Developing local currency bond markets in South-East Asia

Role of local currency bond market

Countries in South-East Asia, in common with those in other subregions, face the challenge of efficiently deploying financial resources to effectively pursue implementation of the 2030 Agenda. The private sector, particularly non-bank private institutions and individuals, can play a vital role in this regard. Fostering government and corporate bond markets can be an important avenue by which Governments and the corporate sector can diversify and increase their financing sources. Bond markets help to reduce excessive reliance on short-term funding from the banking sector. South-East Asia remains highly dependent on banks for private financing. It is estimated that commercial banks account for more than 80 per cent of the total financial institution assets in ASEAN. Moreover, development of local currency bond markets in the subregion can help mitigate currency and maturity mismatches.

In such a context, the robust growth in local currency bond markets in South-East Asia in recent years is a positive development. The size of the market in ASEAN economies stood at $1.19 trillion by mid-2017. However, this growth remains unbalanced across countries due to the continuing prevalence of a range of obstacles. The size of corporate bond markets remains small in most economies as local currency bond markets are concentrated by far in government bonds. The challenge is how to stimulate growth in the local currency corporate bond market to strengthen the financing options of the corporate sector. The potential demand pool for such bonds exists, given the high rate of savings in the region, which are invested mostly in low-yielding foreign assets, such as United States Treasury bills, due to the perceived lack of reliable investment opportunities within the region.

Segments of the local currency bond market

A few countries in South-East Asia have a developed local currency bond market in terms of relative size to GDP. The development is led by Malaysia and Singapore, followed by Thailand and to a lesser extent the Philippines (Figure 1). Indonesia has the smallest bond market in the region, followed by Viet Nam, while Cambodia, the Lao People’s Democratic Republic and Myanmar currently do not have an active bond market. The reasons for the lack of a bond market in the smaller economies include lack of sufficient macroeconomic stability and the strength of legal protection of borrowers.
The 1997/98 Asian financial crisis played a catalytic role in propagating local currency bond issuance in the region, as issuers sought to avoid currency and maturity mismatches in the future. Subsequently, the 2008 global crisis further fuelled the growth of local currency bond issuance as a new source of funds for both government and corporate issuers. Governments turned to local currency bond markets to finance their fiscal stimulus packages in the post-crisis period. Corporate borrowers also turned to issuing more local currency bonds, as banks became reluctant to lend to them when global banking liquidity dried up.

In 2017, the purchasers of local currency government bonds were primarily domestic, with the highest foreign participation being nearly 40 per cent of total buyers in Indonesia, while Malaysia saw about 25 per cent and Thailand about 15 per cent. Among domestic purchasers, banks are the major group as compared with institutional investors, such as insurance or pension funds.

Challenges

Several challenges remain for local currency bond markets’ development in South-East Asia. First, despite considerable growth in the primary issuance of bonds, there is the challenge of secondary market liquidity, that is, there is a “buy-and-hold mentality” in the market. Examination of turnover ratios, measured as the ratio of total turnover to the average outstanding amount of debt securities, is one way to gauge the extent of the liquidity problem in the secondary market; a higher turnover ratio implies a more active and liquid secondary market. Turnover ratios for corporate bonds in South-East Asian countries range between 0.1 and 0.2, as compared with between 0.4 and 0.7 for government bonds (Figure 3).

To address these challenges, first it should be recognized that local currency bond markets are not developed overnight, but through an incremental and slow process. Such an incremental process has been observed in South-East Asia; such countries as Indonesia, the Philippines and Viet Nam first established a government bond market before the corporate one – other countries, such as Malaysia, Singapore and Thailand, have more advanced bond markets because they are wealthier economies and have more advanced financial sectors. Although a government bond market does not automatically lead to the development of a corporate bond market, a reliable benchmark yield curve provided by the government bond market is a necessary condition to allow for efficient and transparent pricing of corporate bonds.

Regional cooperation and integration also have a significant role to play, and ASEAN has undertaken several important initiatives. Notably, in 2003 the ASEAN+3 countries (ASEAN countries plus China, Japan and the Republic of Korea) launched the Asian Bond Market Initiative (ABMI), which is aimed at strengthening regulatory frameworks and necessary market infrastructure and promoting the issuance of local currency bonds. AsianBondsOnline was launched in 2004, which has greatly facilitated access to data in South-East Asia. In 2010, the Credit Guarantee and Investment Facility (CGIF) was established by ABMI in collaboration with the Asian Development Bank to foster standardization of market practices and the harmonization of regulations relating to cross-border bond transactions in the region and to provide credit guarantees for investment-grade local-currency bonds. As of March 2017, CGIF had issued 17 credit guarantees valued at $1.06 billion for bonds issued by 13 companies in 8 ASEAN member countries.
Policy recommendations

Several areas of policy focus should be considered. Improving market efficiency will involve increasing the size and liquidity of secondary markets. A deep and liquid secondary market can reduce liquidity risks and enable investors to exit from long-term bonds before maturity, leading to greater demand for such issues. Key reforms could include improving prudential norms and risk management practices of market participants; promoting institutional investors, who tend to have longer investment horizons, and foreign participation in domestic markets to increase the investor base and diversify risks; enhancing primary and secondary market architecture to provide the appropriate level of market transparency; promoting market-making activities to increase liquidity; increasing the size of benchmark bonds and extending the yield curve. These improvements in market infrastructure will require such aspects as standardized credit rating systems, risk management products and more efficiency in the trading and settlement system.

Lack of investor diversity creates the risk of high volatility and exposure to sector-specific risks. Encouraging institutional investors, such as pension funds and insurance companies, can help contribute to the development of long-term bond markets. Encouraging foreign institutional investors would be particularly useful as their investment horizons and preferences may differ from that of domestic investors, which can result in improved demand structure and secondary market liquidity. However, allowing foreign investors to enter local bond markets should be done cautiously: illiquid markets could undermine financial stability in case there is a sudden capital outflow, which would create volatility in interest rates and exchange rates.

Domestic bond market policies should be supplemented by subregional cooperation and integration to improve subregional market infrastructure. While regional integration in South-East Asia is arguably the most advanced in the Asia-Pacific region, financial integration has traditionally been weaker than that in trade, and economies often developed closer linkages with advanced financial markets rather than among themselves. Furthermore, integration of domestic bond markets has lagged the interconnectedness seen in other markets, such as for equities, although the degree of integration varies across countries. Some markets, such as Malaysia and Thailand, are relatively better integrated than others, such as Indonesia and the Philippines. A road map for capital market integration has been agreed as part of the ASEAN Economic Community, which should facilitate development of corporate bond markets development. It is critical to enable regional regulatory authorities to develop and implement appropriate regulatory frameworks to facilitate market development and integration, while safeguarding financial stability through the monitoring of increased competition and financial innovation.

In the short term it may not be feasible to establish corporate bond markets for some small countries in South-East Asia due to their very low volume of transactions. However, subregional cooperation can support the access of these economies to other subregional bond markets.

The Lao People’s Democratic Republic in recent years has been a leader among smaller South-East Asian economies in intraregional bond issuance, through the issuance of government bonds in the Thai market for infrastructure investment. The Governments of Cambodia and Myanmar and corporate entities could also consider Thailand’s market for financing their large infrastructure and corporate needs.

In the long run, it will still be important to encourage development of local currency bond markets to avoid excessive foreign-denominated debt and offer investment diversification opportunities to the domestic corporate and banking sectors. Cambodia has led the way in South-East Asia, announcing plans to establish a local currency bond market in the near term. In general, small South-East Asian countries looking to establish local currency bond markets will have to engage in a step-by-step process. The pace of financial development is of consequence: evidence shows that too fast a pace leads to instability – the main reason being poor regulatory supervision. Hence, the first step is to establish strong macroeconomic fundamentals to ensure that capital market development does not risk financial stability.

4 Data for 2008 are as of December 2008; 2017 data are as of December 2017. The total local currency bond market comprises both government and corporate bond markets. Source: Asian Bonds Online, ADB. Accessed from https://asianbondsonline.adb.org/.
5 For countries with available data. Available from https://asianbondsonline.adb.org/.
6 Calculated based on data from https://asianbondsonline.adb.org/.
9 Ibid.
10 Bond turnover ratio is defined as the ratio of total turnover to the average outstanding amount of debt securities. Data are not available for the corporate bond turnover ratio of Singapore. Data for 2017 are as of December 2017. Source: Asian Bonds Online, ADB. Available from https://asianbondsonline.adb.org.
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