Asia's Debt Capital Markets

Prospects and Strategies for Development

The Milken Institute Series on Financial Innovation and Economic Growth

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Springer

Library of Congress Control Number: 2005937601

ISBN-10: 0-387-25089-1 e-ISBN-10: 0-387-25090-5
ISBN-13: 978-0387-25089-2 e-ISBN-13: 978-0387-25090-8

Printed on acid-free paper.

The Milken Institute has chosen the material published in this book series for its quality and seriousness of purpose. But the opinions expressed in the books do not necessarily reflect the views of the Institute or its staff.

Printed in the United States of America.

9 8 7 6 5 4 3 2 1 SPIN 11400066

springeronline.com

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James Barth, and Glenn Yago, Series Editors

Milken Institute Series on Financial Innovation and Economic Growth

This volume focuses on the importance of bond markets for economic growth and development. It provides a comprehensive and detailed analysis of the importance of these markets to all countries, regardless of geographic location. The financial turmoil that occurred in East Asia in mid-1997 disrupted spectacular rates of economic growth and taught policymakers, academics and practitioners that excessive reliance on financial institutions as the primary vehicle through which savings are channeled to investment projects significantly exacerbates economic downturns when the banking sector suffers a crisis. Diversification through bond markets enables firms to tap capital markets directly during difficult times when banks curtail the extension of credit to improve their balance sheets. Through the diversification of risk throughout the financial system, less systemic risk and vulnerability are observed and credit crunches can be overcome.

Asian countries experienced rapid and impressive economic growth until the 1997 crisis. Monetary and fiscal stability, along with rapid financial sector development, mainly through an expansion of bank loans, were important factors contributing to the "Asian Miracle". In the years following the crisis, however, it became readily apparent that bank concentration and dependency propagated financial shocks (both internal and external). The lack of a diversified financial infrastructure posed recurring threats to economic stablilty. A consensus emerged that Asia needed strong local-currency bond markets that could act as financial insulators to various disruptions to maintain its current open and growing trading relationships. While the book focuses on Asian bond markets and economic trends in the region, it does not advance the notion that any single approach to development is appropriate for all nations in the region.

There has actually been considerable progress in the development of bond markets in Asia in recent years. At the end of 2003, the volume of domestic bonds outstanding in eight Asian countries was equivalent to 47 percent of their combined GDP, more than double the 20 percent figure at year-end 1995. Over that time, the contribution of bonds to total financing rose to 19 from 11 percent. Despite this impressive growth, Asian bond markets collectively still lag behind those of developed economies in terms of breadth and depth. At less than 50 percent of GDP, many Asian domestic bond markets are still small relative to those in the United

States and Japan, where domestic bond markets are over 100 percent of GDP. Furthermore, bond markets in Asia still lack liquidity and remain largely fragmented.

The costs of underdeveloped Asian capital markets and greater diversification in financial services has taken its toll on Asian growth prospects. Among the countries hit by the Asian crisis, only Korea has approached its pre-crisis growth rate. National savings exceeds national investment in most Asian markets as is reflected in their current-account surpluses. With the exception of China, the decline of capital goods imports, the combination of continued lower rates of foreign direct investment and higher relative unemployment rates since 1998, and overall declining rate of capacity utilization all point to lower rates of job creation and capital formation. In short, the timeliness of this volume in addressing a key structural change necessary for democratizing Asian capital markets remains more urgent than ever.

The Milken Institute and the University of Hong Kong jointly hosted the first Asian Bond Market Forum in 2003 in Hong Kong. The four-day event included several round tables, in which a collaborative network of practitioners, academics and regulators discussed various ways to promote the development of local-currency bond markets in Asia. The ultimate goal of this activity was to suggest reforms that could be taken to enhance financial infrastructure throughout Asia in order to better facilitate strong, stable and sustainable growth. As a result of these roundtables and other interactions among attendees, it was apparent that a book that thoroughly reviews and analyzes the current bond market situation and address impediments to further development was needed. Since 2003, the participants have worked diligently to further detail their empirical analyses and sharpen their recommendations that appear here. This book thus adds to the still relatively few volumes that are dedicated to developing broader bond markets worldwide.

An up-to-date analysis of the underlying financial infrastructure contributing to the Asian crisis and an assessment of current economic condition today are provided. Most importantly, the role of bond markets in promoting growth and stability in Asia are emphasized. Comprehensive information is utilized throughout the book to provide a blueprint for bond market development. The book is the result of a unique collaboration of experts with experience and perspectives gained from backgrounds in the academic, legal, governmental and practical investment fields.

Preface

The Development of Effective Securities Markets

Gary Schinasi

International Monetary Fund

One of the more important lessons of the crisis of the 1990s—not just the Asian Crisis—is that the performance and structure of a country's financial system is an important fundamental factor for assessing that country's overall economic performance and prospects, and as a destination for investment and asset returns. Market participants that are presently managing international portfolios now understand this very well. And as we all know, many countries are making strong efforts to reform their financial infrastructures, and move their financial systems more in the direction of a market-intermediated financial system and away from an exclusively bank-intermediated system.

These reform efforts are putting in place some of the important infrastructure elements that are *necessary* for developing effective securities markets. However, emphasis should be placed on the word necessary: as many of these measures, and all of them taken together, are *only* necessary and not sufficient for establishing effective security markets.

By all accounts, the measures taken so far by many countries in Asia are certainly in the right direction. But they are only a beginning, and they do not necessarily establish well-functioning effective markets per se, at least not yet. And there are risks. One concern that may be on the minds of market participants is that countries will view their efforts to date as very substantial and become overly comfortable with them to the point of becoming complacent in the judgment that they have done enough. It has taken many decades for effective bond markets to develop in the United States and Europe, so it would be reasonable to expect that it would take some time for them develop in Asia, though probably not as long because of the advances in information and computer technology in the past two decades.

Why might reforms to date *not* be sufficient to ensure the establishment of effective bond markets in countries in Asia? Broadly speaking, finance—both bank oriented and market oriented finance–is primarily about **pricing** and **allocating capital** and **financial risk.** Countries can import and implant the most highly sophisticated trading platforms, clearance and settlement systems, and even supervisory and regulatory infrastructures. However, this does not necessarily establish effective financial markets and an effective and well-functioning financial system.

Markets are comprised of market participants, and the pricing and trading activities surrounding the financial products they supply and demand. These financial activities can be allowed and encouraged to evolve more or less naturally and appropriately within the context of the particular economy, economic and financial history, and culture, otherwise the imported sophistication will count for very little... except perhaps to attract foreign capital, and then only temporarily.

So how can the development of a **"finance culture"** be encouraged and fostered? There are no clear uniform answers or blueprints appropriate for all countries. But in all countries the accurate **pricing** of risk is key.

In this last respect—the pricing and allocating of risk—the role of securities markets in Asia is no different from in other countries. And Asia would seem to be in a position to benefit from effective securities markets. From a broad perspective, Asia has

- high domestic savings rates
- great investment needs
- large **gross** capital inflows and outflows
- and primarily, bank-dominated financial systems

In Asia, as elsewhere, reliance on securities markets can

- improve opportunities and returns for savers,
- reduce costs for borrowers
- improve opportunities for financial risk taking,
- and improve the ability to manage financial risk

Moreover, from a national perspective they can

- reduce concentration of risk in the banking and payments system
- improve ability to prevent systemic problems, by dispersing the ownership of risk
- facilitate the repricing and reallocation of risk as economic and financial circumstances change.

There would be at least two important benefits associated with developing effective securities markets. First, they provide a more transparent and in some ways more effective way of pricing and distributing risk. Effective securities markets are a way of diversifying the financial system.

Second, in order to attract and sustain capital flows from abroad, and to more effectively allocate domestic savings at home, investors prefer well designed and appropriately regulated markets that are deep, liquid, and transparent, to those that are not. Given the choice, investors will gravitate to the safer markets that are more likely to ensure liquidity, even during turbulent period.

Looking at the experience of countries that have the most highly developed securities markets, one can point to important elements of their development that may account for the roles they are playing in their respective economies. An important, and often overlooked element, and one that I shall only state, is the level of sophistication and maturity of their economic system. Financial systems work best when they are appropriate for the economic system. By looking at the United States and Europe one cannot help but conclude that well developed government securities markets played an important role.[1] More recent work on the U.S. Treasury Securities markets suggests that government paper seems to provide some financial characteristics that are important, but which U.S. market participants are capable of learning to do without by finding private substitutes.[2]

What are some of the more important elements of effective **private** securities markets, and in particular for **pricing** and **allocating** funds? A list would certainly include the following:

- *Well-functioning money markets* appear to be a critical first step in developing corporate fixed-income markets.
- *Development of an investment-banking culture* for effectively matching demanders of funds with suppliers of funds within markets, rather than across bank balance sheets. Along with this is the need to establish well-functioning primary and secondary securities markets.
- *The emergence of a domestic investor base* is important for developing domestic securities markets, and particularly markets for corporate fixed income securities.
- *Elimination of impediments to market development, which can emanate from within the financial industry* itself, most often from market power in the financial industry that stifles access to securities markets or impedes the functioning of securities markets.
- *Appropriate and effective regulation.* Ineffective regulation in primary or secondary markets is one of the most important reasons historically for the lack of development of corporate debt securities markets in many economies. Of course, weak regulation and supervision of securities markets has also stunted the development and growth of securities markets. Finding the right balance of regulation and market discipline is an important practical issue.

These factors do not constitute an exhaustive list of influences on the development, or lack thereof, of debt securities markets, and there are other more fundamental determinants such as legal structures (including commercial codes), cultures, and histories. Accordingly, there is no simple recipe for "how to" foster the development of securities markets. These factors can be seen as necessary but not sufficient characteristics of effective securities markets, or at a minimum as useful

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[1] See the reference cited in footnote 1.

[2] See "Financial Implications of the Shrinking Supply of U.S. Treasury Securities", with C. Kramer and R. T. Smith, IMF *Working Paper*, 01/61 (May 2001).

for avoiding some historical obstacles to the development of debt securities markets. They also offer some guidance on valuable market practices.

There are characteristics of markets that I have not discussed that are key determinants of the development of effective securities markets. Market liquidity, for example, is a key characteristic of highly developed securities markets. Investors must feel confident that they can buy and sell securities of relatively large quantities without significantly affecting prices and that they can liquidate their holdings in a reasonable period of time, if not immediately. As such, market liquidity can neither be legislated nor dictated by regulations; it must be promoted and nurtured by instilling investor confidence, in part by fostering market integrity, investor protection, and an effective market infrastructure. Each of these factors underlying liquidity can take a considerable time to develop.

Similarly, an essential element of a debt securities market is a finance culture and an investor base with an appetite for evaluating and trading in credit risk. It is relatively straightforward to describe the characteristics of an active and sophisticated investor base, but again it cannot be decreed, and in practice investor bases have developed only gradually as the above characteristics of markets have evolved. The advantage of developing securities markets in the current global financial environment is that there is a ready made international investor base eager to invest in countries with sound fundamentals, reasonable returns, and relatively efficient markets and financial infrastructures. There are a host of additional factors that I have not discussed.

There are also somewhat more fundamental, deeper characteristics of financial architecture and economic structure that influence how the art of finance develops in a particular nation. Historically, U.S. corporate debt securities markets flourished for periods of time in environments characterized by extreme segmentation in the financial system, financial crises and panics, often confusing and overlapping systems of financial supervision and regulation, and a lengthy list of distortion-prone financial sector policies. The strict separation of commercial banking and securities markets, for example, may have encouraged the development of a competitive and efficient set of investment banks and securities firms. Moreover, the more fundamental legal structure of the commercial code and bankruptcy laws, and the systems and patterns of corporate governance that emerged through time also played an important role. Thus, taken together all of these factors might have worked together to encourage finance in the United States to focus to a larger extent than in other countries on tradable and marketable securities rather than closely held, non-traded loan agreements between two counterparts.

By contrast, the underlying legal infrastructures, commercial codes, and governance mechanisms through time encouraged the development of the universal banking concept in European countries, which by encouraging bilateral loan agreements might have discouraged, or at least not encouraged, the more active use and development of tradable and marketable securities and the market structures to price and allocate them. These more fundamental influences are in some ways more important than the factors I have identified because they heavily influence the evolution of economic and financial relationships over long periods of time. As such, they may be difficult to change quickly even if there is the desire to do so.