No.1 | June 2012

Policy Brief

ADB

OFFICE OF REGIONAL ECONOMIC INTEGRATION (OREI)

Key Points:

- Asia's local currency bond markets have made significant strides in the past decade, but intra-regional debt investments remain low at 7.2% of total investment.
- There is a strong "home bias" among Asian investors, while the region's vast savings have traditionally been intermediated through global financial centers.
- Asian investors' home bias deepened after the global financial crisis. But, investors no longer exhibit a strong preference for global over regional markets.
- Empirical analysis shows that cross-border debt investments are influenced by returns, bilateral trade, financial openness, expected currency appreciation, liquidity, and the size of financial markets.
- A survey of 78 Asian investors found that returns remain the primary motive for investors, while enormous weight is placed on the economic and political stability of destination markets. Liquidity, openness, trading barriers, and regulatory hurdles are also cited as key factors.
- The creation of deeper and more liquid markets, harmonization of rules and infrastructure, and easing of cross-border barriers can help facilitate the channeling of the region's vast savings toward long-term productive uses.

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Why do intra-regional debt investments remain low in Asia?[1]

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The recent decision of the People's Republic of China (PRC), Japan, and the Republic of Korea to promote investment by their foreign reserve authorities in one another's government bonds is a boost to financial cooperation in the region. Aside from reserve diversification, it adds impetus to Asia's still low level of intra-regional debt investment.

One key feature of Asia in the post-1997/98 crisis period has been the transformation from a region with a current account deficit to one with a current account surplus. The savings-investment gap in the Association of Southeast Asian Nations (ASEAN), newly industrailized economies (NIEs), and even India widened between 1999 and 2010. Yet, Asia's vast excess savings are usually held in bank deposits or invested abroad in low-yielding securities. Investments return via capital flows that add to intermediation costs, accenting the underdevelopment of domestic financial markets.

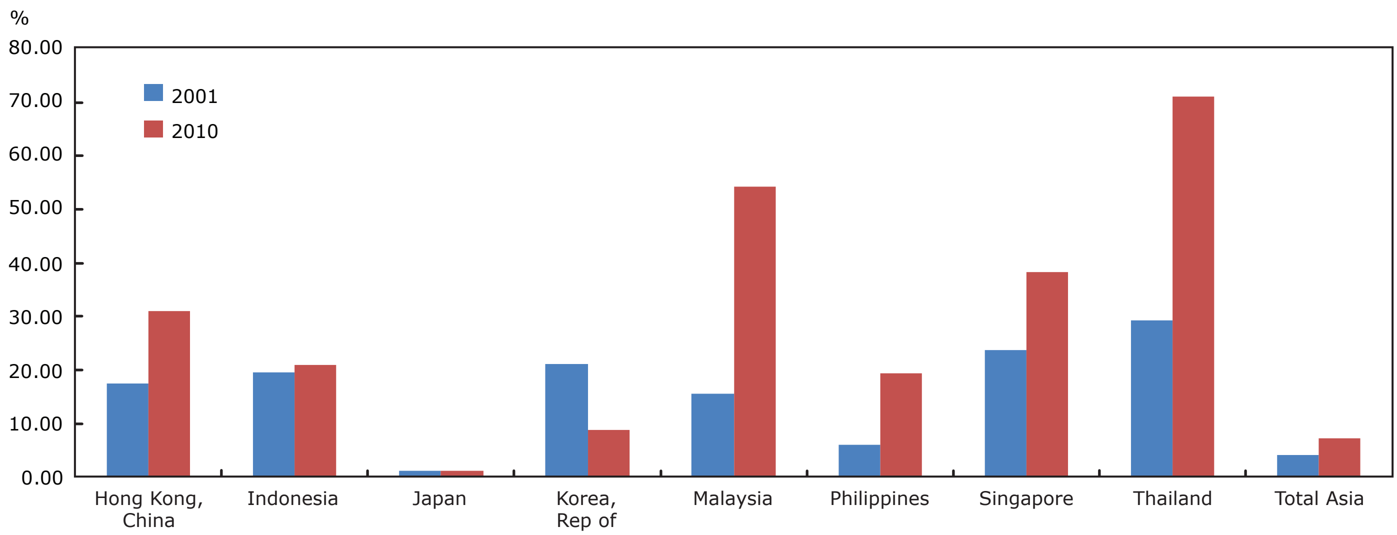
Even as Asia's intra-regional trade grows, a trend that has accelerated after the global financial crisis, Asian investors prefer to invest either in their respective home markets or park the bulk of their funds in global financial centers. Unlocking this paradox and channeling excess savings into long-term productive uses can help to fund Asia's massive development gaps.

National policymakers are cognizant of these inefficiencies and have taken steps in the last decade to develop domestic local currency bond markets. These efforts have borne fruit: total local currency bonds outstanding in emerging East Asia increased more than 15% annually over the last 5 years to reach US$5.7 trillion in 2011. Regional initiatives like the Asian Bond Market Initiative (ABMI) and Asian Bond Fund (ABF) have been launched to further strengthen local and regional markets.

Still, intra-regional portfolio debt investment remains low. Cross-border debt investment in 2010 comprised 7.2% of the region's total holdings, up from 4.2% in 2001 **(Figure 1)**. Excluding Japan, this share rose from 11.6% in 2001 to 20.5% in 2009, before jumping to 28.8% in 2010. The sharp increase amid the global economic crisis was driven by Southeast Asian intra-regional debt investments, which rose from 32.2% in 2009 to 40.6% in 2010.

[1] This is based on a forthcoming article by the authors.

Figure 1: Asia Cross-Border Debt Securities Investments



Note:
1. Data on inter-Asian investments represent share of each market's outstanding bond investments in Asia.
2. The data are derived from the creditor side for both assets and liabilities.
3. PRC does not participate in the survey and information on its outward investment is not available; inward investment to PRC, however, are reporte by the source countries
4. EU-15 consists of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

Source: OREI calculations based on data from the International Monetary Fund's Coordinated Portfolio Investments Survey.

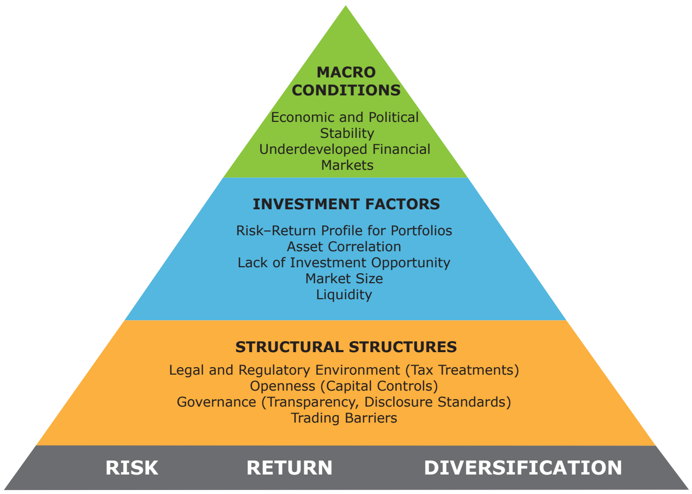
Almost half of all intra-regional debt investments went to the PRC and Republic of Korea, while Hong Kong, China accounted for 45% of such investment. With investments concentrated in larger markets, there is plenty of room to deepen financial integration.

Traditionally, Asian investors prefer to either invest locally—a "home bias" —or invest in mature markets (United States and Europe).[2] Asians have generally been reluctant to invest in regional markets in the past, but there are encouraging signs. While there is evidence that home bias deepened after the 2008 global financial crisis, there was no statistically significant difference between regional and global markets in 2009 and 2010.[3] This is in stark contrast to pre-2008—when Asian investors clearly favored markets abroad.

An empirical analysis of the factors determining cross-border investment in Asian markets shows that returns on assets, bilateral trade, financial openness, expected currency appreciation, liquidity, and the size of financial markets influence intra-regional debt holdings.[4]

AsianBondsOnline also surveyed Asian investors to identify which factors influence their offshore bond investments. It used an analytic hierarchy process (AHP) as a model.[5] **Figure 2** shows the hierarchy map of the decision problem. The general objective is to gain insight on the motivations and priorities of the decision to invest in the LCY bonds of foreign countries. Investors pursue a top-down decision-making approach by initially considering the macro perspective before reviewing the detailed aspects of each macro criterion, and eventually synthesizing this information based on the underlying motives of the decision-making process. The next considerations relate to investment

Figure 2: Hierarchy of Priorities in LCY Bond Investment Decisions



LCY = local currency.

Source: *AsianBondsOnline*.

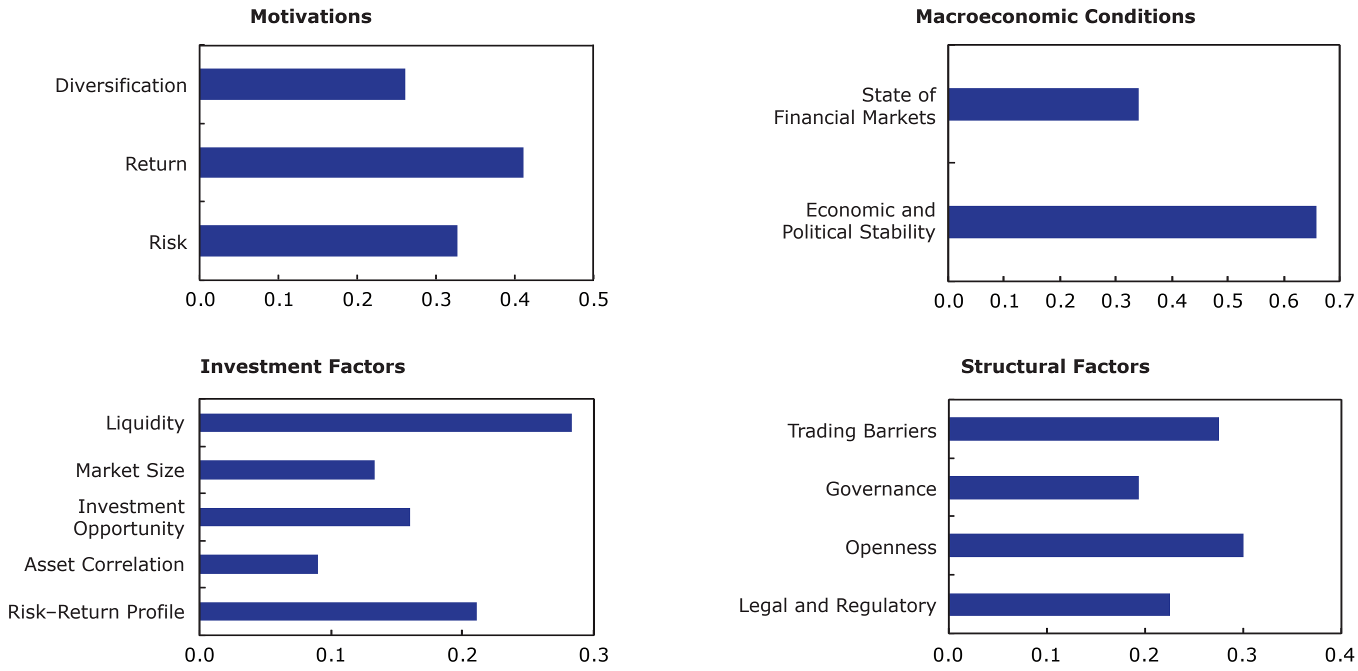
[2] Home bias is a well documented feature of international capital markets. Since the groundbreaking paper of French and Poterba (1991), the home bias in equities has puzzled economists. It is still observed in most countries and tends to be higher in emerging markets. K. French and J. Poterba. 1991. Investor Diversification and International Equity Markets. *American Economic Review*. 81 (2). pp. 222-226.

[3] We applied several non-parametric tests to look at the trends in portfolio allocation shares.

[4] A gravity model was employed to look at the determinants of bilateral debt investment.

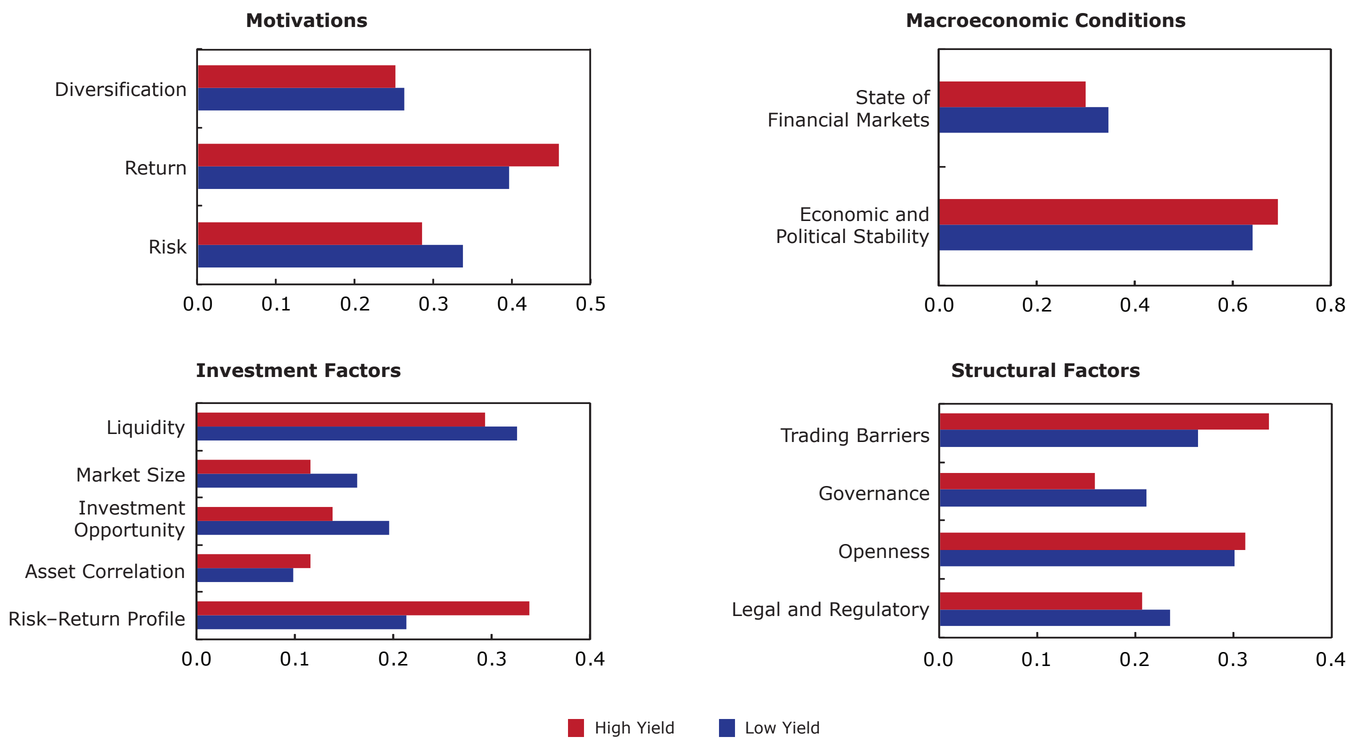
[5] The AHP was developed in the 1970s by Thomas L. Saaty as a structured technique for organizing and analyzing complex decisions. We have also completed an analytic network process (ANP) to test the robustness of the survey model.

Figure 3: Investor Survey Results



Source: *AsianBondsOnline*.

Figure 4: Differences between Decisions of Investors Residing in High-Yield and High-Grade Markets



Source: *AsianBondsOnline*.

factors, and finally, structural issues. At the same time, all priorities are related to the three underlying motives—risk, return, and diversification.

Seventy-eight participants responded to the survey, representing 10 Asian markets. Total assets under management of those surveyed are over US$ 5.3 trillion. Most respondents came from Japan (22% of the total), followed by the Republic of Korea and Singapore (13% each). Respondents based in investment grade sovereigns accounted for 77% of the total with sub-investment grade sovereigns covering 23%.

Asset management companies and funds were 63% of the total. Indonesia and the Philippines (below investment grade) were classified as high-yield markets, while other markets (with investment grade sovereign ratings) were considered high-grade destinations with conservative investors.[6] Participants were classified by bank or fund—with those from banks mostly managing treasury assets.

Increasing overall returns remains the primary motivation for making an intra-regional investment **(Figure 3)**. Minimizing risk is also important—suggesting a general cautious approach to intra-regional investment. The enormous weight placed on economic and political stability partially explains the large home bias among Asian investors. The emphasis on stability of macro conditions is primarily a function of familiarity with local situations. This also suggests that the importance of regional dialogue and cooperation to reduce asymmetric information in the region is crucial to facilitate intra-regional holdings.

Liquidity, or the ease of entering and exiting local markets without adversely affecting prices, is the leading investment factor for intra-regional investments. Among the structural factors, openness and trading barriers were given equal importance, followed by regulatory framework and governance standards.

Investors from high-yield markets like the Philippines and Indonesia prioritize higher absolute returns over reducing risk, especially compared with the rest of the sample **(Figure 4)**. The wider the gap between return and risk, the more reluctant these investors will be to make intra-regional investments since their respective domestic yields provide the highest returns in the region.

Meanwhile, the gap between return and risk priority weighting for conservative investors (from, for example, Japan and the Republic of Korea) is minimal, which is an indication of a more conservative investing approach since minimizing risk is considered to be almost as important as chasing higher returns. This explains the limited investments of such investors in high-yield markets.

The study--both the gravity model and the survey--shows that the direction of cross-border financial flows is determined by both economic and political stability, as well as key market characteristics such as yields, liquidity, expected currency appreciation, financial openness, and trading barriers.

The empirical analysis and survey results hold important implications for financial and monetary cooperation in Asia. Along with investor indifference between regional and mature markets in the aftermath of the global financial crisis, the results justify further support to initiatives that help develop local capital markets. The creation of deep and liquid markets and the easing of cross-border barriers through harmonization of rules and standards can allow the region's vast savings to be put into long-term productive use and fund not only our massive infrastructure deficit, but also much needed investment in health, education, and other social sectors.

[6] The survey was conducted before Fitch Ratings (December) and Moody's (January) assigned investment grade ratings to Indonesia. S&P still rates Indonesia below investment grade.

QUICK LINKS

Asian Bonds Online
www.asianbondsonline.adb.org

Asia Regional Integration Center
www.aric.adb.org

To receive a policy brief from the Office of Regional Economic Integration (OREI), please send an email to asianbonds_feedback@adb.org.

About Us

OREI traces its roots to the Regional Economic Monitoring Unit (REMU)—established in the aftermath of the 1997/98 Asian financial crisis. It was upgraded and renamed OREI in April 2005, as ADB expanded its role in promoting regional cooperation and integration (RCI) throughout Asia and the Pacific.

OREI assists its developing member countries in pursuing open regionalism that serves as a building block to global integration.