

Is There a Case for an Asian Bond Fund?

While there has been a tendency to over-sell the merits of the Asian Bond Fund in some circles, the proposal ought to facilitate the diversification of the region's external financing from quantity-based bank lending to price-based bond financing and should also help reduce the region's vulnerability to 'erratic' international investors.

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A notable consequence of the East Asian financial crisis of 1997-98 has been the emergence of keen interest in exploring various forms of regional monetary and financial cooperation (RMFC). Proposals for such cooperation have ranged from ambitious calls to form a regional monetary union and common currency, on the one hand, to shallower forms of cooperation involving regional capacity building and dialogue, on the other. The most recent manifestation of the desire to enhance RMFC has been a proposal by Thailand's prime minister, Thaksin Shinawatra, to establish an Asian Bond Fund.

The basic idea of the Thaksin proposal is for regional governments to voluntarily contribute about 1 per cent each of their reserves to a fund dedicated to purchasing regional bonds. The proposal simultaneously involves the establishment of an Asian credit agency to offer impartial advice, analysis and general information to both issuers and subscribers of the regional bonds. Singapore's prime minister, Goh Chok Tong, endorsed the proposal, as have many other Asian government leaders and officials. The proposal has since generated a degree of interest in the media and regional analysts, far more than when PM Thaksin had first broached the issue at the World Economic Forum's annual East Asia Economic Summit in Kuala Lumpur in early October 2002.

As with many such proposals to enhance RMFC in Asia, this one is rather vague – long on rhetoric but short on detail. Important questions remain as to the initial membership of the Fund (ASEAN, ASEAN

plus Three, ASEAN plus Dialogue Partners, all of East Asia, all of Asia?), its management, type of bonds to be issued, issues arising from differing stages of financial development and varying degrees of restrictiveness of capital movements across countries in the region, the transactions costs of setting up such a scheme, and such (see accompanying box). While a number of details need to be worked out, it is imperative that the main objectives be clarified if the proposal is to come to fruition and operate effectively.

Four distinct objectives have been mentioned at various times in relation to

the Asian Bond Fund proposal:

- (a) Diversifying debt financing from bank lending to bond financing.
- (b) Reducing the region's vulnerability to 'fickle' international investors.
- (c) Reducing the region's vulnerability to uncovered US dollar borrowing.
- (d) Enhancing regional liquidity.

To preview the main conclusion of this note, a well-functioning Asian Bond Fund may help with the attainment of the first two objectives but not necessarily with the third and fourth ones. Why?

With regard to the first objective, if regional economies hold one another's bonds, this ought to facilitate diversification of financing from bank lending to bond financing (Table 1). This is particularly so if such actions help lower risk premia of regional bonds hence encouraging others to enter the market. But why is there a need to diversify away from bank lending? What is wrong with Asia's continued heavy dependence on bank financing?

Bond financing is considered a relatively more stable source of debt financing, as bank loans are primarily illiquid, fixed-price assets in the sense that the interest rate – which is the price of the loan – does not vary much on the basis of changing market circumstances. Thus,

Table 1: Bank Loans, Debt Securities and Equities in Asian Crisis Countries and the US

(End of 2000, per cent of GDP)

	Outstanding Bank Loans	Outstanding Government Securities	Outstanding Corporate Bonds	Equity Market Capitalisation
Indonesia	60.2 ¹	0.0	1.7	20.1
South Korea	59.6	7.7 ²	25.9	36.4
Malaysia	122.7	1.0	9.2	83.6
Thailand	99.2	0.0	4.2	26.3
US	38.9	33.7	45.4	178.9 ³

Notes: (1) at the end of 1997.

(2) Since 1997, the issuance has rapidly increased to mobilise the resources for financial restructuring.

(3) At end of 1999.

Source: Yun-Hwan Kim, 'Developing Treasury Securities Markets in Asia', Asian Development Bank, mimeo, June 2001.

Table 2: Net Private Capital Flows to Developing Economies

(US dollars, billion)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002 (p)
Total private capital flows	102.0	108.0	139.2	150.1	187.8	130.2	65.2	49.7	16.1	8.3	28.6
Of which:											
Direct investment	32.3	52.1	74.5	82.4	104.3	128.6	129.8	131.8	129.9	147.3	115.5
Portfolio flows	55.5	66.9	93.5	16.7	64.4	36.8	1.8	12.8	-17.9	-51.5	-12.8
Bank flows plus other private flows	14.2	-11.0	-28.8	51.1	19.1	-35.3	-66.4	-94.9	-96.0	-87.5	-74.1

Note: p - projected

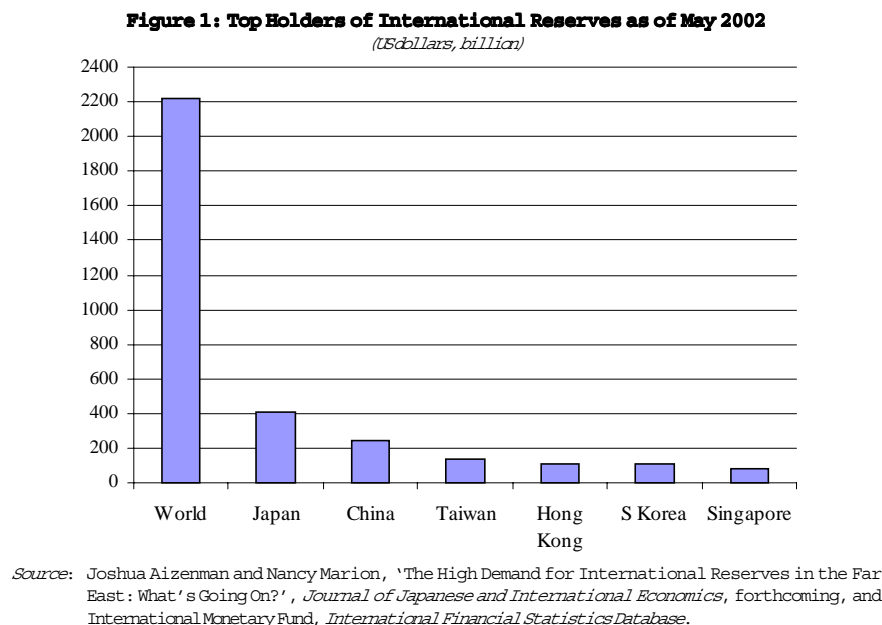
Source: International Monetary Fund, *World Economic Outlook*, various issues.

almost all the adjustment has to take place via rise and fall in the quantity of bank lending, which in turn leads to sharp booms and busts in bank flows (Table 2). These sudden reversals in bank flows had calamitous and long-lasting effects on the domestic financial systems in the East Asian economies in 1997-98.

With regard to the second objective, one of the reasons for the intensification of the regional financial crisis of 1997-98 was the fickleness of international investors, many of whom were extra-regional ones who did not have much knowledge about the regional economies or differences in economic fundamentals between the economies. There was significant 'panic herding' or 'bandwagon' effect during that period as international creditors and investors chose to reduce exposures to all regional economies en masse once they were spooked by the crisis in Thailand and Indonesia, leading to a massive international bank run.

Insofar as the Asian Bond Fund proposal promotes greater intraregional financing, this presumably ought to make the region somewhat less susceptible to extra-regional 'investor ignorance' which led to an indiscriminate and disorderly withdrawal of funds from regional markets in 1997-98. In relation to this, the Asian Bond Fund can be a means by which burgeoning Asian surplus savings are galvanised and directly channelled into regional investments, particularly much-needed longer-term ones (bonds tend to involve maturities of over one year).

If the proposed Asian Bond Fund involves bonds of longer-term maturity which



are more 'durable' and therefore less reversible, it should further enhance regional financial stability. Indeed, as made apparent by the 1997-98 regional crisis, the extreme reversibility of short-term debt in the event of a negative shock exposes borrowers to liquidity runs and systemic crises; consequently, it is not surprising that the extent of short-term indebtedness has been found to be a key indicator of illiquidity and a robust predictor of financial crises.

With regard to the third objective, another source of vulnerability made apparent by the 1997-98 financial debacle arose due to large-scale accumulation of uncovered external debt. To the extent that

a relatively larger proportion of a country's liabilities is denominated in foreign currency vis-à-vis its assets (so-called 'liability dollarisation'), a currency devaluation could lead to sharp declines in the country's net worth, with calamitous effects on the financial and real sectors (so-called 'balance sheet' effects).

Would the proposed Asian Bond Fund help reduce this source of vulnerability? It is not readily obvious that it would, considering that the proposal involves US dollar government bonds. Indeed, it is in this light that many observers have suggested that there would be more value in the proposal if it involved regional bonds issued in domestic currencies rather than US dollars, though the yields on such bonds will invariably have to be higher to compensate for currency risk premia.

More importantly, the political feasibility of an Asian Bond Fund involving local/regional currencies is doubtful. Many smaller creditor countries like Singapore and Hong Kong may be unwilling to support an Asian Bond Fund if it involved them having to hold bonds denominated in 'weaker' regional currencies. Thus, the US dollar denomination of regional bonds might be thought of as a compromise to ensure the proposal gains broad acceptance from regional governments. It is plausible that the types of issuers (not just governments but also regional corporates), the currency denomination of bonds, as well as the aggregate size of the Fund may all increase in scope over time if the initial proposal is effectively implemented.

With regard to the fourth objective, it has been suggested in some quarters that

Box: Basic Outline of the Thaksin Asian Bond Proposal

While details of the structure and modality of the Thaksin proposal are to be worked out, based on initial reports and discussions, the following steps involved in creating the Asian Bond Fund may be deciphered:

- 1 Choose initial set of countries to be founding members of the Asian Bond Fund.
- 2 Member country governments agree to pool about 1 per cent of individual reserves into a "common fund".
- 3 Some or all member governments issue bonds in US dollars.
- 4 Other member countries use their share of their pooled reserves to subscribe to the bonds. A country can simultaneously be a issuer and subscriber of bonds (i.e. issue its own bonds, while purchasing to member country bonds).
- 5 An "Asian" Credit agency will be established to offer "transparent and impartial analysis of bond issuers and credit ratings".
- 6 Over time the proportion/size of pooled reserves may be expected to rise, as would the country membership, the entities eligible to issue bonds (i.e. not just governments bonds but also corporates), as well as the currency denomination of bonds (initially US dollars, then euro and other major convertible currencies and eventually local currencies including an "Asian Currency Unit" if established).

Source: Author

the Asian Bond Fund is a second step after pooling of reserves by regional economies. Recent research by this author has suggested that there may be a sound rationale for Asian economies to consider pooling part of their reserves as a means of safeguarding countries against *liquidity crises* and as a natural extension to the existing Chiang Mai Swap Arrangement which is an important step in RMFC in and of itself. Asia, after all, possesses the bulk of the world's international reserves. To be sure, Japan, China, Taiwan, Hong Kong, South Korea and Singapore are the top six reserve-holders, with a combined total of over US\$ 1,000 billion in mid-2002 (Figure 1).

The key issue is 'liquidity'. There is a basic catch-22 in that the *raison d'être* of holding reserves (individually or as part of a pool) is that it enhances regional liquidity. If the regional government/central banks use some of their reserves to hold regional bonds, especially longer-term regional bonds (as opposed to US treasury-bills and notes), the liquidity objective is compromised. Thus, it is

unclear how the proposed Asian Bond Fund will directly enhance regional liquidity.

The foregoing discussion suggests that there has been a tendency to over-sell the merits of the Asian Bond Fund in some circles. This notwithstanding, the proposal ought to facilitate the diversification of the region's external financing from quantity-based bank lending to price-based bond financing and should also help reduce the region's vulnerability to 'erratic' international investors (though it warrants keeping in mind that domestic and regional investors also fled the regional markets in droves during the height of the crisis). With regard to financial stability, even greater benefits may accrue from the proposed fund if it is extended to domestic currency debt, though this may make the proposal politically unviable in the near term.

In the final analysis, regardless of whether the proposal bears fruition, it is critical that such proposals for regional cooperation do not detract from domestic structural reforms. After all, a regional alliance is only as strong as its weakest link. **EPW**