Comments on Barry Eichengreen and Pipat Luengnaruemitchai's paper "Why doesn't Asia have bigger bond markets?"

Ric Deverell

I thank the Korea University and the BIS for organising this highly topical conference, and for inviting me to participate. Thanks also to the authors for their thought-provoking presentation and paper, which touch on many of the issues which will be discussed over the coming two days. My comments can be loosely categorised into three sections. First, I will elaborate on the genesis of the Asian Bond Fund, and the motivations underpinning its introduction. Second, I will comment on the methodology adopted in the paper, and suggest some avenues for further work. And third, I will discuss conclusions.

1. ABF origin and objectives

The Asian Bond Fund had its genesis within the EMEAP grouping of regional central banks in mid-2002 - independent of other initiatives. The first stage was launched in the middle of 2003, and involved investment by regional central banks of USD 1 billion in a basket of US dollar-denominated bonds issued by government and quasi-government issuers in eight of the EMEAP economies. While this initiative demonstrates the EMEAP grouping's commitment to the continued development of regional bond markets, its impact on the breadth and liquidity of domestic markets is likely to be small. The second stage, which is not mentioned explicitly in Barry and Pipat's paper, is likely to be far more significant. While the final details are still being finalised, this stage will initially involve investment by central banks in bonds denominated in domestic currencies. However, more significantly, it will put in place the structures to allow access by private investors.

In their paper, Barry and Pipat question whether the use of central bank reserves in the Asian Bond Fund will have the desired effect - which they suggest is to jump-start supply and demand by increasing the size of the installed base through government and central bank purchases of bonds.

This characterisation does not, in my view, fully capture the objectives underlying the ABF - and ignores the ABF2 extension, which was always part of the scoped model. The idea of ABF2 is not so much to "jump-start" demand with our own demand, but to blaze a trail that others could follow. By establishing ABF2, we intend to show that it can be done (identifying and removing regulatory or other impediments along the way), and provide the infrastructure for private sector investors to utilise. This is very clear in the focus on private sector involvement following on from the central bank investments, once we have resolved infrastructure issues such as price dissemination services and the setting-up of indices. In fact, we were always conscious not to make ABF so big as to risk locking up securities and depressing turnover as a result! Something that larger investments by the government sector might have done.

2. The results

The paper attempts to shed light on what initiatives are "most urgently needed to promote Asian bond markets". In order to achieve this, it sets out five hypotheses (historical, structural, developmental stage, structure of financial system, and macroeconomic) and proxies each with several variables. Using these variables, a broad-based cross-country econometric analysis is undertaken.

While this broad-brush approach is useful as part of the initial sorting process, in general the discussion of the empirical results is presented as being more certain than the regressions seem to support. As many of the implications drawn depend on model specification, it would be useful to make a judgment as to the preferred model and then to discuss the results. Alternatively, variables that are robust across model specifications could be singled out as the most likely determinants.

Consistent with this, several of the conclusions warrant further analysis. First, the paper sends mixed messages about the effect of exchange rate stability/volatility. On page 53, last full paragraph, it is suggested that "On the other hand, the stability of exchange rates in the region appears, if anything, to have encouraged bond market development". However, on page 50, first full paragraph, the paper suggests "...there is little evidence of a relationship between exchange rate volatility and bond market development". One of the things we have been trying to achieve in emerging markets over recent years is better management of currency mismatch. Part of the solution in our view has to be demand-oriented. That is, there will be little interest in managing currency mismatch if everyone thinks that the exchange rate will be stable. We should not sell currency stability as a means of promoting financial stability.

Second, the paper does not adequately distinguish the type of bond markets that we are seeking to promote, and as such does not explore the important issue of currency denomination of bond markets. Presumably one of our ultimate goals is for bond markets to facilitate borrowing in domestic currency in order to reduce currency mismatch (the so-called problem of original sin). Understanding what allows countries to do this is one of the more important questions the international community faces at the moment.

A third point relates to the type of bond market desired. In the paper, bond market development is defined primarily as aggregate capitalisation. While this may be a useful general proxy, it is not clear that bigger is always better - particularly if a large part of capitalisation is due to large levels of government debt. It is interesting to note that, on this metric, the Australian bond market is almost identical as a share of GDP to that seen in developing Asia. Development may be better defined relative to some metric of secondary market liquidity - for example, bid-offer spread or turnover (ratio of outstandings).

A fourth point relates to the relatively controversial finding that bank financing is complementary to bond market development. Given that market-based financing dominates in some countries, while bank-based financing dominates in others, it may also be useful to split the samples into bank financing and market-based financing countries and examine the relationship between banking sector and bond market development in the subsamples.

3. Conclusions

While the paper says that its intention is to help prioritise potential initiatives, its conclusions are very general, with many factors found to be relevant. Given the general nature of the analysis, no convincing argument is put forward that there is any particular initiative that will be more crucial than others. This suggests that more work needs to be done to test which reforms are more urgent.