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Bank of Japan

Development of Asia's Capital Markets: Roles and Challenges

Keynote Speech at the ASIFMA Annual Conference 2019

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Introduction

Good morning everyone. It is my great pleasure to be here at the Asia Securities Industry and Financial Markets Association (ASIFMA) annual conference 2019. I am honored to address this distinguished audience comprised of representatives from the securities and asset management industries, institutional investors, policy makers, and regulators in Asia and other important regions.

Asia's capital markets have experienced remarkable growth since the Asian financial crisis in the late 1990s. Asia's share of global stock market capitalization[1] soared from 1 percent in 2000 to 15 percent in 2017. Notably, the amount outstanding in local currency bond markets in Asia as a share of GDP[2] in 2018 increased to more than double that in 2000 (Chart 1). Obviously, the rapid expansion of Asian economies has driven the growth of the capital markets in the region. At the same time, the collective efforts of market participants, policy makers, and regulators both at national and regional levels have contributed to market liberalization and enhancement of market infrastructures in Asia.

Typical examples of such regional cooperation include the Asian Bond Markets Initiative (ABMI), launched by the ASEAN+3, as well as the Asian Bond Fund (ABF) initiative[3] of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), which is a group of 11 central banks and monetary authorities in the region. Financial industry associations, such as the ASIFMA, have also played a vital role by facilitating dialogue between market participants, promoting regional coordination, and providing necessary recommendations

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[1] Based on figures for "East Asia & Pacific" (a country and region grouping employed in the World Bank's World Development Indicators) excluding high-income countries and regions (Australia, Hong Kong, Japan, South Korea, New Zealand, and Singapore).

[2] Based on the aggregated amount outstanding in local currency bond markets in China, Hong Kong, India, South Korea, Malaysia, the Philippines, Singapore, Thailand, and Vietnam.

[3] The Asian Bond Fund (ABF), established in 2003, is an index bond fund with a two-phase framework, namely, "ABF1," which invested in U.S. dollar bonds, and "ABF2," which invests in local currency bonds and is open to private sector investors. In 2016, because the EMEAP determined that ABF1 had achieved its original purpose, its proceeds were reinvested in ABF2. In July 2018, some selected bonds held within ABF2 were made available for lending to support the development of local currency securities lending markets and to enhance the functioning of regional money markets.

from a market perspective. Activities by those market participants and relevant authorities have been indispensable for the development of Asia's capital markets. I would like to recognize and praise all of those who have committed to these efforts.

Looking to the future, Asia needs to further accelerate and deepen the development of its financial markets more than ever before. This is because the existence of more developed capital markets both domestically and regionally will play a much more crucial role for the long-term stable economic growth of the region.

Today, I would like to discuss the economic implications of the conference theme, "developing Asia's capital markets," from several perspectives. Then, I will briefly touch on interest rate benchmark reform, as a specific example of the challenges we are facing as we endeavor to further develop market infrastructures.

Economic Significance of Further Developments in Asia's Capital Markets

Financing Economic Growth through the Growing Middle-Income Class

Let me begin with the importance of relying on the growing middle-income class to finance economic growth. The middle-income class in Asia has been growing to a remarkable extent. The Organisation for Economic Co-operation and Development (OECD) forecasts[4] that the middle-income population in Asia will constitute 66 percent of the world's share in 2030, more than doubling that in 2009 (Chart 2).

The rise of Asia's middle-income class will be accompanied by growth and diversification of the financial needs of that class. Both domestic and regional markets in Asia must satisfy those evolving demands by providing various financial services, including investment trusts, pension funds, and insurance.

By doing so, Asia will receive benefits such as inflows of money from the middle-income class into infrastructure projects, which require a significant amount of funding. In other

[4] Kharas, H. (2010), "The Emerging Middle Class in Developing Countries," *OECD Development Centre Working Paper*, No. 285.

words, meeting the financial demands of the growing middle-income class will contribute to utilization of Asian savings for Asian investments.

Strengthening Financial Stability with More Liquid Domestic Capital Markets

Now, I would like to proceed to a perspective of financial stability. Since the Asian financial crisis, many countries in the region have made wide-ranging efforts, including a reduction in the non-performing loans held by banks, in order to enhance their resilience against capital flow dynamics.

However, the presence of domestic bond markets in the Asian financial system is still limited, compared with that of banking sectors. In order to further strengthen financial stability in Asia, it is important to diversify funding sources for firms by developing domestic bond markets.[5] Recent empirical studies[6] point out that domestic bond markets in East Asia provided an alternative source of funding for firms in the region when the liquidity of international debt markets vanished during the global financial crisis from 2008 to 2009. East Asia saw greater domestic bond issuance during the crisis, in contrast with lower international bond issuance and a reduction in the amount of syndicated loan origination (Chart 3). This result tells us how important it is to develop domestic bond markets to make the Asian financial system more robust.

Enhancing the Effectiveness of Monetary Policy

Lastly, I will touch on the effectiveness of monetary policy. For the conduct of monetary policy, central banks buy and sell financial instruments from capital markets, and they also receive financial instruments as collateral for the provision of liquidity. So, the degree of market functioning and liquidity concerning those financial instruments is a critical element that impacts the effectiveness of monetary policy.

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[5] For example, see Bank for International Settlements (2016), "A Spare Tire for Capital Markets: Fostering Corporate Bond Markets in Asia," *BIS papers*, No. 85, which focuses on the importance of domestic bond markets among capital markets in times of crisis.

[6] Abraham, F., J. J. Cortina, and S. L. Schmukler (2019), "The Rise of Domestic Capital Markets for Corporate Financing: Lessons from East Asia," *World Bank Group Policy Research Working Paper*, No. 8844.

In this regard, repos are financial instruments that are frequently used in the conduct of monetary policy, because repos carry a low credit risk and they are suitable for inventory and liquidity management by market makers. In Asia, market participants have preferred to use FX swaps and uncollateralized funding because of their accessibility and operational convenience, and the role of repo markets has been relatively limited overall. However, the situation is now changing. The EMEAP market survey[7] suggests ongoing efforts to enhance the functioning and liquidity of money markets such as repos. These efforts are being driven by various initiatives, such as the promotion of non-bank participation and the enhancement of industry standards. Accelerating these efforts would lead to greater effectiveness of monetary policy in Asia.

Interest Rate Benchmark Reform

Before closing, I will comment on interest rate benchmark reform. It would be beneficial to share some key points of interest related to this issue, as there are active discussions in various markets throughout the world.

In the wake of the LIBOR manipulation scandal, more reliable and robust interest rate benchmarks have been pursued. In addition, LIBOR will most likely be permanently discontinued after the end of 2021 judging from the announcement by the U.K. Financial Conduct Authority in July 2017 that the survival of LIBOR cannot be guaranteed.

LIBOR is the most widely-used benchmark in the global financial system and its discontinuation would have a significant impact on Asian markets. For example, the transition from U.S. dollar LIBOR to an alternative risk-free rate would be necessary in cases where the U.S. dollar is funded via cross-currency swaps. Accordingly, the other leg of the swap could also be affected.

We should also bear in mind that the discontinuation would affect a wide range of market

[7] For details, see EMEAP Working Group on Financial Markets (2018), "EMEAP Money Markets: Survey Report."

participants in Asia. The latest EMEAP report[8] on a survey among member central banks on this issue stresses the importance of raising awareness of the potential discontinuation of LIBOR among institutional investors and non-financial corporates in particular.

In Japan, initiatives to prepare for the possible discontinuation of Japanese yen LIBOR have been taken by the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks. The Bank of Japan serves as Secretariat on the committee, which is composed of a wide range of parties including financial institutions, institutional investors, and non-financial corporates. The committee has also expanded its deliberations into a public consultation and a wide range of outreach activities, such as holding a forum for non-financial corporates and industry associations (Chart 4). As a result, market awareness has been gradually growing and proactive initiatives towards interest rate benchmark reform, such as LIBOR exposure mapping, have been launched.

The permanent discontinuation of LIBOR would be one of the most significant events in global financial history, and the deadline is unavoidable. It is therefore important for us all to work together for our common interest -- a smooth transition to alternative reference rates. We should bring together our cross-sectorial wisdom and experience towards establishing more reliable and robust interest rate benchmarks, and make interest rate benchmark reform one of the great successes in global financial history.

Concluding Remarks

This conference covers so many important topics related to financial developments in Asia. I hope that lively discussions and exchanges of viewpoints over the coming two days will further contribute to the development of Asia's capital markets.

Thank you very much for your attention.

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[8] For details, see EMEAP Working Group on Financial Markets (2019), "Study on the Implications of Financial Benchmark Reforms."

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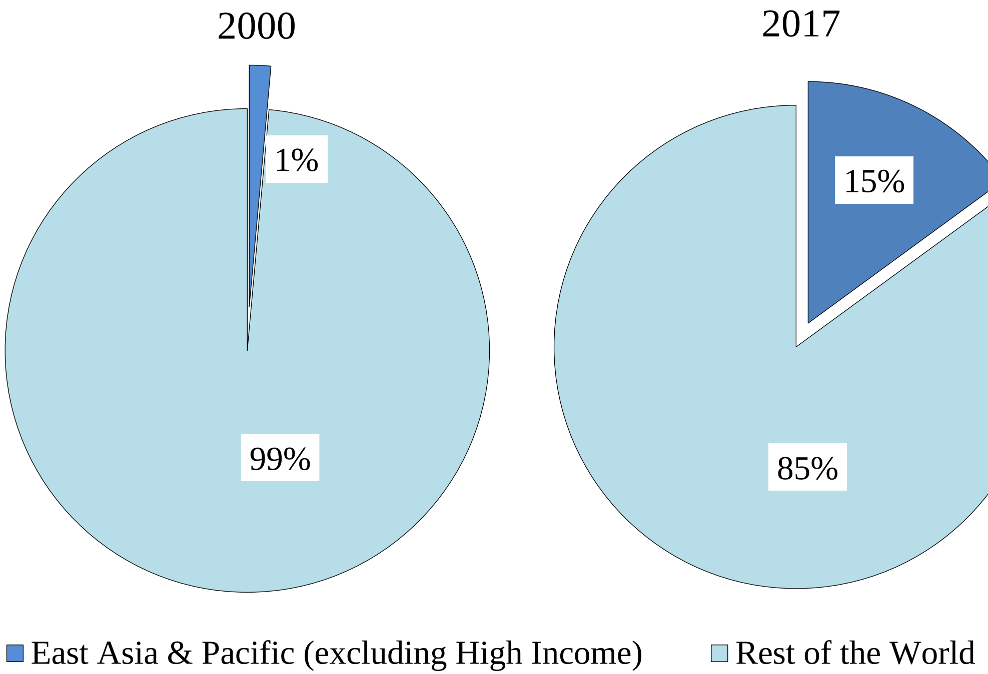
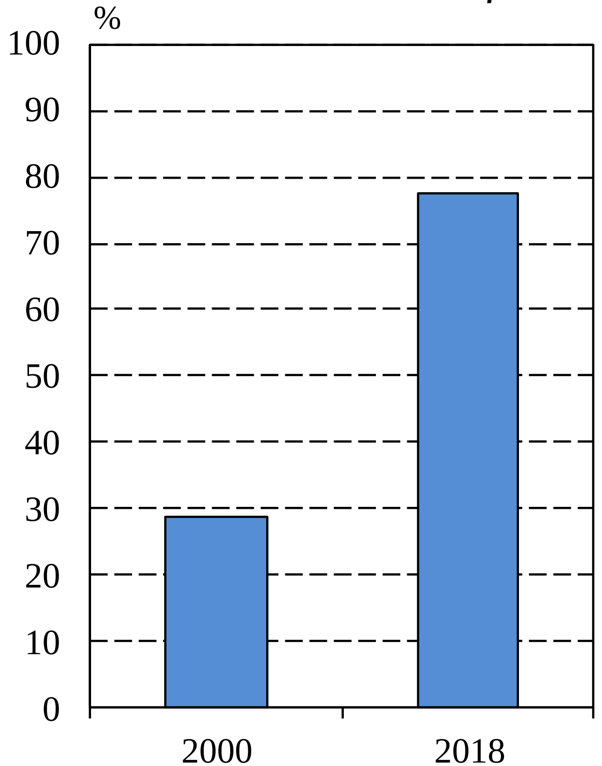
Asia's Capital Markets

Share of Global Stock Market Capitalization



Amount Outstanding of Local Currency Bond Markets as a Share of GDP

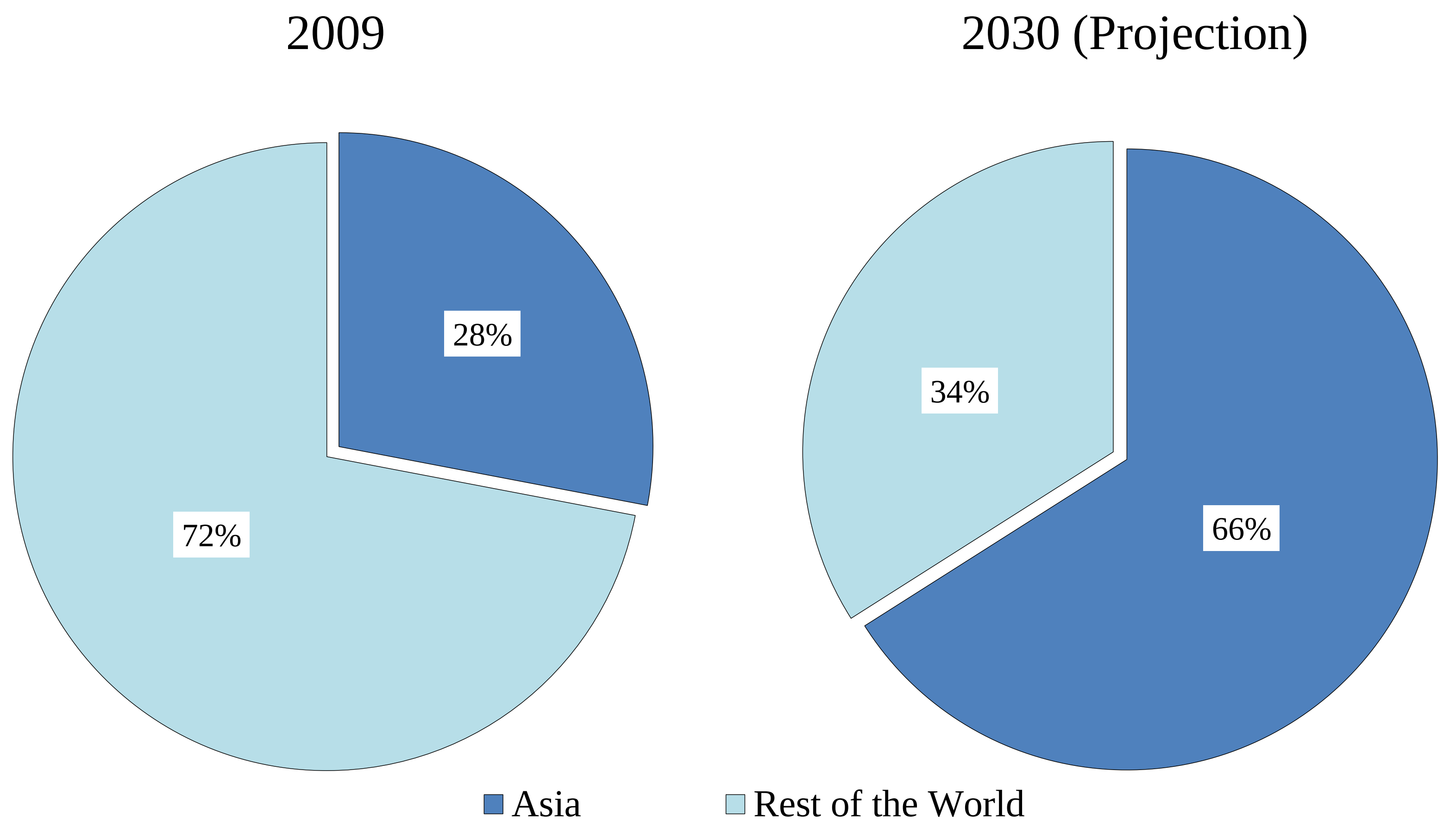


Notes: 1. In the left-hand chart, "East Asia & Pacific (excluding High Income)" covers the "East Asia & Pacific" (a country and region grouping employed in the World Bank's World Development Indicators) excluding high-income countries and regions (Australia, Hong Kong, Japan, South Korea, New Zealand, and Singapore).

2. In the right-hand chart, the figures are based on the aggregated amount outstanding of local currency bond markets in China, Hong Kong, India, South Korea, Malaysia, the Philippines, Singapore, Thailand, and Vietnam.

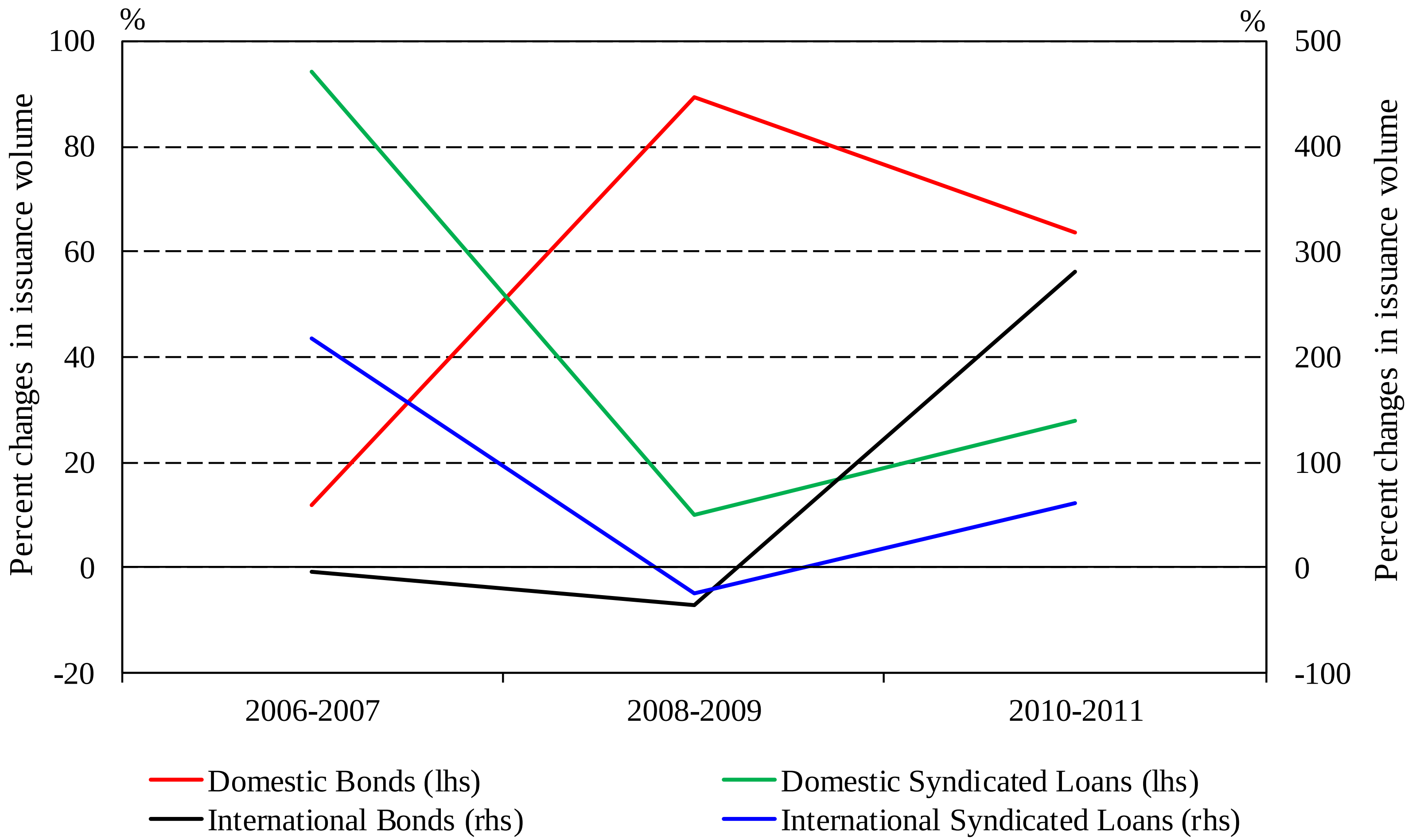
Sources: Asian Bond Online; World Bank, "World Development Indicators."

Share of the World's Middle-Income Class



Note: The share of the number of people with daily per capita income of between 10 and 100 U.S. dollars in terms of purchasing power parity.
Source: Kharas, H. (2010), "The Emerging Middle Class in Developing Countries," *OECD Development Centre Working Paper*, No. 285.

Issuance Activity in East Asia during the Global Financial Crisis



Note: Percent changes in aggregated total issuance volume of domestic and international bonds, and domestic and international syndicated loans in each sub-period. The figures are calculated by referencing Abraham, F., J. J. Cortina, and S. L. Schmukler (2019), "The Rise of Domestic Capital Markets for Corporate Financing: Lessons from East Asia," *World Bank Group Policy Research Working Paper*, No. 8844. The top and bottom 10 percentile of the sample has been excluded in the aggregation of data for each sub-period.

Source: Dealogic.

Interest Rate Benchmark Reform

- Raising awareness is the key to success.
- In Japan, the Cross-Industry Committee on Japanese Yen Interest Rate Benchmarks held the *Interest Rate Benchmark Reform Forum* on August 1, 2019.

http://www.boj.or.jp/en/announcements/release_2019/rel190830f.htm/

Participated widely by:

- Financial Institutions
- Non-financial Corporates (e.g., TOYOTA)
- Institutional Investors (e.g., Insurance Companies)
- Relevant Industrial Groups

Photo: Shoichi Nose