Thirachai Phuvanatnaranubala: The strengthening and development of regional bond markets

Speech by Mr Thirachai Phuvanatnaranubala, Deputy Governor of the Bank of Thailand, at the APEC Business Advisory Council Meeting, Tokyo, 16 May 2003.

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Lessons from the Asian crisis – a local perspective

Thailand's experience

The crisis of 1997 brought to light weaknesses in the country's financial sector development and the sequencing of liberalization policies. Prior to 1997, the function of financial intermediation fell almost entirely on commercial banks. They mobilized funds mainly through deposits, which accounted for roughly 80 percent of domestic banking liabilities. At the same time, they held almost 70 percent of total financial sector assets, most of which were in the form of credits to the household and corporate sectors.

Direct financing through the domestic bond market – through both public and corporate bonds – was relatively small and not well developed. Nine consecutive years of fiscal surplus between 1988 and 1996 provided no incentive for the government to issue regular and substantial amount of government bonds. The resultant limited supply of government bonds inhibited the development of a risk-free benchmark against which to price corporate issues and mark to market daily trading.

The crisis brought to the fore an imbalance in the structure and operation of the Thai financial markets. With financing channels limited to bank loans, Thai businesses faced severe liquidity crunch as the banking sector sharply curtailed their credit operations amidst high non-performing loans and massive recapitalization needs. This intensified the economic slowdown, as highly leveraged businesses and corporates were cut off from their traditional source of funding.

Developing the local bond market

In the aftermath of the crisis, authorities in the region mounted an effort to redress the imbalance in the financial system. In Thailand, development of the domestic bond market was given a high priority, partly because of the necessity to fiscalize the cost of financial sector restructuring and partly as an alternative-funding source to reduce reliance on bank intermediation.

A more developed bond market provides the economy with a more balanced financial infrastructure, thereby diversifying the risk of intermediation across a large number of institutions and market players. This so-called sharing of risks through pricing of risks and trading of risks is aimed to achieve a better structure and balance between bank financing, equity financing, and debt financing.

Development of a liquid bond market also provides other benefits. It allows private and public sector issuers to finance long-term projects at lower cost, thus reducing maturity risks. A liquid government bond market also provides the basis for development of other segments of the financial sector that could draw in significant foreign participation – including forward and future markets, for example, which are needed to support risk management functions of banks and firms. Developments in these markets will not only make local bond markets a more desirable investment alternative to both local and foreign investors, but would be vital in the development of a local-currency bond market.

An active local bond market also supports financial system stability. Holders of bonds – in particular commercial banks – can make use of these bonds in securing emergency funding from the monetary authorities. An active bond market where securities are marked-to-market on a daily basis will facilitate commercial banks' access to emergency liquidity assistance through their sale or the use of such instruments as collateral. This mechanism provides a more efficient and transparent process than the use of other types of collaterals such as land, title deeds, or receivables, which have less transparent market value and less liquidity.

Development of the bond market in Thailand

The local bond market in Thailand, like many other Asian markets, has been hindered by a number of institutional problems. The small size of the markets – and the resultant low liquidity – provided little incentive for active participation by both issuers and investors. On the supply side, a small market limits the feasible range of marketable instruments and their effective tradability. On the demand side, a small number of market players and a narrow investor base provided insufficient demand for private players to act as market-makers. A small number of market players and the dominance of a few players hindered competition and market liquidity.

Thai authorities have made significant strides in developing the government bond market since 1998. A pre-announced and regular issuance calendar for the year is now available to help investors plan their investment horizon. This has enabled the government to borrow at low cost and no longer be penalized for opportunistic behaviour of irregular issuance schedules. The Ministry of Finance now issues on a regular basis Government bonds with a maturity of up to a maximum of 20 years to establish a benchmark rate for medium to long-term debt securities. This has allowed a risk free benchmark to be constructed, and the Thai Bond Dealing Center publishes a yield curve on a daily basis.

The BOT has appointed 10 financial institutions as primary dealers for bilateral repurchase (repo) transactions. This set of primary dealers will be counterparties for bilateral repo transactions with the BOT and act as intermediaries in forwarding liquidity adjustments resulting from bilateral repo transactions with the BOT to other market participants. To further enhance trading in the market and ensure that financial institutions have sufficient liquidity for their day-to-day operations, the Bank of Thailand is in the process of phasing out the repurchase market that BOT currently operates and introduce a full-fledged private bilateral repurchase market.

Future challenges would center around improving the clearing and settlement system. These markets require a minimum turnover in order to function smoothly and cost effectively.

A regional perspective: risks from currency and maturity mismatches

In addition to developing local bond markets, Asian countries have also embarked on a regional initiative to promote the development of the Asian bond market.

Asian countries have long enjoyed the highest saving rates in the world. In recent years regional central banks have also built up a large addition to their foreign reserves. Such a large pool of domestic savings should be channeled into long-term investment in the domestic markets to support growth and development in the region. At present however, the dominant financing tools in most Asian countries still continues to be short-term bank loans, and bond markets in the region still remain underdeveloped.

The bulk of local savings has instead been channeled to international financial centers with a wider alternative for investment and well-developed financial markets. At the same time, Asia is a recipient of short-term portfolio flows that had been destabilizing and highly volatile. These funds have further aggravated the problem of maturity and currency mismatches making the region more vulnerable to fluctuations in international capital movements.

Creating a more stable financial system

Developing regional bond markets for Asia: Asian savings for Asian investment

Efficient and liquid bond markets in Asia - both at the local and regional levels, would enable the private sector as well as the public sector in Asia to raise and invest long-term capital without the currency and maturity risks which accompany international capital flows into the region.

Development of regional bond markets will help governments and businesses in the region reduce currency and maturity mismatches. Aside from providing stable and long-term financing alternatives for businesses and public sector agencies in the region, this would also help strengthen the financial system in the region by making available a diverse choice of alternatives for investment, as well as support economic growth through more stable financial systems in the region.

The necessity to develop a regional bond market

While many countries in the region have begun the process of developing bond markets – or where they exist already, deepen and widen those markets – countries are also looking to promote the development of the regional bond markets in parallel with development of their own markets. Given the problems of economies of scale as mentioned earlier, development of the regional bond markets would offer a more efficient and viable option in neighboring countries until these countries' financial systems are more developed and have a more sophisticated market structure in place.

Roadmap for the development of Asian bond markets

Over the past year, the development of Asian bond markets has been discussed in various international fora, such as ASEAN Finance Ministers Meeting, the Executives Meeting of East Asia-Pacific Central Banks (EMEAP), Asian Cooperation Dialogue (ACD), and the Asia-Pacific Economic Cooperation (APEC).

Development of the demand side, involves promoting the pooling of investor base or the pooling of reserves under the Asian Bond Fund initiative, which has had a good start under the cooperation of central banks.

Work on the supply sides revolves around issues of tax, legal and regulatory as well as accounting and should receive endorsement from the highest levels of government following the adoption of the Chiang Mai Declaration on the Asian Bond Market Development.

Demand side development: establishment of the Asian Bond Fund

On the demand side, central banks in the region have been working closely under the Executives Meeting of East Asia-Pacific Central Banks – or EMEAP – to establish an Asian Bond Fund. Under this initiative, central banks will set aside a fraction of their reserves into a pool that will be invested in bonds issued by Asian governments and government enterprises, with an ultimate aim to provide a catalyst for private investors to consider investment in Asian issues

EMEAP has worked out the details and modalities of the operation of such a Fund and will announce details to the public shortly.

Approaches to regional cooperation: work on developing the supply side

ASEAN+3 and APEC are both working on the development side of bond markets, including the removal of barriers impeding the issuance of bonds both in the regional and domestic contexts respectively. In addition, there has been cooperation in setting up the necessary infrastructure for such a regional bond market, including a regional credit rating agency, as well as credit enhancement facilities.

Recognizing that the reason that investors have generally stayed away from bonds issued by Asian entities is due to their low liquidity and low credit ratings, APEC is currently active in the design of instruments that can be traded in these markets, through its work on securitization and credit enhancement.

Given that at present, a number of bonds issued by Asian entities are below investment grade, the use of securitization and credit guarantees to enhance the quality of these issues can act as a near-term solution to giving these issues a credit quality acceptable to investment managers, and give them the needed initial exposure to private investors. The introduction of these new instruments – which would attain a credit quality acceptable to investment managers by achieving a high rating from international rating agencies – would also benefit the international financial community by providing investors with a greater diversity of products and instruments for investment. More importantly, it would enable smaller corporate entities – who would otherwise be limited to financing themselves through short-term commercial bank lending – to access bond markets and find a source of funding more suitable to their needs.

Cross guarantees

A means of helping economies with less developed local bond markets to issue debt in the regional market may be through the use of cross guarantees. As part of regional financial cooperation and a step towards greater regional financial integration, cross guarantees can reduce the cost of funding for smaller economies with lower credit rating through guarantees provided by more advanced nations. The use of cross guarantees will be similar in principle to the use of credit enhancements, resulting in improved credit risk of bond issuances as well as lower funding costs for bonds. But while credit enhancement can be offered by a third party, cross guarantees are made by countries within the region in an effort to collectively develop the region.

A number of concerns may arise with the use of cross guarantees, namely the problems of moral hazard arising from any type of guarantee, the resultant price distortion, and the perceived free rider problem of the smaller economies. To lessen the risks that would arise from moral hazard, such a guarantee may only be partial. The problem of price distortion will be difficult to mitigate, given that bonds issued with cross guarantees by definition will not have their total risk reflected in price. However, this in turn will help benefit issuers in terms of lower cost of funding. With regards to the free rider problem, it is clear that a system of cross guarantees will benefit the lesser developed economies most, since they will not be in a position to guarantee any other issuers. However – with the spirit of regional financial cooperation for development of Asia as a whole in mine – countries with more advanced financial systems may decide to offer these guarantees for a limited period of time.

Proposals for development and integration: enhancing market infrastructure

Currency arrangements

Issuing bonds under a basket of Asian currencies may achieve a slightly lower cost of funding, given that the currency risk of a basket is lower than the sum of the risk of the underlying currencies. This lower risk should be reflected in a lower cost off capital for borrowers.

With regards to liquidity, if bonds in the region were to be issued in a basket of currencies that could be traded in many Asian bond markets, liquidity of such a bond should be better than that of any individual bond. In this regard, deep and liquid bond markets should also reduce transaction costs, making the regional market more attractive than issuing locally.

Such a basket of currencies may enhance the natural hedging ability of market participants in each country in the region. Given the importance of intra-regional trade, exporters cold better match the currency exposures of their assets with their liabilities.

Cooperative actions needed to facilitate growth of regional bond markets

The use of these mechanisms to promote development of bond products must not detract countries from taking serious steps to developing their bond markets. The use of credit guarantees, cross guarantees, or credit enhancements – to mention a few ways – can only act as a temporary measure to catalyze interest in Asian issues, and at a cost. Such guarantees increase the issuer’s cost of funding, and usually cannot be sustained indefinitely. The coverage of credit guarantees, for example, would have to be reduced from a full guarantee to a partial guarantee as markets develop. In the meanwhile, countries must tackle their fundamental problems that are hindering the rating of their issues, whether it is infrastructure, legal, or regulatory problems.