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SESSION 2: INTEGRATION OF CAPITAL MARKETS IN THE ASIAN REGION

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ASIAN BOND MARKET DEVELOPMENT: PROGRESS & CHALLENGES

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PRESENTATION

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I. INTRODUCTION

- Since the financial crisis of 1997-98, the East Asian economies have embarked on several initiatives to develop Asian bond markets as part of financial cooperation.
- What are the current states of Asian bond markets, in terms of size, liquidity, issuers/investors, regulatory frameworks, and market infrastructure?
- How far have we gone under ABMI and ABF—the most prominent and successful policy initiatives to promote Asian-currency denominated bonds?
- What are the challenges ahead?

II. BENEFITS OF ASIAN BOND MARKETS

1. Key Lessons of the Asian Financial Crisis

- Lesson one—large current account deficits financed by unhedged short-term capital inflows
- Lesson two—excessive reliance on foreign-currency denominated short-term debt for external financing
- Lesson three—excessive reliance on commercial banks for domestic financing
- Asian savings were channeled abroad (New York, London, etc.) and came back to Asia as short-term capital in foreign currency to finance local long-term investment—the “double mismatch” problem

II. BENEFITS OF ASIAN BOND MARKETS (cont'd)

2. Increasing Financial Resilience in Asia

- Asian bond markets can facilitate direct mobilization of Asian savings for Asian long-term investment
- Asian bond markets can reduce the "double" mismatch problem—currency and maturity mismatches
- Asian bond markets can make its financial system more balanced and resilient, with two wheels

  - More competition in the financial system, thus disciplining commercial banks

  - Less concentration of financial risks in one wheel

II. BENEFITS OF ASIAN BOND MARKETS (cont'd)

3. Providing Wider Financial Alternatives for Asian Governments, Firms and Households and for Global Investors

- Asian bond markets can provide alternative sources of financing for public and private investment
- Asian bond markets can provide alternative modes of wealth holding for Asian households
- This is very important for Asian economies which are rapidly ageing and, hence, require many options for retirement financial arrangements and pensions.
- Asian bond markets can provide wider opportunities for portfolio diversification for global investors

III. DEEPENING OF ASIAN BOND MARKETS

1. Bond Markets in the Asian Financial System

- Total local currency bonds outstanding in major emerging East Asia (EEA) tripled from $356 billion in 1997 to $1.2 trillion in 2003.
- The share of local currency bonds in EEA's financial system is rising, from 13% in 1997 to 19% in 2003.
- Despite encouraging growth, local currency bond markets in EEA remain relatively small, about 3% of total local currency bonds worldwide ($40 trillion) and only 44% of EEA GDP.
- Market liquidity, measured by trading volume and turnover ratios, has increased significantly in recent years, but remains low in comparison to developed country markets.

III. DEEPENING OF ASIAN BOND MARKETS (cont'd)

2. Issuers and Investors

- Major issuers of local currency bonds in EEA are governments, with a few exceptions, and corporations are less important issuers.
- In Malaysia, corporations are the largest issuers and in Korea financial institutions and corporations are large issuers.
- Since 1997, bond holdings by commercial banks have been declining while holdings by contractual savings institutions (pension etc) have been rising.
- Nonetheless, overall investor base remains narrow and over half of local currency bonds are still held by commercial banks.

III. DEEPENING OF ASIAN BOND MARKETS (cont'd)

3. Market Infrastructure and Legal/Regulatory Framework

- Market infrastructure in EEA bond markets has improved
  - real-time gross settlement systems with DvP facilities
  - organized exchanges for trading fixed-income securities
  - local credit rating agencies
- Legal/regulatory frameworks have been strengthened
  - institutional and organizational framework for capital market regulation and supervision
  - laws and regulations governing securities markets
  - reform of withholding tax on coupon and interest
  - improvement of information dissemination
- But much remains to be improved.

IV. RECENT POLICY INITIATIVES

1. Several Major Initiatives

- Executive's Meeting of East Asia-Pacific Central Banks (EMEAP)

  - Strengthen the demand side through ABF

- ASEAN+3 Finance Ministers' process

  - Strengthen the supply side through the ABMI

- APEC Finance Ministers' process

- Asia Cooperation Dialogue (ACD)

  - Raise political support to, and public awareness of, the Asian Bond Market Initiative

IV. RECENT POLICY INITIATIVES (cont'd)

2. Asian Bond Fund (ABF)

- Initiated by EMEAP to strengthen the demand side
- ABF-1 (June 2003, $1 billion)

  - Invest in sovereign and quasi-sovereign US dollar bonds issued by 8 members (excl. Japan, Australia, NZ)
- ABF-2 (December 2004, $2 billion)

  - Pan-Asian Bond Index Fund (PAIF), a single bond fund index investing in sovereign and quasi-sovereign local currency bonds issued by 8 members.

  - Fund of Bond Funds (FoBF) with 8 country subfunds

  - Open to investment by the public

IV. RECENT POLICY INITIATIVES (cont'd)

3. Asian Bond Market Initiative (ABMI)

- Initiated by ASEAN+3 to strengthen the supply side
- Current Working Groups:
  - (1) New securitized debt instruments
  - (2) Credit guarantee and investment mechanisms
  - (3) Foreign exchange transactions and settlement issues
  - (4) Rating systems
- Making visible progress in all fronts:
  - A former WG on "issuance of bonds denominated in local currencies by MDBs, foreign government agencies, and Asian MNCs" has been resolved due to its success

V. CHALLENGES AHEAD

1. Further Improvements of Market Infrastructure and Legal/Regulatory Frameworks

- Efforts to improve market infrastructure and legal/regulatory frameworks are essential at the country level.
- Effective coordination among regulatory and supervisory agencies at the domestic level and among economies at the regional level
- Public-private sector partnership
- These improvements can often be better achieved by a focused approach such as the ABMI

V. CHALLENGES AHEAD (cont'd)

2. Further Progress Needed on ABMI

- WG(1): Issuance of regional multicurrency bonds (Asian currency basket bonds) based on regional asset backed securities (ABS), such as residential mortgage backed securities and SME loan backed securities
- WG(2): Establishment of a regional credit guarantee and investment mechanism for credit enhancement
- WG(3): Creation of a regional settlement system linkage through improvement of individual settlement systems by way of greater transparency and harmonization of settlement regulations
- WG(4): Harmonization of regional credit rating systems for convergence of rating methodologies and better comparability of ratings across Asian countries

V. CHALLENGES AHEAD (cont'd)

3. Going Beyond ABMI and ABF

- Going forward, improving market liquidity is key
  - Broaden the investor base
  - Set up efficient settlement systems directly linked to fixed-income exchanges
  - Develop hedging products and derivatives markets
- Supporting corporate bond markets is the next step:
  - Strengthen corporate governance, accounting standards and disclosure requirements
  - Improve pricing efficiency through derivatives
  - Strengthen creditor rights and investor protection
- Further removal of legal, tax & accounting impediments is necessary
- Regional cooperative efforts remain essential

VI. CONCLUSION

- Asian economies are capturing the momentum for Asian bond market development.
- Substantial, tangible progress has been made in deepening Asian bond markets, in terms of size, issuer base, market infrastructure, and legal and regulatory frameworks.
- ABMI and ABF have been quite successful.
- But more remains to be done, at the country level and at the regional level.
- Country level: liquidity and corporate bond markets.
- Regional level: Asian currency basket bonds; regional credit guarantee system; regional settlement system; harmonization of credit rating.