Foreign participation and bond market development in Asia and the Pacific

Closing panel remarks by Jaime Caruana

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I have been asked to present some views on the role of foreign participation in developing bond markets in Asia. I would like to focus my remarks on the role that foreigners can play in increasing liquidity in local currency bond markets. By liquidity, I mean the ability to transact in large quantities cheaply and rapidly without affecting the price. In government bond markets, better liquidity allows the fiscal authority to raise funds with less crowding-out of the private sector and gives the monetary authority more scope to conduct monetary policy effectively. In corporate bond markets, liquidity allows businesses and financial institutions to raise long-term funds on terms that promote a better allocation of resources and risks.

My home country, Spain, provides a good example of how foreign investment can boost the liquidity and growth of bond markets. We made many changes from the mid-1980s to the late 1990s to make government debt more attractive to new classes of investors during the run-up to European monetary union. As late as 1993, most public debt was short-term but, by 1995, some 60% was medium- and long-term.[1] With that maturity extension, the share of government debt held by non-resident investors dramatically increased from one quarter to almost one half over the eight years from 1996 to 2003. More significantly, the evidence suggests that liquidity premia fell as a result of this investment, with the impact of bond-specific characteristics on the pricing of bonds declining, and trading activity becoming more concentrated in benchmark bonds.[2] Foreign investors played an especially crucial role in boosting liquidity at longer-term maturities.

In this region, many initiatives have been taken to boost liquidity in local bond markets. One that has deservedly received particular attention is the Asian Bond Fund 2. This is a $4 billion plus fund invested in Asian local currency government bonds that was established in 2005 by the 11 central banks belonging to the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) and which is administered by the BIS. The so-called ABF2 sought to broaden investor participation, especially of non-residents. And in fact, the amount of debt securities held by foreign investors in the ABF2 markets today is generally much greater than in 2005. Accordingly, liquidity in most of these markets has improved.

[1] See I Ezquiaga, "Los mercados españoles monetarios y de deuda pública en la UME", in E Vidal-Ribas (ed), *El impacto del euro en los mercados financieros, Colección estudios e informes,* no 14, Barcelona: Caja de Ahorros y Pensiones de Barcelona, 1998, p 198.

[2] See A Díaz, J Merrick and E Navarro, "Spanish Treasury bond market liquidity and volatility pre- and post-European Monetary Union", *Journal of Banking and Finance*, vol 30, 2006.

I would like to discuss how emerging Asia has encouraged foreign participation in local currency bond markets. In doing so, I will draw upon a report the BIS submitted to EMEAP this summer on the impact of ABF2 on the development of local currency bond markets.[3] This report examines ways in which policy changes since ABF2's launch have stimulated the participation of non-resident investors and issuers.

Foreign investors often cite the *elimination of withholding taxes* as the key to encouraging their participation in local currency bond markets. Withholding taxes reduce the investment yield. They also enormously complicate the accounting and transactions procedures for many investors, especially real-money investors.

Prior to the announcement of ABF2, only Hong Kong and Singapore among the EMEAP economies exempted non-residents from withholding tax. However, a number of additional economies soon followed suit. In Malaysia, the announcement of plans for ABF2 hastened a review of the tax. Exemption for income from government and corporate bonds was announced in September 2004. Thailand followed in 2005 by granting an exemption to all foreign investors on income from government, state agency and state enterprise bonds. More recently, in 2009, Korea also removed the withholding tax on government securities for foreign investors. The evidence suggests that removing withholding taxes has led to significant increases in foreign investment.

The ability of investors to hedge their local currency risk or repatriate returns at short notice is another important factor affecting demand for local currency obligations. In this sense, it is vital to *reduce restrictions on the convertibility of local currency* as well as to *develop a liquid foreign exchange derivatives market*.

In a number of Asian jurisdictions, the authorities have considerably eased restrictions on local currency convertibility over the past five years. In Malaysia, in 2005, non-residents were permitted for the first time to sell forward FX contracts against ringgit to hedge receipts as well as committed outflows for divestments in ringgit assets. In Korea, in December 2007, the so-called "real demand" principle for purchases of Korean won was eliminated, meaning that it was no longer necessary to document an underlying securities trade. In addition, foreign investors are now allowed to engage in forward FX transactions on an unrestricted basis with local counterparty banks.

Liquid foreign exchange derivatives markets can encourage investment from non-residents by providing hedging opportunities on the FX component of investment risk through forward as well as cross-currency swap markets. They can also facilitate foreign issuance of bonds in the local currency, promoting greater diversity and scale of borrowers in the market.

The importance of liquidity in the FX derivatives market was hammered home during the Asian financial crisis of the late 1990s. At the time, many firms were unable to roll over hedges, turning synthetic local currency obligations into foreign currency liabilities, and even leading in some cases to insolvency.[4] There is evidence that FX derivatives markets have become significantly larger and more liquid in emerging Asia since the crisis.[5]

A third factor I would like to mention is the *ability of non-residents to borrow in the local currency to fund investments*. This also affects the attractiveness of local currency bonds: the

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3 Bank for International Settlements, "Local currency bond markets and the Asian Bond Fund 2 Initiative", report to EMEAP, July 2011.

4 See G Allayannis, G Brown and L Klapper, "Capital structure and financial risk: evidence from foreign debt use in Asia", *Journal of Finance*, December 2003.

5 See D Mihaljek and F Packer, "Derivatives in emerging markets", *BIS Quarterly Review,* December 2010.

more readily available is local credit for foreign investors, the lower the funding costs and hence the higher the returns for them.

Here again, we have seen some progress in Asia since the introduction of ABF2. In Malaysia, in 2007, the authorities abolished the limit for overdraft facilities extended by authorised dealers to non-resident stockbrokers or custodian banks for the settlement of the purchase of listed securities. In the same year, they also eliminated registration requirements on ringgit-denominated loans to non-residents.

So, to sum up, many barriers to non-participant investors have been lowered in Asian markets, and the ABF2 project has played an important catalytic role. That said, of course, work inevitably remains to be done.

So much for the benefits; what about potential costs? We must admit that the elimination of barriers to cross-border investment – even if it may be beneficial to local bond market development – can at times run counter to the policymakers' mandate of stabilising the financial system and macroeconomy when capital inflows are large and volatile. These trade-offs are very real. As a result, policymakers in the region have chosen on occasion to discourage foreign portfolio investment inflows.

In October last year, for example, responding to a surge of capital inflows and significant upward pressure on the currency, Thailand re-established the withholding tax on capital gains and interest payments for government bonds. For similar reasons, in January this year, Korea re-imposed a withholding tax on foreign investors' receipts on government bonds and monetary stabilisation bonds.

While I do not deny the risks of excessive capital inflows, my view is that capital controls should only ever be the last line of defence against the threats posed by gross financial flows to monetary and financial stability. When mitigating the risks of financial flows, macroeconomic policies – including monetary, fiscal and exchange rate policies – should get first consideration, followed by policies to strengthen prudential frameworks and the financial infrastructure. Deepening financial markets can, in the long run, help to widen the range of practical policy choices.

Let me conclude by coming back to the Spanish experience. The specific point of my earlier allusion was that the process of making the Spanish government debt market more congenial to foreign investors helped us to remove impediments and to raise our game in terms of infrastructure. As I noted, foreign investors boosted liquidity particularly at the long end of the yield curve, highlighting the need for Spain to develop its own long-term investing institutions.

Well, an update of the Spanish experience will sound a note of caution. And it will further underline the importance of developing your own long-term investing institutions. Non-resident investors are no heroes – they play by their own rules. As such investors have become less certain of what Spanish policymakers are doing, they have sold down their holdings. Market discipline is more a binary flip-flop than a continuous process.

I draw two lessons from this experience. First, policymakers must never let down their guard in the face of easy financing from the rest of the world, even when government accounts seem to be in good shape. To avoid adverse developments, policymakers should do their utmost to build up fiscal and bank capital buffers in good times. And second, it is important to maintain a balance in the development of your markets. When push comes to shove, it is the strength of your own institutional investors that carries the day.