2002.12.15.(No.7, 2002)

Newsletter

Institute for International Monetary Affairs
財団法人 国際通貨研究所

A Call to Develop a Regional Bond Market in East Asia

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－Summary－

Developing a regional bond market is an urgent requirement for East Asia and it is now a pressing agenda to take concrete measures to facilitate such bond issuance. There are still many factors which hinder the development of domestic bond markets, and a regional bond market would have a double value. It would be beneficial in its own right and it would also stimulate the growth of domestic bond markets. Issuance of bonds denominated in the ACU (Asian Currency Unit) by top rated issuers should be seriously promoted in parallel with the strengthening of regional monetary cooperation.

1. Introduction

In recent years, there have been intense discussions on regional financial cooperation in East Asia. At the same time, market participants from both the public and the private sectors agree that investment and fund-raising should be done in the region and should be matched within the region. It would be a suitable and appropriate time for us, therefore, to consider seriously the development of a regional bond market in East Asia. A regional bond market is defined here as a bond market where fund-raising and investment are conducted on a cross-border basis within East Asia.

(1) Experience of dragon bonds

A regional bond market is not a new idea in East Asia as we had *dragon bonds* in the early 1990s. *Dragon bonds* are those bonds launched in the NIES markets, syndicated in the Asian time zone, distributed in East Asia and listed in Hong Kong, Singapore etc.[1] Most dragon bonds were issued in US dollars.

The Asian Development Bank showed considerable understanding in the development of the regional bond market at the time and the ADB itself issued bonds in several local bond markets in East Asia, starting with Hong Kong[2]. As the ADB was a triple-A rated issuer, its bonds were quite popular among investors and the ADB's example was followed by a series of top-rated issuers such as the international and regional financial institutions in Europe and the U.S.

However, there was quite fierce competition between the Euro bond market, the Yankee bond market and the dragon bond market over the US dollar denominated bonds. Top-rated issuers compared those markets when they consider raising funds. As the cost of issuance for a specific bond issuer is basically the same throughout the world, the dragon bond market became a kind of a shadow market of the other major markets. Furthermore, a *Global Bond* scheme with a single bond being issued simultaneously in London, New York and Tokyo also became popular. Under these circumstances, the competitiveness of a dragon bond was further eroded.

(2) Domestic bond market

The situation was different, however, for domestic bond markets denominated in local currencies. Issuers with high credit ratings did contribute to the growth of domestic bond markets to a greater extent. Hong Kong is at the top of the list of economies where *dragon bonds* did stimulate the growth of bond markets.

Hong Kong bond markets matured significantly in the early 1990s. The Hong Kong Government started to issue 3 and 6 month Exchange Fund Bills in 1990. A benchmark yield curve was formulated up to as long as 10 years and the repo market grew as well. The corporate bond market developed following the CD market, and individual investors began to show interest in bonds as well.

Singapore also started to develop its bond markets aggressively since 1999. The government bond market as well as the corporate bond market expanded within a short period of time.

Domestic bond markets in the region, however, were under some constraints. In particular, the tenure and the amount of the bonds were limited. As the relevant local bond markets were underdeveloped, the decisive factor in a launch was how aggressively investors would participate. Regulations concerning the bond issuance and foreign exchange regulations were also major obstacles.

When an issuer needed to raise US dollars, it initially issued bonds in a domestic bond market and swapped the proceeds in the local currency into US dollars by engaging in a medium-to-long term currency swap. The final cost in US dollar was really the decisive

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1 The first dragon bond was the USD 300mio issue by the Asian Development Bank in November 1991. It was a 7 year issue, led by Wardley (predecessor of HSBC Markets), Development Bank of Singapore, and China Trust Company, Taipei. It was listed in Hong Kong, Singapore and Taipei. It was cleared through Euroclear and Cedel. The author does not have comprehensive material on dragon bonds, but inquiry through newspapers shows the following issuers: GECC, KFW, Ford Motor Credit, Volvo Group Treasury Asia etc.

2 The first Hong Kong dollar bond issued by the Asian Development Bank was a HK$ 500mio issue of April 1992, with the tenure of 7 years. This attracted attention, as it was the first Hong Kong dollar issue whose maturity fell beyond July 1997, when Hong Kong would return to PRC.

factor in issuing bonds in a local currency.

As the medium currency swap market was able to provide relatively stable terms and conditions for actual currency swap business, the cost depended mainly on how aggressively investors would try to lower the target investment rate and what cost the borrowers would be ready to pay, both in the domestic currency[3].

The market-making capacity of financial institutions and securities companies was also limited and there was a constraint on the liquidity of the market.

Dragon bonds in domestic currencies were issued in Korea and Taiwan as well as in Hong Kong. Here the key factors were whether the issuers could observe the foreign exchange and taxation regulations.

There were various limitations on the issuance of bonds in home currencies in domestic markets, but contributions, however limited, that such issues made to the growth of the domestic bond markets should be appreciated. The experience also provides valuable lessons for the regional bond market in East Asia.

2. East Asia and the Currency Crisis

Before the Asian currency crisis, attention had been given to the pressing need for infrastructure development in East Asia. The figure of more than 1 trillion US dollar funding on an accumulated basis over several decades had been mentioned with the extraordinarily bullish expectations for the possible speed of economic development in the region.

The outbreak of the Asian currency crisis changed the atmosphere completely. Some of the corporate bonds issued by companies in the region faced difficulties, and most of the conservative investors became ultra-conservative and declined to take additional portfolio originating in the region.

On the other hand, what is called a double mismatch, namely the mismatch of the currency and maturity of the funding, was understood to be one of the causes of the Asian currency crisis. After this bitter experience, the importance of having a regional bond market was widely recognized. As there were low expectations for stock investment due to the low growth and low inflation after the crisis, investing in bonds became quite popular among domestic investors including individual investors. Serious efforts were made to develop the government bills/bonds market, as it was necessary for the formation of benchmark yield curves and for the efficient conduct of monetary operations by the monetary authorities.

Senior officials in Hong Kong, such as Joseph Yam of the Hong Kong Monetary Authority and Donald Tsang, then the Financial Secretary, repeatedly stressed the necessity of a regional bond market. Yeo Lian Sim of the Monetary Authority of Singapore referred to the need for the region to take collective actions. The importance of creating the cross-border bond market was promoted through these comments.

It was also around this time that the monetary authorities in East Asia intensified relevant studies on this matter, and Compendium of Sound Practices,[4] compiled by APEC,

3 The issuance of bonds by the ADB in some of the home currencies in East Asia did play a certain role in stimulating the domestic primary market, but not all the parties concerned were satisfied. For example, one market participant pointed out to me that the pricing was so competitive that some underwriters and investors had to cut their margins. This experience had some negative effects on the bond issues that followed, according to him. It was quite natural, however, for the issuer to focus on the level of cost for him when raising funds and he should not be blamed for neglecting the purpose of developing the domestic bond market.

4 APEC Collaborative Initiative on Development of Domestic Bond Markets (1999), Compendium of Sound Practices, Guidelines to Facilitate the Development of Domestic Bond Markets in APEC Member Economies.

was finalized as the result of cooperation among the authorities concerned in the region. There was participation from the private sector as well. The immediate focus of the study, however, was on the domestic bond market of each economy.

3. Points to Discuss for a Regional Bond Market

Why do we need a regional bond market in addition to the domestic bond market in each economy?

First, a regional bond market can complement the local bond markets in terms of both fund-raising and investment. Although all the domestic markets grew considerably especially after the currency crisis, the size of the bond markets is small compared with the size of bank loans. How far the investor base grew differed from economy to economy. The role of each local bond market will continue to be limited for a certain length of time.

Some currencies in the region are managed rather conservatively by the monetary authorities as they are afraid that if these currencies became too liquid there would be a spillover into offshore markets which would lead to the outbreak of a currency crisis when speculators got hold of those funds. It may not be easy for a regional bond market denominated in these currencies to make progress in the immediate future in East Asia.

In the case of Singapore, non-residents cannot issue bonds in Singapore dollars except to make foreign direct investment there, as it is obligatory to swap the proceeds in Singapore dollars into another currency. In the course of the liberalization of the bond market, the rules on "non-internationalization of Singapore dollar" were relaxed considerably but the principle of the regulation itself remains intact.

In the case of Hong Kong, there was no written regulation on the issuance of Hong Kong dollar bonds. However, since around 1998 the authorities have been requesting certain international financial institutions not to issue bonds shorter than three years and not to issue bonds with floating rates even if their tenure is longer than three years. Market participants have been requesting the authorities to abolish these pressures so that domestic bond markets could be developed, but the guidance seems to be still in force.

In the case of Korea, the foreign exchange liberalization plan was finalized in January 2001, but the maximum amount that non-residents could raise in Korean won, presumably by borrowing from financial institutions, was raised from 100 million won only to 1 billion won[5].

As we have seen the role that each domestic bond market and each currency can play in the region is limited. A regional bond market could complement their role.

Second, the development of each local bond market could be further enhanced if a regional bond market were to be created. Regulations and taxation with regard to bond issuance should be streamlined and harmonized among the member economies of the region in the near future, and a regional bond market could work as an impetus for such an effort. If a regional bond could be issued in the existing financial centers of the region, it could

5 The medium to long-term development plan for the foreign exchange market was released in April, 2002. The plan indicates that the amount non-residents are able to borrow will be expanded in the first stage (2002-2005), borrowing in won will be shifted from a licensing system to a reporting system in the second stage (2006-2008), and borrowing of won by non-residents will continue to be under a reporting system in the third stage (2009-2011). We have to watch if the borrowing limit will be further expanded in the first stage. Anyhow, we can conclude from the plan that the restrictive stance to the borrowing of won by non-residents will continue.

work as a positive model that would encourage each growing bond market to mature further.

Furthermore, harmonization of regulation and taxation, development of clearing and settlement, credit rating and credit enhancement have been pointed out as the issues to be solved in the region. People of East Asia did not maintain faith in the credit rating agencies in the U.S. and Europe and there were several attempts in East Asia to set up its own credit rating agency after the crisis[6].

4. Proposal for an ACU Denominated Bond Market in East Asia

I would like to propose that an ACU denominated bond market should be established as follows. US dollar or Japanese yen-denominated bonds could be considered, but the ACU would stimulate the integration and development of financial markets in East Asia.

(1) Bonds would be denominated in an artificially created currency, namely the ACU (Asian Currency Unit). Its composition should be a simple one such as the US dollar 60, Euro 20, and Yen 20.

Institute for International Monetary Affairs recently conducted a study on the trade flows in the region and proposed a step by step approach as a means to introduce a common currency basket in East Asia[7]. The ACU would be a basket currency, artificially created

Table1: Simulation of the composition currency of ACU

Exports of ASEAN+2 to other regions (1999～2001)

	Japan	NAFTA	EU	other regions
1999	17.6%	34.3%	23.4%	24.8%
2000	18.7%	34.0%	22.3%	24.9%
2001	18.8%	34.7%	22.1%	24.5%
Average	18%	34%	23%	25%
Average after adjustment 1	18%	59%	23%	—

Imports of ASEAN+2 from other regions (1999～2001)

	Japan	NAFTA	EU	other regions
1999	27.0%	22.6%	18.2%	32.2%
2000	26.5%	20.1%	16.5%	36.9%
2001	24.5%	19.4%	17.8%	38.2%
Average	26%	21%	17%	36%
Average after adjustment 1	26%	57%	17%	—

	Japan	NAFTA	EU
Average 2	22%	58%	20%

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	yen	US dollar	euro
Share of the component currencies in the ACU	2	6	2

(source: Direction of Trade Statistics IMF)

In calculating the "average after adjustment 1", the share of other regions was added to NAFTA. The other regions include the oil exporting countries in the Middle East.

As there are very few countries that publish the currency components for trade transactions, there is no other way than to make some presumption on the trade data as has been done here.

Average 2 was the average of the exports and imports of "average after adjustment". For example, Japan 22% was the average of 18% in Exports of ASEAN+2 to other regions, and 26% in imports of ASEAN+2 from other regions.

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6 ACRAA (Association of Credit Rating Agencies in Asia) was established in 2001 as a cooperative organization linking 15 credit rating agencies in Asia and tried to promote best practice in addition to the education on securitization etc.

7 See Junichi Mori, Naoyoshi Kinukawa, Hideki Nukaya and Masashi Hashimoto (2002) Integration of the East Asian Economies and a Step by Step Approach towards a Currency Basket Regime, a paper presented at International Conference of the Japan Economic Policy Association on November 30, 2002.

with US dollar: 60, euro: 20 and yen: 20. We analyzed the share of trade of East Asian economies with the U.S., Europe and Japan. When calculating the weighted average share of the region, we presumed that trade with the rest of the world should be included in trade with NAFTA, denominated in US dollars. The figures in "Table 1: Simulation of the composition currency of the ACU" are based on this analysis. I believe this is one of the best conceivable compositions. The outstanding characteristic of this basket is that the weight of these three currencies are quite clear-cut as is depicted in the share of 60, 20 and 20. It will be necessary to reconsider the components and their weights when moving from individual currency baskets to a common currency basket.

The creation of the ACU would be based on the assumption that when the economies in the region decide to adopt a common currency basket, as the next step after an individual currency basket, the ACU could be transformed to include renminbi, won and other currencies in addition to the Japanese yen. How far the currencies in the region could be included in the basket at the time would depend on how widely the currencies were used and traded in offshore markets.

(2) Top-tier regional issuers, such as the Asian Development Bank, would be expected to issue ACU bonds.

If a regional issuer with top-tier credit rating issued a bond, investors in East Asia would find it quite attractive. It would also lead to the formation of a benchmark yield curve of ACU-denominated bonds.

The Asian Development Bank would be the most suitable issuer but other major sovereign issuers and high-rated corporations in East Asia would be expected to issue bonds[8].

(3) CMU (Central Moneymarkets Unit) in Hong Kong could play the role of central securities depository (CSD).

Hong Kong has been working the hardest to establish the intra-regional clearing and settlement system of securities in East Asia. CMU was established in 1990. DvP for US dollar securities became available in 2000 with Hong Kong Shanghai Banking Corporation as the agent. Inclusion of the euro and the yen into DvP is possible.

The idea of Asia Clear appeared around the same time as the birth of the dragon bond, but there was no concrete follow-up. Although it was necessary for Hong Kong to develop the infrastructure of its financial markets as a regional financial center, it should be noted that its way of linking CSDs on a bilateral basis is pointing to the creation of an intra-regional clearing and settlement system[9].

The mechanism of clearing and settlement for securities was also formulated in Japan, but it will take some time before the new CSD begins to work including for corporate bonds. If that is the case, we should consider making use of the CMU in Hong Kong for securities denominated in the ACU. Once the preparation was completed in Japan, it could

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8 How much investors in the region prefer the issuers to be in the region is one of the important points to consider. In this regard, bond issues in Singapore by Cheung Kong Finance Cayman (S$300 million, 7 year) and Toyota Motor Credit should be noted. Also some Korean issuers with the equivalent of sovereign status were well received in the Samurai market in Japan.

9 Hong Kong Monetary Authority (1997), Bilateral Linkage of Central Securities Depositories, *HKMA Quarterly Bulletin, November 1997.*

be linked with Hong Kong.

(4) Bonds could be listed on the Tokyo Stock Exchange, SGX, Hong Kong Exchange and Sydney Stock Exchange at the same time.

Listing on plural exchanges in the region would be something similar to the way dragon bonds were issued. This would be a sign of plural exchanges in the region working together. Individual investors would be able to get the daily price easily. If the procedure of listing was too cumbersome at one of the exchanges, improvements should be considered seriously. Listing on the Sydney Exchange should be considered as well[10].

5. Remaining Issues

Initially both issuers and investors in the ACU bonds would find difficulty in hedging. They would not be able to hedge foreign exchange risks and interest rate risks with a single instrument, and would have to divide the risks into instruments in the dollar, euro and yen. However, if the composition of the ACU was simple, it should basically be possible to apportion the risks. And as time passes, interest rate swap and currency swap markets with similar tenures as the remaining period of the ACU bonds will grow up gradually. As

Table 2: Idea of a step by step approach towards a currency basket

			Time	
Individual Currency Basket (First Stage)	First Phase	Some economies in East Asia takes up individual currency basket system.		
	Second Phase	Most economies in East Asia move to individual currency basket system.		ACU is created and its usage starts. Asia Clear is established and ACU-denominated bonds are issued.
Common Currency Basket (Second Stage)	First Phase	Common currency basket composed of US dollar, yen and euro is adopted.		Discussion of moving towards a currency union becomes popular.
	Second Phase	There is a shift to a common currency basket composed of East Asian currencies (yen, renminbi, won etc.).		Foreign exchange regulations on East Asian currencies including non-internationalization of home currencies are completely abolished.

・Two stages (individual currency basket→common currency basket) will be taken. Each stage has two phases.
・Moving to individual currency basket system is relatively easy even now, except for those economies with a currency board system. Individual currency baskets are also compatible with the inflation targeting system, which was introduced in a number of economies.
・Individual currency baskets with simple composition make it possible for economies to monitor external competitiveness while avoiding the difficulty of understanding it.
・The second phase of the first stage, when the discussion for common currency basket becomes popular, is considered to be a key oppportunity for ACU-denominated bonds to be issued and Asia Clear to be established.

issue a bond denominated in the ACU.

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10 Australia has been playing an important role in the financial cooperation in East Asia. Australia is important also in the sense that they have a developed infrastructure of financial markets and that they have a deep investor base. How to treat the Australian dollar in the currency basket is another issue to be considered.

issuers, investors and other market participants get accustomed to the ACU, effective handling of ACU bonds would be possible.

In this regard, the timing of the issuance of ACU bonds is very important（See“Table 2: Idea of a step by step approach towards a currency basket”）. The best arrangement would be for an ACU bond to be issued at the same time as the start of a common currency basket in the region. Issuance at an earlier stage would be possible, however, and may well make sense. If an ACU bond is issued around the time when the monetary authorities are discussing a currency basket seriously and concretely, the issuance might lead to the build-up of a momentum to use the ACU, helped by the intense discussion that would be taking place at that time. It is possible that one of the economies that have adopted an individual currency basket system officially might issue a bond denominated in the ACU.

At this stage, economies in the region should seriously discuss the components of the common currency basket, the ACU. To be simple and to be credible would be quite important. A review on the pattern of trade flows and capital flows would be necessary as well. If ACU bonds were issued one after another, the ACU would be able to gain some popularity.

Participation by the private sector in the development of the regional bond market is very important in this sense. They would, of course, find it beneficial to participate in the regional bond market once they found the market quite matured and business opportunities concrete. It is important, nevertheless, that they contribute to the development of the infrastructure beforehand and in view of the huge potential for the business opportunities in the future, they can be expected to do so. A kind of Giovanni Commission in East Asia could be developed in the near future, and the role that Japanese practitioners could be expected to play is quite significant.

（This paper was published in“International Finance Journal No.1097”issued by the Institute of Foreign Exchange and Trade Research in December 15, 2002）

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