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The Asian Bond Fund: A Case Study of Successful Economic and Financial Cooperation in Asia

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Abstract

The ABF was launched on 2 June 2004 as a response to the late 1990s East Asian financial crisis. The purpose of the fund is to provide its member countries with the liquidity needed to defend their currencies against speculative attacks. The sharp reversal of capital flows during the crisis caused depreciation of East Asian currencies as they were suddenly short of US dollars, which led to a loss of confidence and further speculative attacks leading to sharp currency depreciation. It was argued that a well-functioning US dollar denominated regional bond market would have provided the liquidity needed to avert such a situation from recurring. This paper discusses alternative strategies to strengthen Asian financial systems which involved regional cooperation in financial and monetary matters. However, we focus primarily on the initiative of EMEAP central banks and monetary authorities in developing the ABF to retain the international reserves of the Asian countries in Asia. We evaluate the rationale for setting up the ABF, the structure and operation of the fund and problems that may and will arise in implementing the ABF. The paper concludes that the ABF not only will facilitate the development of an Asian bond market in order to keep Asian international reserves in Asia but also would provide the much needed liquidity in the event of another speculative attack on their currencies. Development of Asian bond markets also promises to diversify Asian financial systems away from a bank-based system which has exposed these countries to currency and maturity mismatches in the event of a sudden reversal of portfolio inflows and bank loans.

Key words: Asian Bond Fund, East Asian financial crisis, Bond market, international reserves.

JEL classification: G10.

I. Introduction

The Asian Bond Fund that was announced on June 2, 2003 by eleven central banks and monetary authorities in the Asia Pacific region, including Australia, China, Hong Kong, Indonesia, Japan, the Republic of Korea, Malaysia, New Zealand, the Philippines, Singapore and Thailand, was a response to the 1997-1998 East Asian financial crisis, which had a devastating effect on the economies of East Asia (Yam, 2003). The 1997-1998 crisis exposed the vulnerability of these countries to external speculative attacks and shocks that caused the currencies of these countries to depreciate sharply and their economies to contract. It has become well understood by the governments of East Asia and the world intellectual community that the crisis was not caused by weak fundamentals or economic mismanagement or cronyism but by a coordinated speculative attack on the East Asian currencies by hedge funds and pension funds, who had plentiful supplies of funds supplied by international banks and the Federal Reserve Bank and the stock market boom in New York (Bhagwati, 1998).

The Central Banks of the affected East Asian countries were unable to defend their currencies because the speculators had more liquid funds at their disposal than the East Asian countries. The countries that had plentiful supplies of reserves, for example, China, Japan, India and Singapore did not suffer from a speculative attack (Radelet and Sachs, 1999: 5). Countries that had not implemented full capital account convertibility or did not allow the free flow of capital, for example, China and India, were also insulated from the crisis (Bottelier, 1998). A consensus has, therefore, emerged that the crisis only adversely affected countries that lacked liquidity to defend their currencies against a speculative attack and countries that had allowed the free inflow of foreign capital (Wincoop and Yi, 2000).

While the rapid and large inflow of foreign capital in the first half of the 1990s created ample liquidity in the East Asian financial system, the reversal of capital flows in 1997-1998, however, created a liquidity crisis in US dollars. The sharp reversal in capital flows occurred when foreign portfolio funds withdrew suddenly and international banks recalled their short term loans and refused to roll over credit. The sharp reversal of capital flows caused the depreciation of the currencies of several East Asian countries as these countries found themselves short of US dollars. The argument is that if there was ample liquidity in US dollars at the disposal of the affected East Asian countries, they would have used it to defend their currencies with US dollars. However, the drop in the rate of growth of exports and the sudden reversal of portfolio flows and bank loans put them in a vulnerable position as they did not have sufficient US dollars to exchange for ringgit or other currencies of the affected Asian countries on demand. This led to a loss of confidence and further speculative activities resulting in the sharp depreciation of the East Asian currencies (Wincoop and Yi, 2000: 52). With hindsight it has been argued that a well functioning American dollar denominated bond market issued by Asian governments and corporations would have provided the liquidity as bonds unlike bank loans can be bought and sold in the secondary market to provide the much needed liquidity. However, there needs to be a well functioning secondary market.

It was noticed during the crisis that there was potentially ample liquidity in the Asian countries as some of the Asian countries had massive external reserves. These included Singapore, Japan, China, Taiwan and South Korea. However, there was no mechanism for the affected East Asian countries to use these external reserves. Most of these external reserves were invested in Western countries. The proposal for an Asian Monetary Fund was also resisted by the United States of America on the grounds that it will lead to problems of moral hazard. Easy liquidity would allow East Asian economies to postpone important domestic reforms. However, the rejection of the proposed Asian Monetary Fund was also probably due to a deeper problem of the loss of control over the East Asian economies by the United States of America (Lipsy, 2003: 103).

To overcome the problem of lack of liquidity in the event of another speculative attack it was decided that Asian countries should get together to set up a fund using the international reserves of Asian countries to invest in the economic development of Asian countries. The Asian initiators of the fund were keen to avoid resorting to the IMF for a bailout in the case of a speculative attack on their currencies. The IMF is not politically appealing to East Asian governments because of the conditionalities imposed by the IMF in exchange for financial assistance. The countries that had accepted IMF financial assistance, that is, Thailand, Indonesia and South Korea, saw the closure of banks, massive unemployment and social unrest. The IMF conditionality led not only to economic and social restructuring but also to a change in the political leadership of Thailand, South Korea and Indonesia (O'Driscoll, 1999).

II. Alternative Strategies to Strengthen Asian Financial Systems

To avoid the consequences of another IMF bailout, the current Prime Minister of Thailand, Shinawatra Thaksin, suggested a new International Financial Architecture in which the Asian Bond Fund (ABF) will play a prominent role (BizAsia.com, 10.7.2002). The ABF will fill the need for a local mechanism to provide nations with more access to liquid American dollars in the eventuality of a financial crisis. The plan calls for ASEAN nations to create a fund by contributing about 1% of their foreign exchange reserves to buy one another's dollar denominated and local currency bonds.

The Asian countries as noted earlier have substantial dollar reserves and investing in bonds issued by Asian countries is one way of keeping the international reserves in Asia so that it can be converted to liquid cash at short notice. The combined reserves of Japan, China, Taiwan, Korea, Hong Kong and Singapore total more than US\$1.227 trillion (Arijit Ghosh, 2004). According to other estimates, the reserves built up by Asian central banks amounted to more than US\$1.8 trillion in November 2003 (The Economic Times, June 23, 2004). One percent of this comes to more than US\$180 billion. This fund could be of substantial use in alleviating the liquidity constraints of countries under a future speculative currency attack by fund managers or by the so-called Wall Street-Treasury complex elucidated by Bhagwati (1998).

The ABF is an initiative by central banks and monetary authorities of the Asia Pacific countries that are members of the Executives' Meeting of East Asian Pacific Central Banks and Monetary Authorities (EMEAP). It was initiated by the central banks and monetary authorities as they are the managers of the international reserves of the respective countries and hence have control over the allocation of the reserves. However, at the same time there are other parallel ASEAN initiatives in capital market developments that help to strengthen EMEAP's initiative in strengthening the Asian financial system both at the national and regional levels. These other initiatives in financial and monetary cooperation are organized under the auspices of the ASEAN +3 grouping; the ASEAN Cooperation Dialogue (ACD) and the Asia Pacific Cooperation (APEC) forum and the Asia-Europe (ASEM) forum.

Under ASEAN+3, which includes the ten ASEAN countries and China, Japan and South Korea, the Study Group on Capital Market Development and Financial Cooperation has made progress towards developing an infrastructure for developing capital market and financial cooperation including developing bond markets both at the national and regional level. The work of ASEAN+3 is being coordinated by the Finance Ministers of the ASEAN+3 countries.

As a follow up of the Chiang Mai Initiative, the ASEAN+3 leaders issued a formal statement in 1998 in which they identified ten areas of regional cooperation including cooperation in financial and monetary matters. In May 2000, the Chiang Mai Initiative (CMI) was launched by the ASEAN+3 countries, which focused on monitoring capital flows, regional surveillance, swap networks and training personnel. The focus on monitoring capital flows was as a result of the volatility of these flows, which had disrupted the process of economic development in these countries between 1997 and 1998. In October 2002, the original Thaksin proposal was introduced at the World Economic Forum's Annual East Asia Summit in Kuala Lumpur (Rajan, 2002: 1). It received considerable support.

The ACD has formed a Working Group on Financial Cooperation to set guidelines to develop sound Asian bond markets. The ACD has also endorsed the Chiang Mai Declaration on Asian Bond Market Development. This together with the bilateral swap agreements, which is also an offshoot of the Chiang Mai Initiative is expected to strengthen the national and regional financial infrastructure. The launching of the ABF was given political support by the 18 members of the Asia Cooperation Dialogue (ACD) in its annual ministerial meeting in June 2003. India also gave its support to the ABF by pledging US\$1 billion towards the development of the Asian Bond Fund (ABF) in pursuit of its intention to have economic integration with ASEAN (The Times of India, June 23, 2004).

The APEC initiative on regional financial sector development has been working on the framework of the region's Finance Ministers' Meetings (FMM). The ministers have called for the development of securitization and credit guarantees, both of which is expected to be implemented over a two year period. Other activities on bond market development under APEC will include seminars on bond market development and the establishment of regional market-based credit guarantee arrangements and the active development of the private sector in the development of the regional capital market.

One of the main objectives of the ASEM initiative is to link the Asian and European bond markets. Thailand's proposal to exchange information and link the "Asian bond" with the Euro bond has been supported by the Fourth ASEM Summit in September 2002. A Working Group has also been set up to promote economic cooperation between Asia and Europe and to promote the sale of Asian bonds in the European market. All four forums emphasize a need for the development of active and liquid regional and national bond markets. These initiatives will eventually, it is hoped, lead to the strengthening of the Asian financial system and not leave it vulnerable to another speculative attack.

Although there are parallel developments by EMEAP, ACD, APEC and ASEM to develop and strengthen the Asian financial architecture to deter the reoccurrence of another speculative attack on Asian currencies, the focus of this paper is modest in the sense that it focuses on the initiative of EMEAP central banks and monetary authorities in developing the ABF to retain the international reserves of Asia in Asia. Although the initial size of the ABF is miniscule in comparison to the international reserves of member countries of EMEAP, it is a credible start with the prospect of growing into a very large bond fund. The next section of the paper will discuss the origins and rationale of the

ABF. The fourth section of the paper will consider the problems in implementing EMEAP's proposal of developing the ABF to purchase Asian bonds. The fifth section discusses the foreign exchange risks of bond investments while section six provides an evaluation of the ABF and its sustainability. The final section will conclude with an analysis of the prospects for the future.

III. Origins and Rationale of the Asian Bond Fund

The origins of the Asian Bond Fund can be traced back to the 1997 East Asian financial crisis as it was during this period that Thailand, which was the first to be hit by the speculative attack, turned to its Asian neighbors for financial assistance to defend the Baht. However, the financial assistance was not forthcoming in the magnitude that was needed to fend off the speculative attack. It was also realized that there was no formal mechanism to deal with a crisis of such a magnitude and that although Asia had a sizeable pool of foreign exchange reserves they were largely invested in the US Treasury, earning a much lower interest rate than if they are invested in local Asian bonds (Jiang and McCauley, 2004: 76).

According to the Prime Minister of Thailand, Thaksin Shinawatra, who is one of the chief proponents of the ABF, it is more efficient to invest Asia's reserves in Asia because, "our reserves, when deposited in the West, created more wealth for the Western hemisphere, without contributing to our own growth" (Business Week, July 28, 2003).

It was felt that the reserves could be put to better use by investing them in an Asian Bond Fund, which could be used not only in the eventuality of another speculative attack on Asian countries but also to build an Asian bond market and to invest in the economic growth of Asia to earn a higher return than the low return available from investments in the USA. The EMEAP central banks and monetary authorities also anticipate that the ABF will play the role of lead investor in the future economic development of Asia (Yoshikuni, 2003).

The formation of the ABF also implied that the EMEAP (Executives' Meeting of East Asia-Pacific Central Banks) group of central banks and monetary authorities had rejected the crony capitalism and economic mismanagement view of the causes of the currency crisis and had accepted the financial panic or herd behavior view of speculators as the main cause of the crisis. The herd behavior or speculative hypothesis gained credence because the worst affected East Asian economies saw a reversal of capital outflows of more than US\$105 billion in a single year. This is the equivalent of 11% of the combined GDP of Indonesia, Malaysia, Thailand, Singapore and the Philippines (The Economic Times, June 23, 2004). Together with the formation of the ABF, the EMEAP countries also felt that to develop the environment suitable for the development of bond markets, the countries in the region should increase transparency, improve supervision, improve corporate governance and limit moral hazard. The emphasis on institutional reform and a new international financial architecture has become the objective of the EMEAP countries so as to strengthen their respective financial systems.

The EMEAP Countries perceive the ABF as having the potential of being an alternative to the International Monetary Fund (IMF) (Iyengar, 27.12.2003). The EMEAP views the ABF as a lender of last resort akin to the central bank. It could lend the much needed capital that the IMF was not willing to part without conditionalities attached to it. The existence of the ABF, which could lend to countries by buying their bonds, would help to eliminate the crisis of confidence in Asian countries and would deter speculators from mounting a speculative attack on the currencies of countries that had access to the ABF.

The launch of the US dollar ABF has been viewed as an important step in regional co-operation aiming at promoting bond markets in the region (Chipongian, 2004). The EMEAP Group has been playing an active role in promoting the efficiency of financial intermediation in the region and the launch of the ABF will facilitate the channeling of a small portion of the very sizeable official reserves held by the Asian economies back into the region. Hitherto most of the financial intermediation was done in Europe and the United States as the reserves were invested there. The Fund will also provide a useful means for the Asian central banks to diversify their investments beyond the more traditional reserve assets and to enhance their returns.

The launching of the ABF signals the success of the East Asian and Pacific countries in forging regional cooperation in monetary and financial affairs. The ABF is also an important

mechanism for developing the hitherto nascent regional and domestic bond markets as a means of reducing the region's dependence on the banking system to provide financing (Ito, 2003: 7). The development of the national and regional bond market will also help to reduce volatility and increase stability in the financial system.

The region has been dominated by bank based financial systems that are prone to boom-bust cycles (Ito, 2003: 7). Bank loans lead to economic booms and the sudden withdrawal of loans often leads to a sudden downturn akin to a bust of the bubble. The bank loans are illiquid in the sense that they cannot be bought and sold in the open market and they are, more often than not, fixed price in the sense that the interest charged does not change with changing market conditions. In contrast bonds are tradable as they can be bought and sold as long as there is an active and liquid secondary market and one of the purposes of the ABF is to develop an active secondary market. The ability to buy and sell bonds reduces the risk of holding the asset. It has been argued that the movement from a bank based to a bond based system is to reduce systemic risk in the financial system. Policy makers have increasingly been concerned about the absence of broad, deep resilient bond markets in Asia. The World Bank has urged the acceleration of domestic bond markets to increase the efficiency of the financial intermediation process (Dalla et al., 1995: 18).

Part of the rationale for the ABF, as pointed out earlier, is to reverse the flow of international reserves from Asia to the USA and Europe, which has been used to fund the balance of payments deficit of the USA and the European countries (Daily Times, August 15, 2004; BIS, June 2, 2004). The efficiency of regional financial intermediation is low in Asia with the bulk of savings in Asia being attracted to the capital markets of Europe and the USA (Nikkeinet interactive, 2003). Some of these savings often find their way back to Asia in the form of foreign portfolio investments and short term bank loans, which are volatile. As noted earlier, the sudden reversal of capital flows from the crisis affected countries was due to the sudden withdrawal of portfolio investments and bank loans. As a result of these sudden adverse movements in the flow of capital, financial institutions and banks in Asia were faced with liquidity pressures and a financial crisis as their balance sheets needed recapitalization.

The Asian corporations, that were over-dependent on the equity markets and the banking systems for financing, were also under stress as they could not service the debt, when interest rates rose as a result of the sudden reversal of capital flows (Ito, 2003: 1-7). They would have been better off if they had raised long term capital from the bond market rather than relied on the equity market and the banking system for largely short term financing. To avoid these adverse effects of the sudden reversal of foreign capital flows and the need to build bond markets as a source of long term funds, the EMEAP Group decided to build up alternative sources of liquidity. The urgency of the matter came to surface when Asian countries had to pay extraordinarily high premiums to float their bonds in the advanced countries of the West, when they needed the US dollars to recapitalize the banking system and rehabilitate the corporate sector in the aftermath of the East Asian crisis. One of the more promising alternatives to reducing the dependence on funds from the West is to invest East Asia's reserves in an Asian Bond Fund to be used to finance the purchase of foreign and local denominated loans issued by sovereign and quasi sovereign bodies in Asia.

The ABF was also formed to avoid the dangers of currency and maturity mismatches. Currency mismatches occur when, for example, Asian banks borrow in US dollars from foreign banks and lend them out to local companies in the domestic Asian currency (Ito, 2003). If the foreign bank suddenly withdraws its loan or does not roll over its credit to the Asian bank, the latter may be caught in a situation without enough US dollars to repay the loan (Radelet and Sachs, 1997). A currency mismatch occurs when Asian corporations borrow in US dollars and convert them for use in their own domestic currency but are unable to generate US dollars when they are required to repay their debt at short notice as occurred during the 1997-1998 East Asian financial crisis. This left the Asian corporations in a distressed situation (Ito, 2003: 1-7). The problem became more severe when as the demand for dollars went up, the exchange value of the domestic currencies depreciated and the domestic value of the debt denominated in US dollars went up. If under these circumstances there was an ABF, the corporations could sell US denominated bonds to the ABF and use the proceeds to repay their US denominated debt or bank loans.

Maturity mismatches occur when Asian banks borrow from foreign banks on short term but lend the borrowed funds out in the domestic economy on long term. However, sometimes even though the foreign borrowings of Asian corporations are long term they can be withdrawn at short notice (Ito, 2003: 1-7). For example, even though the foreign borrowings of many industrial companies in Asia were long term, a lot of loan contracts had default clauses embedded in them. This allows the foreign investor to recall loans early when certain events occur. The maturity mismatch occurs because long term borrowings suddenly become callable almost overnight.

There are, therefore, compelling reasons as to why the development of the ABF is of importance to the sustainable economic development of Asian countries. The ABF will help to reduce the region's over-dependence on short term foreign funds from abroad and on the domestic banking system. The over-dependence on short-term foreign funds and the domestic banking system as we have noted earlier led to the sharp liquidity problems of Asian countries when foreign bank credit shrank and stock markets collapsed and overseas investors withdrew their capital from the markets because they could not diversify their investment into domestic bond markets that were denominated in US dollars.

An added advantage of the development of the Asian bond market will be that it will make available the use of long-term US dollar denominated funds for long-term project investment in Asia. Long term maturity Asian bonds that are denominated in US dollars will provide more stability than short term bank loans from the USA and Europe which when reversed might lead to a financial panic and collapse as it did in Asia in 1997 (Ito, 2003).

The need for an ABF was also noted by the Asian countries that needed to restructure their banks and their corporations that had been damaged by the Asian crisis. Countries that tried to float international dollar bonds to finance their bank and corporate restructuring either found that their bond issues were undersubscribed or were poorly rated by international rating agencies. As a consequence they had to pay a much higher interest rate to sell their bonds. The availability of an ABF would facilitate the recapitalization of banks. If the ABF could also be used to purchase the issue of bonds in the domestic currency, for example, the baht or the ringgit, it would assist in the bond market development of the Asian countries. The existence of a deep and liquid secondary bond market is therefore an essential factor to allow financial institutions to better prepare themselves for risk management. Moreover, a liquid bond market allows the central bank to require the commercial banks to maintain a higher liquidity ratio as bonds are considered liquid assets (Rajan, February 2, 2004).

The ABF and the development of stable and efficient financial markets in Asian countries will attract the international reserves of Asian countries and even investments from foreign countries. Hitherto, much of international investments have been centralized in Europe and the USA. The development of domestic bond markets in Asia and an Asian regional bond market would help to decentralize major financial investments from the USA and European markets into Asian markets. If the Asian regional bond market does not function efficiently to intermediate between savings and investments, Asian central banks, governments and corporations will find an incentive to invest in bonds outside the region, which are perceived to be more liquid and having the property of lower settlement risk. There is therefore every incentive for Asian countries to develop deep and liquid bond and capital markets, which will be able to attract Asian funds that are now invested elsewhere to be reinvested in Asia.

The setting up of the ABF has also been supported because it is felt that it will reduce the vulnerability of the region to unhedged borrowings in US dollars. At the onset of the 1997 Asian crisis it was noted that several Asian corporations had issued dollar denominated or Yankee bonds that had to be serviced in US dollars. However, the depreciation of the local currencies increased the debt burden in US dollars and as a consequence some of these corporations went into distress. According to the Governor of the Bank of Thailand, the absence of bond markets made several Asian economies more vulnerable to the financial crisis (Chatu Mongol, Sonakul MR ADB 2000 cited in Herring and Chatusripitak, 2000). He has also gone on record to suggest that "If I (could) turn back the clock and have a wish (list) high in its ranking would be a well functioning Thai bath bond market" (Herring and Chatusripitak, 2000: 1).

It was originally anticipated that after the launch of the US dollar ABF, the EMEAP Group will proceed to study the extension of the ABF concept to include bonds denominated in

regional currencies, further strengthening the contribution of the initiative to the broadening and deepening of bond markets in the region. According to Thaksin Shinawatra, the main proponent of the ABF, "although the ABF will start out in US dollars, we hope to shift to Asian currencies in the future" (Nikkeinet Interactive, 2003: 1).

The investment in the domestic currency bond market will lead to greater liquidity, increased issuance, better lending terms for governments and corporations and the stability of Asian financial markets. The development of investment grade domestic currency bonds may be able to attract foreign investments. Foreigners can bring in funds to invest in high quality papers denominated in the local Asian currency. The inflow of foreign capital does not only absorb foreign exchange risk but also offers an alternative and an incentive to Asian enterprises and corporations not to depend too much on foreign currency denominated debt as they have to bear the foreign exchange risk of foreign currency denominated debt. Bond market development can also add to corporate transparency and market discipline as those who issue local currency denominated bonds will be subject to international accounting standards and the rigors of the international capital markets.

One of the key features of the Asian bond is that Asian issuers might raise money by issuing bonds in hard currency such as US dollars and their local currencies. There is also the possibility that the bonds could be issued as multi-currency bonds that is they are simultaneously denominated in baht, yen, ringgit or renminbi. However, it is expected that in the short run, the bonds could be denominated in US dollars and the multi-currency package of Asian bonds would be issued in the long run. An added incentive for holding the Asian bonds is that the IMF has recognized the Asian bond holdings in US dollars as part of each country's foreign currency reserves (Nikkeinet, Interactive, 2003).

There are ample savings in Asia to support the growth of an active bond market. Savings in Asia are on the average about 30% of GDP (Mulcahy, September 10, 2003). On the demand side, there is tremendous interest in high quality fixed income securities in Asia. There is also a need for Asian central banks to invest their foreign currency reserves in bonds. Moreover, besides the need for risk diversification, Asian financial institutions such as commercial banks, insurance companies and provident and pension funds, all have a strong demand for quality bonds with good yields.

In short, the bond market is the foundation of the capital market and will play an important role in mobilizing savings into productive investment that promote economic growth and development. The development of bond markets in Asia is therefore recognized as being extremely important in strengthening Asian capital markets and should be done in parallel with the development of banking and equity markets.

IV. The Operation and Management of the ABF

On June 2, 2003 the eleven Central Banks and monetary authorities of the EMEAP (Executives' Meeting of East Asia and Pacific Central Banks) Group issued a joint announcement to launch an Asian Bond Fund, with the undertaking that all EMEAP members had agreed in principle to invest in the Fund (EMEAP, June 2, 2003). The Fund, which will have an initial size of about US\$1 billion, will invest in a basket of US dollar denominated bonds issued by Asian sovereign and quasi-sovereign issuers in the EMEAP economies (other than Japan, Australia and New Zealand). The announcement on June 2, 2003 setting up the ABF also stated that the investors in the ABF will be EMEAP central banks and monetary authorities. The ABF will be invested in the first stage in US dollar denominated bonds that will be issued by member countries of EMEAP. In the second stage, the ABF will be invested in local currency denominated bonds (Jiang and McCauley, 2004: 67). The ABF will be managed by the Bank for International Settlements (BIS), which has considerable experience in prudent fund management. A representative office of the BIS has been set up in Asia for the purpose of managing the ABF. The representative office will be supervised by the BIS Banking Department in Basel.

The Fund will be managed by the Bank for International Settlements in a passive style in accordance with a specific benchmark. The ABF is expected to start operations soon. The EMEAP Group will set up an Oversight Committee to monitor the performance of the Fund. The ABF's portfolio will be invested in a basket of liquid US\$ bonds of major Asian economies (excluding Australia, Japan and

New Zealand). The performance of the fund management will be reviewed by a committee appointed by the EMEAP central bankers and heads of monetary authorities on a quarterly basis.

The work of the fund managers will have an important bearing on the development of Asian bond markets because hitherto investors have stayed away from Asian bond markets due to their low liquidity and low credit rating. Efforts will have to be made on securitization and credit guarantees to enhance the quality of bonds so as to provide issues a credit quality acceptable to investment managers and to offer investors with a greater diversity of products and instruments for investments.

To develop a bond market, the EMEAP and the BIS are expected to work on three essential components, that is, (i) the development of a deep and liquid government bond market to serve as a benchmark yield curve against which corporate papers can be priced; (ii) the development of an adequate infrastructure, both legal and operational, to support the trade and transfer of instruments and funds, and (iii) facilitate collaboration among players in the bond market, namely, the intermediaries, the end-users and the private sector. The operational infrastructure under (ii) includes efficient clearing and settlement systems, short and long term foreign exchange hedging instruments, risk management for investors and the establishment of domestic and regional bond rating agencies, regional credit agencies, regional clearing and settlement systems and the development of secondary bond markets and repurchasing markets. These components are relevant to the comprehensive approach concept of Asian bond market development and Asian bond issuance under the regional cooperation framework. It is also part of the BIS's managers frame of reference to develop the infrastructure to develop the bond markets in Asia.

V. Foreign Exchange Risks and Bond Prices

Fixed income investments, including Asian bonds floated by the ABF, are subject to a several risk factors such as interest rate, default, liquidity, currency, political, legal and regulatory risks. The main contributor of bond price volatility would be changes in the domestic interest rates and for cross-border investments; changes in each countries interest rates vis-à-vis one another and to changes in the exchange rates. However, as most Asian countries operate soft pegs against the US dollar (and therefore with one another), exchange rate volatility is expected to be low. As long as investors perceive that issuer countries will hold on to the peg, price stability will prevail. But this depends to a large extent on the credibility of the governments in the region to maintain such pegs (as the currency crisis of 1997-98 has shown), which the setting up of the Fund seeks to establish. Monetary policy in most Asian countries are also used to support the value of the currency (as inflation is not a major problem) and this means that interest rates of each country are likely to move in tandem with one another. Thus, exchange rate and interest rate risk are perceived to be low for both ABF1, that is invested in US dollar-denominated bonds, and ABF2 (and so on), that will be invested in local currency debt securities.

Although such factors lead to more stable prices, it also means that yields on debt securities are very similar across Asian countries and very similar with those in the US. What this entails is that the diversification benefits of cross-border investment in the Fund are correspondingly less – as the correlation between the different Asian issues would be high and positive.

VI. A Critical Evaluation of the Fund and its Sustainability

ABF1 has a fund size of USD 1 billion while ABF2 has a fund size of USD 10 billion, and we foresee that the size of ABF3 and so on will grow even more. Although the size of the fund is getting larger, it is still a very small amount of the reserves of its contributors, so its direct market impact is not very significant. It is also too small in scale to stimulate issuance. How future contributions will be made or withdrawn, or how proceeds accruing to the fund will be treated, is also unclear. Although the Fund's management would be outsourced, it would be unrealistic to expect full portfolio disclosure or a separation of interests that might compromise established central bank practice such as monetary policy operations.

However, it is the first move to correct the imbalances created due to large amounts of international reserves being placed outside the region and to counter growing criticism that Asian na-

tions are funding a large amount of the US deficit. Whether it will encourage an active debt capital market that could provide a stabilizing resource in times of higher volatility is yet to be seen.

The set up for ABF2 includes both a single currency and a regional multi-currency fund that will each hold sovereign and quasi-sovereign securities. It has two regional vehicles, an index fund to acquire for its own account local currency assets from the target markets, and a second fund that does so indirectly through a series of single currency funds. The eight jurisdictions will host the single currency funds which would be domestic entities to optimize access to securities and mitigate issues of taxation, custody and ranking of claims. Ultimate control of this family of funds would lie with a regional fund to provide some form of regional collaboration. The issue here is that we are unclear as to whether the rights of the fund of funds and the multi-currency index will be as domestic or offshore investors.

Furthermore, the multi-currency and the single currency funds will be competing for the same pool of investible securities although not necessarily on equal terms, due to differences in treatment for taxation, custody and enforcement of rights for local versus offshore holdings of these assets. As the ultimate investors of the multi-currency fund are the regional central banks themselves, we could assume that there may be some special treatment accorded to the fund. However, this prejudicial treatment may be more of a problem than a solution if these funds are then open to outside investors (as the promoters had suggested earlier).

The fund's additional value is that it includes Indonesian and Philippine risk, both sub-investment grade, which is against customary reserve management practice. This means opening up a wider segment of the credit curve to reserve management, and any political gains from regional collaboration.

The funds will be passively managed against benchmarks – but we are unclear as to what that may be, especially for the multicurrency fund (although individual bond market indices are available for those eight countries). It most likely will correspond to a large extent on several of the existing commercial US dollar indices for Asian risk. As the fund would be passively managed it also does not promote liquidity.

A lack of supply and problems of investor access has so far been the main problem preventing the private sector from creating single currency funds, although bond indices providing measures of whole market performance are well established in all eight markets. Single currency funds would be valuable in providing a liquid, low risk investment with easy market access where none exist before. An attractive scenario would be to have those funds traded on exchanges as a more liquid form of fixed income investment – this may encourage more activity in the markets. Continuous supply of government securities is essential but we have seen several short notice cancellation in several of the eight markets, that is, China, Indonesia, Korea and Singapore, due to conditions regarded as excessively volatile or suspect by the respective authorities. This could encourage an attack on the markets' imbalances or inconsistencies. What is probably needed is some form of market reform with removal of supply blockages, enhanced trading liquidity, and equal treatment for domestic and offshore investors in terms of legal rights, taxation and custody.

As the massive international reserves that Asian countries have accumulated as a result of limiting the appreciation of their currencies against the US dollar are invested in the dollar, they contribute nothing to the development of the local bond market. Even if they were invested in Asian government bonds, they would still contribute little due to central banks' buy-and-hold reserve management practices. One option is to leave Asian savings in private hands as opposed to being accumulated by central banks and governments in the form of foreign reserves. This would only happen if Asian countries allowed their currencies to freely float against the US dollar. In this scenario we can foresee some of the funds being actively managed by the private financial institutions in which they were deposited. Some of that money may be allocated to cross border investments thus creating deeper and more liquid regional financial markets.

The effort to harmonize bond market regulation and encourage more cross border flows via the national bond markets of the region somehow may lead towards more capital account liberalization for Asian countries (Eichengreen, 2004). However, lessons learnt from the financial crisis should alert us to the detrimental effects of having capital account liberalization before having exchange rate flexibility. Any pegging of the currency would be an irresistible target to speculators and convertible

capital accounts means easier access for hot money flows. Fisher (2003) argues that moving to managed flexibility is an essential precondition for full capital account liberalization. Of course, Asian countries can opt for a form of monetary union to eliminate intra-regional currency risk, allowing them instead to manage risk with the outside world collectively. This would also facilitate the pooling of liquidity in the different national markets, overcoming the small size problem that most Asian countries suffer from. However, the likelihood of monetary union or single currency in the near to medium term is rather remote as the political will is not forthcoming.

The development of the regional bond markets can be looked at from the demand-side and supply-side. The setting up of the ABF is meant to stimulate the demand side. However, demand for investment grade sovereign and corporate issues has not been the problem. In fact, what is problematic is that there is not enough supply of such issues. Does the setting up of ABF encourage additional issues? Continuous supply of such issues are essential but we have seen several short notice cancellation in several of the eight markets, that is, China, Indonesia, Korea and Singapore, due to conditions regarded as excessively volatile or suspect by the respective authorities. What the authorities need to also do is to encourage and stimulate more investment grade credit, which are the only type of securities pension funds and insurance companies are mandated to buy. Providing credit guarantees may encourage moral hazard problems, as we have seen within the banking system. What needs to be done then is to foster good governance, more transparent accounting practices and tighter (and prudent) regulation for issuers.

The small size of each national bond market limits efforts to increase its liquidity and activity. In order to reap the benefits of scale economies, a Pan-Asian market needs to be set up. This would require, among others, an integration and harmonization within the Asian markets of its financial laws, regulations, taxation and market structures. The problem of heterogeneous ratings can be rectified by having a single regional rating agency or by streamlining rating methodologies. The authorities could go further by setting up an Asia-wide clearing and settlement system to facilitate cross-border trading. For a start, the authorities can facilitate this by making trading on each national market more efficient by cutting out a lot of red-tape.

The ABF will probably succeed in forcing the removal of legal and regulatory constraints, thus contributing to capital market reform. The test of the project is whether it will generate greater liquidity and involve new participants, especially from the private sector. Only then will the Asian bond market be able to stand on its own and sustain its growth in the long run.

VII. Problems in Implementing the Asian Bond Fund Initiative

It has been noted that to develop an active and liquid bond market it is necessary to develop a rating agency for the whole region. At present nearly every Asian country has a rating agency but the criteria that is used to rate bonds are not similar across the countries. As a result of differing criteria and methodology, a BAA rating from a Rating Agency in Thailand may not be the same as a BAA rating from a Malaysian Rating Agency. Heterogeneity of rating practices may be a deterrent to cross-border portfolio flows within the region. Without a systematic and comparable national and regional rating regime, Asian countries may have more faith in the investment climate in Europe or the United States than in Asia.

The different countries that are involved in the EMEAP initiative have different tax systems and different rates of taxing investment income and capital gains. The different statutes and taxes have to be harmonized to facilitate active cross border trading of the bonds and to build a regional bond market. Because the tax rates are different, the yield curve on one country's benchmark bond may be different from the yield curve of another country's benchmark bond.

Some countries also prohibit non-resident access to the local bond market. These include China, Taiwan and India, who require a license, prior approval or impose pecuniary disincentives to limit flows. Other countries like China, India, Malaysia and the Philippines and Thailand require prior approval for resident purchase of foreign bonds. The operation of forward and futures markets in foreign exchange are also restricted in several Asian countries including Japan, Hong Kong, Singapore and Korea and this inhibits the building up of a diversified portfolio of Asian bonds. These restrictions have to be removed if there is to be an active and liquid bond market.

To facilitate the free flow of capital, countries have to open up their capital account. However, full capital account convertibility is not favored by all countries especially China, India and Malaysia. The 1997 East Asian crisis was attributed to the premature opening up of the capital account without first strengthening the domestic financial system. It is important to have well diversified and strong domestic financial systems because otherwise the financial system will be dominated by the banking system, which should be avoided given the experience of the 1997 crisis. If capital account convertibility is allowed in a bank based financial system, the banks may over borrow and this may generate a boom-bust cycle. It is therefore necessary to build a strong bond market before embarking on full capital account convertibility.

VIII. Conclusion

The EMEAP countries have initiated the development of an Asian Bond Fund not only to facilitate the development of an Asian bond market to keep the international reserves of Asia in Asia but also more importantly to provide the much needed liquidity in the event of another speculative attack on their currencies as occurred in 1997-1998. The development of the Asian bond market at the regional and national level also promises to diversify the financial system of Asian countries away from a bank based system, which has exposed these countries to currency and maturity mismatches when there is a sudden reversal of portfolio inflows and bank loans. The Asian Bond Fund has had a modest start with a US \$1 billion initial capital, which has been used in stages to purchase dollar denominated and local currency bonds issued by the member countries. The initiation of the fund has provided some financial security to member countries and strengthened their financial system, which acts as a deterrent to speculative attacks on their currencies. However, the future development of the bond market initiative is dependent on developing a regional rating agency, which would provide the terms of reference to national rating agencies; the harmonization of tax systems across the member countries of the ABF; the removal of restrictions on non-resident foreign investments and full capital account convertibility. These changes will take time but what should be noted is that Asia has taken the first step to retain and invest its international surplus in Asia.

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