Regional Financial Arrangements: Recent Developments

Remarks by Mr GR Stevens, Deputy Governor, to the APEC Business Forum 2004, Sydney, 15 April 2004.

It has become better recognised in recent years that the quality of financial infrastructure is one among several factors which help countries gain from international opening. A high-quality financial sector can assist local producers operating in a globalised economy to manage their risks more effectively. It also helps the domestic economy harness the greater availability of foreign capital.

Yet the experience of the east Asian countries in the late 1990s demonstrated that international openness also exposes any residual weaknesses in the financial sector, and that can potentially amplify the effects of international shocks to the great cost of the local economy. Since the Asian crisis, a great deal of effort has gone into trying to build more robust financial sectors in Asia.

Some of the most important work has been to repair and strengthen banking systems, a costly and time-consuming process. This has involved use of public funds to re-capitalise banks, and efforts to do a better job of prudential supervision. All of that has to be supported by efforts to clarify property rights, bankruptcy procedures and so on, and various countries in the region are working on those things.

One of the key initiatives around at present is the development of Asian bond markets. There are several groups seeking to make a contribution in this area and it is on this that I want to focus my remarks.

To a non-financial audience, the question might occur: what's the big deal about bond markets?

A key reason for wanting well-developed capital markets is that having a diversity of funding sources for governments, businesses and individuals, and a diverse range of opportunities for investors, is advantageous. A system which relies entirely on bank financing, or heavily on foreign capital market financing, arguably unduly concentrates funding risks. A full set of capital markets, on the other hand, offers a more comprehensive combination of financing and risk management to an economy. It would particularly offer currency risk matching for both borrowers and lenders in a way which would have been helpful during the Asian crisis. A deep and liquid official bond market also aids in pricing of assets and risks in the economy. Indeed, some countries have seen sufficient value in having a government debt market that they have taken steps to create one even though the government had no need to borrow (e.g. Hong Kong, Singapore) or to sustain one even when government debt was running down (e.g. Australia).

In the east Asian region outside Japan, the local currency bond markets collectively are thought to be about US$1.1 trillion in terms of total stock outstanding, up from around

US$350 billion a decade or so ago. That is a sizeable sum, but of course it is dispersed around a number of countries in what are essentially a series of local markets. Some countries in the region have first-rate financial infrastructure – legal and regulatory frameworks, trading platforms, clearing and settlement systems, and taxation arrangements. Other countries need, in the opinion of expert observers, more work to lift the quality of their infrastructure. Moreover, to develop a genuine regional market, in which savers and investors in the region can transact on a common set of arrangements, requires attention to harmonisation of many of these aspects of financial infrastructure. All of this is worth doing. The potential financing needs of some of the middle-income but fast-growing economies like China are very large indeed. To that could be added, if we shift our gaze a bit further west, the large and growing economic size of India. Hence there is likely to be significant pay-off to efforts to develop better functioning markets.

A question which arises at this point is whether the priority should be at regional level, in efforts to develop a regional, cross-border market, or at the level of individual countries, developing their own markets. Efforts on both fronts are surely needed. A regional market would offer some efficiencies and enhancements to issuers and investors, but would have to be underpinned by the individual country components. It is in each country's own interest to improve the functioning of their own market in any event. So the case for local initiatives is clear. But the push to take part in a regional project may well create the sort of dynamic which is helpful in overcoming obstacles at the national level, and the collective and individual outcomes will be stronger the more effectively market practices, and regulatory and legal issues, can be harmonised at a 'best practice' standard. Hence, done with good sense, it seems to me that local and regional efforts should be able to be consistent and mutually reinforcing.

Co-operative efforts have been initiated by various groupings to try to identify, and hopefully remove, the various structural impediments and to put in place some things which might accelerate market development. Work under the banner of APEC is seeking to promote securitisation and credit guarantee markets, in order to try to narrow the perceived credit and liquidity mismatch between borrowers in the region and institutional investors. This is helpful, so long as it does not amount to governments taking on large contingent liabilities which weaken their own credit rating.

Then we have the Asian Bond Fund being developed by the eleven central banks in the Asia Pacific region known as EMEAP.[1] The first step (ABF I) was the creation of a fund which pooled a small portion of the US dollar reserves held by the member central banks to invest in US dollar-denominated bonds issued by east Asian governments, as opposed to the US Government. This fund commenced operations last July.[2] The second and more difficult, but more fundamental, step will be the creation of ABF II, to invest in *local* currency-denominated sovereign and quasi-sovereign bonds in the region. Progress in developing the overall structure of this fund is well-advanced. The EMEAP central banks are now in the process of detailed study of design. As it happens, there was earlier today a press release informing markets and other observers of progress.[3]

While this work obviously adds slightly to demand for Asian bonds, the objective is *not* to lower artificially the funding costs for governments in the region by trying to divert major sums of central bank or other official money. Rather, it is to identify and remove where possible impediments to bond market investment, to develop some useful

1. Executives' Meeting of East Asia-Pacific Central Banks. Details of this group's composition, history and work can be found at http://www.emeap.org.
2. See http://www.emeap.org/press/02june03.htm.
3. See http://www.emeap.org/press/15apr04.htm.

infrastructure for investors, and to show the way with a small investment by official institutions. Once established, the ABF II will hopefully be emulated by the private sector, and some parts of the ABF II infrastructure itself will be available for use by private investors looking to acquire an exposure to Asian local currency debt. A well-functioning market will, of course, surely deliver lower cost borrowing to well-run government programs and to private borrowers over time.

Apart from APEC and EMEAP mentioned above, there is also work being done under the auspices of ASEAN plus 3, and the Asian Cooperation Dialogue. So clearly there is a lot of work going on. To date, these groups have managed to avoid working at cross purposes. As the various initiatives actually take more concrete form, it will be important to continue that parallel and complementary development – hence a degree of information sharing will be useful.

But ultimately, after all the facilitation efforts are completed, a critical factor determining the vibrancy of bond markets in the Asian region, as in any region, will be the quality of countries' policies. This starts with macroeconomic policies aimed at fiscal sustainability and price stability – where Asia generally has an exemplary record. It will include strong efforts at financial supervision – an area where a number of countries need ongoing development. It will also involve, in my view, the willingness of individual countries and their governments to allow markets to set prices and to play a major role in the allocation of funds – something some countries in the region have been less comfortable doing up to now. Most likely, countries will need to allow foreign firms to participate actively in market trading activities in order for market-making behaviour to flourish in key markets.

Australia's experience is that the 'embrace of the market' in this way can, on occasion, be uncomfortable. Markets will routinely react, and on occasion over-react, to government policies and other things which occur in the economy. Sometimes the market's reaction is uninformed, unfair or just plain wrong. But over the longer run, vibrant, if on occasion volatile, financial sectors do confer worthwhile benefits on an economy. They are not in any sense a magic bullet to achieve prosperity, but the evidence is fairly clear that properly functioning financial sectors do contribute to better growth. That is a not inconsiderable benefit to the firms, governments and citizens of the countries concerned.