Bandid Nijathaworn: Developing the bond market - a central bank perspective

Remarks by Mr Bandid Nijathaworn, Deputy Governor of the Bank of Thailand, at the Asset Forum, Bangkok, 29 March 2005.

* * *

Distinguished Guests
Ladies and Gentlemen

Let me first thank the Asset magazine for inviting me to give this luncheon address. It is a pleasure to be here.

I also would like to congratulate the organizer for putting up today's event. The bond market in Thailand is now at an important stage of development and a function like this is certainly a positive contribution.

For my brief remark today, I want to make a few points on the Thai bond market from the standpoint of the Bank of Thailand. I also want to share with you our plan for developing the bond market this year.

From the Bank of Thailand's point of view, the bond market is of exceptional importance to us. This is because it is the market that we operate monetary policy through open market operations and through our operations in the repo market. Therefore, the more developed and efficient the bond market, the more effective the conduct of monetary policy would also be.

Also, a vibrant domestic bond market is essential for a robust and efficient financial system. This is important for the development of the economy in the longer-term. At this time, the Thai bond market has a strong potential to become the important third pillar of Thailand's financial structure next to the credit and the equity markets. At present, the size of the bond market in terms of market capitalization to GDP is about 50 percent. Hence, there is considerable scope for the local bond market to grow and expand.

Thai bond market in 2004

Last year, the Thai bond market grew by about 9 percent in terms of the amount of bonds issued, while activities in the secondary market increased by about 12 percent.

The growth reflects mostly transactions in government securities, particularly treasury bills and Bank of Thailand bonds.

Last year was also an important year for bonds as it was the year that we saw a shift in the stance of monetary policy. The policy interest rate was raised three times in the second half of last year in response to increased pressure on prices and economic stability.

Looking back, one has to say that the bond market adjusted very well to the shift in the monetary policy stance. Bond market interest rates responded in an orderly manner and moved in line with policy signal.

This smooth adjustment reflects two important qualities that we are now seeing in the local bond market. The first is greater market liquidity which has allowed the bond market to adjust to the change in monetary policy without difficulties. And the second is the improved communication between policymakers and market participants, which has allowed the bond market to form its own expectations about policy direction and to respond accordingly. These two qualities, in my view, are positive for the development of the bond market in the longer-term.

Outlook and developments in the bond market

This year the Thai economy will continue to expand, driven by momentums in domestic demand and export, including the launching of new infrastructural projects. Higher investment will imply higher funding requirement. Given ample liquidity in the system, funding investment expansion domestically should be a preferred option to funding it from abroad. Domestic funding will help make the domestic credit market competitive while helping to avoid the unnecessary pick-up in external debt. It is in this context of domestic resource mobilization that the bond market can have an important role to play.

This is to say that while bank credit will continue to be a major intermediary for investment finance, the need for long-term investment financing will offer considerable opportunity for the bond market. On the supply side, the fixed income market can be an important channel for long-term capital mobilization, while on the demand side, there will be ample demand to invest in fixed income instruments from domestic institutional investors. It is in this context that the current efforts to develop the domestic bond market by the Government are timely, and this priority now ranks high on the Government's agenda.

Roles of the Bank of Thailand in developing the bond market

A High-level Domestic Bond Market Development Steering Committee was set up by the Government in January this year. The committee is chaired by the Finance Minister and comprises high-level representatives from both the public and private sectors, including the Bank of Thailand. The aim of the committee is to promote the development of the domestic bond market in five key areas, namely, (1) the primary market (2) the secondary market (3) taxes (4) market infrastructure and (5) market information.

As for the Bank of Thailand, we have been tasked with the responsibility to develop an active secondary market. To meet this challenge, the Bank of Thailand has mapped out a multi-year strategy from which our work plan for bond market development this year will focus on six areas.

<u>First</u> is the development of the private repo market. The repo market will provide bond market participants with the tools to hedge their bond position, as well as to manage liquidity more effectively. The private repo market will also provide an important link between the money market and the bond market, meaning that liquidity in the secondary bond market can be substantially improved once a well-functioning private repo market is in place.

<u>Second</u>, the Bank of Thailand will coordinate with the Thailand Securities Depository to set up a "Bond Lending and Collateral Management Unit" to activate the bond lending business. This again will help facilitate the private repo market and enhance overall market liquidity.

The <u>third</u> is that the Bank of Thailand will begin integrating the depository system as well as the clearing and settlement system for all debt instruments with the TSD under a multi-year migration plan. This is aimed at enhancing market efficiency and reducing transaction costs in the debt market. The integrated system will also provide an important foundation for future regional linkages of the clearing and settlement system.

<u>Fourth</u> is the development of hedging instruments. With the current upward trend in domestic interest rates, hedging instruments particularly interest rate swaps will provide the bond market with additional instruments that will be useful in an environment of market volatilities. The interest rate swaps market can help diversify and reallocate risk among various groups of bondholders.

The <u>fifth</u> focus is our plan to improve the functioning of primary dealers as market makers. This is to say that their obligations and privileges will be reviewed so that they will be in a strong position to perform their functions as market makers.

And the <u>sixth</u> is the ongoing project to strengthen the regional bond market through the Asian Bond Funds Project.

For the past years, development of the local and regional bond markets has been given an unprecedented emphasis by various regional fora. The most notable is the launching of ABF1 project by eleven EMEAP central banks. That efforts is now being followed by the ABF2 project. Under ABF2, the eleven regional central banks will invest a fraction of their reserves in the local currency denominated bonds issued by sovereign and quasi-sovereign entities in eight EMEAP markets, namely, China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand.

The passively managed style of ABF2 will help attract the interests of both domestic and international investors in the Asian bond markets, as it would provide an attractive alternative for investors who seek innovative, low-cost and efficient bond products in the Asian financial markets. Furthermore, the ABF2 Initiative would also help expedite market development and regulatory reforms at both domestic and regional levels, which would benefit both potential issuers and investors in the region. But most importantly, ABF2 would make available a new set of transparent, replicable and credible Asian bond indices which will be an important bond market infrastructure for the region.

Conclusion

To conclude, a lot of activities can be expected this year in our domestic bond market. The opportunities will come from continued momentum of investment finance, as well as from the authorities' efforts to push through a number of initiatives to develop the bond market. As for our own monetary operations, the Bank of Thailand also plans to issue more bonds, with more varieties, to support our day-to-day management of domestic liquidity.

The Bank of Thailand now sees the local bond market as entering an important period of growth and market development. The Government is also keen to reduce market impediments in order to help expedite the development of the bond market. Therefore, this year can be a year of many opportunities where a lot of progress can be made.

And to foster its success, a close cooperation between the public sector and the private sector will be vital so that progress made in the bond market will be consistent with the needs and the expectation of the private sector. This is important because, at some point in the longer-term, development of the bond market will need to be driven by market rather than by policy. Hence, your active contribution and cooperation will be vital in fostering the success in the development of the Thai bond market in the longer-term.