Joseph Yam: The case for an Asian Bond Market

Opening address by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Asia-Pacific Bond Market Congress: A New Maturity, Hong Kong, 8-9 July 2004.

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I am honoured to be invited to give the opening address at this congress. The strong attendance at this event, and the quality of the sessions lined up, are, I think, an indication of the growing recognition of the importance of bond market development in this region. I am delighted that Hong Kong has been chosen for the venue. The congress is well timed, since only yesterday the Hong Kong SAR Government launched its HK$20 billion bond issue. I extend a warm welcome to those of you who are visiting Hong Kong: I hope you will be able to stay on for a few days and enjoy the city over the weekend.

The title of the congress “A New Maturity”, apart from the mild and allowable pun, makes a useful comment on the state of the bond market in Asia. Whether “maturity” is quite the right word is a matter of debate, and I note that the title of the panel discussion later this morning adds a question mark to the word. However we might describe it, there is no doubt about the progress that has been made in the growth of domestic bond markets in the region over the past few years. Market capitalisation of domestic bond markets more than doubled over the past nine years - from an average of 20% of combined GDP in 1995 to 47% in 2003. During the same period, the combined share of bond markets in total financing grew from 11% to 19%. Bond markets are, therefore, a growth industry. Quite apart from the considerable initiatives by the private sector, bond market development has been a particular target of initiatives by governments and multilateral agencies. There are good reasons for this. My intention in this short address is to set out briefly these reasons - to put the case for an Asian bond market - and then to examine some of the work that is in progress in this field, particularly from the point of view of the central banks.

The need for an Asian bond market

The underdeveloped state of the Asian bond market - compared with the bond markets in the industrialised economies - has been well documented in recent years. Despite the impressive growth of the size of the Asian bond market that I have just mentioned, it still lags behind the developed economies in terms of breadth and depth. For example, the market capitalisation of the domestic bond market in the US, the UK and Japan is equivalent to over 150% of the GDP compared with just 47% in ex-Japan Asia. Activity in the secondary market is also relatively low.

The disadvantages of not having a developed bond market were brought home to us during the Asian financial crisis of 1997-8. An efficient and mature bond market can play an important role during times when the other channels of financial intermediation - the banks and the equity markets - falter or fail. In particular, through developing an alternative source of funding, the corporate sector can reduce its over-reliance on short-term foreign currency loans. A sound and healthy corporate sector contributes directly to macroeconomic and financial stability. Improved financial intermediation also brings such microeconomic benefits as efficiency gains and diversification of tools for both borrowers and savers. The absence of a developed bond market in the region was one of the main factors behind the extreme volatility that precipitated the Asian financial crisis. The crisis itself spurred governments in the region to focus on bond market development. This has been one of the positive, constructive outcomes of the crisis, and this is the area in which most progress has been made. It is heartening that the lasting response to the crisis has been to develop rather than to restrict markets.

Since the crisis, other important reasons for a stronger, deeper and broader debt market in the region have come to the fore. The strong current account performance of economies in the region has led to a very sizeable accumulation of reserves by the public sector. The total foreign exchange reserves of the major Asian economies outside of Japan nearly doubled in a short period of three years, from about US$700 bn in 2000 to over US$1,200 bn in 2003, generating quite strong investment demand for bonds. We are of course aware of the risk inherent in investing too much of the foreign reserves of Asia back in bond markets in Asia. Indeed, the withdrawal of foreign reserves invested in the region in times of stress in the region can exacerbate the stress. But there is a strong need from the investment

point of view for diversification and not be stuck with or overly exposed to bonds, for example, of a jurisdiction that is running a current account deficit that is so large as to be unsustainable.

On top of the demand from the public sector, private sector funds are increasingly diversifying into bond investment. There are, I think, two main reasons, and both can be related to the idea of "maturity". Greater investor awareness - resulting partly from investor education programmes and retail bond schemes - has encouraged individual investors to think of bonds, instead of just sticking with deposits and equities. In addition, the population of the region - like all of us - is growing older. About 7.5% of the population of the region was over the age of 60 in 2000. That percentage is expected to double to 15% by 2030: in Hong Kong, we have already reached 11.5%. Not only are populations growing older. People are also living for longer. All of these considerations have led to greater attention to retirement planning and to an increase in the size of the pension fund portfolio. Although Asia as a whole lags behind the rest of the world in the development of pension schemes, the numerous pension reforms undertaken to facilitate pension and other retirement schemes have stimulated considerable growth in the size of funds. In some economies, such as Malaysia and Singapore, the pension asset-to-GDP ratio is as high as 50 to 60%. For a number of good reasons, pension funds tend to involve large bond allocations. This has already added to the demand for bonds, and, as with public sector funds, this demand is likely to grow in the future.

But, as we are all aware, there is lack of a deep bond market in the emerging Asian economies and therefore much of the increased demand, from both the public and private sectors, has been satisfied by investments in bonds denominated in the major foreign currencies. Indeed the net portfolio outflows from nine emerging markets in Asia (including both public and private sectors) have increased sharply over the past five years - from US$50 billion in 1998 to US$225 billion in 2003. Emerging Asia as a whole is now a large net exporter of portfolio capital.

The growth in demand for bonds arises from what is surely a positive process - the increase in public and private wealth in our region. However, satisfaction of this demand brings us back to the problem of the market dynamics of globalisation, which, as we all learnt from bitter experience, can have very negative effects. In a discussion about bond market development in the region, it would be useful for us to remind ourselves what this problem is. The pattern of the flow of international funds in Asia has, for some time now and encouraged by financial liberalisation, been characterised by a two-way traffic of investment flows. In the one direction, there is the very substantial outflow to the industrialised economies, predominantly in the form of bond investments but equity investment also featured, and characterised by a large element of public funds. In the other direction, there is the inflow of private sector foreign funds, of more, or less, substantial magnitude, depending on the macroeconomic circumstances, in the form, relatively speaking, of much more equity related investments. This recycling of funds brought benefits and risks. The greater presence of foreign funds, mostly in institutional form, and managed and serviced by highly versatile foreign financial intermediaries, in domestic financial markets in the region, no doubt, promoted financial sector development. Indeed, the overall efficiency, including the level of sophistication, of financial intermediation in the region has been substantially enhanced, contributing to economic growth and development. But, as we have observed, it also presents considerable difficulty to monetary authorities in the region in the maintenance of monetary and financial stability.

In part, this is due to the differences in character between domestic and foreign savings. Those managing foreign savings are, understandably, much less concerned about the long-term public interest than those managing domestic savings. Foreign savings are also much more sensitive to changes in market sentiment and shifts in domestic policies, and are more prone to reversals. While this imposes greater discipline on local authorities in pursuing prudent macro-economic policies, it also brings much higher volatility in the financial markets, to the extent of possibly creating systemic problems that Asian monetary authorities are ill-equipped to handle. Furthermore, the foreign financial intermediaries are usually large international financial institutions with considerable market power and influence, in terms of the amount they are in a position to mobilise, relative to the size of the domestic financial markets of the emerging economies. This enables them to operate in the market not simply as price takers, but as a "price maker" with the power of pushing prices in a particular direction. The implications for the emerging markets are greater market volatility, greater tendency for overshooting, and consequently, greater challenges in maintaining monetary and financial stability. The problems are more intense for emerging economies with medium-sized financial markets that are large enough to attract foreign capital but not large enough to be immune from the manipulative or speculative plays that are, more often than not, associated with these fund flows.

The phenomenon I just described was, in fact, demonstrated in the recent mid-May episode of Asian stock market correction and the associated volatility in response to the reported withdrawal of foreign funds from the Asian market. This was a moderate episode that presented some threat to financial stability, and the markets were well able to take it. If the various measures introduced to strengthen financial systems after the Asian financial crisis had not been in place, and if Asian economies had not been in a recovery phase at this time, the impact of this volatility in fund flows could well have threatened monetary and financial stability in the region. Given the structural trends that I have described, and the market dynamics associated with them, even with benign conditions and stronger financial systems, there is a danger that, as this recycling pattern grows larger, the risks to stability will increase. One way to address the above problems is to develop a regional bond market that is capable of recycling regional wealth in a more efficient and healthier manner, thus reducing the probability and the destabilising impact of any reversal of fund flows on the domestic financial markets.

Fostering regional bond market development

That, briefly, is the case for a regional bond market. Indeed, it is more than a case for just having a regional bond market. It is also a case for developing such a market, and taking quite vigorous measures to stimulate development. Both the pattern of international fund flows and the underdeveloped state of the regional bond market require this. Fostering regional bond market development involves co-operation on a number of fronts among economies with very differing economic, political and cultural backgrounds. It is often said that the diversity of this region - in comparison with, say, Europe - is a considerable obstacle to the kind of financial, economic and monetary co-operation that might be desirable. Nevertheless, it is heartening that, in this area at least, considerable progress has been made over the past few years, particularly among central banks. This co-operation has taken two forms: market development initiatives, which help promote the growth of a regional bond market, and infrastructural initiatives, which facilitate that growth. Let me, in the remainder of this address, briefly outline some of these initiatives.

A number of collaborative initiatives have been undertaken by central banks in the region to foster the development of both local and regional bond markets. These can be grouped into three main clusters, each falling under the auspices of a major regional multilateral organisation. The first of these is the APEC Initiative on the Development of Securitisation and Credit Guarantee Markets, which is being spearheaded by three APEC member economies (Hong Kong, Thailand and Korea) and sponsored by the World Bank. The aim of this initiative is to address structural impediments to the development of bond markets and to provide an effective and immediate solution to the credit gap problem. Under this initiative, four member economies of APEC - China, Thailand, Mexico and the Philippines - have volunteered to receive expert advice through visits from panels of experts. The objective of these visits is to assist the economies in question in identifying potential impediments in their markets and in removing these impediments through specific, achievable and monitored action plans tailored to the individual economy. The programmes under this initiative are making good progress, and, in addition to the panel visits, two policy dialogues have been held to promote understanding and experience-sharing.

A second cluster of initiatives, under the ASEAN+3 forum, involves a variety of studies known as the Asian Bond Market Initiative (ABMI) on issues such as new securitised debt instruments, issuance of debt by international financial institutions, regional credit guarantees and enhancement facilities, and the establishment of local and regional credit rating and credit enhancement agencies.

The third set of initiatives falls under EMEAP - the Executives' Meeting of East Asia-Pacific Central Banks - and takes the form of bond funds aimed at channelling a small portion of the very large official reserves held by the Asian economies into the region. The first of these funds - Asian Bond Fund I (ABF1) - was launched in June 2003 and is now fully invested in US dollar-denominated bonds issued by sovereign and quasi-sovereign issuers in the EMEAP economies. The EMEAP Central Banks are currently working on ABF2, which will invest in local currency-denominated Asian bonds. Both initiatives are aimed at promoting the development of index bond funds in the regional markets and, at the same time, enhancing both domestic and regional bond market infrastructure. This is a very concrete initiative, involving the allocation of funds by a considerable number of central banks.

These three sets of initiatives use differing approaches and a variety of tools. But they have common aims. One important aim is to identify - through individual studies, experience-sharing, and the practice of fund management - where obstacles exist and how best standards and practices can be harmonised to facilitate cross-border financial transactions within the region. A separate, but parallel

consideration is the development of financial infrastructure. A number of studies have been carried out to explore the feasibility and desirability of establishing region-wide infrastructure, such as a regional rating agency and regional settlement and payment systems. Apart from the many technical complexities, any proposals for infrastructure on a regional dimension would require thorough discussion among different jurisdictions and rigorous assessment of business viability and impact on the market. Long planning time would therefore be expected before any conceptual proposal could be put into practice.

Effective financial infrastructure across the region is a precondition for debt market development within the region. Without it, all of the other initiatives I have described would be about as useful as buying aeroplanes without having the airports in which to land them. A pragmatic approach is therefore necessary, leveraging on existing infrastructure within each jurisdiction and creating a network of bilateral links between jurisdictions. Each jurisdiction will, of course, develop its own infrastructure and links according to needs, although the main lesson in this field is that it is better to be ahead of needs than behind.

Let me take Hong Kong as an example. We have a reasonably advanced and sophisticated financial infrastructure, in keeping with our status as a regional and international financial centre. We have, over the past decade, extensively developed our payment and settlement systems to enable cross-border, multi-currency transactions to be conducted and settled in real time, without settlement risk. For debt settlement, we have established bilateral linkages between our Central Moneymarkets Unit and debt depositories in other jurisdictions, such as Euroclear and Clearstream, Australia, New Zealand and Korea. We have also recently set up a direct link with the GSBS in Mainland China.

Hong Kong already has a real time settlement system for the Hong Kong dollar, the US dollar and the euro. We have a standing offer in the region to link up the RTGS payment system with other currencies in other centres with RTGS capability - for example Tokyo. We hope that, in time, when circumstances permit, it will be possible to extend this to the renminbi. The aim is to provide a platform that prepares Hong Kong to maintain and develop its role in the changing regional and international financial intermediation process.

Conclusion

I have outlined in this address the case for an Asian bond market and the role being played by the public sector in promoting the development of such a market. Collectively and individually, central banks and governments are making good progress on a variety of initiatives aimed at reducing barriers, building infrastructure and encouraging interest in the market. In the end, however, there is only so much that the public sector can - or should - do, particularly in a region where there is traditionally not a lot of public debt. Central banks and governments have a responsibility to facilitate and promote development, and to provide an environment that is conducive to both supply (the issuers) and demand (investors). It is, I have argued, in the public interest that a healthy bond market should develop in our region. However, it is for the private sector to provide the great bulk of supply and demand. Happily, it appears that the private sector is playing its part with enthusiasm.