

**The Context for Bond Market
Development in the Asia-Pacific**

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ABSTRACT

This paper considers the broad context within which bond market development in the Asia Pacific is taking place. The focus is upon common patterns and themes of local bond market development in the main emerging economies which are members of APEC. The key driver in bond market development has been the sustained, unsurpassed rates of real GDP growth over the past 50 years in the Asia Pacific, achieved through fundamentally similar forces. Financial development generally has not led economic development, but has occurred with, or in many cases lagged behind, it. Financial systems, particularly in East Asia, have been bank oriented; the development of securities markets, and especially bond markets, has been slower. Bond markets require high standards for access to information, disclosure, transparency, credit analysis and ratings, and effectively regulated markets. The current emphasis on local bond markets reflects the recognition, following Mexican and Asian financial crises, that economies need both to strengthen and deepen their financial systems and to enable bond finance to play a more significant role. East Asian bond market development programs can contribute to better regional financial cooperation. This will be open, not closed regionalism since, as bond markets epitomize, regional finance will develop within the context of global financial markets.

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I am honored and pleased to speak today as we begin this program on bond market development in the Asia-Pacific. I look forward to the presentations, commentary, and open discussion in the three sessions – the development of emerging local currency bond markets in the Asia-Pacific region, the business opportunities these developments provide, and the role of trans-Pacific collaboration in a bond market development.

The task I have set myself is to provide the broad context within which bond market development in the Asia Pacific is occurring today. I will say relatively little about the bond markets themselves, since that is the purpose of the program. What I have to say is no doubt well known by you, but it sometimes is useful to remind ourselves of important if obvious truths.

My context has several overlapping dimensions: degree of development, geography, history, and the current policy environment. I will focus particularly on the emerging, developing economies of the Asia Pacific, on their patterns of financial development and on corporate as well as government bond market development. I use the term economies rather than countries since both Hong Kong and Taiwan are important economic and financial players and I want to avoid political issues.

A well-developed financial system embodies deep and broad markets for a wide range of financial instruments, with prices set through competitive bidding. It requires a pro-market prudential regulatory system, disclosure, transparency, honesty of course, and objective evaluation of credit risk for creditors, including arm-length rating agencies, securities analysts, and knowledgeable bankers. The emerging Asia-Pacific economies have yet to fully achieve these standards, but most are making good progress, albeit from rather low levels.

For our purposes I define Asia-Pacific as the 21 members of APEC. Only a few members – advanced economies – have well developed financial markets and bond markets. After that, it is a matter of degree. As you know, APEC is the most heterogeneous grouping in the world – culturally, racially, linguistically, in population size, and in political, economic and social systems, much less in degrees of economic and financial development. Indeed this is the case when we consider specifically the East Asian members of APEC – the Southeast Asian members, China, Japan, South Korea, Taiwan and Hong Kong. Each economy has its own specific, distinctive features and characteristics. However I will generalize to emphasize common patterns and themes for all the economies, or for relevant subgroups of them. As a practical matter, I exclude the very small, less developed Asia-Pacific economies, including several APEC members and the several Southeast Asian non-members, as well as Russia even though it is an APEC member.

The Asia-Pacific has been and is an extraordinarily useful political concept. APEC is the only governmental economic institution that links East Asia and the United States, and includes Australia, New Zealand, Taiwan, Canada and the Latin American Pacific nations. However, APEC is unwieldy, given both its large number of members and divergences of preferred approaches to trade liberalization. While the APEC Finance Ministers meet separately, they have not yet generated an APEC leadership in Asia-Pacific financial development.

We now have two East Asian regional political economy models, ASEAN +3 – China, Japan, and South Korea – and now the East Asian Summit which adds India, Australia and New Zealand to the ASEAN+ 3. ASEAN+3 has become a major leader in the still nascent efforts to develop East Asian region-wide financial cooperation. In the Western Hemisphere there are also several political economy models, though most in Latin America appropriately do not limit themselves to a Pacific Ocean constraint. The one that does is NAFTA, but essentially because it is North American rather than Pacific in geographic orientation

Economic Development: The Key Financial Development Driver

The most important single economic fact is that for the past 50 years the Asia-Pacific has achieved unsurpassed sustained rates of real GDP growth, indeed in virtually every economy, unsurpassed not only historically but relative to the rest of the world.

In long run perspective the United States, economically most advanced, has been driven in substantial part by a continuous process of invention and innovation which raise labor productivity, as well as by immigration. Japan's rapid growth early on brought it from developing country status to the economic forefront as the world's second largest economy.

The Asian NIEs – South Korea, Taiwan, Hong Kong and Singapore – were next in achieving and sustaining long run outstanding growth. They were soon followed by the rapid development of the resource – rich Southeast Asian countries. Perhaps most important has been the dynamic, indeed dramatic, economic development of China, now a major player though with a still-backward financial system. The Latin American APEC members – Mexico, Chile and Peru – have grown less conspicuously well, but certainly better than ever in their long-term history.

On the whole, the economic forces bringing about this truly impressive Asia Pacific economic development and growth have been essentially the same for all.

Perhaps the most important has been first the successful importation, assimilation and adaptation of foreign technologies, and then domestic R & D, innovation and technical upgrading, notably in Japan, South Korea and Taiwan. High investment rates have taken advantage of these profitable new technologies and the initially ample supplies of labor. Dramatic increases in household and business savings provided the resources which financed most of this investment domestically. Not only has labor shifted from low productivity agriculture to higher productivity industries, but there have also been significant improvements in the quality of labor – human capital – through increases in formal education and, importantly, learning by doing.

Governments have created positive environments in support of economic development, have given high priority to economic growth over other social objectives, have on the whole constrained inflation, and where private growth has been strong, have not engaged in expansive government spending and deficit financing. Governments have come to emphasize markets increasingly, particularly export markets with all the business disciplines they impose – the export-led economic development model. At the same time the role of the government in the economic development process has differed significantly between East Asia and Latin America.

Financial development has not led economic development, but at best has proceeded along with it. Perhaps Hong Kong and Singapore are exceptions. Indeed, quite often financial development has lagged somewhat behind the economic development of the real economy.

A second profound force in this historical perspective is the persistent, dramatic, and widespread demographic transition from high to low birth and death rates, significant increases in life expectancy, and in due course incipient population decline, as has already begun in Japan.

For most of the last 50 years in most of the emerging economies a major economic challenge has been how to absorb the huge numbers of young people newly entering the labor force. Over the next 50 years the challenge will be how to respond to the absolute declines in those of workforce age. The Asia-Pacific is in the long-run process of shifting from abundant labor and scarce capital to the reverse – abundant capital and scarce labor. That is what economic development and high standards of living are all about.

Financial Development

Why is finance so important in the development process? The answers are obvious. First, because to a significant and indeed increasing degree as development proceeds, savers and

investors are not the same units. The purpose of the financial system is to transform these savings, while protecting risk-averse savers, to those who can best invest these savings in real, productive assets – to risk-taking businesses. Second, as a corollary, rapidly growing businesses in rapidly growing economies must rely significantly on external sources of finance; even high profits are not sufficient to finance their expansion.

This transformation of savings into productive investment is easy to say, but it is not at all easy to achieve. Fundamentally, creditors, the providers of funds, have to know enough about debtors, the borrowers of those funds, to be able to ascertain pretty accurately the risks of default. That imposes huge information requirements in what is an imperfect and asymmetric information world, particularly in less-developed economies. Fortunately the law of large numbers makes it possible for creditors to pool individual risks, each with its own idiosyncratic elements, so as to make probabilistic estimates of the degree of risk. The most efficient markets are deep, broad, and competitive, based on a great deal of information.

The correlation between the level of economic development and the level of financial development of the Asia-Pacific economies is pretty high. This is not surprising, since each fuels the other. Consequently there are several tiers of financial system development, and especially of government and corporate bond market development. The higher the level of economic development, the better the financial system. However, as I have already noted, historically financial development has not led economic development; at best finance has developed along with the real economy. Quite often, and China is an outstanding case, financial development lags significantly behind economic development.

This is mainly because financial systems, particularly in East Asia, have been and still are bank oriented. The development of securities markets, particularly bond markets, has been slower. While in some cases, such as Japan, discrimination in favor of banking was a postwar government policy, in most economies banks simply have been better at obtaining information about borrowers than capital markets until the economy, and its financial markets and institutions, have become quite well developed. Capital market development has been hindered by inadequate financial and legal structures, low accounting and auditing standards,

and weak corporate governance. On the other hand, the essence of banking is repeated lending to the same borrowers, based on private access to information about the borrowers and on the development of trust – learning by doing. Bank lending is a relationship business, not a commodity business.

In virtually all emerging Asia Pacific economies, family-owned business groups are the dominant form of big business organization. In most, business groups have been allowed to own banks; South Korea is a major exception. This is relationship banking in its most extreme, opaque, cozy, and at times corrupt form.

While securities markets, particularly in their early stages of development, have also often been non-arms-length, cozy, and subject to manipulation, as they develop they have to become more open in order to appeal directly to a wider range of buyers and securities holders. This is particularly the case for bonds. It is not surprising that in the emerging economy context, bond market development has usually lagged far behind stock markets, much less behind banking.

This historical process of economic and financial development was subject to major shocks in the 1990s – the bursting of Japan’s immense stock and real estate bubbles in 1990 and 1991, the Mexico crisis, and then the 1997 – 98 Asian financial crisis.

Two of the major lessons of the Asian financial crisis for the East Asian emerging economies were, first, that each economy’s financial markets, especially its banking sector, had fundamental weaknesses that had to be addressed by major substantive reforms; and, second, that the East Asian economies should find their own ways to cooperate with each other financially since they could no longer rely upon quick, effective, and beneficial help from the IMF and the United States. While not directly affected very much by the Asian financial crisis, both Japan and China have faced the same horrendous problems of huge non-performing loans, overextended banks, and weak financial institutions. Japan had its own domestic banking crisis in 1997-1998, while China’s banking crisis is yet to come. Whenever

economies have severe banking difficulties, inevitably they spill over to the real economy, as well as contaminating all domestic financial markets.

Bond Markets

Let me make a few general comments about bond markets, especially in the Asia-Pacific emerging economy context. I consider two categories of issuers, governments and corporates, including private financial institutions; and two categories of markets, domestic and international. Local currency government debt and its term structure provide the benchmark against which corporate bonds and other fixed income assets of different creditworthiness and maturities can be measured, since domestic currency government debt is virtually free of default risk. International issues are typically in major foreign currencies, especially the dollar, through there are a few recent cases of Latin America sovereign international issues denominated in local currency. Most international bond issues by emerging economies are by governments, though a small but increasing number of investment grade corporations have been able to make international issues. International issues typically have lower interest rates than domestic rates, but are subject to exchange rate risks, and have greater risk of default than local currency issues.

As an aside, it is fascinating and in historical perspective surprising that Japan, earlier on the paragon of low reliance on budget deficits and government debt, now has by far the highest government local currency debt and bond issue relative to GDP of any Asian-Pacific economy. Moreover the interest rates on Japanese government bonds (JGBs) are extraordinarily low in nominal terms, and quite low in real terms. The basic reasons for this extraordinary situation are well known.

First of course have been the huge declines in land and share prices following the bursting of their huge bubbles in 1990 and 1991. The policy response of both the government and businesses were too slow, leading to deepening difficulties. Macroeconomic stimulus was late and somewhat erratic, unprepared to cope fully with such unprecedentedly difficult

circumstances. The government engaged in huge budget deficit stimulus, though in a series of steps that at times were too little, too late, and too temporary. The Bank of Japan lowered interest rates dramatically, with the overnight rate going down to zero. While these policies prevented a crisis, they were not sufficient to restore full employment growth and halt mild but persistent deflation.

A high national savings rate, greater than the investment rate, meant that the financial system and the economy have been awash in funds. Accordingly, despite their low interest rates, virtually all JGBs have been purchased by domestic investors as the best risk-averse financial investment in an uncertain environment. Moreover, policy has not been able to generate a desirable degree of inflationary expectations. The market yields of JGBs even today indicate that inflation is expected to be very low for the foreseeable future, 10 years or longer

While the JGB issue market increased dramatically, the Japanese corporate bond issue market and secondary market have stagnated. For 15 years corporations were not interested in borrowing; they have now successfully restored balance sheet credibility and strength by paying down debt.

It is appropriate that the following program on bond market development focuses on local currency bond markets in emerging Asia-Pacific economies, because that is where the need for financial development is especially great. Why is the development of local currency bond markets so important now? One reason is more efficient financial intermediation; corporate borrowers can obtain external funds more cheaply and with other better terms, and lenders can obtain higher yields relative to risk. A second reason is even more important; an effective bond market requires high standards for access to information, disclosure, transparency, credit analysis and ratings, effectively regulated markets, and of course the rule of law. In developing bond markets, economies must establish and maintain higher standards than in bank -based finance. A third reason is that active bond markets both transmit information about investor expectations and provide risk diversification services. Furthermore, for government and top-quality corporate bonds issued in dollars or another

major international currency, existing global capital markets – London, New York, Tokyo, Hong Kong, Singapore – are no doubt more efficient and less costly than the development of purely regional markets.

Why is local currency bond market development attracting government policy action now? One important factor of course is the recognition by governments that, following the Asian and other crises, they need both to strengthen and deepen their financial systems and to enable bond finance to play a more significant role. To that is added in the East Asian context important regional groups: ASEAN+3, EMEAP (the Executive Meeting of East Asian-Pacific Central Banks, which include Australia and New Zealand), and the Asian Development Bank. They are cooperating to support bond market development in China, Hong Kong, Indonesia, Malaysia, the Philippines, Singapore, South Korea, and Thailand.

Conclusion

The prospects for bond market development are good, but long run. Basically this is because the emerging Asia-Pacific economies will continue to be the most rapidly growing region in the world for the foreseeable future, and because economic development pulls financial development with it. Moreover, the financing opportunities – domestically, globally, and now regionally – are significant and are being increasingly recognized.

Seen within the broad context of East Asian comprehensive regional financial cooperation and integration, bond market development and the ASEAN+3 Chiang Mai swap initiatives are only modest first steps in what inevitably is a long-run process. It is appropriate now that the focus in this still nascent process is on dialogue – an important mechanism for the mutual education of participating government officials – and on confidence building. Success in cooperation on building domestic bond markets, as well as their potential regionalization, can be significant contributors to the enhancement of regional financial cooperation. This will be a process of open, not closed, regionalism since, as bond markets epitomize, regional finance has to be within the context of global financial markets.