

Luncheon Speech
“Asian Bond Market Development: Progress, Opportunities and Challenges”
Asian Bond Markets Summit
14 November 2006
Singapore

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1. Introduction

Distinguished guests, colleagues, ladies and gentlemen. Thank you for your warm welcome and for the opportunity to talk to you today.

The Asian Development Bank (ADB) is very pleased to join the Asset Forum as a co-organizer for this important event. As Asia's partner in development, ADB has a vital role to play in assisting the region to achieve sustainable economic development and higher living standards. The development of sound, resilient financial systems is clearly an important agenda for this effort.

Since the financial crisis of 1997-98, the East Asian economies have embarked on various initiatives to strengthen their financial systems—both banking sectors and capital markets. These economies have particularly focused on ways and means to develop local currency-denominated bond markets. Today, I would like to talk about progress, opportunities and challenges of Asian bond market development. In this context I will discuss the role of the ADB in assisting further development of bond markets in the region.

2. Importance of Bond Market Development for East Asia

With hindsight, we now know that the Asian financial crisis was the culmination of twin crises—a currency crisis due to volatile capital flows, and at the same time a

banking sector crisis. We have learnt several key lessons from the financial crisis; among them:

- That large current account deficits financed by unhedged short-term capital inflows are a source of financial risk;
- That excessive reliance on commercial banks for domestic financing is another source of financial risks—particularly when banks are inadequately supervised, lack risk management capacity, and are neither sound nor resilient: and
- That a country’s exposure to the “double mismatch” problem (a currency mismatch and a maturity mismatch)—financing through short-term capital in foreign currency for long-term local currency investment—is a major risk.

Thus, for financial stability, a country needs to avoid the “double mismatch” and have a financial sector that is resilient enough to absorb shocks due to volatile capital flows. East Asian savings used to be channeled abroad (New York, London, etc.) and come back to East Asia as short-term capital in foreign currency to finance local long-term investment. So Asia needs to keep these savings within Asia’s financial systems.

Limits of the East Asian financial system were based on a high growth model of rapid capital accumulation, bank-based financial intermediation, and export orientation. Now in the post-crisis period, globalization is forcing the pace of change toward a more market-based, more open financial system. Asia’s increasing demand for physical infrastructure (such as power, transport and telecommunications)—amounting to some \$3 trillion over the next ten years—needs to be financed and increasingly so by the region’s savings. And a rapid demographic change is demanding an efficient financial and asset management industry in East Asia so that post-retirement people can expect high real rates of return at the smallest risk.

Now many economies have restored financial strength, after having gone through a series of bank and corporate restructuring and banking sector reconstruction and reforms, and by running sizable current account surpluses and accumulating large foreign exchange reserves. This is the mirror image of the global payments imbalance—

large US current account deficits and large East Asian surpluses. Asia faces the new challenge of recycling its savings for its productive investment, thereby reducing its excess savings over investment.

Both the crisis experience and the new reality require the development of local currency bond markets in East Asia. First, Asian bond markets can provide alternative sources of financing for public and private investment and alternative modes of wealth holding for Asian households. This is very important for Asian economies, which are gravely in need of building infrastructure, investing in capital stock and widening options for retirement financial arrangements and pensions in a rapidly ageing society.

Second, Asian bond markets can improve financial resilience by putting in place two balanced wheels of the financial system—sound banking sectors and well-developed capital markets. This can be done through encouraging competition in the financial system and diversifying financial risks across these two wheels.

Third, Asian bond market development can reduce the “double mismatch” problem—currency and maturity mismatches—by mobilizing Asian savings for Asian long-term investment in local currencies. This will reduce reliance on international capital markets, which have acted both as a reservoir for Asian surplus funds and as a source of finance for Asian investment.

Finally, mobilization of Asian savings for Asian investment can help reduce global payments imbalances. Well-developed, liquid, transparent local currency bond markets can mitigate “information asymmetry” between investors who seek attractive investment opportunities but cannot tell between good and bad projects and corporations which need funding for their good investment projects but cannot convince investors that the projects are good. “Information asymmetry” can be mitigated through enhancing information transparency and the market-based identification of the right investment opportunities in the region. Once successful, this would generate greater investment activities by infrastructure and other firms, thus narrowing the Asian savings-investment

gap. For this to be possible, a more robust financial system should be created to facilitate price efficiency, legal certainty, and information transparency.

3. Towards Efficient Regional Capital Markets

To nurture local-currency bond market development, national governments have made major efforts in several ways. They have:

- Created enabling environments by removing policy distortions that affect the efficient allocation of domestic savings;
- Enhanced market infrastructure to support the functioning of bond markets;
- Provided sovereign and quasi-sovereign issues to establish benchmark yield curves; and
- Strengthened the regulation and supervision of capital markets—often in accordance with international standards and practices.

Significant policy efforts have also been made at the regional level as well. For instance, the Executive’s Meeting of East Asia-Pacific Central Banks (EMEAP) established an Asian Bond Fund (ABF) in June 2003 to facilitate bond issuance. The idea was to help expand the bond market through the purchase of sovereign or quasi-sovereign bonds issued by 8 members (PRC; Hong Kong, China; Indonesia; Korea; Malaysia, Philippines, Singapore; and Thailand) by using all 11 members’ foreign exchange reserves (including Australia, Japan, and New Zealand). The initial attempt was to purchase \$1 billion of US dollar denominated bonds—called Asian Bond Fund-1 (ABF-1). Recognizing that local-currency denominated bonds need to be promoted in order to address the “double mismatch” problem, the central bankers introduced ABF-2 (December 2004), which involved purchases of \$2 billion of Asian-currency denominated sovereign and quasi-sovereign bonds. ABF-2 has introduced a Pan-Asian Bond Index Fund (PAIF) and a Fund of Bond Funds. PAIF is a single bond fund index investing in these local currency bonds issued in 8 economies. The Fund of Bond Funds has a two-tiered structure with a parent fund investing in eight sub-funds, each of which invests in local currency bonds issued in their respective markets.

Another initiative is the Asian Bond Market Initiative (ABMI), launched in 2003 by the ASEAN+3 Finance Ministers to develop local currency denominated bonds. One of its aims is to establish a national and regional market infrastructure for bond market development. The ABMI created working groups to conduct various studies, including: the issuance of new securitized debt instruments; establishment of a regional bond guarantee agency; creation of a regional settlement and clearance system; and strengthen of regional rating agencies. These working groups have been consulting with the private sector to create synergies between policies and market activities. Some tangible outcomes have already been produced and significant progress has been made on these studies.

The Asia-Pacific Economic Cooperation (APEC) Finance Ministers process and the Asia-Cooperation Dialogue (ACD) process have also been strongly supporting Asian bond market development initiatives.

Table 1. Various Initiatives for the Development of Asian Bond Markets

Initiatives	Activities
Executive's Meeting of East Asia-Pacific Central Banks (EMEAP)	<ul style="list-style-type: none"> • Strengthen the demand side of bond market development • Establish the Asian Bond Fund (ABF-1, ABF-2)
ASEAN+3 Finance Minister's Meeting	<ul style="list-style-type: none"> • Strengthen the supply side of bond market development • Study and implement initiatives through working groups on: new securitized debt instruments; credit guarantee and investment mechanisms; foreign exchange transactions and settlement issues; and rating systems
Asia-Pacific Economic Cooperation (APEC) Finance Minister's Meeting	<ul style="list-style-type: none"> • Study measures to promote regional bond market development • Study securitization, credit guarantee mechanisms and new instruments
Asia-Cooperation Dialogue (ACD)	<ul style="list-style-type: none"> • Improve public awareness of the various initiatives and secure political support

Source: Asian Development Bank.

4. ADB's Role

In the immediate aftermath of the Asian financial crisis, in partnership with the IMF, the World Bank and bilateral donors, ADB assisted the crisis-affected countries in reforming and restructuring their financial sectors. ADB also worked very closely with

several East Asian countries to develop Early Warning Systems that could help them detect economic and financial vulnerabilities at an early stage.

As part of financial sector reform, ADB has been providing support to bond market development, particularly within the ASEAN+3 ABMI framework. ADB's support in this area includes:

- Technical assistance and policy advice to remove impediments to domestic bond market development, create enabling environments, and strengthen market infrastructure;
- Provision of partial credit and political risk guarantees;
- Issuance of ADB bonds to promote national and regional bond market development;
- Support for regional joint studies through examining the feasibility of a regional guarantee mechanism, a regional clearing and settlement system, harmonized credit and trading standards, and improved local credit rating systems; and
- Establishment of an online clearing house for information on bond market initiatives, legal and regulatory frameworks, and government policies affecting the industry.

ADB is perhaps best known in international finance circles for its issuance of prime name credit paper in Asian local currency debt markets. This dates back to the early 1970s when we opened the domestic bond market of Japan to foreign issuers through the first Samurai issue. Since then, there have been similar market-opening transactions in the region, including Korea; Taipei, China; India. In the last few years, we have issued local currency bonds in Malaysia, Thailand, PRC and the Philippines. ADB and other multilateral and bilateral institutions issue such bonds to create a pricing benchmark for triple-A debt in the local markets, and to stimulate local and international investor interest.

In September this year, ADB launched a \$10 billion Asian Currency Note program, the first multicurrency bond platform. The program represents a major regulatory

milestone, as it links the national capital markets of Singapore and Hong Kong, China, and later Malaysia and Thailand. Under the scheme, Asian local currency bonds can be issued in these national markets under a single, unified framework with a common set of documents governed by English law. This structure offers significant savings in legal and transaction costs. Potential leading issuers will no longer be constrained by any one Asian capital market—be it size, timing, currency or investor appetite.

Besides issuing own local currency bonds and providing considerable technical assistance to the ABMI, ADB has developed a unique website—AsianBondsOnline since May 2004—a one-stop information center on Asian local-currency bond markets. My colleague Jim Turnbull gave a brief presentation on this earlier today, but I would like to elaborate on some very successful elements of the site. Apart from a process-driven overview of Emerging East Asia's bond markets, one of our most visited features is "How to Buy Bonds"—a step-by-step primer on how to purchase and sell government and corporate bonds in East Asia. What was planned as an initiative aimed at retail investors is now widely used by asset managers and even compliance personnel as a check list.

We also introduced the NEW@AsianBondsOnline sections to keep investors informed on regulatory reforms, cutting edge research, and new development indicators (such as insurance density ratios) and transactions data (such as bid/ask spreads). And we are constantly enhancing the site; in the New Year 2007 we will be releasing investor compositions and foreign ownership statistics—the site does not remain static!

ADB also publishes the semi-annual Asia Bond Monitor (ABM)—a report card on the progress of Asian bond market development, highlighting key thematic issues. The most recent issue was just launched this morning. This issue updates you on the development of East Asian local currency bond markets in the first half of 2006 (size and composition, market liquidity, yields and returns, and institutional and regulatory developments). It also contains a special theme chapter on market liquidity in East Asia, covering measurements of liquidity, statistical analysis of the determinants of liquidity,

and a market survey on factors affecting liquidity. We will be discussing these issues in the afternoon today.

Going forward, the ongoing work of national governments, the private sector and ADB will be positive steps. For success, Asia will also need to import greater transaction efficiency and risk valuation techniques from global markets and players. This will encourage greater participation by a larger range of investors, issuers and intermediaries. The ultimate goal of Asian initiatives is to create an environment where domestic currency bond markets can provide funds for all levels of investors as an efficient alternative to international debt markets, and an environment in which issuers can freely access markets and investors can feel comfortable placing their funds in the region.

5. Concluding Remarks: Challenges Ahead

In summary, development of a well-functioning bond market improves resource allocation by achieving a better balance between bank finance and bond markets, enhancing market transparency through efficient price discovery processes, and allowing substantially better risk management on the part of both investors and borrowers.

Challenges in bond markets are many and, for this reason, a more focused approach would be useful—such as focusing on developing a liquid corporate bond market. Broadening the issuer base can help address the shortage of corporate investment paper in Asia, but it is not the whole answer. Further efforts to remove regulatory, legal, tax and other impediments would be critical. Market infrastructure needs to be improved through the creation of efficient settlement systems and through the development of hedging instruments and derivatives markets. Corporate governance of firms should be strengthened through better accounting standards and disclosure requirements so that corporate issuers are subject to sufficient checks and balances.

Regional cooperation is a useful way of achieving these. The launch of Asian Bond Fund 2 (ABF-2) is an excellent example. The listing of exchange traded funds and the creation of a well structured Asian index have created a benchmark against which all investment vehicles can evaluate their performance in Asian bonds. This has also opened the markets to a wider class of investors. The Asian Bond Markets Initiative (ABMI) has been focusing on strengthening national and regional market infrastructure in consultation with the private sector. It is exciting to see rapid advances in these areas.

I would like to congratulate the Asset Forum and the co-sponsors for providing an opportunity for rich and detailed discussions of the issues facing Asian and global bond markets. Conferences such as this provide valuable feedback for ADB on how policy makers and the private sector would like to see markets develop. We are gratified to see that you share many of our concerns. And we look forward to working with all our partners to promote efficient and well-balanced financial markets in the region.

Thank you.