Why Doesn't Asia have Bigger Bond Markets?

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Summary

Asia's underdeveloped bond markets and dependence on bank finance have attracted concern since before the crisis of 1997-98. The result has been a host of official responses, from reports by the multilateral financial institutions on the importance of reliable contract enforcement, strengthened prudential regulation and improved market infrastructure to the Asian Bond Fund funded by EMEAP central banks. But it remains uncertain whether these initiatives will succeed in surmounting the fundamental obstacles to bond market development, since there has been little systematic analysis of the nature of those obstacles. This is a gap that the present paper seeks to fill.

We find that the slow development of local bond markets is a phenomenon with multiple dimensions. To some extent the problem is one of minimum efficient scale: larger countries have better capitalized bond markets when capitalization is measured relative to GDP. But market size is not the entire problem. In addition, the failure of countries to follow internationally recognized accounting standards has slowed the development of private debt markets. Corruption and low bureaucratic quality, which are signs of unreliable securities market regulation, work in the same direction. Countries with competitive, well-capitalized banking systems, on the other hand, have larger bond markets.

Macroeconomic policy appears to have played both a supporting and an impeding role. On the one hand, Asia's strong fiscal balances, while admirable on other grounds, have not been conducive to the growth of government bond markets. Fortunately, there is little evidence that the small size of public debt markets is an insurmountable obstacle to corporate bond market development. On the other hand, the stability of exchange rates in the region appears, if anything, to have encouraged bond market development.

Over time, markets, institutions, and social convention have adapted to the status quo, which in the case of Asia is the dominance of bank finance. Some may worry that, as a result of this inheritance, Asian countries will not be able to develop bond markets as efficient and well capitalized as those of the advanced industrial countries. In this respect our results are reassuring: they suggest that the region's structural characteristics and macroeconomic and financial policies account fully for differences in bond market development between Asia and the rest of the world. Once one controls for these characteristics and policies, in other words, there is no residual "Asia effect."