The 3rd Annual PECC Finance Conference

Institution-Building in a World of Free and Volatile Capital Flows: PECC Perspectives

Sheraton Santiago Hotel & Convention Center, Santiago, Chile
June 20-21, 2004

Discussant Comments on Session III

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Comments for Session III: Assessing and Building Capacities for the Development of Bond markets in the APEC Region --- Talking Points

Considering the 4 questions asked by the organizers:

- What are the <u>issues and problems</u> faced by economies in the region at present with respect to their domestic bond markets?
- What <u>challenges</u> do they face <u>in managing capital inflows</u>, and how do these affect the prospects for domestic and regional bond markets?
- What are the <u>key ingredients for the development of domestic and regional bond markets</u> that capacity-building efforts should address?
- What needs to be done to <u>promote effective cooperation between public and private sectors</u> in undertaking such capacity-building measures?

and, in light of the 3 presentations, I would like to organize my comments as follows:

1) First, I will briefly comment on each of the 3 papers, and then,

2) briefly describe OECD activities related to this field, and

3) finally, elaborate on the discussions on index-linked bonds, which was one of the focal points for discussion in the latest OECD-World Bank Bond Forum in May.

1. Ghon Rhee's paper:

- correctly identifies the development of government bond markets as one of the key issues that national authorities should consider in order to better manage capital inflows

- and notes (p.8) that the lack of well-functioning gov't bond markets will lead to other distortions in financial markets, which

- was, in fact, a phenomenon observed in the JGB market until around the mid-1980s when the liberalization of interest rates in general and market issuance of JGBs began in Japan

- I will also add, in this context and related to Professor Eichengreen's "dilemmas" that it is important not to "put the cart before the horse" --- i.e. the development of bond markets should be well balanced w/ other sectors in the financial arena and the real sector; I say this because, having worked in Moscow just before their financial crisis, I would say that their GKO (Treasury) market was too well-developed relative to other institutions in their economy, and as a result the country "drowned" in the liquidity and depth of this market, which we all know was a disaster for the entire economy.

- in response to Ghon's questions asked of us at the very end, the only "off-the-cuff " answer that I can provide relate to the scarcity of foreign investors in the JGB market --- this relates of course to the low yield currently available on JGBs, an also to some unfavourable tax treatment that was improved only recently

2. J.C. Parrenas and Ken Waller's paper:

- nicely summarizes the discussions in the ABAC/PECC conference on the same subject in May

- I cannot agree more w/ the conclusions of this paper, which include
  1) expanding the institutional investor base
  2) developing a strong regional rating agency
  3) promoting effective insolvency and creditor rights systems

- While I will come back later in my comments to the issue of "expanding the institutional investor base", w/ elaboration on the discussion of ILBs, allow me to mention that a few years ago in JMoF when I was responsible for PR and IR, we had a huge "theological debate" about sovereign rating methodologies, to which I believe we never received a satisfactory answer from the major international CRAs.

3. John Farrell's paper:

- summarizes, in a general manner, the importance of the Public/Private Partnership, w/ which also I fully agree

- however, readers may be interested in how this is actually implemented in NZ

- In the case of Japan, where I have long worked, there has been a long history and tradition of Public/Private Partnership in such issues as developing JGB markets, which continues to this day; two notable examples where we had intense consultation w/ banks and securities dealers in introducing new systems and instruments are:
1) in the late 80's when we introduced competitive bidding in JGB auctions and introduced futures trading for JGBs
2) more recently when we recognized WI ("when-issued") trading for JGBs

4. OECD activities in this field:

- in the OECD, we have a senior gathering of OECD member debt managers, which as we wrote in the other paper effectively functions as the peer review forum to discuss and compare best practices on public debt management and the development of gov't bond markets

- a memo on the OECD WP on Public Debt Management will be circulated for your information, and I should add that we also conduct various "Outreach" activities in this field, so as to extend our discussion to developing country needs and interests

5. Index-linked bonds

- Inflation index-linked bonds have recently been one of the focal points of discussion in the above OECD forums that I have just mentioned

- In fact, they were introduced for the first time in my home country Japan in March this year, and are increasingly being better received most recently, w/ signs of deflation finally starting to dissipate in the economy

- Today, I would just like to highlight some of the arguments/discussions on this issue in the latest OECD-WB Global Bond Market Forum, in which I was not physically able to participate due to other pressing issues, but nevertheless have been able to reconstruct thanks to kind assistance from my colleague Hans Blommestein who is the Secretary of the above WPPDM

- This issue is important because in many of the emerging pensions/insurance market meetings that I have attended in the past year, many regulators/supervisors who are also versed w/ capital markets (including the Chilean supervisors of insurance and pension funds (Alejandro and Guillermo) cite the underdevelopment of capital markets, inter alia, long-term bond markets, as critical to the development of their pensions/insurance markets/systems. The linkage is clear in that these institutional investors require long-term instruments to hedge their liabilities, and is also a "chicken-and-egg" question in that the development of capital markets is inhibited by the lack of long-term investors in their respective domestic markets. ---- and what better hedging instruments for this purpose than "inflation index-linked bonds" where you are fully protected against future price movements!

- W/ the above background allow me to sum up the discussions on this topic from the latest OECD-WB Global Bond Market Forum

- As you all know, there are two "public good" arguments for "inflation index-linked bonds":
1) One is for "Market completeness", where from the investors' viewpoint, private agents are provided w/ the "perfect hedge" as described earlier
2) Two is for "Macro management" where the gov't strengthens its commitment to price stability --- under usual circumstances, the <u>gov't commits to low(er) inflation</u>, but in the case of Japan, there has been a novel circumstance where the investors will probably not tolerate a reduction in the "nominal value" of their security

The general financial arguments re: bond issuance, i.e. of cost-effectiveness, and ALM or hedging inflation risk on the public sector's B/S, should also be considered; these are often "trade-offs", in the case of ILBs, however, both criteria are met, and everyone is happy!

- In our latest OECD-WB Global Bond Market Forum last month, a representative from Barclays further elaborated on the situation in emerging markets, the gist of which I will introduce to you:

1) According to Barclays, the size of the "Linker" market has grown rapidly in the world
over the past 12 months, it has doubled, in the past 5 years grown by 2.5 fold
---- from USD 200 bln to more than USD 500 bln

2) But they play a modest role in emerging markets
under 5 % of total outstanding local currency debt in emerging markets at end-2003 was inflation linked; the lack of focus on Linkers by these governments is partly a by-product of a general lack of development in local bond markets --- domestic savings gaps are often financed via the issuance of foreign currency debt ----- (which is one of the problems that Ghon referred to in his paper)

3) However, as most Asian economies enjoy excess domestic savings, this latter point should not be a problem for these economies; moreover, partly due to the same "ageing" phenomena (that most OECD economies are now suffering from), in these economies as well, the local institutional investor bases are growing in importance, size and in sophistication.

4) From the above observations, ILBs may play a far larger role w/in emerging markets, particularly in Asia
- In comparison w/ G7 economies, emerging markets tend to be characterised by:

- More volatile business and inflation cycles
- Higher trend rates of inflation

While these elements have often been obstacles to the development of bond markets in general, as most Asian economies seem to be stabilizing after the financial crises, and added to that the pressure from ageing populations for more long-term hedging instruments, these may provide fertile ground for the development of an ILB market ----- I should also add that gov'ts also benefit, as I referred to before, if they implement an anti-inflationary growth program

Of course, many policy and technical issues (e.g. which inflation index?) need to be thoroughly investigated before governments can embark on such a path (as was the case in Japan and in France), but in light of the general macro-economic and demographic situation especially in Asia, such investigation is certainly worth the consideration in order that we may further develop bond markets, particularly those denominated in local currency ---- and I hope that this idea can be plugged into the Eichengreen-Hausman proposal to promote more issuance of local currency debt in this area.

(end)