

ISSUES



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PACIFIC ECONOMIC COOPERATION COUNCIL



Developing Regional Bond Markets in East Asia: The Way Forward

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About this Issue

This **ISSUES@PECC** is the summary report of a study on the subject matter undertaken by the PECC Finance Forum in 2003.

The PECC Finance Forum serves as an open forum for a tri-partite dialogue among the academia, government, and business sector, on the financial policy issues facing the Asia-Pacific region. The purpose of the dialogue is to assess the international environment for financial stability and development in the region, to assess progress in the promotion of financial reforms, integration and cooperation in the region, and to develop the desired vision of regional financial and monetary cooperation. For the purpose of these assessments, the Finance Forum undertakes survey-based task force studies on specific issues as well as convenes an annual conference of experts drawn from the member economies and the international financial institutions. For more information, visit www.pecc.net/finance.

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Introduction

The Asian financial crisis of 1997-1998 has triggered intense efforts to promote regional monetary and financial cooperation to prevent recurrence of future crises. Recently, developing regional bond markets in East Asia has emerged as one of the key agenda for regional financial cooperation. There is no assurance, however, that the proposed regional bond markets will ever leave the drawing board. Even if they do, they may never reach the maturity to be competitive vis-à-vis global bond markets in North America and Europe. A few critical issues arise from this perspective:

- If regional bond markets are to be created in East Asia, would they be viable? What is the economic rationale for the creation of regional bond markets in East Asia?
- What would be the structure and characteristics of these markets, if they are to be designed to serve the needs of both borrowers and investors in East Asia?
- How could these markets be organized? Would they emerge in the course of economic integration that has become deeper in recent years? If not, should East Asian governments make joint efforts to build the necessary institutional

infrastructures and harmonize their financial and other standards as well as tax treatments?

The PECC Finance Forum undertook a study of these issues in 2003 and discussed the findings from this study at its 2nd Annual Conference held in Hua Hin, Thailand, on July 8-9. The present report summarizes the outcome of this discussion in terms of the rationale, the strategy, as well as the roadmap, for the creation of Asian bond markets.

What are the Asian bonds?

Asian bonds share three common factors; Asian issuers, Asian investors and Asian currencies. Asian bonds are issued by Asian entities including governments, government agencies and corporations. They are denominated in Asian currencies. They will be purchased by Asian investors as well as by global investors.

Rationale and Strategy

Developing regional bond markets in East Asia enhances global financial stability as well as regional financial stability. The double mismatches, the maturity mismatch and the currency mismatch, can be overcome by developing Asian bond markets where regional issuers can raise



funds with longer maturities and in local currencies. Developing bond markets in the regional level as well as the domestic level reduces over-reliance on bank financing, which has been pointed by many as the main culprit of the Asian financial crisis. In addition, Asian bond markets provide Asian investors with opportunities to invest in the region. With the information advantage enjoyed by regional investors, deeper capital market integration in East Asia enhances the financial stability of the region.

The aforementioned problems including the double mismatches, over-reliance on bank financing and lack of regional mobilization of savings can be resolved if a country has sound and efficient domestic bond markets in which foreign investors and issuers actively participate. The reality is that, in many East Asian economies, domestic bond markets are at the nascent stage of development. It will take much time and resource to develop the market infrastructure required of efficient bond markets. Some economies simply do not have the economic size to bear the burden of developing such a market infrastructure. Issuers in these economies should rely on cross-border issuance for long-term bond financing.

Global bond markets provide issuers with alternatives to regional bond markets for cross-border bond financing. The global financial centers with well-established exchanges and over-the-counter markets and clearing and settlement systems provide a cost-efficient way of cross border financing. The reality, however, is that most of the East Asian borrowers sub-investment grade issuers. They cannot issue bonds on their own credit.

Various financial schemes and products including securitization, credit guarantees, currency basket bonds, and Asian bond banks can be employed to develop Asian bond markets. Securitization can help issuers overcome the credit/maturity mismatch with reasonable cost by allowing them to create securities whose risk profile is tailored to the risk preference of the investors. Credit guarantees are also useful in further reducing the credit quality gap. Oh and Park (2003)¹. propose establishment of regional credit guarantee facilities to supply credit insurance that suits the need of East Asian issuers. Rhee and Stone (2003) propose that credit enhancement can be achieved by adopting the idea of municipal bond banks. Asian bond banks can reap the benefit of credit-rating arbitrage and the economies of

¹ Gyutaeg Oh and Jaeha Park, "Fostering Asian Bond Markets Using Securitization and Credit Guarantee." material presented at the Voluntary Working Group Meeting of the Asian Bond Market Initiative, June 16, 2003, Tokyo

scale by pooling the funding needs of Asian borrowers.

Currency basket bonds can be useful in overcoming the currency mismatch problem if their risk-return profile can secure demand from investors. For example, the ABC bonds proposed by Ito (2003) distribute cash flows from pledged bonds with local currency denomination on a pro rata basis to the holders.

On the demand side, the Asian Bond Fund launched by the EMEAP will invest in dollar denominated bonds issued by Asian sovereign and quasi-sovereign issuers. In order to resolve the currency mismatch problem, however, an extension of ABF need to be established to include bonds denominated in Asian currencies in the portfolio.

There are plenty of reasons to believe that the proposed financial schemes can achieve the goal of creating Asian bond markets and resolving the double mismatches. There are, however, reasons to doubt if these schemes are capable of accomplishing their tasks as pointed out in Park and Park (2003) and Tran and Roldos (2003). We cannot take it for granted that adoption of these schemes will automatically resolve the double mismatches. It is because there is no free lunch in the financial market. These

schemes have to be examined carefully for their commercial viability.

Roadmap

It is desirable that development of regional bond markets be a market-driven evolutionary process where countries aspiring to become regional financial centers compete with each other to enhance their market efficiency. Still, there is room for cooperation among governments but it should be confined to development of financial, legal and regulatory infrastructure at the regional level to ensure efficiency of regional bond markets. Once the infrastructure is in place, promotion of regional bond markets should be left to the private participants.

While various financial schemes proposed will turn out to be useful in creating supply and demand for Asian bond markets, a large number of market-supporting institutions should be created to ensure stability and efficiency. They are: regional credit rating agencies, credit enhancement and guarantee agencies, clearing and settlement system, a central securities depository, cross-border securities borrowing and lending mechanisms, and exchange and over-the-counter markets for bond trading. In addition, existing barriers to efficient



cross-border trading and settlement in East Asia including national differences in technical requirements, market practices, tax and legal procedures should be identified and properly addressed.

While promoting regional bond markets, continuous efforts should also be made to develop sound and efficient domestic bond markets. The double mismatch problem can be best overcome by domestic financial reforms to enhance efficiency and transparency of domestic financial markets. Institutional reforms to garner investor protection are also in

order. Without domestic financial reforms to increase supply of investment grade financial products and to enhance market efficiency, regional bond markets cannot be a success. Regional bond markets cannot be a replacement for domestic financial reform.

Regional bond markets should be developed as an integrated part of the global capital market. The governments hoping to create regional financial centers in their economies should be ready to open up their domestic financial markets to foreign investors, foreign issuers and foreign financial intermediaries.

As part of the study done by the PECC Finance Forum, the following papers were presented at the 2nd Annual Conference of the Forum held in Hua Hin on July 8-9, 2003:

Ho, Richard Yan Ki and Chak Sham Michael Wong, "Road Map for Building the Institutional Foundation for Regional Bond Market in East Asia"

Ito, Takatoshi, "The ABC of ABC bonds"

Park, Yung-Chul and Daekeun Park, "Creating Regional Bond Markets in East Asia: Rationale and Strategy"

Rhee, S. Ghon, "The Structure and Characteristics of East Asian Bond Markets"

The following papers were submitted to the Conference as background materials:

Rhee, S. Ghon and Gregory R. Stone (2003), "The Asian Bond Bank: A Good Idea to Explore for Credit Enhancement"

Tran, Hung Q. and Jorge Roldos (2003), "Asian Bond Markets: The Role of Securitization and Credit Guarantees"

These papers are all available on-line at <http://www.pecc.net/finance/forum2003>.