ASIAN BOND MARKETS *

The new and comprehensive study by the World Bank projects rapid growth in the Asian bond market. However, ensuring the market achieves a critical mass requires a sound policy environment, benchmark government issues in a free market, an efficient financial market infrastructure, credible ratings agencies and effective demand and supply. The bond market should then complement the banking system by channelling long term savings to long term projects.

Good morning and welcome to the Emerging Asian Bond Market Conference. For those participants from overseas, a warm welcome also to Hong Kong. I hope in addition to attending this conference, you will have an opportunity to see a bit of Hong Kong and feel the pulse of this thriving city.

It is indeed a great pleasure for the HKMA to join the World Bank in hosting this conference. As you know, the World Bank has carried out a major study on *The Emerging Asian Bond Market* and the results of the study are being released on the occasion of this conference.[1] In my opinion, the study is by far the most comprehensive one on the subject. Mr. Ismail Dalla and his team should be congratulated on their excellent efforts. The Emerging Asian Bond Market study and this conference mark the World Bank's increasing support and participation in the development of bond markets in the Region. I hope in particular that I will have the opportunity of welcoming the World Bank again to the Hong Kong market as a borrower.

Stories of economic success abound in this region. But our bond markets have only just begun to develop. As a very positive recognition of the potential of the East Asian bond markets, the World Bank projects the combined market size (excluding Japan) to quadruple within a time span of ten years, from US$338 bn at the end of 1994 to US$1.3 trillion by 2004. I share this optimism. But we should not obviously feel complacent about the promising prospects. The market is unlikely to develop and mature by itself. We in Hong Kong have held this mistaken view in the past. Our experience more recently tells us instead that a mature bond market does not come easily. As the World Bank Study also pointed out,

> "the projected rapid growth in the region's bond markets is contingent upon the continuation of sound macroeconomic management and policy and institutional reforms...... The growth rate of the East Asian bond markets will depend to a large extent on these countries' efforts to systematically build the market".

At the risk of overgeneralisation, I can perceive two possible scenarios for the development of bond markets. One is what I would call the "constrained market development" scenario, where the forces of market development are not well coordinated and are hampered by a restrictive policy environment. There may still be the initial euphoria of primary issues of debt securities which are well subscribed for, but there is no sustained momentum for continued growth. Restrictions in market access and inadequate investor education limit the investor base. Market appetite for debt securities is soon filled up. Thin secondary market activity further dampens investor interest in these securities, leading to the market developing a gridlock characterised by smallness and lack of liquidity. Adding to these problems, administrative controls on bond yields and inadequate risk assessment in the market result in gross mispricing of debt issues. And market confidence is further eroded by sub-standard issues and a sub-standard market infrastructure.

If this story sounds unpleasant and unpalatable, I do have a much nicer one to tell. This is what I call the "sustained market development" scenario.

* This is the text of the opening remarks by Joseph Yam, CBE, Chief Executive of the HKMA to the World Bank/HKMA Emerging Asian Bond Market Conference on 26 June 1995. He is grateful to Priscilla Chiu for assistance in its preparation.

1 *The Emerging Asian Bond Market*. Produced by the East Asia & Pacific Region division of the World Bank. June 1995. Washington DC.

Under this scenario, the initial pick up of activities in the bond market, nurtured within a sound policy environment and with suitable involvement of the authorities, quickly builds up into a critical mass and the market attains a momentum of its own. Given the size of the market, traders find it viable to set up dealing desks and participate in market making arrangements. Active trading in the secondary market, helped by a robust market infrastructure, improves liquidity, thus mobilising an even larger amount of funds into the bond market, and facilitating its development into a fully fledged fund raising avenue.

In this connection, some have asked the question as to whether the second scenario is necessarily better than the first one. What difference do they make ultimately to economic development? Is a mature bond market really necessary, given the fact that a number of economies in this region have scored remarkable economic success in the absence of one? These are legitimate questions and I am happy that the World Bank Study has given authoritative answers. Put simply, the level of development of the financial system should be commensurate with the level of economic development for the latter to be sustained. The historical sequencing is that the development of banking institutions has come first, followed by the emergence of the equity markets. We have now reached a stage when the bond market has an important role to play in enhancing liquidity and reducing intermediation costs.

As the World Bank Report suggests, the financing needs in relation to the development of the physical infrastructure and the provision of housing in the region, coupled with the structural change towards capital intensive industries, will require long term borrowings. While the supply of long term funds is indeed increasing in the region owing to growing affluence, demographic factors and a high savings rate, these funds are not natural or direct investors in infrastructural projects or in the housing sector. The development of the bond market helps to bridge this important gap.

It has sometimes been suggested that bond market development will pose a challenge to the banking sector and perhaps undermine its profitability and stability. I believe this is too narrow a view. When the banking system is fairly well developed, the bond market complements, rather than competes with banking institutions. In channelling long term savings to long term projects, the bond market reduces the risks arising from the maturity mismatch, which would otherwise have to be assumed by the banking system if it was solely relied upon to finance those long term projects with short term deposits. Furthermore, an active bond market would encourage securitisation of illiquid bank assets, such as home mortgages, and provide an avenue for banks to off-load assets to capital market investors, thereby enhancing their overall liquidity position. The bond market is thus a source of stability for the banking system.

For the investors and borrowers, the bond market obviously provides opportunities for respectively enhancing the rate of investment return and reducing the cost of borrowing.

If we are in one mind that an active bond market is desirable for economic development, the next important question is how this can be brought about and sustained. Bond markets in this region have often been described as fledglings, meaning young birds that are learning to fly. Coincidentally, the word "BIRDS" also encompasses what I think are the five essential elements for bond market development. The letter "B" stands for the need for Benchmarks, the letter "I" refers to the market Infrastructure, "R" stands for Rating, "D" stands for Demand and "S" for the Supply of paper, interacting to make up the bond market.

Benchmarks are essential to facilitate the pricing of issues by different issuers in both the primary and secondary markets. A regular and well structured government borrowing programme with the full range of maturities along the yield curve is one way of achieving this. And this is the approach we have adopted in Hong Kong. Our Exchange Fund Bills and Notes Programme started in early 1990 from the short end of the yield curve and maturities have since been continuously extended up to five years. We intend to go further, hopefully with seven-year issues later this year.

But establishing a reliable benchmark yield curve goes beyond the technicalities of putting in place a regular government borrowing programme.

It also involves a number of fundamental policy issues. For benchmarks to be meaningful, they must be determined in a free market environment. This stands in contrast with administratively determined bond yields, which I understand is still the practice in some bond markets in this region. In some economies, government securities have been placed at artificially low yields to a captive investor base, notably the financial institutions. This is not conducive to the emergence of a reliable benchmark.

Another important pre-requisite for establishing a reliable benchmark is credibility in macro-monetary policy. Unless investors have confidence in the long term stability of the currency, it could prove to be quite difficult to extend the benchmark yield curve beyond the very short end. In this connection, I am glad to refer to the example of Hong Kong where the clarity of purpose of our monetary policy of maintaining currency stability, in terms of the external value of the HK dollar against the US dollar under the framework of a currency board system, has given considerable impetus to the development of the HK dollar debt market. Initially, when I suggested the creation of Exchange Fund Bills and Notes to create this benchmark, there was a lot of sceptics. I think the markets now accept the yield curve of Exchange Fund paper as a good benchmark of public confidence in Hong Kong, now and beyond 1997.

An active secondary market is also necessary to ensure benchmarks are kept up-to-date. Secondary market trading in turn is dependent upon an efficient trading platform, which leads me to the second essential crucial element for bond market development – the market **I**nfrastructure.

If physical infrastructure holds the key to the long term development potential of an economy, market infrastructure is the backbone for bond market development. Few of us will dispute the importance of robust clearing and settlement systems to the integrity of financial markets and the confidence to trade in them. You are probably aware of the current preoccupation of central bankers on the minimisation of clearing and settlement risks in financial transactions. This is an area that is receiving much attention in Hong Kong. We hope shortly to achieve "real time gross settlement" in our payment system and therefore "delivery versus payment" in our debt market.

While efforts to develop the market infrastructure have started only fairly recently in the emerging Asian bond markets, we do have the advantage of being a late starter. Building our system almost from scratch, we can make use of the latest technology and incorporate a high standard of security and efficiency that will be able to cope with a high volume and the complexity of financial transactions. In fact, Hong Kong, Malaysia and a few Asian markets have already introduced paperless systems for government securities, which are more advanced than those in many developed markets.

Let me now turn to the third essential element for bond market development – the letter "R", which stands for **R**ating. The process of financial intermediation involves the management of risks. The banking sector has long been a lynchpin of the financial system because there is a concentration of skills in managing risks. Depositors feel safe about putting their savings in the banks and the banks in turn take prudent risks in lending depositors' money. If the bond market, involving instead a process of financial disintermediation, is to establish a significant niche in the financial system, obviously there should be an effective and transparent mechanism for risk assessment to facilitate decision making by depositors and investors.

This therefore is the important role that can be played by rating agencies. In a number of economies in this region, domestic credit rating agencies are being established. Whilst they obviously would possess the necessary local knowledge, it is clearly essential for them to build up a high degree of professionalism and integrity, and be seen to be impartial and objective. There is also the alternative of using the services of established international rating agencies. Where there is a perceived lack of local knowledge, which is understandable, it would be in the interest of these agencies to step up their research on the economies in this region.

It is also important that the role of the rating agencies is properly understood by investors and perhaps by regulators as well. While rating does to some extent serve as a gatekeeper to fend off sub-standard issues, it is not a guarantee against credit loss. The investors themselves bear the credit risk. Rating is therefore not a substitute for investor protection. To reach an informed decision, investors should perhaps also look beyond ratings, and in this context improved corporate disclosure is also important.

Let me turn to the fourth essential element for bond market development – "D" for the **D**emand for bonds. With real GDP growth averaging 6 – 10% per annum over the past decade and domestic savings ratios generally higher than 30% in this region, there should be strong demand for good quality financial assets. One would not therefore expect that demand side considerations would constitute a problem for bond market development in this region. Yet it seems that a disproportionately small amount of funds in this region find their way into domestic bond markets. In fact, over the past decade, while wealth has been accumulating rapidly in this region, the equity markets and the banking system have attracted the biggest share of these funds. Investments in bond markets have largely concentrated in the more mature markets of the developed world.

To some extent the situation is a reflection of how the investor base has hitherto been organised, or rather, disorganised. However, along with some aging of the population and the increasing weight of the compulsory savings sector, in the form for example of mandatory provident funds, whether or not centrally managed, more attention will be given to fixed income securities in the domestic currency. This is only prudent in view of the exchange and possibly other risks that are being incurred in investing in bond markets overseas. I see the greatest potential area of growth in Asian investors buying Asian bonds, in addition to demand from the developed markets.

In cultivating investor interest in debt securities, one real challenge is to develop liquidity in the market. We find that even the "buy and hold" type of investors attach great emphasis to liquidity. Some regional economies have traditionally relied on a captive investor base to increase the size of the primary market. This does not amount to genuine market development, and spins off little trading activity in the secondary market. As the experience in Hong Kong suggests, a pragmatic starting point for improving liquidity in the market is to put in place an effective market making system for government debt securities and to build an efficient trading platform.

Let me turn briefly to the fifth essential element for bond market development – "S" stands for **S**upply of bonds. There is already an indepth analysis of the regional funding needs in the World Bank Report. The Report projects infrastructure investment of $1.4 trillion between 1994 and 2004, and housing finance of around $160 bn in 2004. These impressive figures point to the potential scope of market expansion. As evidenced by a surge of Asian issuers in the US and European markets, there is already an increasing awareness among Asian borrowers of funding through debt issues. And as domestic debt markets develop, they would naturally become the preferred source of debt financing. But I would like to add here in passing that the inertia on the part of borrowers to use the established markets overseas may prove a little difficult to neutralise, notwithstanding higher all-in costs of borrowing overseas, after currency hedges, and in some instances expensive road shows. It takes time for confidence in the domestic markets and hence the supply of domestic debt issues to build up. This is an area in which the presence of multilateral organisations like the World Bank would help. Their tapping of the debt markets in the region may have a catalytic effect on domestic issuers.

To conclude, I am totally convinced that the bond markets have an important role to play in economic development. I am hopeful that bond markets in this part of the world can attain a higher level of maturity, and contribute positively to the process. But market development is far from a straight forward matter, even in the case of Hong Kong where the financial system has already

attained some degree of sophistication and where there is no restrictive controls to speak of. However, the essential elements for bond market development are the same everywhere, regardless of the stage of financial liberalisation. There is perhaps a need for different emphasis in the light of domestic circumstances.

The term "emerging markets" is a good adjective for markets which begin to develop. It is certainly not a label we would like to continue to carry in the coming decades. Ten years later, we may still be discussing the untapped potential of our markets. Alternatively, we may gather again to share each other's success. Which of these two scenarios will materialise will depend on what the policy makers, regulators and market participants in Asia decide to do.

I wish you all a fruitful and stimulating discussion in this conference. I am confident that the discussion will help us to map out strategies for the development of our bond markets. Thank you.