Regional Cooperation in Developing Bond Markets

-harmonization and standardization of the region's bond markets-

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1. Introduction

The East Asian region has several financial centers and international capital markets that have progressed over the years. While Hong Kong and Singapore have developed small but efficient bond markets, the region's government and corporate bond markets are generally considered underdeveloped. There is a growing consensus in the region, especially after experiencing the Asian financial crisis of 1997-98, that it is indispensable to create a deep and liquid domestic bond market.[1] Japan has the largest capital market in the region, but its bond market lags behind that of the United States. Therefore, creation of a deep and liquid bond market is a common objective of all East Asian economies.

After experiencing the Asian crisis, each of the governments in the region started considering that the development of domestic bond markets was necessary. As many of the region's economies succumbed to the crisis through contagion, it became a more realistic endeavor for the governments to work together to harmonize and standardize development of the bond markets in the region. Harmonization and standardization of the domestic bond markets is a constructive process of coordination among the countries towards the same objective to build robust bond markets. This is, indeed, a form of regional financial cooperation in itself.

Harmonization and standardization of the region's bond markets require concrete actions by policy-makers, central banks and private sector participants such as issuers, investors and securities services companies. In this study on the Asian capital markets, it became clear that there were impediments to the development of the government bond market mainly in three areas, i. e. tax, legal and the clearing and settlement systems which require much work in their detailed practical and policy aspects. This paper, therefore, focuses on Japan's JGB market that illustrates many of these issues.

The paper first points out the importance of domestic bond markets, and briefly observes recent developments in Korea, Malaysia and Thailand. Then, it looks at Japan's capital markets, focusing on the Japanese government bond (JGBs) market. The JGB market has been undergoing structural reforms in recent years, but needs further improvements in, among others, taxation and the creation of a more reliable and efficient clearing and settlement system.

The region is known for its high savings ratio in terms of GDP. However, savings are not used effectively in the region due to market inefficiency. It is important to establish a mechanism to mobilize financial resources within the region rather than to be overly dependent upon the New York or London markets. Only an efficient money and capital market can serve this function. In conclusion, the paper stresses the importance of regional financial cooperation.

2. Asian financial crisis as impetus to create bond markets

Unlike the Latin American crises in the 1980s and the Mexican crisis in 1994-5, the Asian crisis of 1997-98 was not a crisis of sovereign government debts, but one involving private sector debts. The crisis revealed weaknesses in the region's financial system, in particular, the banking system and corporate governance.

The governments of crisis-hit economies injected public funds to re-capitalize banks and purchased non-performing loans through publicly owned asset management companies. However, the banking system in many of the East Asian economies has not yet recovered from the damage. Many of the region's banks, some of which are still nationalized, suffer from non-performing loans amounting to 10-30 % of their total loan portfolios. It will take more time for the banking system to recover to the pre-crisis level.

Although the region enjoys a high savings ratio, amounting to 30-40% of GDP, the bank-based system failed to channel savings effectively to the needy private sector. Private corporations relied on bank loans consisting mostly of short-term domestic or dollar funds that created maturity and currency mismatches. Such a system could not cope with a sudden reversal in the movement of capital flows, and the inherent structural weakness of the financial system was revealed. If corporate debtors were funded directly through long-term domestic corporate bond issues, they could have avoided mismatches, mitigating the damage suffered from the financial crisis.

The East Asian governments, therefore, need simultaneously to strengthen their banking system and to create a strong domestic corporate bond market. A corporate bond market will compete with, but at the same time, work as a supplement to the banking system. However, there are special features that are necessary to develop a corporate bond

market in a bank-based financing system. It is important to recognize that, in an economy where a bank-based financial system is dominant and the corporate bond market is at an early stage of development, like Japan's corporate bond market in the 60-70s, the development of the corporate bond market is dependent upon the banking system.

A corporate bond issue differs from a bank loan, because it involves a well-established issuer and a wide range of investors who agree to invest on the basis of disclosures by the issuer of its financial standing. For the bond market to function, it requires, among other things, institutional investors prepared to take corporate risks, a set of market rules, a legal framework and a proper supervisory mechanism. The level of development of these essential elements, that are necessary for the smooth operation of the corporate bond market, is still at an early stage in many of the region's economies. A United States style corporate bond market system cannot be applied directly to many of the region's markets, because it needs to be tailored to fit the region's particular feature of a bank-based financial market. As Japan's case illustrates, it is a long and energy consuming process to develop a corporate bond market.

In order to develop a corporate bond market, there is a general consensus that the government bond market must first be developed, to provide a benchmark for corporate bonds and other types of bonds and financial products. General principles and specific policy recommendations to create deep and liquid government bond markets have been presented by a number of studies including works by APEC, ADB, BIS and other institutions.[2] These studies provide useful guidelines to East Asian economies in developing their government bond markets.

3. Recent bond market reforms in Korea, Malaysia and Thailand

Government bonds

Governments in the region had generally maintained balanced budgets and the issue of government bonds had been limited. Maturities were relatively short and a smooth benchmark yield curve had not been drawn, while the secondary market was inactive. However, the governments' fiscal stimulus policies and fund-raising to inject capital to financial institutions led to rapid growth in the region's government securities markets.

Corporate bonds

The corporate bond markets in Korea, Malaysia and Thailand were generally marginal compared to bank loans. These economies traditionally gave priority to the banking system rather than the bond market and it was the banking sector that supplied the financial resources to these economies, leading to high economic growth in the post war period. In the bank-based economies including Japan, the credit worthiness of corporate bonds was strengthened either by collaterals provided by an issuer or a guarantee issued by a bank. Furthermore, a substantial proportion of bonds issued was purchased and held until maturity by banks, as if the corporate bond market were an extension of the bank loan market. The development of the corporate bond market in these economies was in fact dependent upon the banking system. It is only recently, particularly after the Asian financial crisis, that the governments started focusing on the development of the corporate bond market.

Among the three countries, equity market capitalization in terms of GDP is the highest in Malaysia and the lowest in Thailand. While bank loans play a central role in all three countries, the corporate bond market appears to contribute a substantial part of corporate finance in Korea, although it plays a distinctively smaller role in Malaysia.

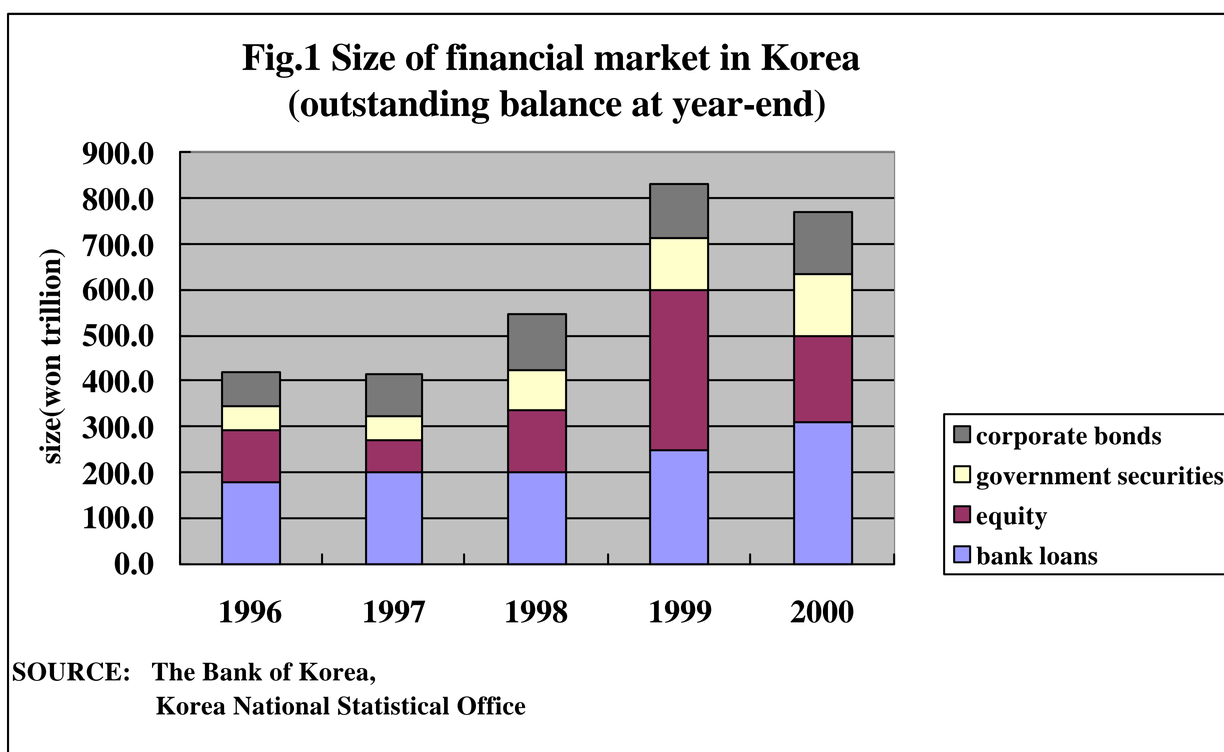
The following summarizes policy measures recently adopted by the governments to develop the government bond market.

Korea

During the Asian financial crisis, the Korean government injected huge amounts of public money into the financial sector amounting to won 130 trillion (US$103billion) since 1998. Reflecting this large outlay and also to finance the fiscal deficit, the outstanding balance of Korean government bonds (KGBs) increased from won 50.3 trillion in 1996 to won 137.6 trillion in 2000. During the same period, the outstanding balance of corporate bonds increased from won 73.1 trillion to won 133.6 trillion, while the outstanding balance of bank loans increased from won 177.2 trillion to 310.8 trillion. (Fig.1)

Immediately after the crisis, the government started to reform the market. In 1997, the

bond market was liberalized to foreign investors. In 1999, a primary dealer system was introduced. An inter-dealer market was created for KGBs and Korea Futures Exchange (KOFEX), the first derivative exchange in Korea, was also established in the same year. The government introduced many other measures in a short period of time to improve the liquidity of KGBs including diversification of maturities from 3 years to 5 to 10 years, introduction of a fungible issue system, publicizing KGB issue schedules and improving the settlement system.

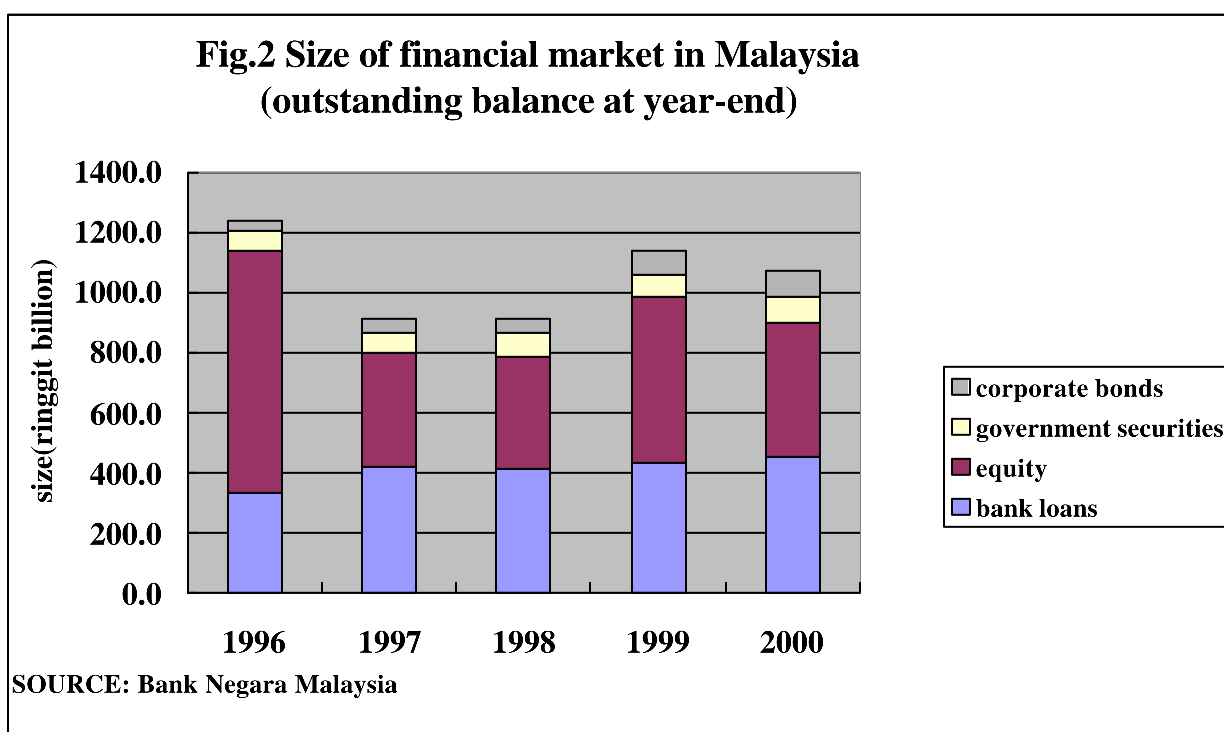


As a result of the government's strenuous efforts, the turnover of KGBs has increased dramatically in recent years and a yield curve has been drawn up to 10 years. However, KGBs are not widely distributed. At the end of March, 2001, 83% of the total outstanding amount of KGBs and public bonds was held by financial and investment trust companies, 16% by individuals and 1% by non-resident investors.

The Korean bond market, as the second largest in East Asia, needs further reforms in the area of the futures and the repo market, and the clearing and settlement system, among others.

Malaysia

The Malaysian Government has been playing a critical role in the development of its bond markets and their infrastructure. From the end of the 1980's, the government has made efforts to develop the corporate bond market, and after the Asian crisis, the government increased bond issues to fund its fiscal deficit. In 1998 the government issued the National Economic Recovery Plan, and in 2000, the Ministry of Finance announced the "Initiatives for the Development of the Ringgit Corporate Bond Market", both stressing the importance of developing bond markets.



The outstanding balance of Malaysian government securities (MGSs) increased from ringgit 66.9 billion in 1996 to ringgit 89.5 billion in 2000, and that of corporate bonds rose from ringgit 33.5 billion in 1996 to ringgit 86.0 billion in 2000. The outstanding balance of bank loans was ringgit 444.4 billion in 2000, much larger than the corporate bond market. (Fig. 2) In Malaysia, equity and bank loan markets play a dominant role while the corporate bond market is dependent upon the bank-based financial market system.

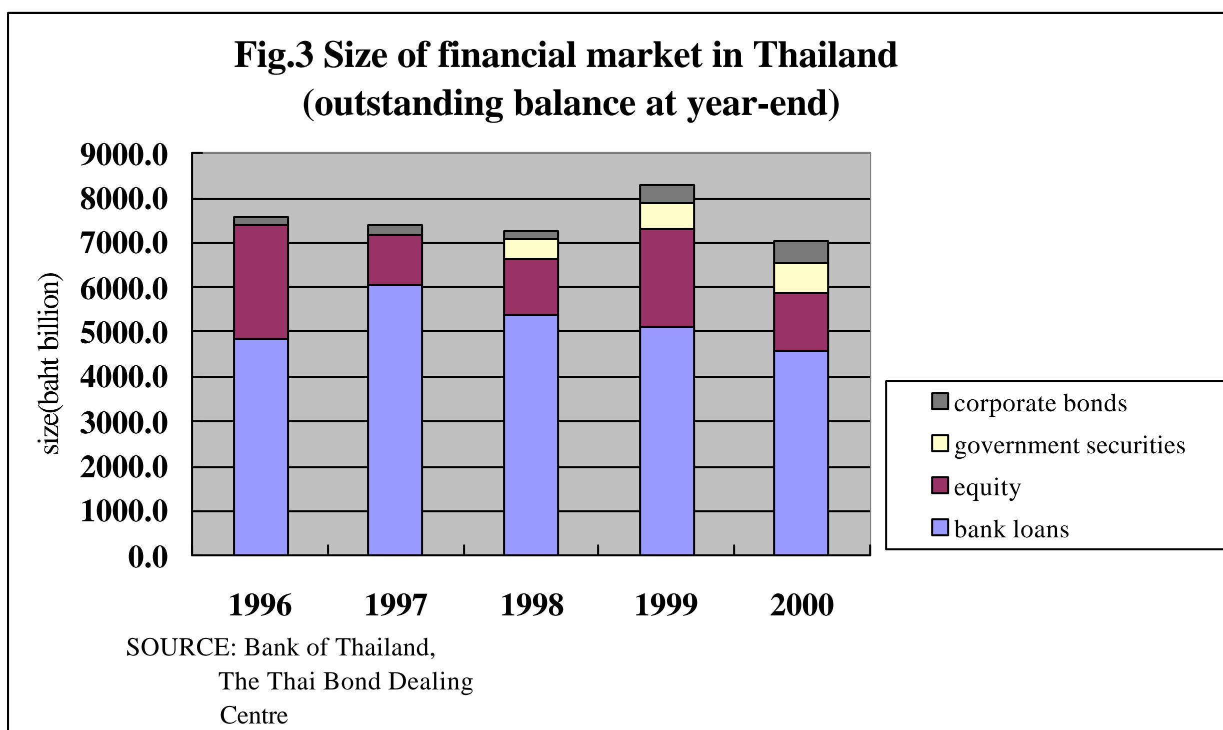
Government bonds are issued under competitive bidding among Principal Dealers. The reopening of new issues of MGSs started in 2000. The repo market is becoming active, as the Bank Negara Malaysia, the central bank, has introduced measures to activate the

market. Employee Provident Funds (EPF) is the largest investor, which has bought and held a very large portion of government bonds. Fostering retail investors will help to develop the capital market. The government released the Capital Market Master Plan in February 2001, which stipulates a grand design for the market including the bond market for the next ten years.

Thailand

After the Asian financial crisis, the Government resumed the issuance of treasury bonds in 1998 to finance its budget deficit and to inject capital into the ailing financial institutions. The bond market in Thailand started to develop significantly, and the outstanding amount of government securities went up from baht 13.8 billion in 1997 to baht 658.7 billion in 2000. The outstanding amount of corporate bonds also increased from baht 182.4 billion in 1996 to baht 501.2 billion in 2000.

The outstanding balance of bank loans was baht 4,586 billion in 2000, still much larger than the bond markets. (Fig. 3)



The Thai government has made efforts to reform the bond markets. With the help of

favorable market conditions, the government was able to issue bonds as long as 10 years. The procedure to issue government bonds has improved and the Bank of Thailand is also working to cultivate the repo markets.

There are still many issues that should be addressed in the Thai bond markets. For example, the Specific Business Tax, which levies 3.3% tax on all interest received on a gross basis, is too expensive. The clearing and settlement system for government bonds should also be improved significantly.

4. Japan's bank-based financial system and corporate bond market

Japanese, like most East Asians, are great savers. Household financial assets reached yen 1,390 trillion by the end of 2000. Japan's household financial assets are equal to one third of United States household assets, and the second largest in the world. Fifty-two percent of total household financial assets are placed in bank deposits and postal savings and 28% in insurance and pension funds. Investments in securities including investment trusts, amount to only 9% (4.8% in equities, 2.4% in investment trusts and 1.9% in bonds). In the past 10 years (from the end of March 1990 to March 2000), net household financial assets increased by yen 407 trillion, which was almost entirely channeled to bank deposits, postal savings and institutional investors, while net investment in securities has even been declining. Banks, post office and institutional investors placed at least 60 % of yen 407 trillion in central and local government bonds. Therefore, a huge amount of public sector debt is indeed funded by household savings in Japan. By contrast, in the United States, net household financial assets increased by $21 trillion in the past 10 years, half of which went to equity investments either directly or indirectly.

The rate of return on household savings is the lowest among the G7 countries, reflecting the low return in Japan's financial system as a whole. The most serious economic issue Japan now faces, is how to manage savings in a more effective manner to produce higher returns.

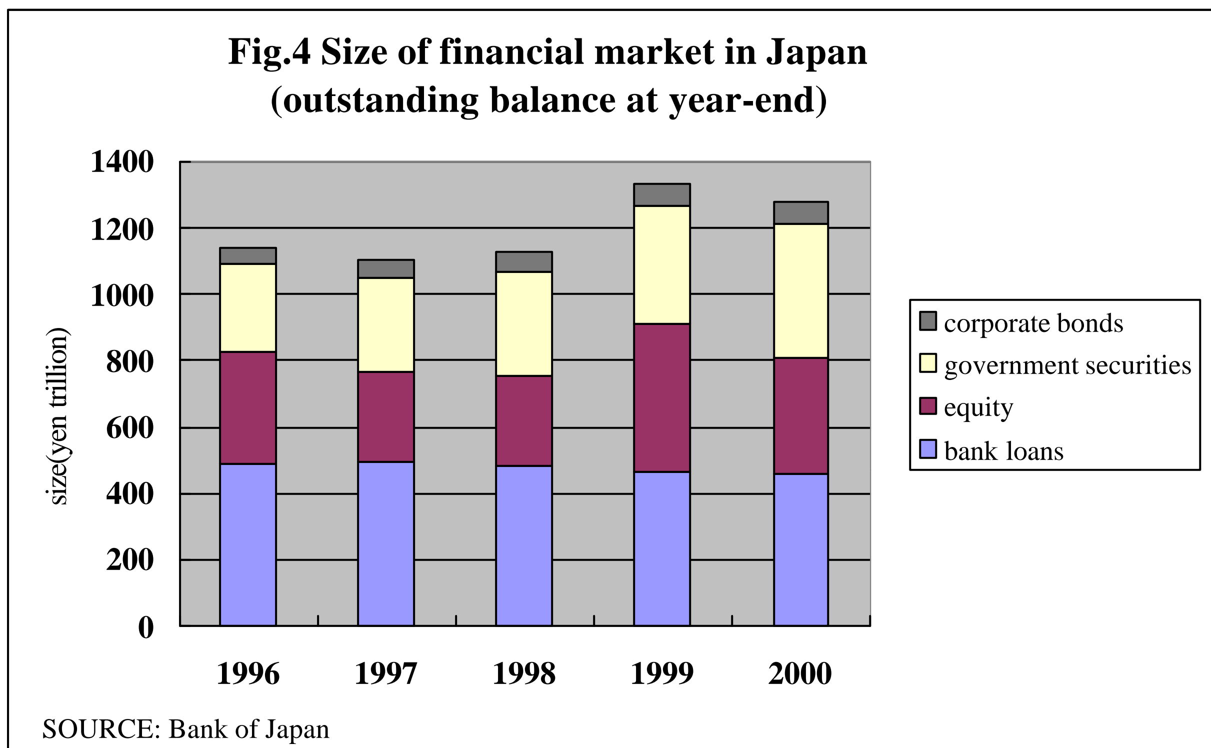


Fig.4 Size of financial market in Japan (outstanding balance at year-end)

SOURCE: Bank of Japan

Corporate bond market

The total amount of outstanding corporate bonds in Japan was yen 54.0 trillion at the end of March 2001, representing 10.5% of GDP and 11.8% of bank loans. (Fig. 4) Funding through corporate bond issues i.e. a market-based financing system is still considered to be marginal compared to funding by bank loans. Although the need to shift from a bank-based financing system to a market-based financing system has been recognized for several decades, and many patched reforms have been implemented in the past, the bank-based financing system remains basically unchanged. The characteristic of a bank-based financial system, with a less efficient corporate bond market, is similar to many of the region's economies, such as Korea, Malaysia and Thailand.

Until 1975, the corporate bond market was heavily regulated. Interest rates were kept below market rates to supply cheap money to corporate debtors, resulting in a strong demand for corporate bond issues. Bonds were issued on a collateral basis that was managed by a trustee company.[3] The Bond Issuing Committee controlled the new issue market by selecting bond issuers. In that committee, the trustee (a bank) had a greater

voice than the underwriting securities companies and acted as de facto underwriters absorbing the bulk of new issues on their account. The bank-supported corporate bond system and bank loans were the main stream for channeling savings to the industry.

Some liberalization measures were introduced towards the end of the 1970's, permitting, for instance, unsecured corporate bond issues. However, well-established Japanese corporations preferred to issue their bonds in the much freer Euro or Yankee bond market. Several reforms were introduced in the 1980s, including relaxation of market eligibility standards, establishment of domestic rating agencies, and the beginning of market making of corporate bonds. After 1995, further steps were taken to liberalize the corporate bond market, including the abolishment of market eligibility standards in 1996.

In the history of the corporate bond market in Japan, banks played a major role at the early stages of development. However, as the corporate bond market developed, banks continued to act as buy and hold investors and failed to contribute towards developing a more flexible and market-oriented market. As a result, the banks' presence in the market adversely affected the development of both the primary and secondary corporate bond markets.

5. Government bond issues

The government started actively issuing JGBs from the middle of the 1970s, and since then, the outstanding balance of JGBs steadily increased. In the 1980s, the increase in the balance of JGBs was modest, reflecting strong economic performance. Entering into the 1990s, however, economic performance became sluggish as the asset bubble burst. To cope with the situation, the government adopted fiscal stimulus measures rather than promoting structural reforms and the issue of JGBs accelerated. In the past 10 years, the government adopted fiscal stimulus measures ten times, allocating a total amount of yen 136 trillion to projects such as public works. As a result, the outstanding amount of JGBs, which was yen 162 trillion at the end of August 1990, increased to yen 368 trillion by the end of FY2000.

Despite the government's huge fiscal outlay, the economy remained generally sluggish over the past ten years, achieving an annual growth rate of only 1.3%. In fact, the government poured in public money to help private companies in sectors such as public

works where labor productivity was low. Furthermore, as a by-product, government measures induced corporations and individuals to rely on the government's fiscal outlay to cope with the sluggish economy. The period has been called the lost decade for Japan, like the lost decade of the Latin American countries in the 1980s. The Koizumi administration took office in April this year and is vigorously pursuing structural reforms of the economy. The administration is focusing on cleaning up banks' non-performing loans, and it is determined to restrict its reliance on JGB issues for deficit financing.

The Japanese government's total debt (national and local) will amount to a staggering yen 666 trillion (nearly 128.5% of GDP) at the end of FY 2001, of which yen 368 trillion is currently funded by government bond issues. The JGB market became the largest in the world, surpassing the outstanding amount of United States government securities which represent 55 % of U.S.GDP. The total amount of JGBs issued in fiscal 2001 will amount to yen 100 trillion, consisting of yen 30 trillion for new issues and yen 70 trillion for refinancing. It is expected that the refinance portion will increase by yen 10 trillion annually, and that the outstanding amount of JGBs will continue to increase at least for several years to come. The government's main goal is to manage the JGB market more efficiently, cutting costs by streamlining JGB market operations, and increasing market liquidity. It must cope with pressing issues such as a possible down grading of JGBs and an increase in long-term interest rates.

The bulk of JGBs are held by Japanese household investors, through financial intermediaries. The share held by non-resident investors is a mere 5.1 % as of the end of June 2001. In the case of United States and United Kingdom government securities, non-resident investors held 35 % of the total at the end of March 1999 and 20 % at the end of March 2000, respectively.

6. Recent reforms of the government bond market

When the government started issuing JGBs in a major way in the middle of the 1970s, the JGB market was operating in an environment where interest rates were artificially controlled by the authorities. Ten-year JGBs were underwritten and held by a syndicate dominated by banks. JGBs so underwritten were systematically sold after one year to the Bank of Japan. The 10-year JGBs were effectively one year instruments for underwriting banks and were not traded in the secondary market, although they were

listed on the exchanges. In Japan there was an interest rate hierarchy, on top of which were JGBs (lowest yield). Yields of other bonds like government-guaranteed bonds, municipal bonds, bank debentures and corporate bonds were determined in accordance with their deemed credit standings, following the JGB yield. As interest rates applicable to JGBs were artificially determined at a level lower than market rates and other types of bonds were also artificially priced, Japan's primary and secondary bond markets were, therefore, not operating on a market base.

Interest rate liberalization started in 1985, but it was not until 1993 that artificially controlled interest rates were finally abolished. Since then, overnight inter-bank rates have provided a base rate for short-term interest rates and JGBs started reflecting real market prices.

The government and market participants recognized that JGB market practices were obsolete in the competitive world market. In view of ever increasing JGB issues, and the need to streamline the JGB market, the authorities intensified their efforts to reform the market. It was only three years ago that reforms of the JGB market started in a major way.

The government's recent reforms of the JGB market include the following:

Primary market reforms

(1) Enhancing short-term government bill issues

In April 1999, competitive price auctions were introduced for Financing Bills (FBs) issues, and original issue discounts for Treasury Bills (TBs) and FBs were exempted from withholding tax. The amount of short-term bills issued reached yen 81 trillion in March 2001 from yen 47 trillion in March 1999. Since then, the Bank of Japan has been using the short-term government bill market for open market operations.

(2) Diversified maturities

Before 1990, the government mainly issued 10-year maturity bonds. Entering into the 1990s the government started to diversify maturities to 2, 3 and 6 years, and in 1999, the government began to issue bonds with 30-year maturity. From February 2000, the government started to issue 5-year coupon-bearing bonds to serve as medium-term benchmark issues. Traditionally, 5-year government bonds were not issued because that

length of maturity was allocated for bank debenture issues, which used to be the major source of long-term funds for long-term credit banks. With the failure of two out of the three long- term credit banks in 1998, the government decided to issue 5-year bonds. Thus, coupon-bearing JGBs now have maturities of 2, 4, 5, 6, 10, 15 (floating-rate bonds), 20 and 30 years, making it possible to draw a yield curve for JGBs.

(3) Reopening rules

From March 2001, the government started implementing immediate reopening rules for new issues. While an additional issue used to be combined with the original issue only after the initial interest payment, under the new rules any additional JGB is considered as part of the original issue by adjusting the amount of the initial interest payment, at the time of issuance.

(4) Better communication with the market

Since March 1999, the auction schedules and amount of JGBs issued are announced in advance. The quarterly funding schedule is announced in the month prior to that quarter. This arrangement makes it easier for participants to foresee market movements. In September 2000, the Meeting on Japanese Government Bond Market, including representatives from 12 major market makers and academics, was established. The Meeting is held once a month, serving as a forum to enhance communication between the government and market participants. [4]

Secondary market reforms

(1) Taxation

In 1999, the securities transaction tax was abolished. In September 1999, to promote non-resident holdings of JGBs, interest from interest-bearing government bonds was exempted from withholding tax for non-residents and foreign corporations under certain conditions. However, withholding tax was still applied for those non-resident investors who invested in JGBs through "global custodians". From April 2001, taxation was amended further to the effect that withholding tax exemption was also granted to interest on JGBs deposited by non-resident investors in the Bank of Japan book-entry system through foreign financial institutions (including "global custodians") that are approved by the Bank of Japan and National Tax Administration as qualified foreign intermediaries.

(2) Securities lending and repo market

The JGB futures market started in 1985. However, the repo market was still under-developed, hindering arbitrage between cash and the futures market. The securities transaction tax was also an obstacle to the development of the repo market. In order to avoid paying the securities transaction tax, bond traders started using the bond lending market in 1989. Bond lending was either on an unsecured or secured basis. Before 1995, a major part of bond lending was made as unsecured lending without cash collateral. In February 1995, Baring Brothers was in danger of failing to return bonds it had borrowed on an unsecured basis. Market participants felt it was necessary to make bond lending on a secured basis. In January 1996, lower limits on interest chargeable on cash collateral, which had hindered market development, was lifted. Since then, the bond lending market has developed quickly and the outstanding balance of bond lending amounted to yen 49 trillion as of June 2001.

As a result of these reform measures, the market improved to such a degree that a smooth and reliable yield curve for JGBs up to 20 years has been drawn, serving as a benchmark in pricing other securities and derivatives. Bond traders claim that the bid-ask spread has narrowed and that the JGB market has become a liquid market. Bond traders say they are ready to quote a firm price over yen 50 billion to 100 billion for most maturities. Previously there was limited liquidity for off-the-run issues, but now there is not much difference in yield between benchmark issues and off-issues. The JGB market has already become one of the most liquid markets in the world and further reforms will enable more sophisticated market operations. The JGB market may eventually serve as a base for other domestic and international bond markets.

Further measures need to be introduced

The reform measures taken by the government so far have had positive effects on the JGB market. However, even after the introduction of withholding tax exemption, there has not been a marked increase in investment by non-residents, partly because of complicated approval procedures. Practices common to the United States Treasury market have not yet been fully introduced in the JGB market.

(1) Repo transactions

The repo market, which is the market for cash collateralized securities lending transactions, is different from the United States repo market, although it fulfills the

same function. One obstacle to the development of repo transactions in Japan was the securities transaction tax, which was finally removed in March 1999. The Bank of Japan and the private sector are currently developing a new repurchase agreement mechanism, that is expected to be introduced sometime next year. The new mechanism basically follows the global standards of repo transactions, shifting from the current cash collateralized repo mechanism, providing risk management, legal framework and convenience to the participants.

The reforms are expected to contribute to the further development of the repo market. The new market will become a core market not only as a repo market, but also as a short-term money market. The Bank of Japan is now considering the use of the new repo market for its open market operations, starting sometime in 2002[5].

(2) Introduction of STRIPS

Currently, coupon stripping is not allowed in Japan, which is the only country among the G7 that has not adopted the Separate Trading of Registered Interest and Principal of Securities (STRIPS) program. One of the reasons why Japan has not issued STRIPS is because a reliable clearing and settlement system has not yet been established for JGBs. Another reason is that withholding tax treatment of STRIPS has not been decided yet. In the United States, the Treasury introduced STRIPS in 1985 for designated Treasury securities and now STRIPS comprises 23% of total United States government securities, contributing to the liquidity of the treasury market. The Japanese government is planning to start issuing STRIPS some time next year, to provide the market with zero coupon bonds.

(3) Auctions and the primary dealer system

Towards the end of the 1980s, Japan started to introduce a competitive public auction system for JGBs with all maturities except for those with 10-year maturity. The benchmark 10-year JGBs are currently underwritten by two methods; 60% of an issue is underwritten through a partial competitive auction, and the remaining 40% is underwritten by a syndicate currently consisting of 1409 members at a price equal to the average paid in the competitive auction. The comprehensive public auction system ought to be applied to JGBs with 10-year maturity, while a primary dealer system should be introduced to increase liquidity and narrow the spread between bid-and-ask prices.

7. JGB distribution

The outstanding amount of JGBs at the end of June this year was yen 424 trillion at the current price. As of the end of March 2001, the public sector and banks held 32.5% and 27.8% of the total respectively, whereas corporate and non-resident investors held only 0.3% and 5.1% respectively. The breakdown is very different from the United States government securities, where the public sector and banks held only 7.6% and 5.1% respectively, whereas corporate and non-residents held 1.0% and 35.0% respectively as of March 1999. The JGBs' over-dependence on banks is a cause of particular concern, because banks tend to behave in a similar manner. If, for some reason, banks decide to sell JGBs simultaneously, it would sharply push long-term interest rates up, creating a serious debt management problem.

The low level of holdings by non-resident investors demonstrates the fact that JGBs have not tapped the pool of global capital that is another cause of concern. Promotion of sales to non-resident investors is a major challenge and from that point of view the following issues must be tackled. First, confidence in Japan's macro economic policy measures must be restored. Second, less complex procedures are necessary, while non-resident investors should be exempt from withholding tax on JGBs. Third, the clearing and settlement system should be improved promptly. Fourth, an efficient money market and yen bond market should be established to allow non-resident investors to invest in short and long-term yen funds. For this purpose, short-term money and government securities markets such as CDs and CPs need to be improved.

8. Samurai market

The international bond market in Tokyo (Samurai market) was created in the early 1970's with the issuance of the first Asian Development Bank yen bond in 1970 and the first World Bank yen bond in 1971. Creation of the Samurai market was welcomed by market participants because it would not only create new business for them, but more importantly because it would help to liberalize the rigidly regulated primary and secondary bond markets in Japan.

While the Samurai market functions as one of the important international markets, its contribution to the liberalization of domestic bond markets has been limited. The Samurai market basically followed the practices of the domestic market which was less

efficient than the euro yen bond market. As a result, well-established high-rated issuers such as International Financial Institutions (IFIs) prefer the euroyen market to the Samurai market, due to its cost efficiency. The Samurai market should be designed to become accessible to both sovereign and corporate borrowers in Asia, to become competitive with the euroyen and other international bond markets.

The Samurai market could be improved by:
(1) introducing English as an official language in filing registration forms (currently only Japanese is permitted),
(2) making registration effective immediately after filing by an issuer (currently 15 calendar days are needed before an issue is launched),
(3) exempting non-resident investors from withholding tax.

9. Further reforms of the government bond market

Several reforms have taken place, but there are still two large obstacles to the sound development of a liquid JGB market. One is the lack of a suitable taxation regime and the other is the absence of a reliable clearing and settlement system.

Taxation

The liquidity of the JGB market is still hindered by the complicated withholding tax system applicable to Japanese investors. Withholding tax on coupon payments of JGBs is treated differently according to types of investors. For example, financial institutions or religious organizations are exempted from withholding tax, but private corporations and individuals are subject to 20% withholding tax on coupon income. Non-uniform treatment of withholding tax is a source of confusion. If one takes into account the two different tax treatments of JGB investors in three different forms (physical bonds, registered bonds and book-entry bonds), then there are theoretically six different types of JGBs traded in Japan. This system impedes JGBs' market liquidity. However, it should not be difficult to change the three different forms of JGBs to a book-entry system, since physical bonds and registered bonds represented only 0.4% and 1.0% of outstanding bonds respectively as of the end of August this year.

In February this year, a proposal was made by the Meeting on Japanese Government Bond Market to simplify the tax system and to improve the settlement system. In

September, as a response to the proposal, the Ministry of Finance disclosed a list of recommendations it has made to the Tax Reform Program of Fiscal Year 2002 which include the following:

(1) Withholding tax exemption to be extended to non-corporate type non-resident investors.
(2) Withholding tax exemption of repo transactions for non-resident investors.
(3) Appropriate taxation for STRIPS issues to be introduced in the near future.
(4) Exemption of private corporations from withholding tax.

It is not certain that the proposed tax reforms will become effective, but it is generally considered that the tax reforms are essential for the smooth distribution of the huge amount of JGB issues.

A clearing and settlement system

	Japan	USA	UK	Germany	France
Form	◆ Book-entry ◆ Registration ◆ Physical Bond	◆ Book-entry	◆ Book-entry	◆ Book-entry	◆ Book-entry
Settlement Date	T+3	T+1	T+1	T+2	T+3
Physical Bond	Still in use	Until 1983	Until 1987	Until 1972	Until 1984
Netting	No Netting	GSCC 1995	LCH 1999	No Netting	Clearnet 1998

In Japan, there are different clearing and settlement systems for JGBs, CPs, CDs, corporate bonds, convertible bonds and equities. This lack of uniformity is a source of inefficiency and high operating risks in settlement.

In the case of JGBs, the three different forms of bonds with different tax treatment cannot be dealt with in the same settlement system and this causes JGBs to be scattered into different methods. In January this year, the Bank of Japan introduced a Real Time Gross Settlement System(RTGS) for JGB settlements. The introduction of the RTGS is significant because it reduces systemic risks involved in the designated-time settlement system. The RTGS is now an internationally accepted norm for bond settlements, recommended by the BIS and the International Organization of Settlement Commission (IOSCO), and many countries have introduced the RTGS in the last 10 years.

Unlike the United States, where all government securities are settled through delivery versus payment (DVP), JGBs are partially settled through DVP. JGBs are also not eligible for clearing houses such as Euroclear and Clearstream, mainly due to tax reasons. In spite of the recent changes in taxation, problems in withholding tax for non-residents remain to be solved. Furthermore, the clearing systems in Tokyo are not linked to other regional clearing systems like Hong Kong, Singapore and Sydney.

In order to develop a fully functional JGB market, an efficient clearing and settlement system needs to be created, streamlining the settlement process and minimizing settlement risks. For this purpose the following proposals were also made together with tax proposals in February 2001:
(1) The integration of three different forms (physical bonds, registered bonds and book-entry bonds) of JGB issues to book-entry bonds.
(2) Creation of a netting system.
(3) Promotion of T+1 (one day after trade date settlement) and Straight Through Processing (STP).
(4) Promotion of cross-border transactions.

The increasing volume of market trading requires an efficient clearing system for the development of the market. In developing such a system, the private sector should play a more important role than in the past. The creation of a netting system or the promotion of STP, for instance, is possible only with the active involvement of the private sector. At the same time, fails should be accepted more broadly in Japan. Fails are now common in the inter-dealer market, but many customers still reject fails. Such an attitude prevents smooth settlement and a broader acceptance of fails should be promoted both by the private and public sectors.

If the reforms of the tax system and the improvements in the clearing and settlement systems are carried out as planned, the JGB market will become deep and liquid, increasing convenience for both resident and non-resident investors.

10. Lessons from the Japanese government bond markets

There are many lessons to be learned from the history of the Japanese corporate and government bond markets. The following summarizes some of those lessons:
(1) The liberalization of interest rates should be made in a timely manner. In Japan, the

government and the central bank did not discard traditional measures for controlling interest rate structures. An artificially controlled interest rate mechanism created distortions in the market for a long time in the post-war period, in effect, slowing down the development of the capital market.

(2) The government undertook serious reforms of the JGB market only after the outstanding amount of total government debts exceeded GDP. The JGB reform process should have started much earlier.

(3) The legal system, including various regulations, administrative guidance and tax system are major impediments to the reform process of the bond market.

(4) Strict division of business between banks and securities companies, in particular securities underwriting, created a less competitive environment in the securities business and often blocked reforms. Furthermore, Japan adopted a specialized banking system, which created an uncompetitive environment with a tendency to preserve the old system, hindering the process of capital market reforms.

Japan's "Big Bang", the financial reform of 1997, eliminated these old business separation rules between banks and securities companies. For example, a securities subsidiary of a bank now engages in stock brokering business, while banks may sell mutual funds at their branches and their investment management companies offer 401 K pension funds to clients. Full implementation of pay-offs from next April will also reduce financial intermediation. Full liberalization in Japan will help channel Japanese household savings to equity or bond products with higher returns.

11. Regional cooperation

Although each of the region's governments is responsible for the creation of a robust domestic bond market, regional cooperation will greatly assist and enhance the process. First, through cooperation, countries in the region can share practical knowledge and experience. Second, the countries can develop cross-border transactions, promoting freer flows of capital in the region. Third, policy dialogue among the governments can provide peer pressure, assistance, and impetus to reform their economies. These processes are in fact regional efforts towards coordinating the governments' policies on bond market development.

Liquid bond markets would improve resource allocation by effectively channeling both local and foreign savings into domestic investments, diversifying investment channels

for both retail and institutional investors. While each of the regional economies works towards building a liquid bond market, cross-border arrangements such as cross-exchange listing, cross-border bond transactions, intra regional repo transactions and infrastructure development of a regional clearing and settlement system will promote regional integration. Such cooperation, if successful, could pave the way to further steps such as the creation of a regional currency mechanism or currency union in the future.

Compared to Europe and North America, the East Asian region is known to be rather indifferent to and does not have a history of strong regional cooperation. In the aftermath of the Asian financial crisis, however, the countries realized the importance of regional cooperation.

In May last year, at Chiang Mai in Thailand, an agreement called the Chiang Mai Initiative, was reached among the ten ASEAN countries plus Japan, China and South Korea (ASEAN+3), aiming to promote regional monetary cooperation to deal better with future financial crises. Key aspects of the initiative were, first, to reach bilateral swap agreements among ASEAN+3, and second, to strengthen policy dialogue among them, such as in monitoring short-term capital flows. Since then, several bilateral swap agreements have been reached and it is expected that the total amount of bilateral swaps may reach a substantial amount, exceeding US$30 billion in a few years' time, symbolic of regional monetary cooperation. On the other hand, arrangements on policy dialogue among ASEAN + 3 countries have not materialized yet.

It is not easy to reach an agreement on policy dialogue, partly because several East Asian countries find themselves unprepared to accept surveillance of their policies. However, policy dialogue, such as on monitoring of short-term capital flows, is indispensable to deepen regional cooperation and to avoid future financial crises, and the countries involved should strive to create a more coordinated system.

Many East Asian economies have been undergoing major structural reforms since the Asian financial crisis took place. China carried out major structural reforms prior to its entry to the WTO, and will continue, or even accelerate, the reform process after joining the WTO. Japan, too, has been pursuing reforms under the Koizumi administration. Such efforts towards structural reform can be expedited through regional cooperation.

Starting January 1, 2002, the EU will have a full-fledged unified currency system among 12 of the member countries. The EU member countries underwent a long structural reform process in the past several decades. They set forth targets of macro economic frameworks by agreeing on arrangements like the EMS in 1979 and the Maastricht Treaty in 1991. In order to achieve structural reforms, European countries cooperated among themselves, and peer pressure among them worked effectively to achieve common goals.

In October 1999, an interesting document called the "Giovannini Group" report titled "EU Repo Market: Opportunities For Change" was published. Chairman Giovannini was appointed by the European Commission to chair a study by a group of financial market experts on the repo market. The Chairman commented that "there are many areas where the introduction of a single currency alone cannot be sufficient to induce the degree of integration and efficiency of financial markets that is needed for the development of the European economy. -------- The repo market is a perfect illustration of this problem. Repo markets are important both for the conduct of the single monetary policy and for the efficient use of collateral in the private sector. Yet, in Europe there are essentially 15 separate repo markets." The financial experts "uncovered a very wide range of problems. Cross-border transactions suffer from an unhelpful degree of legal uncertainty. Different tax treatments help keep the market divided. The infrastructure to deliver and settle trades is not well connected."

Even the EU, which has arrived at a single currency, still faces such a wide range of legal, tax and infrastructure problems in its capital markets. The real challenge facing East Asian countries is whether they have the courage to tackle these problems now or delay them to the future. The answer is that they should start now.

Although the level of development of each market differs among the countries, there are many issues which are shared in the region and which could be tackled jointly among the members.

(1) Benchmark bonds and risk-free yield curves
The countries in the region are expanding bond offers by providing various maturities and are now succeeding in strengthening the yield curve. It is important to continue this effort.
(2) Primary dealer system and competitive auction rules

Many Asian countries now apply competitive bidding for new issues. This effort should be strengthened, while the introduction of an effective primary dealer system would help to enhance market liquidity.
(3) Futures and repo markets
Well functioning futures and repo markets are indispensable for the development of efficient capital markets. The countries should provide a firm base for the sound growth of these markets, including improvement of legal, tax and system support.
(4) Tax treatment
An obsolete tax system prevents capital markets from growing soundly. The tax system should be reviewed and overhauled throughout the region for this purpose.
(5) The lack of an efficient and unified settlement system

Singapore and Hong Kong, which have already undertaken major reforms, are ahead of other Asian countries. However, other countries, including Japan, are still lagging behind the US and Europe. Concerted effort in the region will help to speed up reforms.

To promote cooperation in developing regional bond markets, it is necessary to maintain frequent interaction among East Asian members through a suitable regional forum. Several regional forums have been established, including APEC, the Manila Framework, ASEAN+3 and so on, some of which have been created after the Asian financial crisis. Among them, ASEAN+3, which meets regularly, including a high level official meeting to promote regional cooperation, should be suitable for this purpose. The Manila Framework is a unique forum, developing policy dialogue in the region and dealing with regional surveillance. Group includes the North America and Oceania countries, and therefore is expected to contribute a global viewpoint to regional arrangements such as ASEAN+3. The participants in these meetings are from the public sector. Capital market development cannot be promoted in the absence of the private sector, but there are few opportunities for the public and private sectors to interact and discuss important subjects such as bond market development. A group of private sector experts, like Mr. Giovannini's group, should start working on the bond market to come up with a set of recommendations for the public sector.

The membership of such a group should be flexible and open-ended. Participation by market experts from Australia and New Zealand would contribute to the discussions, not only because these Oceania countries are in close proximity to East Asia, but also because they maintain close economic ties with the region.

12. Conclusion

In conclusion, three points should be highlighted: First, each of the East Asian countries should give priority to developing the government bond market. A liquid government bond market will serve the economy by providing a benchmark in pricing for the money market, other fixed income bond markets and derivative transactions.

Second, it is inevitable that the corporate bond market needs to be supported by the banking system in many of the region's economies, at least until the corporate bond market develops to a certain level. The challenge to many East Asian economies, therefore, is to have a robust banking system to effectively channel savings to the corporate sector through the corporate bond market. As Japan's experience tells us, however, a bank-based system will tend to preserve, often very strongly, old rules and practices that often become the main obstacles to change in the system. The governments and parties concerned need to eliminate such obstacles so as to attain a higher degree of efficiency, while maintaining a harmonious, but competitive relationship between different types of financial institutions.

Third, since there are already several money centers and international capital markets in the region, ways and means to develop intra-regional transaction through these money centers should be studied. It is encouraging that such movements have already taken place, for instance, in the clearing and settlement system between the Australian and Singapore exchanges. It is also interesting to note that Japan and Singapore will shortly enter into a free trade agreement that may include a linkage between the two stock exchanges whereby the investors of both countries can trade shares listed on the two exchanges directly through their own brokers. This will simplify cross-border investment transactions and reduce costs. The region will become increasingly integrated, while its economies will compete with each other at the same time. This process should accelerate structural reforms and provide greater efficiency, which will enable the regional economies to be more competitive in international markets.

While Japan strives to further improve its capital market and the market infrastructure, it should play, as an economy that represents two third of the region's GDP, a leading role in regional cooperation that will contribute to the development of the domestic and regional bond markets.

Endnotes

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[1] S. Ghon Rhee, *Rising to Asia's Challenge: Enhanced Role of Capital Markets,* 1999. Rhee made a comprehensive study on the Asian capital markets and offered a wide-range of policy recommendations.

[2] Ibid.

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[3] Japanese Securities Research Institute, *Securities Market in Japan 2001,* 2000.

[4] Tomita, Toshiki, *Nihon Kokusai no Kenkyuu,* 2001. Tomita describes how the Meeting works. Recently Ministry of Finance Japan started to show English translation of the minutes on their homepage: http://www.mof.go.jp/english/bonds/minutes.htm

[5] Bank of Japan, *Gensaki Torihiki no Seibi Kakujyu ni Muketa Ugoki ni tsuite,* 2001.