

**“Developing an Asian Bond Market as a Means for Regional
Financial Cooperation”**

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by

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1. Introduction:

Asia's 3.2 billion people are half of the world's population. The region is in abundance of natural resources, and accounts for one fourth of the world's exports and GDP. In addition, East Asia, in particular, continues to realize current account surpluses and to pile up large domestic savings relative to national investments. The region has to date already accumulated a stock of official international reserves as large as US\$ 2 trillion or around 65% of the world's total of US\$ 3 trillion reserves. The total amount of Asia's financial resource is only part of a huge volume and diversity of wealth owned by the region. The resource reflects the tremendous potential available for furthering the growth and stability of the countries in the region if properly managed and utilized.

The huge resource of Asia in terms of foreign reserves, for the most part, is invested in other regions. This financial resource has traditionally been invested principally in the US\$ denominated assets, especially the US Treasury bills and bonds, owing perhaps to a limited choice of alternative and equally good or better investment instruments and vehicles within a liquid and well functioning capital market. It is therefore ironic that, while the region enjoys an abundance of international liquidity, its own capital intensive development projects of both the public and private sectors continue to be left in dire need of financing and much of the capital goods that are produced in many industrialized parts of Asia have been exported to help build up productive capacity of other regions of the world.

Lessons learnt from the 1997-1998 Asian financial crisis and its devastating economic aftermath show that individual countries' foreign reserves alone could not deal with the abrupt and sudden consequence of large and volatile short-term international capital reversals. In the words of Thailand's Prime Minister, Dr. Thaksin Shinawatra, " such flows that had been inflicted on us were the result of people using, manipulating, and managing our own capital, very much against our

own interests.” In seeking ways to rejuvenate regional growth, deflect another possible Asian financial crisis, and return Asia to the days of prosperity by combining the regional strengths for mutual benefits, a mechanism to prevent the abuse of Asia’s own savings should be created. In this context, Dr. Thaksin asks whether it is “time for Asia to explore the setting up of an Asian bond market to facilitate and trade in a new financial instrument to help maximize the continent’s potential and prevent exploitation of Asia’s savings and foreign reserves by others against its own best interests.” Asian bonds can play an important role as a financial option for both the public and private sectors within and outside Asia. The Asian bond concept is not so much aimed at reducing reliance on the US dollar, but rather at strengthening the economic and financial stability of the region. The idea of establishing an Asian bond market is intended as a means of keeping capital within Asia. A regional bond market would help pool information and serve as a center for investors, thereby helping to boost the development of Asia’s financial and capital markets.

Thailand had in fact discussed the matter with other Asian countries.

Dr. Somkid Jatusripitak, the Minister of Finance, referred to the idea of introducing Asian bonds during an official visit to Japan in August 2002. Moreover, during the fourth Asia-Europe Meeting in Copenhagen, Denmark, in September 2002, the leadership of the EU and Asia agreed to work towards a closer ASEM economic partnership by setting up an action-oriented task force to study a potential linkage between the Asian bond and Euro-bond markets. In his keynote speech advocating Asian economic cooperation and self-reliance under the “New Asian Realism,”

Dr. Thaksin was calling for an early implementation of the Asian bond market at the opening of the East Asia Economic Summit 2002 Meeting organized by the World Economic Forum on October 6 of the same year in Kuala Lumpur, Malaysia. Since then many leaders of Asia have concurred and actively support the Asian bond concept. The important task of adopting and creating a new financial architecture for Asia in the globalized economy should therefore no longer be left to anyone else but Asians themselves.

2. What are not the Asian bonds?:

What Dr. Thaksin calls for is certainly not the promotion of the traditional bonds that are already in existence and are nothing new—namely, international bonds that are denominated in the US\$ or the Euro. Rather, he is calling for the promotion of an Asian bond market that would provide an alternative source of funding and of monetary control across countries in Asia.

Let us begin by asking what are not Asian bonds? Most likely they are traditional bonds which have the following characteristics:

- (2.1) Yankee bonds: US\$ denominated bonds issued by Non-US governments or corporations, sold and traded globally, especially in the USA, Europe and Asia. Dealers in money center cities such as New York, London, Frankfurt, Hong Kong and Singapore make market on these bonds to provide liquidity for international investors.
- (2.2) Euro-bonds: Euro denominated bonds issued by Non-European governments or corporations, sold and traded internationally.
- (2.3) National currency or local bonds: national currency denominated bonds issued by that country's government or corporations, sold and traded almost exclusively in the issuing country. For example, any batch of Thai baht denominated government bonds would fall into this category. However, the Thai authorities do not prohibit non-resident investors from buying or trading in Thai-baht denominated government or corporate bonds. Therefore, foreign investors can theoretically buy and own these bonds. The fact of the matter is that few

foreign investors invest in these local currency bonds due to a number of impediments such as imposition of withholding tax

on interest and capital gains income, foreign exchange control, lack of liquidity in the secondary market, and unfamiliarity with the exchange rate, credit and transfer risks across countries. The US\$ denominated Treasury bonds issued by the US Treasury and other quasi-statutory bodies, sold and traded initially many years ago among the US investors also belong to this category of local currency bonds. Legal and tax rule changes which predated the creation of the euro-dollar market (1970's) based initially in London have removed many impediments and made the US Treasury bonds a darling of central banks and long-term institutional investors of the world.

Why do central banks and financial authorities of Asia who hold 2 out of 3 trillion US\$ of the world's international reserves put most of their reserves (80-95%) into US\$ denominated Treasury bills and bonds while many Asian countries need money to finance their own development projects?

Can leadership of Asian countries coordinate and initiate a new capital market infrastructure to mobilize and reallocate financial resources for their own needs and mutual benefits?

Can the Asian bond concept be developed and implemented by Asian governments and private institutions to answer many of the post-1997 pressing questions of the Asian financial cooperation?

3. What are the Asian bonds?:

The Asian bonds are obviously not Yankee or Euro bonds but might have some characteristics and attributes of these bonds. Such characteristics are likely to be as follows:

- (3.1) The Asian bonds represent medium or long term promises to pay interest and principal (IOUs) **denominated in national Asian currencies** of the governments or corporations domiciled in Asia.
- (3.2) To be true Asian bonds, these local currency denominated bonds must be **bought and traded actively in the secondary markets across Asia** and in the world.
- (3.3) The national currency denominated individual bonds from many countries and/or issuers can be mutualized or securitized into a new synthetic debt instrument called the **“Asian bond fund or ABF,”** the beneficiary units of which can be sold and traded separately as derivative bond products called the bond funds.

The Asian bond funds referred to above, e.g. a basket of government bonds denominated in the Japanese yen, the Chinese yuan, the Korean won, the Singapore dollar, the HK dollar, the Malaysian ringgit, the Thai baht etc. in some proportions, can be sold and traded as a variation of the Asian bonds with a good diversification property for long-term investors such as national pension funds from high saving but narrowly based and small country with little or no fiscal deficit to be financed by local government bonds such as Singapore or Brunei. Since the synthetic Asian bond funds have intrinsic, multi-dimensional credit and foreign exchange risks of the issuers (governments or corporations) and national currencies in which the individual bonds are denominated, the securitization process enables the packager to reduce the multi-dimensional risks into a more manageable overall portfolio risk with **self-diversifying property**. This is a critical role of the financial market makers, either monetary authorities or private sector specialists, who perform risk assessment, underwriting and marketing functions in the regional and international bonds market.

On the demand side of the Asian bond market, the regional countries might choose to earmark, say, a proportion of their long-term foreign exchange reserves to purchase the Asian bonds or the Asian bond funds. Such investments would not only serve as a catalyst for the regional demand for the Asian bond funds, but also create derived demands for the individual national bonds from non-central bank institutional investors seeking diversification and better risk-return profiles for their long-term investment portfolios. Apart from averaging the coupon rates on the individual local currency bonds that represent components of the Asian bond basket, either prepackaged and sold by capital market professionals or being blended on a tailor-made basis by very sophisticated fund managers themselves, a self-diversifying property of the basket would render the overall risk level of the bond basket lower than those of the individual component bonds themselves. This particular property is thus a major source of **value-added** for the Asian bond funds. The self-diversifying property can be quantitatively verified and its extent assessed using the portfolio approach of mean-variance analysis of expected return and risk.

Currency risk management could become even more potent if **specific rules of foreign exchange rates coordination** were to be agreed upon and abided by the monetary authorities of Asia under a regional currency plan, one of the long-term goals of the financial authorities of ASEAN+3. One example of such regional agreement is, for a selected number of countries who are at a similar stage of financial development and trade actively in real goods and services (tourism included) with each other and are willing to work together on a voluntary basis, for each of the participating countries to target its currency value (e.g. the Singapore dollar or the Thai baht) relative to the value of its active trading partners (e.g. the Japanese yen or the Chinese yuan as well as other major outside the region currencies such as the US\$ or the Euro) and intervenes in the FX market to obtain the overall target of its currency value along the line of maintaining its exchange rate stable on the basis of the nominal effective exchange rate (NEER) or the real effective exchange rate (REER) principle. Under such a circumstance which might still be years away, the overall currency risk of the Asian bond basket packaged in a similar proportion to the currency basket can be further reduced for the bond investors. Obviously, the desirable proportions of the component bonds/currencies that are to be put into the

synthetic basket will have to be proposed, discussed and agreed upon by the participating monetary and financial authorities of Asia.

4. Infrastructural Support for the Asian Bonds:

First and foremost among the structural **impediments** that stand in the way of active Asian bond market development is the imposition of **withholding tax** on interest and capital gains income for non-resident investors in the local currency denominated bonds. At present only Japan, Hong Kong, and Singapore impose no withholding tax while Thailand is in the process of removing such a tax for non-resident investors by the end of 2004. The ASEAN+3 ministers of finance have asked Thailand during the 2004 ADB Annual Meeting in Korea to study this withholding tax issue and it is hoped that the comparative study for all Asian countries including India and Pakistan will be tabled for consideration by the finance ministers during the next ADB Annual Meeting in June 2005. As this is obviously the policy oriented study, it is anticipated that some actions from other countries besides Thailand will be forthcoming before the final study is presented.

Second on the list and often related to the withholding tax issue for the Asian countries that employ the concept of “qualifying foreign institutional investors” is the **exchange control restriction** limiting the magnitude and type of foreign capital inflows. As more countries accumulate FX reserves and introduce regulations related to the offsetting “qualifying domestic institutional investors” to allow their long-term investors to invest abroad, a more consistent framework to allow two-way investment flows among Asian countries will become a norm and the strict exchange control rules and regulations will give way to a more liberal but yet closely monitored capital account system for desirable investments such as the Asian bonds under a more flexible exchange rate regime.

Credit rating of the Asian bonds for cross-border investments is another often mentioned reason (excuse?) for institutional investors from Asia not to invest in the government bonds of other Asian countries. The cited reason is inability to evaluate “credit risk” of the bond issuers. But given the fact that many investors

from the same country invest in common stocks of the other country which carry much higher credit and FX risks but promise higher returns, the real reason must be **unfamiliarity with FX risk** for relatively stable and nominally low yield products such as the local currency denominated bonds. Unfortunately and sadly for Asia, none of the international rating agencies (including those from Japan) has a quantitative model or methodology to assess FX risks for each Asian currency (e.g. the Japanese yen) relative to other Asian currencies (e.g. the Singapore dollar or the Thai baht). How to evaluate FX risk and provide hedging mechanism for such risk arising out of cross-border investments in the Asian bonds for institutional investors including the Asian central banks remains perhaps the most challenging issue to be tackled by stakeholders in the demand, supply, and market making sides of the Asian bond development initiative.

5. Conclusion:

The potentially high rate of return with acceptable risk in anticipation of a secular decline in value of the US\$ relative to the Asian currencies due to huge and unsustainable current account deficits of the USA has made the Asian bonds attractive in the eyes of institutional investors in Asia and for that matter in the world. As more investors gradually diversify their investments away from the US\$ assets, alternative assets to the traditional instruments such as the US Treasury bonds are already on the radar screen of many sophisticated investors and national reserve managers, some of which are in Asia. For the regional monetary authorities who are likely to be the initial and catalytic group of Asian bond investors, stimulating this new market would also represent a means to enhance regional financial self-help and support beyond the short-term liquidity providing Chiang Mai Initiative. Developing the Asian bond market under the challenges of globalism and regionalism would contribute towards the building of a more stable and integrated Asian financial system for long-term investments and financings that is capable of withstanding crisis-inducing external shocks in the future. The economic pains and social sufferings after the 1997 financial crisis should not have a chance to come back and haunt Asia again.