

Making Markets: Reforms to Strengthen Asia's Debt Capital Markets

Paul Lejot

The University of Hong Kong

Douglas Arner

The University of Hong Kong
Hong Kong Institute for Monetary Research

and

Liu Qiao

The University of Hong Kong

July 2004

Summary

This paper seeks to explain the factors that obstruct or deter debt capital market activity in East Asia. It then describes major reform proposals to advance development of the region's financial markets, and so help guard against financial contagion from unforeseen losses of confidence similar to the experience of the 1997-98 crisis.

A companion HKIMR working paper (No. 19/2003) published in November 2003 gave an appraisal of Asia's principal domestic and offshore debt markets. The report showed that liquid markets for debt securities exist comprehensively in no East Asian economy other than Japan, even though short or medium-term bonds are issued in most and Asian borrowers are established (though generally not prolific) international issuers. Today's markets provide a borrowing medium for governments, financial institutions and some companies, but investor activity is closely correlated with bank credit creation. Above all, the region's markets provide no real guard against crisis or contagion, nor act as a balance to banking systems susceptible to distortion, event risk and moral hazard. Asia's economies may not suffer general capital shortages but poor resource allocation is pervasive and could be greatly improved by effective, transparent markets.

The central argument of both reports is twofold:

1. Until recently Asia's principal economies have had insufficient reason to develop active debt markets. However, the profound wish to avoid financial contagion of the kind widely experienced in 1997-98 has provided motivation on the scale needed to make reform effective, both nationally and collaboratively.
2. Deliberate effort is needed to create sophisticated debt markets: this has been observed since the late 17th century. Contrary to some views, economic growth or gradual development will not organically produce sophisticated markets. Asia's governments need therefore to facilitate and encourage system development (as some have begun), legal reform and usage.

This new paper identifies a matrix of steps to remove legal, fiscal, regulatory and systemic obstacles or omissions that hinder market usage, and which would, for example, constrict the operation of the EMEAP group of regional central bankers' proposed local currency Asian Bond Fund. Its reform proposals include:

1. A regional agency allowing credit enhancement to facilitate credit risk transfer, encourage securitisation and create new sources of well-rated risk. This market-orientated initiative would assist the securitisation of a wide range of credit risks, including non-performing loans, and finance for infrastructure development and medium-scale enterprises. It would avoid direct credit guarantees, which is essential to prevent unwanted moral hazard.
2. A collaborative regional public debt market for domestic and major currency issues, monitored by confederal regional regulation in an established Asian financial centre. This represents both a means to remove impediments to market participation and growth, and a path to encourage national harmonisation and regional usage using accepted Euromarket practice.