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Asian Financial Markets and Asian Bond Markets Initiative

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Discussion Draft

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Asian Financial Markets and Asian Bond Markets Initiative

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(I)

The East Asia financial crisis has generated a wide spectrum of analysis as to its cause. During the early days of the crisis, discussions focused on macroeconomic fundamentals and structural problems of the countries in question. That was only natural, as the G7 and IMF were operating under the premise that sound macro-policies and liberalized markets were basically what were required to achieve good economic performance. Moreover, since the collapse of the Soviet Union in the early 1990's, structural reforms to quickly move to an open market economy had been emphasized as appropriate, along with sound macroeconomic management. This initial reaction was derived from what John Williamson termed "the Washington consensus."[1] However, subsequent research revealed that macroeconomic indicators were generally strong amongst crisis-hit East Asian countries, although there was individual country variation. Neither market interest rate spreads nor rating agency forecasts gave prior indications of macroeconomic weakness. Indeed, there was structural weakness in corporate and national governance, but as it had been there for decades, why it suddenly became a problem in 1997 was hard to explain. The problems of the financial systems of East Asia had existed for many years and yet there were large numbers of countries with weak banking systems which were not hit by crisis. As Barry Bosworth rightly pointed out, "to generate a crisis of the magnitude of East Asia there is a

[1] John Williamson, 1990, "What Washington Means by Policy Reform." in John Williamson (ed.) Latin American Adjustment: How Much Has Happened? Washington D.C., Institute for International Economics.

need to link a weak banking system to some other triggering event. It was financial liberalization and the effort to link domestic financial markets to those of other countries. Many countries have encountered difficulties in managing this process of financial market reform."[2]

Indeed, it was the combination of premature capital liberalization and insufficient financial supervision with the luck of resilient financial markets. With regard to the latter, Donald Tsang, Chief Executive of Hong Kong, then, Financial Secretary, pointed out as early as December 1997, that dual mismatch, currency and maturity mismatch, was one of the major causes of the crisis. Asian high saving had been channeled to dollar assets and returned to Asia as short-term dollar lending .When the lending was quickly withdrawn from East Asia with various triggers, the crisis developed and rapidly deepened. Against this background, Donald Tsang called for the creation of regional debt market. "What Asia lacks, and Europe and the U.S. have, is a deep, liquid and mature debt market where three things can occur. First, governments and corporations can borrow long to invest long, thus eliminating the maturity mismatch inherent in Asia. Second, corporations can issue paper in U.S.-dollar, yen or Euro currencies, with clearing and settlement in Asian times, thus eliminating currency mismatches and developing a truly deep Asian debt market along the lines of Euro-dollar and Euro-yen markets. Third, finance ministers in Asian economies can foster a vibrant debt market with adequate risk management by investing their reserves in Asia."[3]

International bond market has been dominated by U.S. dollar and Euro. Together, they amount to around 90% of total issues in the first quarter of 2005. Also, this implies dominance of markets like New York and London.

What accounts for this dominance? There are a large number of issuers in Asia, but somehow they have not used markets in Asia. In all of major Asian markets, authorities have welcomed and encouraged bond issuance by nonresidents and there are no legal constraints for bond issuance. However, there seem to be some significant infrastructure problems in these markets. First, the settlement

[2] Barry Bosworth, "Asian Miracle, Crisis and Recovery." A paper presented at ADBI workshop on Development Paradigms, Dec. 10, 1999.

[3] "The Asian Debt Market", Asiaweek, Dec. 19, 1997.

and clearing system has been inadequate, requiring a much longer transaction time as compared to London, for example. Second, repo markets have not developed sufficiently. Third, although there are not direct regulations hampering transactions, such practices as withholding taxes, or the existence of multiple regulatory agencies has discouraged issuers. Also, in some countries the numbers of investors, particularly institutional investors in debts instruments have been somewhat limited. As a result of all these factors, the liquidity in Asian markets has been low and there have not been sufficient numbers of market makers.

Asian countries have traditionally relied on indirect financing, or bank lending, as a major intermediation mechanism between savings and investment. The system had worked well during the seventies and eighties when globalization and markets oriented transactions had been relatively limited. Thus, the development of debt markets, which is a substitute for bank lending, had lagged behind western countries significantly. Neither authorities nor banks had an incentive or the motivation to develop markets until quite recently. Developments of debts market on one hand meant the loss of loan business by banks.

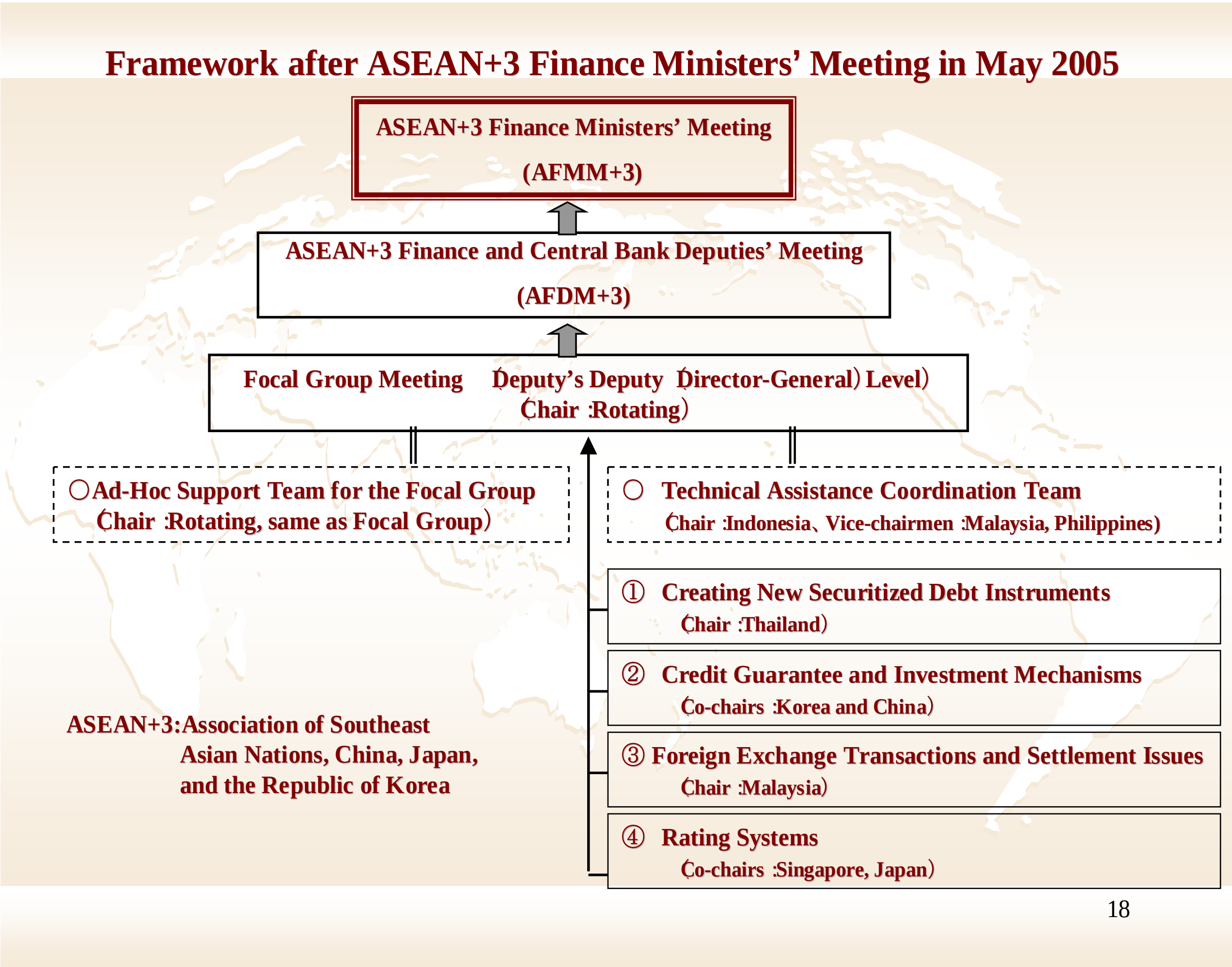
However, dramatic globalization of the world economy driven by the IT revolution during the decade of nineties has fundamentally altered the scene. Without the existence effective debt markets in the region, Asian countries were forced to rely on financial intermediation through Euro and New York markets by global market players. The result was the maturity and currency mismatch previously mentioned.

Authorities in the region have now come to recognize the need to nurture the regional markets and to build necessary infrastructure. There are some who argue that markets should evolve spontaneously without official intervention. Indeed, the Euro-markets, for example, developed without endorsement of authorities, or rather, as ways to circumvent regulations that restricted market transactions. However, it needs to be recognized that necessary infrastructure was there, for example, in London. Also, it should be noted that the chicken and egg type situation does exist here in the region. Since markets are not developed, the accompanying infrastructure has not emerged and the liquidity as a result is low and vice versa. Therefore, it is probably quite appropriate that authorities and self regulatory organizations in the region make a conscious and coordinated effort to nurture markets, here. In addition to creating an efficient and common settlement mechanism and other necessary infrastructure, or eliminating tax disincentives, authorities could encourage market participants to start new market practices conducive to dramatically increase transactions in the region.

(II)

Against these backgrounds, official sector has moved jointly to launch an initiative called Asian Bond Markets Initiative (ABMI). The framework of the initiative was formalized at Asean + 3 Finance Ministers' meeting in May 2005 as described by chart1.

Chart 1.



Among the four working groups, the first two, Working Group on Creating New Security Debt Instruments (WG1) and Working Group on Credit Guarantee Mechanism (WG2), were established in February, 2003 and have some substantial track records. Major progresses in these areas are listed in Table 1, and Table 2, below.

Table 1.

Progress in the ABMI

- Asian Development Bank (ADB) and the International Finance Corporation (IFC) issued local currency-denominated bonds in Malaysia and Thailand. (IFC's bond is an Islamic Bond.)
- Korean Collateralized Bond Obligations (CBO) ("Pan-Asia Bond") with guarantee by the Japan Bank for International Cooperation (JBIC) and the Industrial Bank of Korea (IBK) was issued in the region. (Dec.2004)
- JBIC started providing a partial credit guarantee for the issuance of baht-denominated bonds by Japanese subsidiaries in Thailand. (Jun. 2004)
- The "Asian Bonds Online Website (ABW)" was launched to disseminate information on bond markets in the region and progress in the ABMI. (May.2004)

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Table 2.

Progress in the ABMI

Issuer / Name of bonds	Issuance	Currency	Total Amount	Maturity	Interest Rate	Ratings
Isuzu Thailand	April 2004	Thai Baht	1 bil. Baht (approx. 3 bil. yen)	3 years	3.30%	N.A. (private placement)
Tri Petch Isuzu	June 2004	Thai Baht	3.5 bil. Baht (approx. 10 bil. yen)	4 years	3.35%	AAA (Thai Fitch)
ADB	November 2004	Malaysian Ringgit	400 mil. Ringgit (approx. 12.4 bil. yen)	5 years	3.94%	Triple A (Fitch, Moody's, S&P)
Korean CBO ("Pan-Asia Bond)	December 2004	Yen	7.7 bil. Yen	3 years	3-month Yen LIBOR	Aaa (Moody's) AA-(S&P)
IFC	May 2005	Malaysian Ringgit	500 mil. Ringgit (approx. 15.5 bil. yen)	3 years	2.88%	Triple A (Fitch, Moody's, S&P)
World Bank	May 2005	Malaysian Ringgit	760 mil. Ringgit (approx. 23.5 bil. yen)	5 years	3.58%	Triple A (Fitch, Moody's, S&P)
ADB	May 2005	Thai Baht	4 bil. Baht (approx. 11.1 bil. Yen)	5 years	3.87%	Triple A (Fitch, Moody's, S&P)
JBIC	September 2005	Thai Baht	3 bil. Baht (approx. 8 bil. yen)	5 years	4.78%	Aaa (Moody's) AA-(S&P)
IFC	October 2005	Chinese Yuan	1.13 bil. Yuan (approx. 15.8 bil. Yen)	10 years	3.40%	Triple A (Fitch, Moody's, S&P)
ADB	October 2005	Chinese Yuan	1 bil. Yuan (approx. 14 bil. Yen)	10 years	3.34%	Triple A (Fitch, Moody's, S&P)
ADB	November 2005	Phillipine Peso	2.5 billion Peso (approx. 5.2 bil. Yen)	5 years	8.70%	Triple A (Fitch, Moody's, S&P)
Mitsubishi Motors (Thailand) Co. Ltd.	December 2005	Thai Baht	5 bil. Baht (approx. 14.5 bil Yen)	3 years	6.62%	AA+ (Fitch)
ORIX Leasing Malaysia Berhad	January 2006	Malaysian Ringgit	150 mil. Ringgit (approx. 4.5 bil. yen)	3 years	4.052%	AAA (Rating Agency Malaysia)
Mitsubishi Motors (Thailand) Co. Ltd.	February 2006	Thai Baht	2 bil. Baht (approx. 6 bil Yen)	3 years	5.65%	AA+ (Fitch)
P.T. SUMMIT OTO FINANCE	March 2006	Indonesian Rupiah	1 trillion Rupiah (approx. 12 bil Yen)	2 - 3 years	various	AAA (PEFINDO)
ADB	April 2006	Malaysian Ringgit	500 mil. Ringgit (approx. 15.5 bil. yen)	5 years	4.265%	AAA (Fitch, Moody's, S&P)

- For more information on ABMI, the "Asian Bonds Online Website (ABW)" is available on http://asianbondsonline.adb.org.

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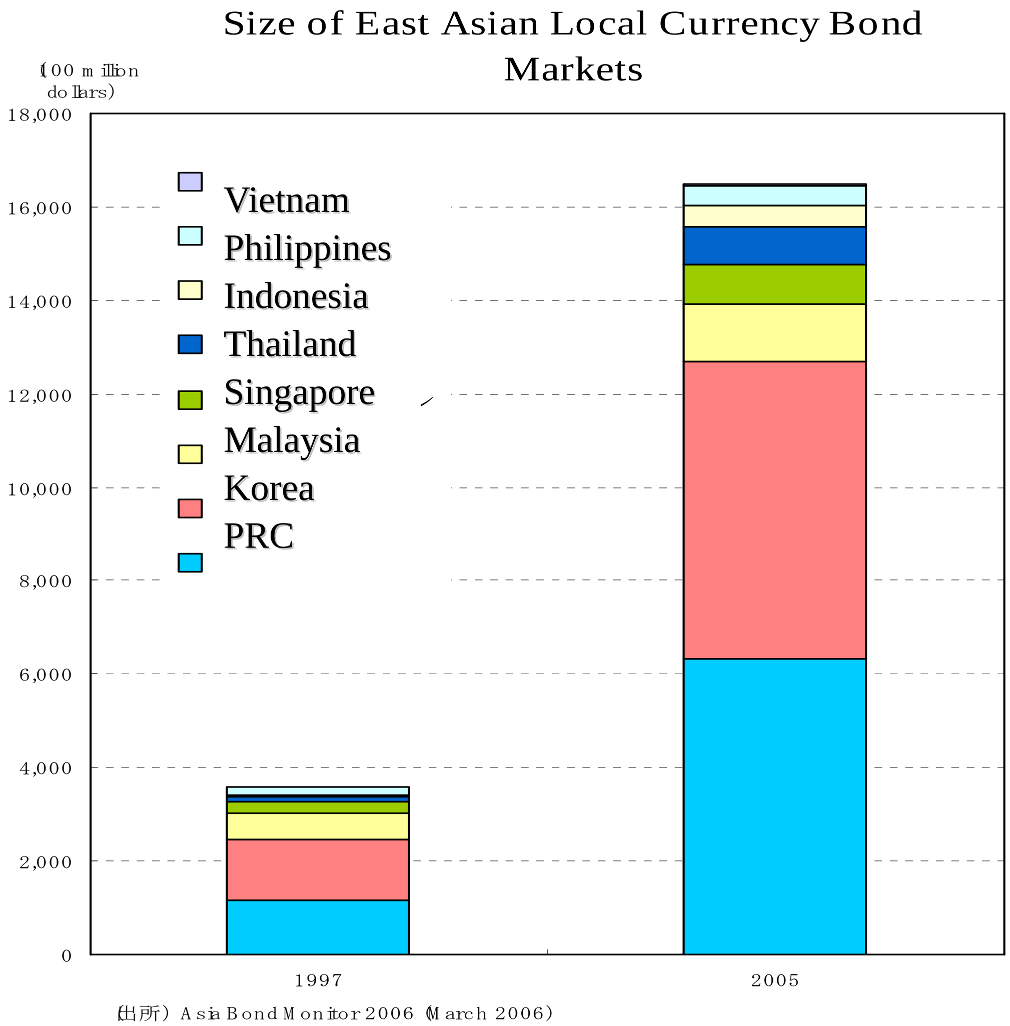
The latter two working groups are comparatively new, but have started to study the issues. In particular, Bank Negara of Malaysia has presented a proposal to establish the regional institution to set up common rating standard in the area.

Although efforts to nurture Asian bond markets have just started, it has had some initial positive effects. Chart 2 shows the size of East Asian local currency bond markets. Compared to when the currency crisis hit the area in 1997, the scale of regional bond market expanded more than 4.5 times (annual amount) in 2005. In terms of its ratio to GDP, it rose from 16.5% to 48.0% during these eight years.

Products and issues are more diversified while sovereign yield curves are expanded much larger. Compared to the GDP ratio of 158.7% for U.S. (March 2005) and 189.5% for Japan(March 2005), it is still less than one third but the tripling of the size during the last eight years is quite significant.

Chart2.



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While the measures described in the previous section focus on the effective utilization of private saving in Asia for long-term financing, we could also consider making efficient use of foreign reserves for further economic development , since a substantial amount of foreign reserves have accumulated in the region. One possibility might be to use foreign reserves to invest in sovereign and/or corporate bonds. We would also utilize foreign reserves to strengthen the financial safety nets of the region, which would contribute to the economic and financial stability vital for bond market development.

a. Short-Term Regional Financial Arrangements-Extended Chiang Mai Initiative

We would earmark a certain portion of the foreign reserves held by ASEAN+3 member countries as financing for possible future short-term liquidity needs.
Such a short-term financing mechanism would sere to suppress turbulent fluctuations in capital flows and thereby help prevent a financial crisis.

Since stable financial markets would constitute an important basis for active bond markets in the region, the short-term financing facility would add further impetuses to the promotion of bonds markets by giving confidence to both investors and issuers regarding the stability of financial markets in the region.

Such a short-term financing mechanism would also enhance the policy dialogue on the economic conditions and challenges facing ASEAN+3 member countries in the ASEAN+3 Finance Ministers Process. Strengthened policy dialogue would certainly help reinforce mutual trust among member countries so as to increase the ability of the region to prevent future financial turbulence as well as to address any difficulties that may arise in the future. Enhanced policy dialogue among AEAN+3 members would therefore contribute to the development of bond markets in the region by directly coordinating efforts by member countries and by ensuring the financial stability of the region.

The newly created short-term financial arrangements by earmarking foreign reserves would not require either institutional settings regarding the management of the resources provided by member countries or agreed rules regarding the investment of the resources. Earmarking a portion of the foreign reserves of each country would therefore be relatively easy to realize in comparison with other mechanisms.

The proposed short-term regional financial arrangements would also complement existing international financing attunements, such as the IMF arrangements and the ADB loans, as well as existing regional financing arrangements, such as the Chiang Mai Initiative.

b. Pooling of Reserves

In the medium to long term, we would consider establishing a pool of foreign reserves in the region. The pooling mechanism would provide important institutional underpinning to strengthen regional financial cooperation as well as to ensure financial stability in the region.

While a pooling mechanism would require the ASEAN+3 countries to agree on institutional settings, experience in earmarking foreign reserves would certainly contribute to the better design of such a pooling system and assist member countries in making the necessary arrangements.

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