



BANK FOR INTERNATIONAL SETTLEMENTS

Learning-by-doing in market reform: The Asian ABF2 exercise

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The issues at stake

- Why develop local currency bond markets?
- Why central banks?
- Why do it at regional level?
- Why do it through a bond fund?
- How to do it through a regional bond fund?



Why develop local currency bond markets?

- To provide financial system with “spare tire”
 - Asian crisis showed short-term credit markets subject to sudden stops
 - Corporate bond markets can diversify sources of financing
- To bring intermediation home
 - Asians invest abroad at low yields, foreigners invest in Asia at high expected returns
 - Costly intermediation is being done abroad



Why central banks?

- Advocating market reform is costly public good
 - If private investor lobbies for reform, others would free ride
 - Central banks more likely than private investors to worry about system as whole
- Finance ministries also have role but may have other conflicting objectives -- eg, raising tax revenue
- Central banks tend to operate in financial markets and be familiar with them



Why do it at regional level?

- Various regional initiatives promote Asian domestic bond markets
 - By Association of South East Asian Nations (ASEAN) plus China, Japan and Korea (ASEAN+3)
 - By Executives' Meeting of East Asia and Pacific (EMEAP) central banks
 - Initiatives tend to complement each other.
- Can lay groundwork for regional integration by pushing for harmonisation and mutual recognition of markets
- Peer pressure to fast-track market reforms



Can regional bond funds help?

- Asian bond funds are project of EMEAP central banks
- In June 2003, EMEAP launched ABF1, investing USD 1 billion in dollar-denominated sovereign issues from eight of the countries
- For ABF2, EMEAP has raised USD 2 billion to invest in local currency bonds – but only government and quasi-government
 - Pan-Asian Index Fund to invest in 8 markets -- not including Australia, New Zealand and Japan but including China
 - Country sub-funds for each of 8 markets
 - Subscription initially limited to central banks but soon opened to private investors



The Asian bond fund initiatives

	ABF2	ABF1
Launch date	June 2005	June 2003
Seed money	US\$ 2 billion	US\$ 1 billion
Constituent bonds	Local-currency sovereign & quasi-sovereign in 8 Asian markets	USD-denominated sovereign & quasi-sovereign bonds in 8 Asian markets
Management style	Passively managed to bond index	Passively managed to bond index
Investors	Open to public	Only EMEAP



Why do it through a bond fund?

- Financial stake is incentive to push hard and get reforms right
 - In ABF2, 11 central banks have \$2 billion at stake
 - The more open markets receive greater slice of pie
- Concerted learning-by-doing an important advantage
 - Key is process, not size and not whether fund trades actively
 - Myriad impediments encountered in process



How to do it through a regional bond fund

- Start with the simple and easy
 - ABF1 limited to USD issues but built trust and rapport among central banks
- Size of the funds – not so big as to influence markets but big enough to signal serious intent
- Build incentives into portfolio structure
 - Allocation to local markets depends on liquidity and openness as well as on capitalisation and sovereign rating
 - Allocation will change as liquidity and openness improve



How ABF2 helps open markets

- ABF1 was useful since it taught EMEAP how to work together and established principle of pooling reserves
- Central banks find setting up of ABF2 to be effective exercise in market reform with “learning-by-doing”:
 - Lesson 1: Myriad capital controls enforced by making investors report to central banks (or SAFE in China and FSS in South Korea)
 - Lesson 2: Recognise other jurisdictions
 - Lesson 3: Lift withholding taxes or simplify procedures for reclaiming
- Market reforms complement other initiatives, for example, by ASEAN+3’s Asian Bond Market Initiative

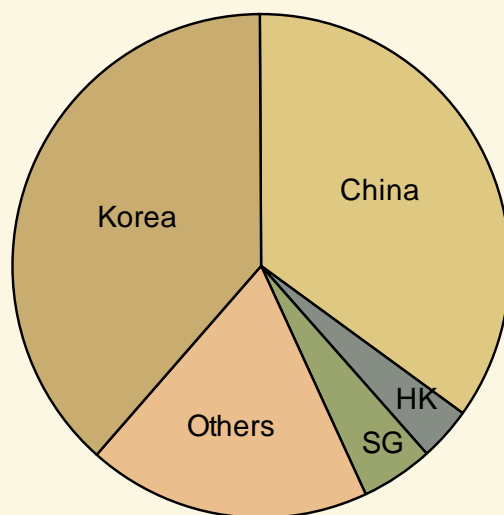


Incentive mechanism for further reforms

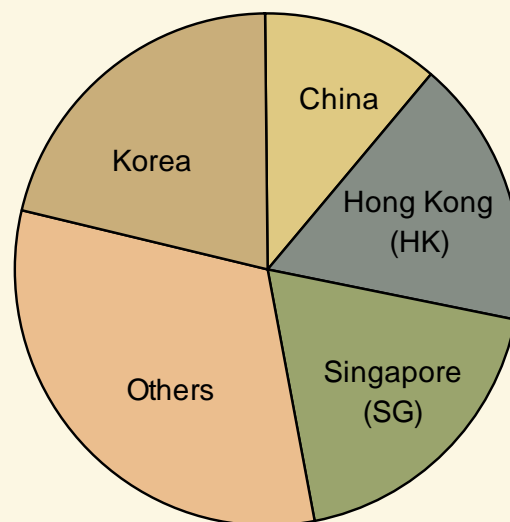
- Weights for country allocation decided by means of four factors
 - Market size, 20%
 - Turnover ratio, 20%
 - Sovereign credit rating, 20%
 - Market openness score, 40%
- International Index Company (IIC) developed market openness score and responsible for monitoring it
- For now, South Korea, Hong Kong, Singapore and China have the most weights



Market weights for the PAIF



Based on market cap alone



Based also on liquidity and openness

Note: Others comprise the remaining four EMEAP markets of Indonesia, Malaysia, the Philippines and Thailand.

Sources: International Index Company (2005b, right-hand panel); BIS calculations (left-hand panel).