ASIAN BOND MARKET[1]

The failure to establish a strong and robust Asian bond market is among the reasons that led to the recent financial turmoil. The crisis reflects the region's funding mismatch with an over-reliance on short-term funds. This demonstrates that the Asian markets must work together to overcome the deficiencies and create a deep, liquid and mature Asian bond market. There are adequate savings, technical know-how and sufficient market participants in the region to make this happen.

I am honoured to be invited this morning to address you on the Asian bond market. And I would like to congratulate the organizers for this timely and important Conference on a subject in which I take a keen personal interest — the challenging, but sometimes frustrating, subject of getting the Asian bond market off the ground.

Those of you whose memory spans the past 30 years or more — and I know in my case the older I get the more difficult it becomes — may recall that the Eurobond market took off in 1968, when the Euroclear securities and settlement system was established in Luxembourg. You might even remember that one of the first Eurodollar bonds issued financed the famous Italian Autostrada highways. From that tentative start, the Eurodollar market has never looked back. So, how is it that we in Asia have never been able to replicate the Eurobond market success in this part of the world?

It is one of the ironies of history that our failure to establish a strong and robust Asian bond market is among the reasons why we are facing the Asian financial crisis today. At last December's meeting of Finance Ministers of ASEAN plus Six held in Kuala Lumpur, I said that the Asian currency problem was essentially one of funding mismatch compounded by ineffective intermediation. Despite high growth, high savings in excess of 30% of GDP and almost no fiscal deficits, Asia managed to stumble into a world-class liquidity crisis because of private sector over-borrowing, especially in short-term foreign exchange debt. Much of our scarce savings were stuck in non-liquid long-term projects, such as real estate, that did not yield the returns to justify the risks.

At this juncture, perhaps it would be timely for me to reiterate some of the points I made in Kuala Lumpur and to again spell out why I feel we must build a deep and liquid Asian bond market to help the region recover as quickly as possible.

The need for an Asian bond market

One of the major causes of the Asian financial turmoil was the lack of proper risk management at the corporate, bank and policy levels. Before the crisis began, East Asia had the fastest growth, the highest level of domestic savings, no overall fiscal deficits and no overall current account deficits. Unfortunately, undue exuberance in asset prices caused some economies to run unsustainable current account deficits and external debt ratios. By over-relying on equity markets and banking systems, including short-term capital flows, Asian corporations over-borrowed and incurred huge liquidity and currency risks. There were some who thought that the capital inflows of more than US$200 billion into the region would never stop. But when international banks panicked and withdrew funds, net capital outflows from the Asian Five [Korea, Indonesia, Malaysia, Thailand and the Philippines] amounted to some US$109 billion, or roughly 10% of their GDP. The result was a chain reaction of collapse in Thailand, Indonesia and then Korea.

[1] This is the text of the speech by the Hon Donald Tsang, Financial Secretary of the Hong Kong Special Administrative Region, at the Asian Debt Conference on 6 July 1998.

According to data from Nomura on 8 Asian countries, total funds raised through bank loans amounted to 92% of GDP, compared to 71% from the stock market and only 22% from the bond market. Given this over-reliance on short-term funds, it was not surprising that Asia suffered a sharp liquidity shock. Once bank credit shrank and stock markets collapsed, overseas investors could not diversify into domestic bond markets even if they wanted to. The only alternative was to withdraw their capital.

Secondly, from the investor point of view, the bond market provides an important source of information on the state of the economy. The stock market index is an important indicator of the current state of market confidence. But the long bond spread, such as the spread of 10 year sovereign US$ bonds on their US Treasuries counterpart, is a key market indicator of the credit risks in the domestic economy. If the spread widens, it is an indication that market perception of long-term credit risks is rising. It is a natural health warning.

Of course, some may argue that the Asian bond market had difficulties taking off because Asian issuers were reluctant to subject themselves to the stringent disclosure rules in making bond issues. It is true that stock market listings and bank borrowings are so much more convenient than bond market issues. There is the question of high cost fees, stringent listing rules and the need to undergo credit rating procedures. But it is also true that Asian corporations have preferred bank debt and stock market listings because of family ownership or close group control purposes. By not subjecting themselves to the discipline of bond prospectuses and credit ratings, Asian corporations were able to maintain tight control over their operations through short-term leverage. But as we discovered, this was achieved at the risk of maturity mismatches, lack of transparency and inadequate corporate governance. In other words, bond markets add to corporate transparency and market discipline.

Thirdly, there is also a simple official reason why the Asian bond market did not take off. Prudent Asian governments, with little fiscal deficits, had no incentive to develop active domestic bond markets. The philosophy being, if you don't have a fiscal deficit you don't borrow. However, Hong Kong decided to establish a benchmark yield curve in Hong Kong dollars, even though we did not have to borrow. The establishment of this benchmark yield curve was crucial in developing the highly liquid HK$ debt market.

Fourthly, as the domestic population begins to age and the size of retirement savings continues to grow, it is important for the domestic bond market to be developed in conjunction with such institutional development. One of the reasons why we established the Hong Kong debt market was the realization that with the emergence of the Mandatory Provident Fund scheme, there has to be a channel for the growing Hong Kong retirement savings. As part of the development of the debt market, we established the Hong Kong Mortgage Corporation to provide security on residential mortgages, creating a genuine market of long-term investments, which could be funded by long-term savings from the MPF scheme.

Finally, there is one other reason why the Asian bond market is now a matter of priority. The Asian crisis has damaged the corporate and banking sectors in some economies so much that the public sector has been forced to absorb part of these losses. From Japan to Indonesia, governments are issuing sovereign or government guaranteed debt to swap out the bad loans of the banking system. This is modeled on the experience of the US and the Nordic countries, which used their deep bond markets to allow debt-equity swaps to clean up the portfolios of the banking system and assist in corporate debt restructuring during their banking crises in the 1980s. But such large issues of government debt must find a ready market of investors. These cannot be built overnight domestically, nor can we expect foreign investors to come in willingly in the midst of a crisis. The question then arises: how can Asian surplus savings be tapped to meet the demand for resources more efficiently?

The supply of Asian savings

It is a fact, there is no shortage of domestic savings in Asia. They stand at more than 30% of GDP. Although individual economies do run current account deficits, those in Asia with aging populations, particularly Japan, have huge savings. It is the lack of a sound, robust intermediation channel in Asia that has brought about the liquidity problems in the region.

Japan alone has 1,200 trillion yen (US$8.5 trillion) in household financial assets and more than US$800 billion in external assets. The Japanese financial system is 2.7 times larger than the rest of the Asian financial systems. As Japanese households generally save through bank deposits (just under 60%), most of the Japanese capital outflow to the Asian region is in the form of bank loans. An excellent study by the Japanese rating agency R&I showed that 48% of the country's capital outflows to Asia in the first half of 1997 were in the form of bank credit, compared with 7.1% in bonds and 7.7% in equity. Indeed, Japanese capital outflows to North America (US$31.5 billion) were nearly double that to Asia (US$18.6 billion), while Japan's trade surplus with Asia's newly industrialised economies in 1997 was US$66 billion, compared with US$41 billion for the United States. The flows to the US were mostly in the form of bonds which were worth US$37.4 billion. In the words of R&I, "the foreign exchange earned by Japan has been invested in overseas markets, principally the USA, and Japanese banks then procure a portion of these funds through overseas banks and lend them on to the Asia region."

As Japanese banks are unlikely to fulfill the same role of a financial channel to the Asian region as they have in the past, I fully agree with our Japanese friends that the most likely candidate to fulfill the role of intermediation of long-term funds is the Asian bond market. There are signs now that even in Japan, the process of intermediation is changing. In the past, Japanese corporations obtained 70% of their funds from the banking sector, compared with 20% in the US. However, as the credit crunch begins to bite in Japan and elsewhere in Asia, there is a growing trend to resort to the bond market.

At the same time, the lack of a sophisticated Asian bond market has resulted in substantial official savings being invested outside the region, particularly in the OECD markets. For example, more than US$600 billion in foreign exchange reserves from Asian economies have been invested largely in US and European markets. These flow back in the form of short-term portfolios, which, as we have seen, can be withdrawn in no time. I find it rather ironical that Asian savings are being used by overseas funds to engage in short-term speculation in Asia. Of course, low Asian interest rates, such as that in Japan, have helped to fund such arbitrage activities. In my view, it is time we again had a serious look at the intermediation process in Asia to reduce the maturity, currency and credit mismatches in the region. We must build deep and liquid bond and other capital markets to help us finance stable, sustainable and long-term growth.

Demand for Asian bonds

But this begs the question — Is the time ripe for the development of Asian bond markets? On the demand side, there is tremendous interest in high quality fixed income securities in Asia. As I said earlier, there is a need for Asian central banks to invest their foreign currency reserves in bonds. As long as Asian bonds do not offer the liquidity, credit quality and low settlement risks of OECD markets, Asian central banks will continue to invest outside the region, in particular in US Treasuries. The US is a major absorber of capital from Asia, with a capital account surplus of US$264 billion in 1997.

Asian financial institutions such as commercial banks and insurance companies, and provident and pension funds, all have a strong appetite for bonds. As the Asian population begins to age, they will need high quality, stable long-term income from bond yields rather than volatile equity dividend flows. In Europe and North America, mutual and pension fund assets are beginning to seek high quality bonds with good yields to place their funds. In the past, the scarcity of liquid, high quality Asian debt has resulted in unrealistically low spreads. However, the spreads in Asian debt paper are now very attractive relative to other emerging markets, but there are not enough good quality issuers and insufficient liquidity to make Asian and non-Asian investors buy such paper with the same level of confidence as they invest in OECD markets.

Which is why I come back to the story about Euroclear and Autostrada. The conditions in Asia are now ripe for the Asian bond market to develop. Let me now point a way forward.

Potential for growth

In broad numbers, there is tremendous potential for the Asian bond market. At the end of September 1997, the nominal value of all outstanding bonds issued by Asian economies, including Japan, was about US$6 trillion. Out of this amount, about 90% were domestic bonds, that is, bonds denominated in local currencies. This represents less than half the amount issued by the US and about the same amount as that issued by the EMU member states.

Asian bonds account for about 21% of the world total, but Asia accounts for 31% of the world's GDP. By comparison, Asian bond markets account for 82% of GDP, compared with 153% for North American bond markets and 108% for EMU markets. Excluding Japan, Asian bond markets account for less than 34% of GDP. In Mainland China, for example, the bond market is only 6.5% of GDP. The potential for growth therefore is huge.

What do we need to do to make this happen? Technically, I have already outlined a number of reasons for the relatively under-developed bond markets in Asia. Apart from the disincentive for governments to issue bonds because of continued surpluses, international issuers are reluctant to issue bonds in Asia because of the weak investor demand. The weak demand is due to the lack of participation of local institutional investors, such as pension funds and insurance companies. The lack of liquidity is because Asian bonds are usually small in issue size (less than US$100 million). There is a lack of uniform issues at regular intervals. And there are few benchmark issues, which makes it difficult for the international issuers to price their bond issues.

Since the secondary market is not active, trading spreads are usually very wide. Also, the under-developed securities trading infrastructure makes the securities trading, settlement and custody systems inefficient, leading to higher settlement and systemic risk. For example, it takes 3 days to settle a Japanese Government Bond transaction, compared with almost real-time settlement for US Treasuries and Hong Kong Exchange Fund paper.

Developing the Asian yen bond market

It follows that we have to overcome these market inefficiencies before we can move forward. Given the sheer size of Japanese savings and the Japanese bond market, I feel we cannot develop the Asian bond market without working with our Japanese friends.

As we all know, Japanese savings are moving to the OECD markets whilst they are shunning Asian markets. This continued withdrawal of bank credit without a replacement in terms of long-term stable flows cannot be healthy for Japan or its trading partners. However, the introduction of the so-called "Big Bang" has the objective of developing the yen as a major international reserve currency, and the evolution of the Asian yen bond market is a natural outgrowth of that policy. Of course, such a development of yen bond market cannot be isolated from the use of yen as a currency for trade settlements. We would not wish to encourage yen borrowing without adequate yen sources of income as another source of currency mismatch.

It is now well known that Asian economies need to access international capital. Korea and Thailand are issuing sovereign bonds in US dollars, paying around 350 to 400 basis points over US Treasuries. If they were to issue equivalent bonds in yen, their sovereign quality paper would make very attractive investments for both domestic and foreign investors in yen paper. Moreover, Japanese investors do not generally like currency risk. Therefore, high quality yen bonds will attract their investment, thus preventing the capital outflows that are weakening the yen. And if other Asian economies are willing to issue yen paper with attractive spreads similar to what they are paying on spreads against US Treasuries, these will meet not only the needs of Japanese investors, but investors from the rest of Asia and the OECD countries. The 10-year benchmark Japanese

Government Bond is earning less than 1.5% per annum. With a spread of 350-400 basis points, this would make yen bonds much more attractive than at present.

With this background, I sincerely believe the time is ripe for an Asian bond market to develop, with the joint efforts of all — the private as well as the public sectors. It is in the common good to rebuild an efficient channel of Asian savings.

I know there are many official and unofficial bodies studying the Asian bond market. But crisis times need urgent response. The multilateral development banks such as the World Bank and the ADB, which have the market standing, can use their AAA-rating and capacity to help intermediate Asian savings and promote the Asian bond market. We understand of course why they may have many valid bureaucratic reasons why it cannot be done. But these are bureaucratic reasons that can be overcome.

For Hong Kong's part, let me outline what we can do.

- First, we have already made long-term bond issues in Hong Kong dollars and other currencies tax-free if they are issued in Hong Kong.

- Second, our CMU debt market clearing and settlement system is already linked with Euroclear and Cedel, as well as Australian and New Zealand systems. We are prepared to share our technical experience in software, hardware and market-making arrangements with any Asian economy that is willing to work together to make the Asiaclear network and the Asian bond market take off. Specifically, we can work together to reduce settlement and clearing risks.

- Third, we are prepared to invest in high quality benchmark Asian debt paper, provided there are proper credit ratings, issued regularly to enable liquidity in any of the major currencies. Such paper must be at market pricing as we believe that a healthy Asian market cannot operate on the basis of subsidies or market intervention.

- Fourth, we will actively work with the private sector funds, investment banks and authorities to see how we can take this forward. Although Hong Kong has ample reserves and does not need to borrow, we will consider, for example, investing in paper issued by the multilateral banks which have good credit standing.

With good experience in developing the local bond market and the existence of an effective securities clearing, settlement and custody infrastructure, we stand ready to work with everyone in Asia in overcoming the market infrastructure obstacles.

The Asian crisis demonstrates that we must work together to overcome the deficiencies that created that crisis. There are adequate savings, technical know-how and sufficient market participants to make this happen. Hong Kong has the largest concentration of asset managers in Asia outside Tokyo. Our appetite for bonds will increase further when the Mandatory Provident Fund starts its operations in the year 2000. The asset size of the MPF is estimated to be US$1.5 billion in its first year of operation, and is expected to grow to US$9 billion by the end of the 5th year and US$22 billion at the end of the 10th year.

This means that everyone can gain from a deep, liquid bond market in the region — Asians and our friends in Europe and North America. I see that through the Asiaclear network, Tokyo will be the natural centre of the Asian yen-bond market, just as Sydney will be the natural centre for Australian bonds. But, this does not mean that Hong Kong, Singapore or other regional centres could not support that growth and also trade Asian bonds in other currencies.

From the Kuala Lumpur meeting, I know my fellow Finance Ministers agree that this is a matter of priority. In April, the Korean government issued US$4 billion in global bonds. We participated in a small way in that bond issue. The multilateral development banks, such as the World Bank and the ADB, have also recently indicated their interest in issuing more bonds in Asia.

Ladies and gentlemen, all we need now is the will and the push to make the Asian bond happen. I am confident that we are ready to make it so. I wish your Conference every success in its deliberations. By this time next year, I am sure we will have more progress to report in hastening the Asian recovery.