Comments on Session III (Assessing and Building Capacities for the Development of Bond Markets in the APEC Region)

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Thank you for inviting me to the third annual PECC Finance Conference. I am very glad to participate in this conference and give comments in this session. I enjoyed reading the three excellent papers (Paper 1: Bond Markets in Asian Emerging Economies and Domestic Policy Challenges of Managing Capital Inflows, by S. Ghon Rhee, University of Hawaii, Paper 2: Key Ingredients for Development of Bond Markets and Capacity-Building in Emerging APEC Economies, by J. C. Parreñas, Taiwan Institute of Economic Research, and Paper 3: Development of Bond Markets: A Public/Private Sector Partnership, by John Farrell, NZPECC Finance Forum IAG Member and former Chief Executive, New Zealand Securities Commission) and obtained a lot of valuable information from the three papers. I am interested in the Asian Bond Market Initiative so much that my arguments are focused on the Asian Bond Market Initiative rather than give specific comments to each of the three papers. I would like to focus on especially currency basket bond because the denomination currency issue is the most controversial among the related issues. In fact, Prof. Eichengreen referred to this issue in his Keynote Speech titled by Strengthening the International Financial Architecture: The Agenda as of 2004.

We learnt many lessons from the Asian currency crises on 1997-1998. Among them, two lessons are the most important in reforming a regional financial architecture in East Asia. The first lesson was the danger of the “double mismatch of currency and maturity in financial intermediation.” Especially, the currency mismatch related to the fact that banks in the emerging market countries borrowed in the US dollars and lent in the local currencies under the dollar pay system. The second lesson was the danger of over-reliance on the banking sector. When a currency crisis happened, banks that had developed the double mismatch problem fell into bank insolvency and outright failure. The banking crisis caused a credit crunch, and deepened the economic crisis. In order to solve the problems of double mismatch and over-reliance on the banking sector, development of the bond market, especially the market for domestic currency denominated bonds, is regarded very important.

After the Asian currency and financial crisis, the East Asian government started to discuss establishing regional bond markets in East Asia. However, it takes time and government's will to build the bond market infrastructure, such as credit rating agencies, accounting rules and accounting firms, trading and clearing-settlement systems. The bond markets in each emerging market may be too small for efficient trading even if they were established in each of the countries. Accordingly, one way is to build a regional bond market in order that both potential issuers and investors should have a large pool.

Policy challenges in promoting Asian bonds have two targeted clients, issuers and investors. For the governments of potential issuers, obstacles for issuing corporate bonds to regional investors have to be removed. Accounting standard has to be best in the world and legal rights of investors. Whether local-currency-denominated bonds can be acceptable to investors depends on liquidity of the bond markets.

Issuers would like to issue bonds in local currency, while investors prefer receiving dividends and interest payments in investors' currency. Professor Takatoshi Ito has a proposal of an Asian Bond Corporation (ABC). The Asian Bond Corporation purchases local-currency-denominated bonds among East Asian countries and transforms into a basket currency bond for investors. The bonds reflect the value of the underlying assets. Ideally, the basket of bonds held by the Asian Bond Corporation would include bonds with the same maturity, so that maturity mismatch would not occur. The bonds would be purchased by investors in terms of a currency basket of bond-issuing East Asian countries.

On one hand, we can propose another kind of currency basket denominated Asian bonds. The basket currency comprised of the US dollar, the euro and the Japanese yen. This proposal is also intended to contribute to an integration of financial markets in East Asia through regional cooperation and it realizes an introduction of a common currency unit into East Asia in the future, perhaps in the distance future.

In selecting currencies and deciding their shares of the composition of Asian basket currency bonds, I believe that one of the criteria should be: to what extent such selected currencies are internationally used. From the investors' viewpoint another important criterion should be: to what extent these currencies of investment instruments are liquid and have deep markets and diversified hedging tools. According to these criteria, it is reasonable to assume that the US dollar, the euro, and the yen may comprise the currency basket.

The composition of the currencies for the Asian bonds still needs to be limited to the key currencies with high liquidity in international trades and other transactions by East Asian countries. However issuances of the Asian bonds will enable borrowing entities to reduce foreign exchange risks to some extent. As issuances of the Asian bonds increase, liquidity of the bonds will expand in the market and the concept of basket currency will be recognized throughout East Asia. It might be reasonable to assume that the composition of currency basket for East Asia be based on trade volumes with their major trading partners.

In my paper "Bond issuers' trade-off for common currency basket denominated bonds in East Asia" (*Journal of Asian Economics*, vol. 15 (2004) 719–738), I investigated advantages and disadvantages of choosing a common currency basket over an international currency as a denomination currency in issuing the bonds from viewpoints of both foreign exchange risks and liquidity. My empirical analysis in the paper obtained the following results:

(i) the G3 currency-basket-denominated bonds would be able to decrease foreign borrowing costs and their foreign exchange risks for bond issuers in many cases except for HK$ and Malaysian ringgit, depending on exchange rate system, that is dollar peg system or managed floating system,

(ii) the US dollar has the highest degree of liquidity in all of the East Asian countries,

(iii) bond issuers in East Asia face trade-off between foreign exchange risks and liquidity in choosing currency denomination of issued bonds.

Accordingly, I believe that we should establish markets for regional bonds denominated in terms of a common currency basket from a viewpoint of liquidity in order to activate the bond markets in East Asia.