

## **The ABC of the Asian Bond Fund**

*It could work as an insurance against another Asian crisis, says Ramkishan S Rajan*

**By RAMKISHAN S RAJAN**

WHILE the regional economies are taking note worthy steps to strengthen and upgrade their respective financial systems, the contagious nature of the 1997-98 crisis has convinced many observers and policy makers that there are significant positive spillovers from cooperating to develop regional financial markets.

There have been a number of recent proposals and initiatives to enhance regional financial cooperation. Among the latest is the establishment of an Asian Bond Fund (ABF) which was initially proposed by Thai Prime Minister Thaksin Shinawatra.

The ABF came into force in June 2003 when 11 Asia-Pacific central banks created a regional fund of US\$1 billion by pooling a small portion of their foreign exchange reserves.

The countries involved are Australia, China, Hong Kong, Indonesia, Japan, Malaysia, New Zealand, Singapore, Thailand, the Philippines and South Korea - all of which are members of the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP).

Individual amounts pledged to the fund ranged from US\$25 million by New Zealand to US\$120 million by Thailand (the ABFs most enthusiastic proponent), with most other economies contributing US\$100 million. India has confirmed that it will invest about US\$1 billion of its own reserves in the ABF.

Other reform-minded countries in Asia ought also to be encouraged to join as full members, making the ABF truly pan-Asian, as its name suggests. The fund itself is passively managed by the investment management unit of the Swiss-based Bank for International Settlements (BIS Asset Management). Its mandate is to invest in a basket of liquid US dollar sovereign and quasi-sovereign debt issued by major member economies (excluding Australia, Japan and New Zealand).

What is the economic rationale for the creation of the ABF? It is commonly noted that, if regional economies hold each others' bonds, this ought to facilitate diversification of financing from bank lending to bonds. 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 effectively the price of the loan, does not vary much on the basis of changing market circumstances. Thus, almost all the adjustment has to take place via a rise and fall in the quantity of bank lending, which in turn leads to sharp booms and busts in bank flows.

These sudden reversals in bank flows had calamitous and long-lasting effects on the domestic financial systems in some East Asian economies in 1997-98. One of the reasons for the intensification of the regional financial crisis was the seeming fickleness of international investors, many of whom were from outside the region.

There was mass panic during that period as international creditors and investors chose to reduce exposures to all regional economies en masse once they were spooked by the crises in Thailand and Indonesia.

Insofar as the ABF promotes greater intraregional financing, this ought to make the region somewhat less susceptible to foreign investor ignorance and consequent sudden and sharp international capital withdrawals.

Probably an even more convincing line of reasoning is that the ABF can be a means by which burgeoning Asian savings are galvanised and directly channeled into regional investments. If the proposed ABF involves bonds of longer-term maturity, which are more durable and therefore less reversible, it should further enhance regional financial stability.

However, the ABF as it is currently structured, has a major limitation. Since it deals with regional bonds in US dollar denominations, it will not help in reducing the region's vulnerability to uncovered US dollar borrowing. As made clear in 1997-98, to the extent that a relatively larger proportion of a country's liabilities is denominated in foreign currency vis-a-vis its assets, a currency devaluation could lead to sharp declines in the country's net worth, with catastrophic effects on the financial and real sectors (so-called balance sheet effects).

It is in this light that many observers have suggested that there would be more value in the ABF if it involves 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.

It is noteworthy that current proposals to extend the ABF would have regional governments and corporations issuing bonds in domestic currencies or a basket of regional currencies. It is also expected that future phases of the ABF will involve local currency bonds as well as include a larger portfolio of non-investment grade issues.

While a well-functioning and expanded ABF could promote the development, efficiency and integration of the Asian financial markets, its role in fostering the secondary market of Asian bonds will remain limited in view of the passive investment mandate of the BIS.

In any event, the ABF should play a catalysing role in bolstering interest in and demand for Asian fixed income instruments over time. Market evidence suggests that there is considerable latent demand for such assets. Nevertheless, for the benefits of the ABF to be enjoyed in full, it is imperative that steps be taken to improve and harmonise the regional regulatory, infrastructural and institutional frameworks.

In similar vein, individual countries need to continue taking steps to carefully liberalise their individual financial sectors, capital and currency markets that may impede regional financial market integration.

It is also critical that the ABF and future regional financial proposals do not detract from much-needed domestic structural reforms to broaden and deepen individual capital markets. After all, a regional alliance is only as strong as its weakest link.

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