonds have been proposed, most prominently in several speeches by Prime Minister Thaksin of Thailand. The Asian bond has become a focal point for regional financial cooperation after the Chiang Mai Initiative. Below, I will review what has been done and propose a particular form of Asian bonds.

2. Essential Elements of Asian Bonds

Asian bonds are bonds issued by Asian institutions (government, corporations, and financial institutions), denominated in an Asian currency, and sold, traded, and settled in an Asian financial center (Tokyo, Singapore, and Hong Kong). Investors are expected to be mainly regional (Japan, Singapore, Hong Kong, in particular), but others are welcome.

In order to solve the double mismatch problem, it is essential that Asian bonds are issued in a local currency, or a basket of local currencies. By issuing bonds in local currency, the governments or corporations will be freed from possible problem of acute dollar liquidity shortage, unless maturities are bunched in particular months. Major trading center should be regional so that settlement and clearance should be done in real time. Delivery vs. Payment (DvP) can be done if regional central banks extend real time gross settlement facility to financial centers and settlement and clearance facility is developed in regional financial centers.

Investors are known to have "home bias", that is, investors' portfolio is heavily biased toward domestic securities. Many possible reasons, including avoiding currency risk, familiarity, etc, have been presented. There may be "regional bias" in that investors may be attracted toward securities issued by countries in the region, second to domestic securities. The currencies in the region are more correlated than other currencies, and familiarity of regional companies and currencies are high. That is the reason to think that major investors into Asian bonds are Asian investors.

3. Asian Bond Fund by central banks

The central banks in the region (EMEAP)[1] have announced that they will contribute US$1 billion to the Asian Bond Fund (ABF), managed by the BIS, in order to invest in dollar-denominated bonds issued by Asian issuers, namely Yankee bonds.[2] The central banks will set aside a certain portion of their foreign reserves (estimated to be more than 1 trillion US dollars) to invest in ABF. Eligible securities are those issued by governments and quasi-governments.

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1 EMEAP (Executives' Meeting of East Asia-Pacific Central Banks) members consist of central banks of Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, and Thailand.

2 See http://www.boj.or.jp/en/about/03/un0306a.htm for the announcement.

This is a good step toward an eventual development of the Asian Bond market. However, this proposal does not fit perfectly in what was envisioned as Asian bonds. First, the use of the U.S. dollar, presumed in the current version of ABF, does not contribute to the financial and monetary stability of the region. Second, under the current version of ABF, the monetary authorities buy and hold the Asian bond fund as foreign exchanges, so the secondary market of Asian bonds would not develop. Third, the ABF is contributed from central banks, but foreign reserves are strictly regulated on their eligible securities. Due to the regulation, the market size of bonds that can be invested by the ABF will be limited.

4. Asian Bond Corporation Proposal

I propose that the fiscal authorities of Japan, Korea, and Thailand, and any other willing Asian countries, should jointly establish the Asian Bond Corporation (ABC) in offshore market (Tokyo, Hong Kong, or Singapore). The ABC will purchase sovereign bonds (later, corporate bonds and asset backed securities) of the participating countries, issued in the respective local market and denominated in the yen, won, and baht. The ABC's asset side is composed of a basket of bonds in different currency denominations and different coupon rates. The ABC bond, on the liability side of the ABC, is backed by the market value of the bonds on the asset side. Hence, pricing of ABC bonds in the secondary market should reflect the value of the underlying assets.

For example, we recommend that the ABC initially purchase Japanese, Korean, and Thai government bonds with value-weights of 50-30-20, respectively. Then the pricing of ABC bond reflects both the exchange rate fluctuations of the yen, won, and baht, as well as the interest rate movements in the three countries. With respect to currency risk, the ABC bonds show a feature of a basket currency, namely a weighted average of the three currencies. The coupon interest rate of the ABC bond will be a weighted average of the underlying bonds.

It is likely that many investors find ABC bonds attractive. Investors have to take some currency and credit risk to receive some extra returns. But risks have to be transparent, fair, and diversified. (The Japanese investors currently receive only 0.8% yield from holding Japanese bonds, but some of them are eager to purchase Australian-dollar-denominated bonds yielding 5%, reflecting currency and credit risk. They may be attracted to an ABC bond yielding 3%, with lower currency risk.) The role of ABC is to bundle bonds from diversified sources, so that a reasonable tradeoff point in the risk-return curve will be offered in a transparent manner. The regional investors who pursue higher returns without increasing too much of risk will regard bonds issued by the ABC as just such financial instruments.

If credit risk of participating bonds makes ABC bonds unattractive to risk-averse bond investors in the region, the partial guarantee may be offered by a credit enhancement agency. When corporate bonds and asset backed securities (ABS) are bundled into a ABC corporate bond, credit enhancement or separating into senior bonds and junior bonds may help widen the customer base. If currency risk, even as a weighted average, is not desirable for some home-biased investors, swap into local currencies may be offered by the ABC, or its foreign exchange swap partners.

The ABC sovereign bonds will not assume any major risk, because the value and coupon payments of assets and liability matches all the time. It should behave like a currency board or a mutual fund. The ABC helps create the Asian bond secondary market. The ABC encourages the issues of bonds in the region. The ABC sovereign bond should give the benchmark for the ABC corporate bonds and ABC-ABS bonds.

In comparison to the ABF proposal, the ABC proposal has several advantages. The ABC promotes local currency bond issues, while the ABF in the current version invests in the dollar-denominated bonds only. The ABC will bundle them as a basket currency bond for investors. My proposal of the ABC bonds promotes the secondary market by issuing the ABC bonds, while ABF does not. In the sense the central banks in the ABF are a buyer-investor, while the ABC is an issuer as well as a buyer. In this sense, the two proposals are quite complementary, while the ABC is based on market participants and principles. The ABC has no limit in what kind of securities to invest in, while the ABF is limited to sovereign and quasi-sovereign bonds. If another crisis comes, then the foreign reserves may have to be sold to help stabilize the currency, then the monetary policy has to sell Asian bonds, aggravating the crisis by depressing the bond market. This kind of procyclicality is something to be avoided in institutional design. The ABC proposal does not have such a deficiency.

6. Conclusion

I urge fiscal authorities of Japan, Korea, Thailand, and any willing Asian countries to cooperate in setting up the ABC, promoting development of the Asian bond market, so that the region can reduce reliance on the banking system, and help directly channeling saving in the region into borrowers in the region. The ABC sovereign bond may be created without too much changes in infrastructure. It is up to the will of the fiscal authorities. The securities firms can find investors who are willing to invest in a basket of local currency bonds with different coupons. The healthy development of capital market in the region will be important for the region in order to avoid another financial crisis in the future.

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