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Regional Bond Market Development:

Challenges for Asia and Broader Dilemmas

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1. The Problem

The 1997-8 crisis in East Asia prompted considerable rethinking of the role of financial markets in the region's economic development. Banks had long been at the center of Asian financial systems. For a set of late developing economies with urgent needs for financial intermediation, banking systems were easier to get up and running. Governments could supply the equity capital and in some cases the managerial talent. Close cooperation between banks and governments allowed the authorities to influence the flow of funds – ideally, to ensure that finance flowed toward sectors that were the locus of productivity spillovers and the generators of export revenues. Large corporations in need of substantial funding for expensive investment projects that might require a lengthy incubation period could be confident of stable source of external finance.

Through the middle of the 1990s this bank-centered financial system was one of the foundation stones of East Asian economic growth. The crisis that followed then revealed that this form of financial organization also had serious weaknesses. The short maturity of bank loans meant that when confidence was disturbed, as happened in 1997-8, what had once been a set of patient lenders might not be so patient anymore. Seeing their funding decline, banks might call in their loans, subjecting their borrowers to a painful credit crunch.

Moreover, with the opening of capital accounts, banks might be in a favored position to access foreign funds, not least because of the perception that their obligations

were guaranteed by the public sector. They aggressively extended their intermediation role by borrowing offshore and on-lending the proceeds to their domestic customers. Generally, the tenor of these foreign credits was even shorter than that of the banks' own loans, exposing them to a maturity mismatch that might cause serious problems if confidence took a hit. Since most foreign funds were denominated in dollars, euros or yen, the banks were exposed to either dangerous currency risk if they on-lent in local currency or equally serious credit risk if they on-lent in those same foreign currencies. Meanwhile, deregulation allowed banks to take on additional risks using techniques that supervisors found difficult to follow. And insofar as the banks had allowed themselves to be utilized as instrumentalities of the government's industrial policies, they expected help from the official sector in the event that they encountered difficulties. Thus, the moral hazard inevitably associated with the existence of a financial safety net may have been particularly pervasive in the Asian case.

This episode of financial turmoil led to the restructuring of banking systems and to efforts at upgrading their supervision and regulation. But it also created an awareness of the need for better diversified debt markets and specifically for bond markets to supplement the availability of bank finance. Bank and bond finance have different advantages. Bonds and securitized finance generally arguably have better risk-sharing characteristics. Risks can be more efficiently diversified when they are spread across a large number of individual security holders. This spreading of risks and the existence of liquid secondary markets in standardized securities encourages creditors to make longer-term commitments and allows debtors to borrow for extended periods of time.

Banks, in contrast, have a comparative advantage in operating in the information-impacted segment of the economy. They invest in building dedicated monitoring technologies. (This is one way of thinking about what distinguishes banks from other financial market participants.) Banks are therefore well placed to identify and lend to small, recently established enterprises about which public information is scarce. In addition, by pooling the deposits of households and firms with non-synchronized demands for liquidity, they are able to provide maturity transformation services for small savers reluctant to lock up their funds for extended periods of time. As concentrated stakeholders, they contribute to effective corporate governance and are prepared to incur the costs of litigation when legal recourse is required.

The point is not that either banks or bond markets are better; there is little systematic evidence of the superiority of one financial form over the other. Rather, there is a growing body of evidence that countries benefit from well diversified financial systems with a role for both well-regulated banks and well-functioning securities markets.[1] The existence of such a system is conducive both to an efficient allocation of resources compatible with sustainable medium-term economic growth and to financial stability (to whit, to minimization of the risk of late-1990s style financial crises).

2. The Policy Response

It is in this context that recent efforts to foster the development of Asian bond markets should be understood. These efforts have focused on the development of a more robust and efficient market infrastructure at the national and regional levels. Among the noteworthy initiatives in this area is the Asian Bond Fund Initiative (ABFI) of the

[1] See Demirguc-Kunt and Levine (1996, 2001).

ASEAN+3 countries.[2] As endorsed by ASEAN+3 finance ministers at their August 2003 meeting in Manila, the ABFI takes as its goal the development of more robust and efficient primary and secondary markets. To this end it has established working groups concerned with the creation of standardized debt instruments, the establishment of rating agencies, the provision of technical assistance, foreign exchange transactions and settlement issues, credit guarantee mechanisms, and the role of multilateral development banks, foreign government agencies and Asian multinational corporations in issuing in local markets and local currencies.

These working groups can be seen as mechanisms for sharing information and providing technical assistance about best practice in fostering and regulating bond markets. They can be seen as working toward the establishment of concrete benchmarks for the development of market infrastructure against which national policy and practice can be assessed. Private sector practice has shown such benchmarks to be an effective focal point for reform.[3] The working groups thus may function as a source of peer pressure for governments to move more quickly in the direction of creating active and liquid bond markets than they might otherwise, something that is desirable insofar as the official sector often enjoys privileged access to bank finance and therefore faces a moral hazard of its own.

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[2] The members of ASEAN are Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam; the "plus 3" countries are Japan, South Korea and China. Another initiative deserving of mention is the APEC Regional Bond Market Initiative agreed to by the APEC Finance Ministers' Process (FMP). The FMP was established following the 1997 financial crisis to provide a forum for the exchange of views and information on regional financial developments and to cooperatively pursue programs for the promotion of financial sector development and liberalization. In 2002 APEC finance ministers then agreed to a second policy initiative on the Development of Securitization and Credit Guarantee markets, which aims at using high-level policy dialogues and expert panels to identify impediments to the development of these markets. For details see www.apec.org, and in particular www.apec.org/apec/ministerial_statements/sector_ministerial/finance/2003_finance/annex.html.

[3] The use of benchmarking to generate peer pressure for reform is a widely utilized private sector practice. It is also used by the European Union as part of its method of "open cooperation." See Wyplosz (2004).

Other initiatives seek to remove the obstacles to the development of a pan-Asian bond market. They seek to encourage Asian investors to build regional bond portfolios by removing obstacles to cross-border portfolio capital flows and by harmonizing the regulations, withholding-tax provisions, accounting practices, rating conventions, and clearing and settlement systems that pose obstacles to foreign participation in regional bond markets. These initiatives respond to the perception that the small size of Asian bond markets is part of what limits their liquidity, efficiency and growth. To be attractive for investors, a bond market must operate at a certain minimum efficient scale. Otherwise market participants will not be able to acquire or dispose of their holdings without significantly moving prices.[4] Small markets with limited number of participants may also create scope for strategic behavior by competitors and counterparties to deter entry and participation by other investors.[5] There may exist significant scale efficiency effects in clearing and settlement, payment system data processing, trading operations, firm-specific information processing activities (such as listing), and even regulation.[6] In addition a small market may not be able to develop liquidity in the full range of marketable instruments, including the derivative instruments needed by investors to hedge market risk, which in turn may deter participation.[7] For all these reasons, small countries may find it difficult to develop deep and liquid bond markets. Securing foreign participation through the removal of impediments to cross border issuance and investment is in turn a potential way around this problem.

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[4] McCauley and Remolona (2000) provide evidence on the relationship between market size and liquidity, as measured by inter alia bid-ask spreads and market turnover.
[5] Mohanty (2001) cites a number of real-world instances where such behavior has been evident in small and even middle-sized markets.
[6] For evidence on this see Hancock, Humphrey and Wilcox (1999), Saloner and Shepard (1995), Malkamaki (1999) and Bossone, Honohan and Long (2001).
[7] See Turner and Van't dack (1996).

The most prominent initiative in this area the Asian Bond Fund created by the Executives' Meeting of East Asian Pacific Central Banks (EMEAP).[8] As launched in June 2003, the Asian Bond Fund (ABF) has an initial size of $1 billion US. The ABF invests in a basket of US dollar denominated bonds issued by Asian sovereign and quasi-sovereign issuers in EMEAP countries other than Japan, Australia and New Zealand. It is managed by the Bank for International Settlements and supervised by an EMEAP Oversight Committee. A second Asian Bond Fund, under discussion at the time of writing, is to include investments in bond denominated in regional currencies issued by sovereigns, quasi-sovereigns, and creditworthy companies.[9] By encouraging the reinvestment of central bank reserves in the qualifying bond markets and securities of the region, the ABF initiative can be seen as helping to augment the installed base of local security holdings and thus overcome the problem of inadequate scale. More generally this initiative can be seen as one of a set of measures designed to foster the development of a deep and liquid bond market at the regional level.

3. Dilemmas

There is an almost instinctual tendency on the part of economists to applaud efforts in this area. But there is also a dilemma. In reality, what we are talking about is capital account convertibility, and capital account convertibility in advance of the development of regional financial markets. This, of course, is the opposite of what most

[8] EMEAP is a forum of central banks and monetary authorities in the East Asia-Pacific region with 11 members: Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore and Thailand.

[9] The stated purpose of ABF2 is to encourage the development of index bond funds in regional markets and to act as a catalyst for the improvement of domestic bond markets and for greater harmonization of bond market infrastructure and legal, regulatory and tax arrangements across the region. For details, see www.emeap.org/press/15apr04.htm.

of us thought that we had learned from the Asian crisis about the right time at which to liberalize the capital account. The lesson of the Asian crisis is important to have strong, diversified and well-developed domestic financial markets, including by implication bond markets, before liberalizing the capital account. If financial markets are underdeveloped, market discipline will be weak, and banks and firms will be prone to overborrowing. Capital account liberalization will then cause funds to flow in through the banking system. And the Asian crisis is a stark reminder of the havoc that can be wreaked by this combination of circumstances.

Thus, macroeconomists will insist that governments should not proceed with capital account liberalization unless they have first made considerable progress in developing local bond markets. And market participants will insist that countries cannot have local bond market development unless they first have open capital accounts. Lee Hsien Loong, Deputy Prime Minister of Singapore and head of that country's Monetary Authority, put the point well when writing in the BIS Quarterly Review (2002-I), as follows: "There is a trade-off between tightening up the capital account, and developing the bond markets. Measures to restrict offshore foreign currency trading have been effective, in so far as reducing or eliminating offshore markets is concerned. But these safeguards come at a cost – they also hinder the development of capital markets, especially bond markets. Size and liquidity are essential attributes for a market to attract international interest. Already in size and liquidity, we clearly lag behind our counterparts in the West. If Asian markets are fragmented and unable to grow, they risk being ignored by global investors."[10]

[10] I owe this quote to Dwor-Frecaut (2003).

Thus, Asia would seem to be in a classic Catch-22 situation. Without removing capital controls, attempting to foster domestic bond markets can be an uphill fight. Yet trying to win it by removing restrictions on the ability of residents and foreigners to invest across borders could be a risky strategy. It is widely understood that these tradeoffs are implicit in efforts to build domestic bond markets by removing capital controls.[11] What is less well understood is that even seemingly benign steps like harmonizing regulations and taxation, or creating an Asian rating agency (or a common standard for national rating agencies), or using central bank reserves to jumpstart private cross-border investment are the equivalent of capital account liberalization in the sense that they too would work to encourage cross border capital flows. That is their intent, and it would certainly be their effect. And these measures create risks – as well as conflicting with the conventional wisdom regarding sequencing – insofar as they encourage capital mobility first and only produce stronger markets later.

The positive message is that governments should proceed with all due speed to strengthen market infrastructure at the national level: more efficient clearing and settlement systems, more efficient information provision and assessment (through inter alia the establishment of disclosure requirements for issuers and the creation of rating agencies), stronger creditor rights, and the development of benchmark assets and yield curves. Even small countries can make progress in this direction, although they may have to forego some of the cost savings associated with the scale efficiency effects enumerated above. They can also overcome some of the disadvantages of their small market capitalization by consolidating the public debt and overfunding their fiscal

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[11] The econometric results in Eichengreen and Luengnaruemitchai (Chapter 2 below) are consistent with this emphasis, in that they find a number of alternative measures of capital controls to be negatively associated with domestic bond market capitalization in a panel of data for 41 countries.

needs.[12] One reading of the European experience from the 1950s through the 1980s is that, through the dedicated pursuit of such measures, reasonably robust and liquid markets in debt securities can be created, given sufficient time.[13] At that point it becomes safe to remove residual capital controls, as Europe did in the 1990s, and to encourage market participants to build pan-regional portfolios.

This perspective suggests that Asian countries, especially lower-income Asian countries with less developed financial infrastructure, should proceed cautiously with capital account liberalization. It suggests that a relatively small Asian Bond Fund (recall that an ABF-I funded to the tune of $1 billion US compares with regional bond markets with a market capitalization of some $1.5 trillion) is appropriate in that it does not put the cart before the horse. That is, it does not commit Asian central banks to large amounts of cross border portfolio investment before a stronger market infrastructure is in place. It suggests that cooperative efforts to foster the development of bond markets should focus, in the first instance, on measures to strengthen market infrastructure at the national level and not on measures to harmonize and integrate those market structures, thereby encouraging cross-border capital flows, per se. Measures to harmonize and integrate institutions and regulations should come later, once those stronger market structures are in place.

The other issue raised by Europe's experience in creating a regional bond market is the role of the exchange rate. In Europe, the elimination of currency risk by virtue of the creation of the euro strongly stimulated the further development of regional bond markets. This was evident in the dramatic increase in corporate bond issuance,

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[12] See McCauley (2003).
[13] Wyplosz (2001) advances this position.

speculative-grade issuance in particular, following the irrevocable locking of exchange rates in 1999, and in the adoption of the ten-year German government bond as the benchmark issue for the region.[14] This experience suggests that an exchange rate regime that minimizes currency risk can lend strong stimulus to the development of a regional bond market by encouraging investors to build pan-regional portfolios, thereby enhancing market liquidity and in turn inducing additional issuance and investment. Cross-country regression results in Eichengreen and Luengnaruemitchai (2003) provide further support for this association between exchange rate stability and bond market capitalization.

For Asia, these facts again create something of a dilemma. Another widely-drawn lesson of the Asian crisis is that countries need to move to more flexible exchange rate regimes to limit crisis risk and in order to be able to better tailor domestic money and credit conditions to local needs. Moreover, the presumption that Asian countries will continue to move gradually down the road toward full capital account convertibility reinforces the argument for greater exchange rate flexibility, insofar as moving to managed flexibility is an essential precondition for full capital account liberalization.[15] Hence, the exchange rate regime consistent with financial stability in the short run may not be conducive to bond market development in the longer run.

The severity if this problem is not entirely clear. The observation that countries with more stable exchange rates have better capitalized bond markets is based on an everything-else-equal comparison. In practice, everything else may not be equal. In

[14] In the first year of the euro, the value of euro-denominated corporate bond issues more than tripled, and the share of corporate bond issues accounted for by speculative (sub-investment-grade) issues rose from 4 per cent to 15 per cent. Corporations were able to place unpredecentedly large issues on European markets. See Detken and Hartmann (2000). These extraordinary early growth rates have now tailed off a bit, but the rate of growth of issuance of debt securities by nonfinancial corporations continues to outrun the growth of their other sources of finance. This enhanced access of euro-denominated corporate debt markets helped to finance a wave of mergers and acquisitions which in turn promises to strengthen Europe=s corporate sector.
[15] See for example Fischer (2003).

particular, macroeconomic policies that minimize currency risk by holding exchange rates stable may heighten credit risk by encouraging banks, firms and governments to borrow more freely, thereby exposing them to financial distress when cyclical conditions deteriorate. McCauley (2004) finds a closer conformance of bond yields across countries with flexible exchange rates. One interpretation is that credit risk is even more important than currency risk in driving a wedge between national markets and that in countries where the bulk of debt is domestic-currency denominated these two forms of risk are negatively correlated. If this is right, then greater exchange rate flexibility may not in the end be an impediment to bond market development.

The other solution, again suggested by European experience, is monetary unification to reconcile the desire for exchange rate stability with the reality of capital account convertibility, along with stronger financial market institutions and regulation to prevent overborrowing and avoid unnecessary credit risk. From this point of view the Chiang Mai Initiative for swap lines and other financial supports, ongoing discussions of a collective currency peg, and initiatives to foster the development of bond markets are of a piece. That is to say, these various efforts to further economic and financial cooperation at the regional level are strongly complementary to one another. The problem is that the time horizon relevant to these different initiatives is not the same. While furthering the development of bond markets is an urgent task that needs to be advanced now in order to foster growth and buttress financial stability, monetary

unification is a long-run objective that presupposes a significantly more extensive political commitment.[16]

The other question in this context is whether Asia is the right level at which to pursue these objectives. A positive answer is generally supposed in discussions of exchange rate stabilization and monetary unification. There is both the European precedent and the fact of rapidly growing trade and foreign investment linkages in Asia, heavily centered on China. But it is not clear that a positive answer is appropriate in discussions of bond market development. There already exist well-developed global securities markets into which Asian countries can link. Many of the large issuers and large investors – multilateral institutions, foreign government agencies and multinational corporations alike – whose participation in local markets is desired are headquartered outside of Asia. Harmonizing institutions and policies across Asian countries is not the most obvious way of encouraging their participation; better would be to harmonize institutions and regulations with those prevailing in global markets. Even if the answer to the question of whether Asian countries should attempt to integrate into global or regional bond markets is not obvious, that question should at least be asked.

[16] This is something that is acknowledged even by the proponents. Thus, Mallet (2004) in describing discussions at the 2004 Asian Development Bank meetings for achieving currency union in Asia, reports that "economists and bankers say a common east Asian currency would take two or three decades."

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