The Emerging East Asian Bond Market

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The rapid growth of East Asia's bond markets mirrors the region's spectacular economic development. East Asian bond markets are projected to thrive over the next decade, reflecting continued strong private sector growth and deepening financial reforms.

EAST ASIA'S financial markets have caught up, though somewhat belatedly, with the rapid development of the region's real economy. The region's financial markets, which were dominated by commercial banks, have been transformed by the emergence of a wide array of financial instruments, including equities and bonds. At the end of 1994, total market capitalization of the East Asia Stock Exchanges amounted to 71 percent of East Asian GDP, while bonds represented 22 percent of GDP (Table 1). The development of the securities markets was aided by increased foreign portfolio investment in East Asia's booming economies, which was attracted by open capital accounts, stable exchange rates, and sustained macroeconomic stability.

The emergence of bond markets is linked to financial liberalization. Until early 1980, East Asian banking systems were repressed by extensive controls on interest rates and credit allocation. In recent years, reforms have dramatically transformed the financial environment in the region, giving a boost to the development of bond markets.

Size and structure

Although small compared with bond markets in industrial countries, the East Asian bond market is a substantial presence in the bond markets of emerging market economies, representing about 40 percent of their combined market value. During 1989–94, the East Asian bond market grew by almost 10 percent annually (see chart)—twice the growth rate of bond markets in Germany, Japan, the United Kingdom, and the United States.

National governments have been by far the largest issuers of securities in the East Asian bond markets (Table 2). State enterprises and central banks were also significant issuers of bonds, particularly in the Republic of Korea. Private corporations were not very active in the early stage of bond market development in East Asia, reflecting pervasive controls on financial systems, inadequate investor protection, and tax discrimination. The situation has

Table 1
East Asia
Relative position of bank assets, equity, and bonds in 1994

	Bank assets		Stock market capitalization		Bond market	
	Billion dollars	Percent of GDP	Billion dollars	Percent of GDP	Billion dollars	Percent of GDP
China	388	76	44	9	33	7
Hong Kong [1]	257	195	270	205	11	9
Indonesia	90	57	47	30	9	6
Korea	283	75	192	51	161	43
Malaysia	70	100	199	283	40	56
Philippines	34	54	56	87	25	39
Singapore	115	186	135	217	45	72
Thailand	153	110	132	94	14	10
Total	**1,390**	**92**	**1,073**	**71**	**338**	**22**

Source: World Bank.
[1] Includes only Hong Kong dollar-denominated assets.

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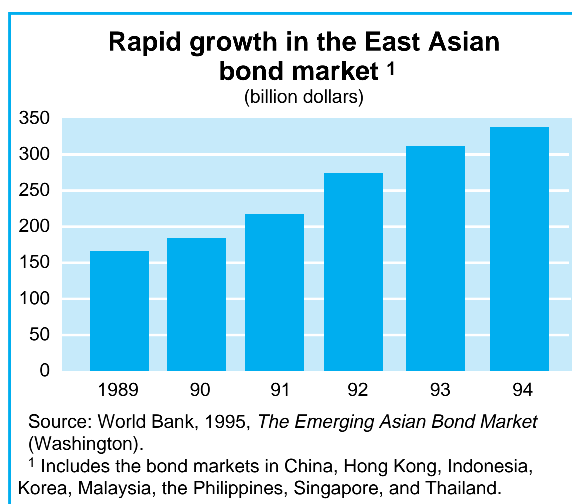
changed in recent years, with financial and other reforms; corporate bond issues have been rising rapidly, both in absolute terms and relative to other issuers of bonds in East Asian markets since 1990.

The growth of private bond issues has been stimulated by three main factors. First, most East Asian governments have been corporatizing and then privatizing their major state enterprises, notably major public utility companies. Since the intention was not to shed ownership control during the initial phase of privatization, state enterprises were encouraged to meet their financing needs mainly by issuing bonds in the domestic market. This is well illustrated by the case of Thailand, where state enterprises' bonds constitute the largest segment of the domestic bond market. Second, the fastest-growing firms tend to prefer bond to equity financing, both because bonds allow owners to retain greater control over corporate decisions and because their massive investment requirements cannot be adequately met by bank finance or rights issues. Third, while commercial banks played a vital role initially in financing the needs of public and private enterprises in East Asia, their ability to carry out maturity transformation has been seriously constrained of late by large capital requirements. Too much long-term lending has led to asset and liability maturity mismatches. Moreover, the adoption of risk-based capital-adequacy requirements has restricted banks' ability to finance private fixed investments.



Source: World Bank, 1995, *The Emerging Asian Bond Market* (Washington).
[1] Includes the bond markets in China, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, and Thailand.

Three major classes of institutional investors—the contractual saving sector, pension funds, and financial institutions—hold the bulk of East Asian bonds. Bond holdings by individuals are negligible, except in China, where individuals are the major investors in government bonds. The extent to which each of the investor classes dominates the bond markets varies from country to country. In Malaysia, the Philippines, and Singapore, the contractual savings sector constitutes the largest single segment. Financial institutions are the dominant bondholders in Korea, the Philippines, and Thailand, although in Thailand, mutual funds are becoming more prominent as major investors in bonds.

Holdings of East Asian bonds by foreigners surged between 1990 and 1993 (Table 3). International bond issuance by East Asian countries has been very successful, reflecting their past economic performance, good track records in servicing external debt, and the growth potential they offer to international portfolio investors. Foreigners' access to domestic bond markets in the East Asian countries has been limited in the major markets, however, owing to the policies of the authorities in these markets. Indonesia, Malaysia, and Thailand allow relatively easy access to their domestic bond markets, but the bond market in Korea is not open to foreign investors to any significant degree, and China's bond market is currently closed to foreign investors.

Table 2
East Asian bond market
(end of 1994, billion dollars)

	National government	State government	State enterprises	Central bank	Corporate sector	Total
China	24.4	0.0	9.0	0.0	0.0	33.4
Hong Kong	0.1	0.0	0.0	6.8	4.7	11.6
Indonesia	0.0	0.0	1.5	6.8	0.7	9.0
Korea	27.9	2.7	37.4	32.1	60.8	160.9
Malaysia	29.0	0.0	3.7	2.0	4.9 [1]	39.6
Philippines	24.8	0.0	0.1	0.2	0.0	25.1
Singapore	42.3	0.0	0.0	0.0	2.5	44.8
Thailand	2.6	0.0	7.6	0.0	3.5	13.7
Total	**151.1**	**2.7**	**59.3**	**47.9**	**77.1**	**338.1**

Source: World Bank, 1995, *The Emerging Asian Bond Market* (Washington).
[1] Includes Cagamas bonds issued by the National Mortgage Corporation.

The markets

Primary markets. There is no uniform practice among East Asian countries regarding the organization of primary markets, the range of issuers and investors, the instruments available, and bond-issuance methods. Government bonds in primary markets are issued by competitive auction in Hong Kong and the Philippines. In contrast, in China, government bonds are placed through administrative allocation, which often leads to their prices being below the market-determined level. Issuance practices for government bonds in the rest of East Asia fall somewhere between these extremes. As experience and expertise have been gained, the differences in practices among the East Asian countries have substantially narrowed, and the functioning of primary markets for government bonds has tended increasingly to approximate those in the industrial countries.

Issuance methods for private bonds vary widely across the region. In Thailand, for example, public issues of bonds are more cumbersome than private placements, since issuers must satisfy various stipulations of the Security Exchange Commission. In the Philippines, private bond issuance—which generally consists of commercial paper with a maturity of less than one year—is limited to a handful of blue-chip corporations. Among the East Asian countries, Korea has the largest corporate bond market. As is true of the primary markets for East Asian countries' government bonds, practices, and procedures for issuing corporate bonds in the region are beginning to converge to common norms based on best practices prevailing in Japan and the United States.

Secondary market. East Asian countries are gradually building an infrastructure for secondary markets for bonds, although trading has been modest so far. Hong Kong and Korea have the most active secondary markets, with a turnover rate averaging about 58 percent in 1993. In the East Asian bond market, trading in any particular issue is typically active shortly after the initial offering and tapers off immediately after. Thus, secondary market activity tends to rise and fall with primary market activity.

Trading in bonds is mostly over the counter (OTC), as in the industrial countries, even though bonds are generally listed on stock exchanges. Exchange listing is often seen as a requirement for widening the investor base and enhancing the acceptability of bonds, particularly when institutional investors are prohibited from holding unlisted securities. The predominance of OTC trading is due to the relative ease of trading because of the absence of minimum trading amounts, less restrictive trading times, and expeditious and prompt settlements. For example, virtually 100 percent of trading in Korea takes place on the OTC market even though more than 80 percent of bonds outstanding are listed on the Korean Stock Exchange.

Table 3
Foreign private capital flows to East Asia
(billion dollars)

	1985	1990	1991	1992	1993	1994
Commercial banks	1.0	4.5	5.1	7.6	-2.1	--
Bonds	4.3	0.5	3.6	3.0	8.2	--
Other private flows	2.2	2.2	1.9	6.2	2.4	--
Foreign direct investment	3.2	11.0	14.0	20.9	36.5	42.7
Portfolio equity flows	0.1	2.3	1.0	5.1	18.1	17.6
Total	**10.9**	**20.5**	**25.6**	**42.8**	**63.1**	**60.3**

Source: World Bank, 1995, *Managing Capital Flows in East Asia* (Washington).

There are several impediments to the development of a vigorous and vibrant secondary bond market in East Asia. The absence of a critical mass of bonds and the relatively small size of issues tend to raise the transaction costs of trading. As fiscal deficits decline or disappear, the number and frequency of government bond issues are declining in the East Asian countries, except in China and the Philippines. Though the gap is being filled by corporate bonds, trading volume in the latter has not reached the threshold necessary for the development of secondary market trading. This reflects several related factors, such as a narrow eligibility criterion for bond issues by corporations, elaborate and long drawn-out issuing procedures, the absence of a streamlined regulatory framework, and discriminatory taxation. Moreover, institutional holders, who form the backbone of the bond market, are "buy and hold" investors whose main objective is to avoid or minimize mismatches in the maturities of their assets and liabilities. There is thus little incentive for secondary market trading in bonds. The situation, however, is slowly changing, with greater autonomy being given to the managers of pension, provident, and insurance funds and more flexibility permitted in their operations.

Other factors, such as a lack of market makers with access to liquidity support, also hamper bond market development. Bond dealers run highly leveraged operations, and their inventories usually represent a certain multiple of their capital bases. Dealers can be market makers only if they obtain liquidity through the repurchase market or the central bank rediscount window. Credit facilities of this type are presently unavailable in most East Asian countries.

The secondary bond market also needs to be supported by an institutional infrastructure that includes, among other things, efficient clearing and settlement arrangements, credit-rating agencies, and bond insurance. Clearing, settlement, and payment systems are either absent or not fully developed; and, as a result, traders run many risks, such as those that may be created by the unreliability of counterparties, fraud, and multiple trades of the same securities. Except in Malaysia and Thailand, there are no respected and prestigious rating agencies. Likewise, except in Hong Kong, there are no market-based benchmarks that can guide market participants to price bonds in both the primary and the secondary markets.

Progress has been made in many of the areas of institutional infrastructure during the last few years, however. In Hong Kong, a Central Money Market Unit system now discharges the clearing and settlement function. Malaysia has set up two clearing systems—one transfers funds in the interbank money market and the other transfers scrip through electronic book entries. Rating agencies are being set up, too, in countries like Indonesia, Korea, and the Philippines. Malaysia's effort to develop a benchmark bond through Cagamas—a mortgage bond—is a particularly striking example of an innovative response by policymakers to the institutional imperatives.

Regulation of bond markets

Bond market regulation in East Asia has gone through major changes in recent years. Until 1991, central banks were largely responsible for regulating fixed-income securities. Then, primary responsibility shifted to newly created securities and exchange commissions. However, regulatory practices are not uniform across countries in the region. In Indonesia, for example, the domain of the securities regulator, BAPEPAM, is limited to financial instruments with maturities exceeding one year, while the central bank is responsible for regulating money market instruments. In Singapore, regulation of financial instruments falls within the jurisdiction of the Monetary Authority of Singapore. Hong Kong and the Philippines follow the more common practice of placing private sector bond offerings under the charge of securities commissions. Despite all these divergences in regulatory practices, a consensus is emerging, in all the countries, that the main regulatory powers need to be vested in securities commissions.

The future

The coming decade promises to be the age of the Asian bonds; the size of the East Asian bond market (excluding Hong Kong and Singapore) could grow to over $1 trillion, net of redemptions, by the year 2004. Korea is projected to be the leader in the region, followed by China, Malaysia, and Thailand. The profile of the bond market is likely to change dramatically, with the corporate sector leading the way in most of the countries, except China and the Philippines, and surpassing the government as the major issuer of bonds.

The projected rapid growth of the region's bond markets is contingent upon the continuation of sound macroeconomic management and policy and institutional reform. Most of the East Asian countries have undertaken comprehensive policy reforms during the past decade—deregulating banking systems, jettisoning directed credits, laying the infrastructure for deepening financial markets, introducing new financial instruments, and establishing a modern legal framework. However, there is a residue of reforms yet to be carried out, particularly concerning banking systems, regulatory authorities, and institution building. After these reforms are in place, the East Asian bond market will come into its own. F&D

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