

**OECD/ADBI 7th Round Table on
Capital Market Reform in Asia**

**27-28 October 2005
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**SESSION 2: INTEGRATION OF CAPITAL MARKETS IN
THE ASIAN REGION**

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East Asian
Financial Market Integration:
Reality or Illusion?

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on Capital Market Reform in Asia
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Three Pillars of **European Monetary Union**

- **European Currency Unit and Exchange Rate Mechanism**
 - No discussion on public sector forums
 - Scattered academic papers
- **European Monetary Cooperation Fund**
 - Multilateral Liquidity Swap Arrangements under Chiang Mai Initiative
- **Integration of Financial Markets**
 - ASEAN+3 Asian Bond Market Initiatives
 - EMEAP ABF1 and ABF2

Stock-Taking Exercise on ABMIs

- **Spearheaded by**

 - APEC Finance Ministers Meeting Process

 - ASEAN+3 Finance Ministers Meeting Process

 - Pacific Economic Cooperation Council Finance Forum

 - Multilateral Financial Institutions

 - ADB and ADBI

 - BIS

 - IMF

 - OECD

 - IBRD

- **Where Are We?**

 - A Stock-Taking Exercise is in Order**

Size of Local Currency Bond Markets

Unit: US\$ Billion

| | <u>1997</u> | <u>2004</u> | <u>Annual Growth Rate</u> |
|----------------------|-------------|-------------|---------------------------|
| Worldwide | \$25, 420 | \$44,049 | 8.2% |
| United States | \$12000 | \$19,187 | 6.9% |
| EU-15 | \$7,013 | \$11,385 | 7.2% |
| Japan | \$4,148 | \$8,867 | 11.5% |
| East-Asia excl Japan | \$402 | \$1,420 | 19.8% |
| Latin America | \$468 | \$651 | 7.2% |

Source: BIS

Size of Local Currency Bond Markets by Economies

Unit: US\$ Billion

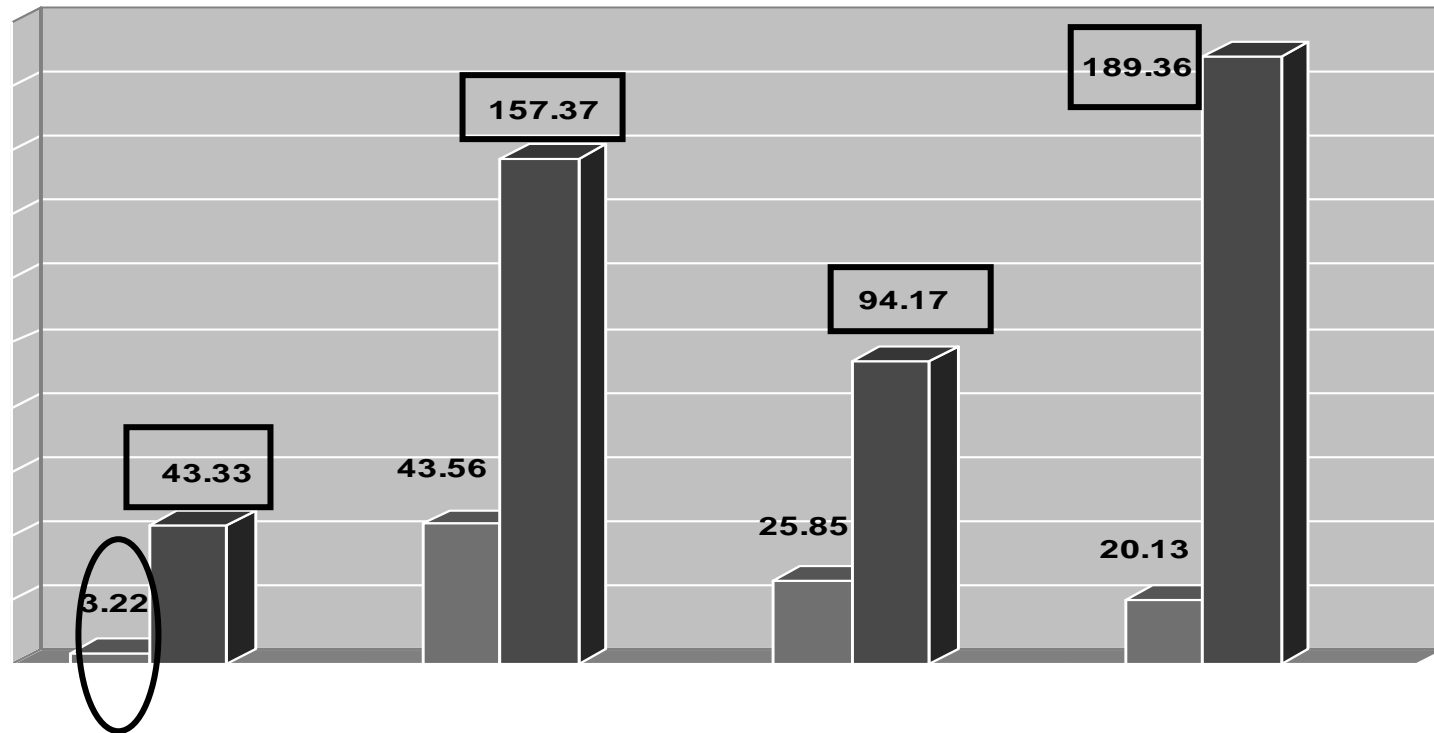
| | <u>1997</u> | <u>2004</u> | <u>Annual Growth</u> |
|---------------------|-------------|-------------|----------------------|
| <u>China</u> | 116.3 | 483.3 | 22.6% |
| Hong Kong, SAR | 41.1 | 46.5 | 1.8 |
| <u>Indonesia</u> | 4.3 | 57.8 | 44.9 |
| <u>Korea</u> | 130.3 | 568.4 | 23.4 |
| Malaysia | 57.0 | 106.6 | 9.4 |
| Philippines | 18.4 | 25.2 | 4.6 |
| Singapore | 23.7 | 66.3 | 15.8 |
| <u>Thailand</u> | 10.6 | 64.9 | 29.5 |
| <u>Viet Nam</u> | - | 0.8 | - |
| East Asia w/o Japan | 401.7 | 1,419.8 | 19.8% |

Source: BIS

Despite Remarkable Growth in Local Currency Bonds...

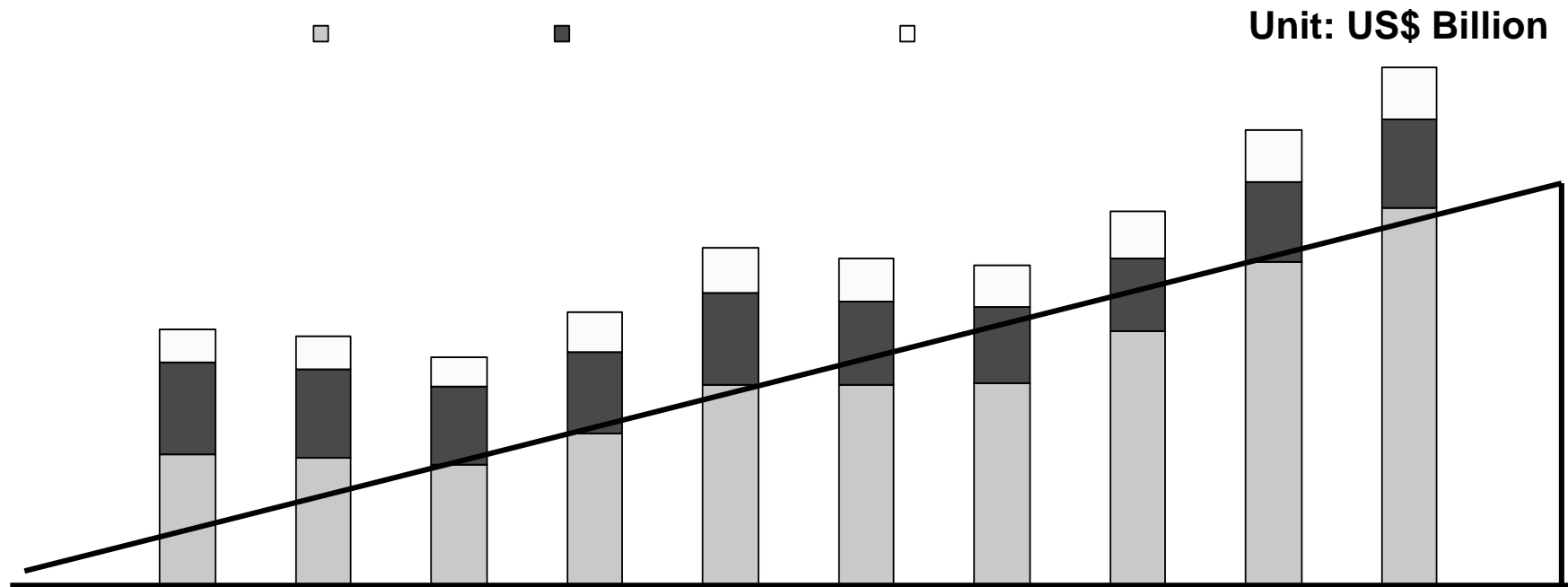
**Three Concerns about the
Current Status**

Relative Size of East-Asian Bond Markets (2004):



1. Market share should have been greater

Composition of Asian Bonds:



2. Rapid growth is attributed to the expansion of government bond markets not corporate bond markets

Source: BIS

Relative Size of Corporate Bond Markets (% of GDP):

| <u>Economy</u> | <u>As % of GDP</u> |
|--------------------------------------|--------------------|
| China | 0.73% |
| Hong Kong | 3.65% |
| Indonesia | 1.47% |
| Korea | 23.41% |
| Malaysia | 38.14% |
| Philippines | 0.12% |
| Singapore | 5.14% |
| Thailand | 11.74% |
| East Asia w/o Japan | 7.70% |
| East Asia w/o Japan, Korea, Malaysia | 1.80% |
| Japan | 16.86% |
| United States | 21.17% |

Source: BIS

3. Development of corporate bond markets is uneven

Who are Receiving Investments in Asian Bonds (as of 2003)?

Unit: US\$ billion

Total Investments in Bonds Worldwide
Total Investment in Asian Bonds

\$9,127.8

190.5

| | |
|-------------|---------------|
| Japan | \$107.5 (56%) |
| Korea | 24.6 (13%) |
| Malaysia | 14.4 (8%) |
| Philippines | 11.7 (6%) |
| Singapore | 11.5 (6%) |
| Hong Kong | 9.2 (5%) |
| Indonesia | 4.2 (2%) |
| China | 4.1 (2%) |
| Thailand | 3.1 (2%) |
| Viet Nam | 0.2 (0.1%) |

Source: IMF

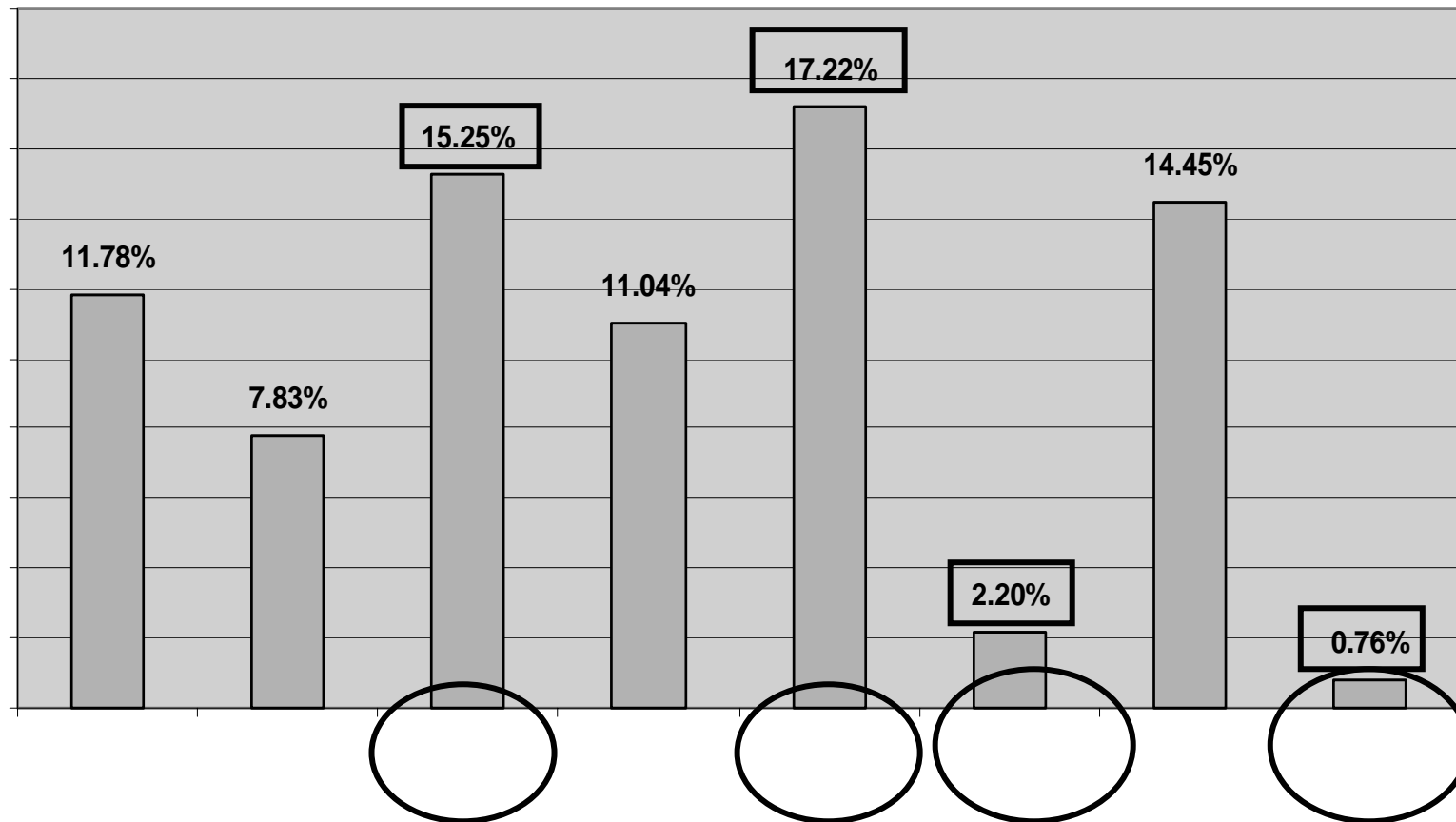
Who are the investors in Asian Bonds?

Unit: US\$ billion

| | |
|-------------------------|--------------------------|
| EU-15 | \$70.2 (37%) |
| United States | 53.8 (28%) |
| Hong Kong | 22.3 (12%) |
| Japan | 10.8 (6%) |
| Singapore | 9.9 (5%) |
| Korea | 1.1 (0.57%) |
| Philippines | 0.2 (0.01%) |
| Indonesia | 0.2 (0.01%) |
| Malaysia | 0.1 (0.00%) |
| Thailand | 0.1 (0.00%) |
| Others | 21.8 (11%) |
| Total Investment | \$190.5 (100.00%) |

Source: IMF

Investment in Asian bonds by Asian Economies in Proportion to Total Investments



Source: IMF

Two Questions

- Why are Intra- and Inter-Regional Investments in Asian Bonds so Small?
- Why Isn't Japan More Proactive in Investing in Asian Bonds?

Why are intra- and inter-regional investments in Asian bonds so small?

- **Too many legal and institutional impediments**
- **Institutional investors avoid Asian bonds because of their concerns about investment risk**

Why Isn't Japan More Proactive in Investing in Asian Bonds?: Gaisai Bond Market In Japan

Unit: ¥ trillion

| <u>Japanese Fiscal Year</u> | <u>Number of Issues</u> | <u>Samurai Bonds</u> | <u>Number of Issues</u> | <u>Shogun Bonds</u> |
|-----------------------------|-------------------------|----------------------|-------------------------|---------------------|
| 1991 | 27 | 0.71 | 1 | 0.41 |
| 1992 | 37 | 1.57 | 0 | 0 |
| 1993 | 49 | 1.23 | 1 | 0.59 |
| 1994 | 60 | 1.26 | 0 | 0 |
| 1995 | 85 | 2.11 | 0 | 0 |
| 1996 | 154 | 3.79 | 0 | 0 |
| 1997 | 66 | 1.53 | 0 | 0 |
| 1998 | 10 | 0.15 | 0 | 0 |
| 1999 | 24 | 0.86 | 0 | 0 |
| 2000 | 64 | 2.40 | 0 | 0 |
| 2001 | 41 | 1.31 | 0 | 0 |
| 2002 | 30 | 0.67 | 0 | 0 |
| 2003 | 39 | 0.94 | 0 | 0 |
| 2004 | 45 | 1.68 | 0 | 0 |

Source: Japan Securities Dealers Association

Comparison between Japan and Hong Kong/Singapore

A. Local Currency Bonds Issued by Foreign Borrowers in 2004

| | <u>Amount</u> | <u>(% of total bond market)</u> |
|------------|------------------|---------------------------------|
| \$ bonds | US\$3.5 billion | (5.3%) |
| HK\$ bonds | US\$10.6 billion | (22.8%) |
| ¥ bonds | US\$16.0 billion | (0.2%) |

B. Foreign Currency Bonds Issued by Foreign Borrowers

| | | |
|----------------|-------------------------|---------|
| Non-\$ bonds* | US\$33.7 | (50.8%) |
| Non-HK\$ bonds | No Statistics Available | |
| Non-¥ bonds | US\$0.00 | (0.00%) |

Sources: HKMA, MAS, JSDA

What's Wrong with Japan's Gaisai bond markets?

- **High transaction costs**
More than **200 basis point differential** between samurai bond issue and euro-yen bond issue.
- **Inordinate delay in bond issues**
Several weeks in Tokyo vs. **three or four days** in Eurobond market
- **Cumbersome recording system and clearing and settlement processes**
Euroclear and Clearstream are readily available and utilized for cross-border transactions

A Good Question to Ask Is.....

If Japan alone were unable to do it, how can the 13 ASEAN+3 member economies create regional bond market activities?

Three Concerns about Asian Bond Market Initiatives

- 1. Strong Sense of Regionalism**
- 2. Overemphasis on Public Sector's Role**
- 3. Preoccupation with harmonization of rules and regulations**

Extreme Regionalism Is Costly and Counterproductive

Some Troubling Suggestions

- a. Bonds rated by Asian rating agencies**
- b. Bonds issued by Asian borrowers and purchased by Asian investors**
- c. Bonds traded, cleared, and settled in Asia**

“Asia Only” Market will

- a. Limit Number of bond buyers**
- b. Discourage competition**
- c. Increase borrowing cost**

As long as Asian Borrowers

Issue bonds at a minimum cost and the majority of these bonds are purchased by Asian investors, does it matter?

1. Where these bonds are issued
2. Who rates these bonds
3. Who serves as lead managers
4. Where these bonds are traded
5. Where they are cleared and settled

Regional markets must be a part of global markets rather than being a segmented and isolated market

Does It Make Sense?

For the Public Sector to Spearhead:

- a. Creation of a regional bond rating agency**
- b. Creation of a regional clearing and settlement system**
- c. Creation of a regional trading system**

Definitely Not!

Regional Integration of Equity Markets

Foreign Shareholding of Listed Companies

(as of December 2004)

- | | | |
|----|---------------|--------|
| a. | Japan: | 24.0% |
| b. | Korea: | 40.1% |
| c. | Thailand: | 30.0% |
| d. | Taipei,China: | 11.33% |

Creation of Regional Equity Market Index

Malaysia/Indonesia/Philippines/Singapore/Thailand collaborate with the FTSE Group for the ASEAN equity market index

All Private Sector-Initiated Integration under Progress without Public Sector's Involvement

Pre-Occupation with Harmonization

- Harmonization is not necessary for financial market integration
- Principle of “Mutual Recognition” and “Home Country Control” is important
- Regional efforts have overemphasized harmonization while elimination of impediments to capital flows has been largely overlooked

“Putting the cart before the horse”?

Ways Forward

- 1. ASEM Finance Ministers' Meeting Process: Ideal Forum to Share EU's Experiences**
- 2. ADBI, EMEAP, OECD: Focal Point for Academic and Policy Research on Asian Monetary Union**
- 3. Chiang Mai Initiative → Asian Monetary Cooperation Fund**
- 4. Development of Local Currency Bond Markets: Top Priority**
 - a. Elimination of Legal and Institutional Impediments to Inter- and Intra-Regional Capital Flows into Asian bond markets: Comprehensive Study**
 - b. Japanese Institutional Investors' Participation in Asian bond markets: Key to Success**
 - c. ASEAN+3 ABMI: Credit Guarantee and Enhancement Focused**

**Thank you
for your attention**

**For Further References,
Please visit
<http://www2.hawaii.edu/~rheesg>**