M R Chatu Mongol Sonakul: Thoughts and reflections on the development of the domestic bond market in Thailand

Speech by Mr M R Chatu Mongol Sonakul, Governor of the Bank of Thailand, at the ADB Conference on Government Bond Market and Financial Sector Development in Developing Asian Economies, held in Manila, 28-30 March 2000.

* * *

Mr Chairman, distinguished Guests, Ladies and Gentlemen,

I am honored for the opportunity to share with you some of my thoughts and reflections on the development of the domestic bond market in Thailand.

The Asian economic crisis, which started in Thailand in 1997, posed the most severe challenges to policymakers - how to contain the crisis, how to ease the burden of the poor and how to ensure a sustained recovery.

But the biggest challenge to us all must be how the crisis could have been avoided in the first place.

If I can turn back the clock and have a wish, my list may be long. But high in its ranking would be a well functioning Thai baht bond market.

Benefits of bond markets

A bond market provides a basic infrastructure for the development of the financial system and the overall economy. The bond market is an important alternative to bank lending.

During a crisis, banks themselves often come under liquidity pressure, from both domestic and foreign withdrawals. Not only do they cease to lend, they also recall loan from their best debtors. And even after the crisis has peaked, banks still face the problem of recapitalization. During these times, the process of intermediation suffers.

The existence of a deep and liquid bond market allows financial institutions to prepare themselves better for risk management. The authority can require the banks to maintain a higher liquidity ratio, comprising both government and top-rated corporate bonds. The banks can then resolve their liquidity problem on their own by selling these bonds, regardless of their credit standings, which tend to suffer during a crisis.

In Thailand, the lack of a liquid bond market meant that the only way to obtain liquidity under pressure was for the banks to come to the Bank of Thailand using their entire loan portfolio as collateral. And as the crisis deepens, these loans were deteriorating day by day.

Another benefit of the bond market is that it can attract foreign investments. Foreigners can bring in funds to invest in high quality papers denominated in Thai baht. They are the ones to absorb foreign exchange risk. Without a bond market, Thai companies have no choice but to borrow abroad and bear the foreign exchange risk, themselves. Experience has shown that they have yet to fully develop their skills in doing so.

It is our intention, therefore, to expedite the promotion and development of the domestic bond market. The process is very time-consuming, but they are worthwhile for they provide the foundation for a strong and diversified financial market that would be more resilient to future shocks.

Necessary conditions for bond markets

To develop a domestic bond market, we need three essential components:

First, there must be a deep and liquid government bond market to serve as a benchmark against which corporate papers can be priced. To ensure that the government bond market can continue to provide the benchmark yield curve, the supply of government bonds must be regular, predictable and transparent.

In short, the framework of the budgetary process as well as debt management operation must support the continuing supply of bonds through operations such as automatic refinancing or refunding of maturing debt. Tools such as re-opening of benchmark issues, government bond buy-back schemes or repurchase operations are also essential for the efficient functioning of debt management operation.

Second, there must be adequate infrastructure, both legal and operational, to support the trade and transfer of instruments and funds. Operational infrastructure includes such things as a delivery versus payment system that is safe, rapid and efficient to ensure finality of fund transfers. An efficient bond registration system is also essential to provide legal protection of ownership of bonds. Rules and regulations to support trading and financing operation such as repurchase agreements, securities lending, short positioning as well as hedging practices are all essential elements.

Third, there must be a pool of market participants comprising both intermediaries such as dealers or inter-dealer brokers as well as end-users such as mutual funds, provident and pension funds, insurance. The end users will provide a steady stream of long-term demands for bonds which will complement the dealers' more traditional short-term horizon. In addition, the portfolio structure of end-users also acts as a countercyclical force to the one-way market of financial intermediaries which is common to an emerging market, and help preempt a massive panic or withdrawal of funds.

How are we doing on all these, then?

In the *primary market*, fiscal prudence in the past decades before the crisis had resulted in a very limited supply of government bonds. All this has changed as a result of the crisis. The amount of public sector bond has increased substantially during the past 2 years. Much of this was created by the government taking on the responsibility of fiscalizing the costs of financial sector restructuring incurred by the Bank of Thailand in our cleaning up of the financial institution system.

Currently, there is close to one trillion baht in public sector bonds outstanding, amounting to about one fourth of the country's GDP and the banking system's deposit base. With even further losses to fiscalize, the supply of government bond is not going to be a constraint for future development.

Attempts have also been made to introduce a quarter-ahead calendar of regular issuance. Thus, Mondays were typically reserved for treasury bills, Tuesdays for state-enterprise bonds and Wednesdays for government bonds.

This has worked well for a brief period, but now we are back temporarily to waiting for new supplies of bonds.

Therein lies an important lesson I would like to share with colleagues and friends in the process of developing their bond markets.

Industrialized countries have been in a position to promote and sustain the development of their bond markets because of the continuity and predictability of supply.

In our case, due to restrictions on management and investment of the government's treasury balance, the government understandably has been unwilling to issue securities when the treasury balance is high. This causes discontinuity in the supply of bonds.

At the same time, because the treasury balance could not be invested to earn a return, there is a cost in terms of interest expense on those bonds issued against no revenue proceeds. Bond issuance has to be done on a regular basis, irrespective of the size of the treasury balance. But it may be difficult to explain politically why it should become necessary to maintain a higher-than-necessary treasury balance with borrowed money.

Proposals are on the way to fine-tune the current legal framework, to permit greater flexibility in the management of treasury balance, while not compromising the discipline of budget finance.

Turning now to the *secondary market*. This is an area where a central bank can become more active and can make a more significant contribution than in the primary market. To date, substantial progress has been made with regard to the basic rules and regulations to govern both market participants and trading practices.

Daily trading volumes have quickly picked up in line with interest from market participants and now amount to about 3-4 billion baht per day, compared to about 1-2 billion baht last year. Annual turnover for 1999 for certain popular issues amount to one-third of its outstanding amount, which is a very encouraging sign. Bid-spreads are narrowing and now can boast a level not significantly far from the more developed bond markets.

We have completed a yield curve available on the internet that spans from less than one-year, out into the 15-year tenure. This, complemented with the low interest environment, has boosted the issuance of corporate bonds. Last year alone, we have seen over 200 billion baht of private bonds issued. Of course, some of these were used to recapitalize the banking system, but no small amounts were also used for refinancing corporate debts as well as for business expansion.

We are fortunate that the legal framework for the supervision of the capital market, namely private and public offering and investor protection, have already been instituted. In fact the private debt market started to flourish since 1992 after we set up the Securities and Exchange Commission. With this framework, the private debt market was able to resume activity again after the crisis but this time with the government yield curve as pricing benchmark.

With regard to the operation of the secondary market of government bonds, the Bank of Thailand is currently working on the promotion of a full-fledged primary dealership system to facilitate the conduct of open market operations. We aim for the primary dealers to eventually provide market-making functions for both government and private securities.

The operation of primary dealers or counterparties of the central bank will be complemented, should market participants deem it useful, by the presence of inter-dealer brokers, who can assist in ensuring continuous two-way quotation, as well as helping to preserve the anonymity of transactions or positions held by a market participant.

In August 1999, we appointed 9 counterparties, which comprised eight banks and one securities firm. Starting 19 January 2000, the Bank of Thailand also began trading outright with the 9 counterparties. This operation serves as a monetary policy instrument as well as the mechanism to promote the development of the secondary bond trading. At this early stage, the outright operations will be conducted primarily in the benchmark issues or those with potential to become benchmark issues. These selected counterparties are expected, ultimately, to become primary dealers and we are currently working on putting the right incentives to ensure that appropriate rights and obligations be accorded to these primary dealers.

The third area I would briefly touch on is *infrastructure* issues. Here, work is ongoing to promote a fully automated system of delivery versus payment (DVP) settlement, information disclosure, and instituting appropriate code of conduct on market participants.

Currently, we have a semi-automated real-time delivery versus payment (DVP) system in place. It is a stop-gap measure but it serves as an important infrastructure in the settlement of the scripless government bonds. The system, when fully developed, will be supplemented by the intraday liquidity facilities and queuing mechanism, employing the latest digital signature technology to ensure secured and smooth real-time delivery and payment transactions.

We are entering an era when capital flow across borders can only become more volatile than in the past. And we still have fresh memories of how disruptive it was before the crisis. In fact, it was a major cause of the crisis.

How do we go forward? How do we guard against this?

The work on the new International Financial Architecture seems to be very much lacking in the area of the behavior of key players, especially the highly leveraged institutions. In the eyes of the large

Western countries, such issues have somewhat lost their urgency since the event surrounding the Long-Term Capital Management (LTCM) left the headlines.

In the absence of such rules, it appeared that emerging markets can only look to our own selves for protection. We have to help ourselves. A well functioning bond market is an important tool in this respect. It will act as a reservoir that absorbs capital inflow, and channel it to good use. A sudden withdrawal of foreign investors' confidence may cause the price of bonds to soften, making new issues temporarily unattractive, but it will not affect the business that had already obtained the funds.

However, developing a well-functioning bond market is no easy task. The work done in Thailand is only half completed, with many important agendas still remaining. The ingredients that I have mentioned: adequate supply, good infrastructure, central bank's active involvement in the market, and investors' demand - these are all very important. But they alone will not ensure continued success.

Success can be assured, and maintained, only if the market is able to win trust and confidence of all investors. This means good governance all round. This means not only a well-supervised and fair trading system, but also a clear and transparent information system. And this covers not only the information on macro economy, government actions and rules and regulations, but also information on the firms, the issuers of the papers, to name but a few.

Asia, because of our younger population and our early stages of industrialization, will continue to need funds from outside the region to finance our growth for many years to come. The countries that can succeed in attracting the funds, and more importantly, can properly manage the inflow and outflow of such funds, will have to develop not only the tools, but the high standards to go with it as well.