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SESSION 2: INTEGRATION OF CAPITAL MARKETS IN THE ASIAN REGION

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ABF2 and Regional Initiatives

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Introduction

This presentation attempts to present the rationale for integration of regional financial and capital markets in East Asia, the Asian Bond Fund 2 and the way forward towards further integration.

The needs to further develop and integrate markets : Financing of current account deficit

Today, the world's attention seems to be focused on the global imbalance; the growing current account deficit of the United States and, on the opposite side, the current account surplus of Asia. Both phenomena are considered unsustainable, and countries are urged to cooperate to help the unwinding of this imbalance in an orderly way.

Emerging countries in Asia have not always enjoyed current account surplus, however. They all have long lists of infrastructure bottlenecks that need to be developed, and in many countries, their entrepreneurs should be investing a lot more in order to take advantage of the higher rates of return that are supposedly available to investments in emerging countries compared to developed countries.

In normal times, they should be investing more than they can save by themselves. They should be running mild current account deficits, seeking additional savings from abroad to fuel their thirst for investments. The fact that some countries are now running current account surpluses can perhaps be explained by (a) some countries went through massive economic crises so are still suffering from the overhang of excessive capacities that were built up during the bubble periods, and (b) some countries may be stimulating the export sector hard today, accumulating surpluses in order to salt away as international reserves for use for future importation of goods that will be needed for further development. For emerging countries, therefore, current account deficits shall sooner or later take over as the norm until their needs for infrastructure development lessen or until the rates of return for their additional private investments cease to be superior to developed countries. They therefore need to fill the gap by importing capital from developed countries or from regional countries that command poorer rates of return for their additional investments.

The importation of capital itself, however, has been a major source of risk to the financial system of these countries. The first reason for capital market development is therefore to allow the regional countries to better manage this risk.

The safest form of capital importation is Foreign Direct Investment. In FDI, foreign investors bring in everything: capital, technical know how, managerial skills as well as the markets. FDI has been the main driving force of many Asian countries, and lately have been planned more and more on the regional basis rather than individual countries, linking parts and raw materials from many countries into a single commercial scheme.

The second safe form of capital importation is portfolio investment into the stock market. Even though there is a risk of market volatility where the size of the market is small compared to capital inflows and sudden outflows, the volatility itself serves as a safety valve. The market that rises out of proportion on sudden inflows will deter additional inflows by itself. Sudden outflows will also cause the market to react, making it unattractive for foreign investors to sell too much too soon.

The most risky form of capital importation is that of borrowings. Foreign borrowings are done through two channels: foreign loan contracts direct to domestic investors and foreign borrowings by local banks for on lending to domestic investors. They are both subject to liquidity risk in time of crisis.

Since the Asian crisis of 1997, the mantra now is to avoid short-term foreign borrowings. They can cause sudden instability because credit perception of the debtor country may change, causing loans not to be rolled over. However, the experience of Thailand showed that even long-term borrowings could also be subjected to sudden withdrawal. Many of the long-term contracts did have clauses imbedded that allow for early recall of loans should certain events occur, for example, when the debt to equity ratio of the borrower drops below a certain point. Unfortunately, in the situation of a country wide economic crisis, many of these events could occur at the same time, causing what seemed previously to be long-term loans to turn almost overnight into callable loans of short maturity.

Foreign borrowings through local banks are perhaps subject to less liquidity risk. Governments can and do step in to bail out the banking system to avoid a total collapse. However, it is perhaps this particular option that can develop the tendency to give false sense of confidence to foreign lenders. This may cause them to lend too much, far too much compared to what they might do if they have to rely on the strength of the balance sheets of the local banks alone.

The disbursement of imported capital by the local banks to domestic investors can also lead to over investment. If bank supervision of a country is lax, and if bank regulation is not up to international standard, poor credit decisions can often be made without proper assessment of market potential for those additional investments. The risk may be higher in countries where banks are largely owned by the state. Often during the bubble period before the crisis, loans in local banks would grow at exceptionally high rates for many consecutive years, making it impossible for loan officers to cope and for the check and balance within the banks to function properly.

In addition to the risk of liquidity and resource misallocation, emerging countries also face the risk of currency mismatch. Emerging countries face what some economists call the “original sin”, the fact that they cannot borrow from abroad in their own currencies. Theirs are not reserve currencies. They have to borrow in the currencies of the major countries instead. The domestic borrowers would therefore have mismatch, their earnings would be in domestic currencies while their borrowings in currencies of the major countries. This risk came alive when the economic crisis set in. Short-term loans were not rolled over. Early repayment clauses in long-term loans started to kick in. Loan recalls led to more and more capital outflows. This caused the domestic currency to weaken further and further. Exchange losses to the domestic borrowers with the mismatch could expand very fast, causing the non-performing loan ratios in local banks to balloon and causing the stock market to collapse, worsening the already precarious situation.

Development of local capital markets in the region will therefore help better manage the risks associated with capital import. This is particularly important for emerging Asian countries whose current account deficits now come under pressure from rising oil price, and whose future demand for infrastructure investment is still very large. The need for capital import into the region will grow as well as the need to be better prepared to manage these inflows.

Regional capital movement

The second need to develop local capital markets in countries in the region is to encourage and pave the way for movement of capital within the region in the format of portfolio investments rather than the format of loan contracts.

The advantages of regional capital flows in the format of portfolio investment are;

(a) It will allow regional savings to finance regional investments directly instead of the prevailing practice of having to round trip through the major countries. Investments into a country from nearby neighbors may also be able to withstand temporary shocks facing the recipient country since the investors may understand and see through the temporary nature of the disturbance better and be more willing to hold on to the investment. The resilience to temporary shocks should be better than capital flows from the major countries further away.

(b) It will allow investors to better diversify their risks by allocating a part of their portfolios abroad. Better risk diversification may occur not only on foreign exchange, but may also extend to maturity where the recipient country may have longer dated assets or more liquidity in some sector, financial product type, business sector availability, in addition to the potential to enhance yields.

(c) It will pave the way for further expansion of regional trade in goods and services. This is particularly relevant for Asia where regional economic and trade integration is poised to increase substantially in the coming decades. It will lead not only exchange of goods and services, but also the setting up of production facilities cross borders, the marketing centers, the procurement points and other commercial activities. Financial services will have to follow commerce to facilitate transactions as well as to allow users of funds to efficient tap capital for these cross border operations.

It may be argued that many emerging countries in Asia may not be in the position to have excess savings to become a capital exporting country on a sustained basis for many more years. However, emerging countries may allow limited amounts of outflows even will before they reach the stage of a capital exporting country. A few countries in Asia now allow outflows for portfolio investment by institutional investors in order to develop their skills in the more developed markets where product variety is greater and understanding of advanced derivatives and securitization needs time to accumulate. The amounts of outflow are then determined each year depending on the economic circumstance of the country.

Policy measures :
Bond market development

It has been said that part of the reasons that the United State has been able to sustain a very large current account deficit for a long period of time are that US dollar is a reserve currency and that the United State can borrow in its own currency. Emerging markets in the region definitely cannot imagine their currencies becoming the preferred reserve currencies anytime soon. In fact many countries may even argue against having their currencies become reserve currencies for the burden they have to bear and for the lack of control over their currencies.

However, they can indeed aim for borrowing from abroad in their own currencies. They can do this by developing their domestic bond markets in their local currencies. If they can win sufficient confidence of foreign investors, regional or otherwise, to bring in funds to invest in local bonds denominated in local currencies, whether issued by the public sector or the private sector, they will succeed in passing onto the foreign investors both the currency risk and the maturity risk. Fluctuation in the currency value and the price of bonds will be for the account of the foreign investors, while the user of funds will not be affected even in time of a full blown crisis. There will no longer be the double mismatch.

Unfortunately, confidence of foreign investors can only be gained by having all the right conditions in place in the recipient countries. The investors must have confidence in the macro economy, monetary policy and public policy. Transparency of the macro economy must be up to international standard. The bond markets must have sufficient size and liquidity to allow big institutional investors to exit in a relatively orderly manner. There must be infrastructure that allows proper price discovery, credit risk analysis, risk management for changes in both bond price and foreign exchange as well as a strong and convenient system for settlement. The tax regime must also be investor friendly, and at least as attractive as other international markets. In many emerging markets, taxes that are levied on trading values, despite being of tiny percentages, can have the effect of preventing secondary market trading because when traders in money market change their outlook on the market, they cannot cancel the original contract but instead have to strike another contract in the opposite direction making tax burden worse each time they change their outlook.

Infrastructure development is also needed for legal framework, standard documentation and market codes to facilitate settlement of disputes. Complicated derivatives and bundling and un-bundling of risks can be done only with clear-cut legal certainty. Finally, the securitization and credit enhancement in many emerging markets often require a new set of law altogether. Developing local bond markets in emerging countries because the work to be done often spans many government agencies. The technical complexities involved and the long years needed for drafting and passing the laws also makes it difficult to command top attention of politicians. Therefore, it was proposed in official regional meetings to adopt bond market development as an important agenda so that countries can help each other with information, technical know how and peer encouragement.

There are many initiatives among regional countries to help with bond development, but the launch of Asia Bond Fund 2 (ABF2) was certainly one of the really major moves. ABF2 is the second phase of the Asian Bond Fund initiative which pools together government reserves from 11 central banks and monetary authorities in the East Asia Pacific region (EMEAP countries), namely Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, and Thailand to invest in local currency-denominated Asian bonds. The ABF2 funds will be passively managed against a set of pre-determined benchmarks, covering local – currency bonds issued by sovereign and quasi-sovereign issuers in EMEAP economies. ABF2 is designed in such a way that will facilitate investment by other public and private sector investors.

The objective is to establish Asian local currency bonds as an asset class worthy of attention of international investors. ABF2 has two components; a Fund of Bond Funds (FoBF) and a Pan-Asian Bond Index Fund (PAIF). FoBF is a two-layered structure with a parent fund investing in a number of country sub-funds comprising local currency denominated bonds issued in the respective EMEAP economies. Each country sub-fund will be listed and traded in the relevant local exchange and domestic institutional investors will be allowed to participate. The ABF 2 will therefore promote the development of index bond funds in each of the regional markets and enhance the domestic as well as regional bond market infrastructure. Many countries involved have never had exchanged traded funds before that allow investors to invest in local currency bond index. The introduction of bond index fund will mark a very important milestone in bond market development in these countries.

PAIF is a single bond index fund investing in a basket of all local-currency denominated bonds in EMEAP economies. The advantage of the PAIF is that it will establish a benchmark for international investors wishing to invest in a basket of local currency Asian bonds can follow, or use as a base to modify to suit their particular risk preferences. In anticipation that in future the private sector may decide to launch a similar type fund for sale to the general public both within and outside the region, the securities regulators of ASEAN countries have proposed to facilitate the setting up of private sector Asia Bond Mutual Funds (ABMF). The ABMF will invest in bonds of ASEAN and other Asia-Pacific countries that agree to provide privileges under a request list to facilitate the private sector to launch structured funds that invest in Asian currency sovereign and quasi-sovereign bonds. One important condition is that investment in bonds of ASEAN countries should be of a significant proportion. The countries in which the Asia Bond Mutual Funds invest will give privileges by way of lifting tax, regulatory, and other impediments should any still exist.

Where any part of the fund is to be offered for sale in ASEAN, each ASEAN country will determine the amounts to allow for its domestic investors to invest in Asia Bond Mutual Funds under the scheme. The countries involved will give privileges by way of granting capital control, granting simultaneous permissions through a single passport, and allowing concessions to resolve other impediments that may exist. The ABMF was tabled at the ASEAN Finance Ministers' Meeting (AFMM) in Laos last April and was tasked to the Working Committee on Capital Market Development (WC-CMD) to further study the proposal.

Global issue of local currency bonds

One important trend that developed this year is that several countries in Latin America started to issue bonds in the international market but in local currencies. The rationale is to pass the foreign exchange risk from the issuer to foreign investors. Benefits promoted included (a) better liquidity in the international market compared to the domestic markets, (b) international investors can conveniently clear their transactions through established international organizations such as Euroclear, (c) international investors enjoy better legal protection because they come under US or European laws.

Global issue of local currency bonds clearly provides more convenience to international investors than domestic markets. For investment in domestic bond markets, international investors have to bring in the foreign exchange for conversion into local currencies themselves to buy local currency bonds. The domestic foreign exchange market may be small and subject to volatility particularly for large size transactions. The rates faced by investors will depend on market conditions, instead of being fixed in advance. Even if the investors can hedge their risk in the domestic foreign exchange market, the hedging period available may be far shorter than the maturity of the bonds, and in the subsequent rollovers, hedging costs may increase substantially. Investors naturally prefer to have the sovereign issuers quote exchange conversion rates instead of them having to deal in the domestic markets by themselves. Global issue of local currency bonds therefore serves as a measure to temporarily fill the gap, while the domestic markets undergo development.

However, the advantage to the issuers is much smaller than the alternative of real domestic market development. There is a real risk that a country may slow down or even neglect domestic market development altogether because of the complexity and difficulty involved. Global issue of local currency bonds provides solution only for sovereign foreign borrowing needs. But it does not pave the way for the private sector to conveniently issue domestic bonds to tap money from international investors. It also allows the market for foreign exchange in one's currency to develop offshore. When that is allowed, one's currency will often become tools for financial transactions in the international market that have no connection to the country of that currency altogether whether in term of payment and transfer for trade of goods and services or in term of capital investments into and out of the country.

With foreign players having direct access to one's currency in the offshore markets, information about transactions become lost. The country has not only no control over these transactions, it has no information as to the buyers and sellers. It has no way to influence the direction of its currency movement other than through buying and selling in the international market. There is no room for moral suasion or other administrative measure as available to onshore transactions. There is no room to fend away the hedged funds. This approach is therefore only suitable for countries that allow their currencies to float freely and where their domestic businesses can tolerate high volatility. It is best for the countries that can tolerate imbalances that may temporarily occur in the financial system, and can allow the market mechanism to work out these imbalances rather through official interventions.

While global issues of local currency bonds have their advantages, efforts to develop domestic markets should continue. The problems that make domestic markets inferior to the global market should be removed or steadily improved. The goal should be to make domestic markets attain equal or better liquidity than the global market, equal development in infrastructure equal ease in settlement and transfer and equal comfort in legal system as the global market. When the domestic markets become developed to such high level, linkage with offshore or allowing one's currency to be active offshore does not pose such a risk to the country as allowing the global market to develop on its own.

Mutual recognition

The second group of effort is being organized among the securities regulators in the region. Mutual recognition and harmonization of standards are the issues currently addressed as priority agenda in a number of regional forum. The main objective would not only be for paving way towards regional integration but also for upgrading the regulatory framework of the economies involved.

Among securities regulators in the ASEAN region, we have agreed on areas to be explored for mutual recognition and harmonization to include (a) disclosure, accounting and auditing, (b) cross border offering and distribution documents, (c) cross recognition of qualifications of market professionals, (d) harmonization of rating agency comparability. Currently we have the ASEAN Capital Market Forum that meets twice a year. However, in the future, I am sure that this kind of forum could expand to include the plus three as well. In the wider area of Asia Pacific Regional Committee under the International Organization of Securities Commissions, we are also working on mutual recognition of collective investment schemes.

In addition, several countries are also working towards establishing mutual recognition arrangements on a bilateral basis. Thailand's SEC has signed a Letter of Intent (LoI) with Hong Kong Securities and Futures Commission to establish mutual recognition in the area of cross-border trading and supervision of regulated collective investment funds. It is hoped that this initiative would be an exemplary effort for other countries in the region to follow and thus encouraging greater harmonization of standards and regulations. Many such bilateral arrangements are currently in the pipeline among regional countries, and I expect many more to be executed in the future. To use the example of Thailand, we are at the moment actively exploring the possibility of more such arrangements with other countries within the region.

Conclusion

Emerging countries in the region do need to further develop their capital markets in order to better manage capital flows in the future, both the flows needed to finance current account deficits that may build up or for some countries may occur in the future, and to allow for better diversification of portfolio investments among the regional countries. While many countries are engaging in domestic measures to develop their markets, help from other countries together with opportunity to compare notes and experiences with other countries should enhance the domestic efforts. Initiatives such as ABF2, Asian Bond Mutual Funds, mutual recognition and bilateral recognition of standards, rules and regulations are therefore important steps in furthering this development through regional cooperation. However, many more such regional initiatives will need to be created in the future as and when the regional markets mature and develop into the next stages.