Sharing experiences in developing corporate bond markets

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It is a pleasure to be in Kunming, participating in this very interesting discussion on developing corporate bond markets in Asia. As I said earlier today, we have Governor Zhou to thank for the idea of holding a seminar on financial markets in Asia, and for the choice of this specific topic.

At the BIS, we have been impressed with how, in the space of just a few years, you in Asia have been able to develop your government bond markets. These markets now function with well-designed auctions, reasonably liquid secondary markets and efficient settlement systems. It is now clearly time to turn our attention to corporate bond markets, still a rather neglected topic in the world of central bank meetings and market participant conferences.

As you know, even where the corporate bond market is as large as the government bond market, the difference in liquidity between these two markets can offer a stark contrast. You can have active trading in government bonds and hardly any trading in corporates. We still don't know very much about how to foster liquidity in corporate bond markets, and this is why this seminar is so timely.

Why do we need well-functioning local currency corporate bond markets? We all understand how the availability of local currency funding precludes currency mismatch problems, and how the availability of bond financing mitigates maturity mismatch problems in the banking system. Perhaps most importantly, though, a robust financial system requires a diversity of financing channels, in which both banks and fixed income markets compete in gathering funds and onlending them to deficit-spending agents. As Marvin Goodfriend explained this afternoon, bond financing strengthens the financial system by serving as an additional alternative form of intermediation to short-term credit markets, which are inherently volatile and subject to sudden stops and creditor runs.

You have seen these creditor runs in your own markets, but they also happen in the large markets of the most advanced economies. In November 2001, for example, a consequence of Enron's default was that the US commercial paper market seized up. Banks were suddenly reluctant to provide backup liquidity lines. Fortunately for the major borrowers in this market, they could turn to the bond market, which remained liquid and resilient. To use Chairman Greenspan's metaphor, corporate bond markets are an important "spare tyre" that is always ready to be brought into active use, especially at times when other financing mechanisms "hit potholes".

When I look at Asia's corporate bond markets, one of the first things that strike me is how much they differ in size across countries. If we define corporate bonds to include quasi-government issuers and financial institutions, the big markets are Japan, Korea, China and Australia, each one with over $100 billion in outstanding issues. The medium-sized ones are Malaysia, Thailand, Hong Kong SAR, New Zealand, India and Singapore. The smaller ones are Indonesia and the Philippines.

I mention size because the size of total outstandings does seem to matter as an indicator of bond market efficiency. In 2000, two of my colleagues at the BIS, Bob McCauley and Eli Remolona, wrote an article[2] suggesting that the size threshold for a deep and liquid government bond market is $100 billion. This is, of course, only a rough threshold, and does not account for a number of factors that would affect liquidity. Nonetheless, whatever the threshold, it is actually likely to be higher for corporates than it is for governments, not least because individual corporate issues traded are of smaller size and far more heterogeneous.

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1 General Manager of the Bank for International Settlements (BIS). This text is based on remarks made at the the BIS/PBC seminar on "Developing corporate bond markets in Asia" held in Kunming, China, 17-18 November 2005.

2 R McCauley and E Remolona, "Size and liquidity of government bond markets", *BIS Quarterly Review*, November 2000.

However, in mentioning size thresholds, I don't want to leave the impression that the smaller markets have little hope of developing liquidity. I only wish to suggest that the current size of the market is likely to have important implications for the strategy necessary to develop it. I think this is useful to keep in mind because it is often very tempting to try to emulate the structure of the US corporate bond market. Because of the size and long history of the US corporate market, it is familiar to everyone and much has been written about it. But the domestic US corporate bond market is over $13 trillion in size and, by virtue of that size alone, there are things that work in that market that may not work in other markets.

To cite one issue we face, if the US market has a government bond benchmark yield curve that helps in the pricing of corporate debt, does that mean your market should have the same kind of yield curve? Let's bear in mind that even the euro zone's corporate bond market, which is about $7 trillion in size and which functions efficiently, relies for its benchmark yield curve not on a government curve, but on the euribor or euro-swaps curves.

It is precisely for this reason that a seminar like this is so useful: it is a way to share experiences and not depend on just those of the US market, which may well be unique to that economy and therefore not applicable in a "cookie cutter" fashion elsewhere.

The experience of the Korean corporate bond market is illuminating. As I mentioned earlier, this is now quite a large market, with the equivalent of more than $350 billion in outstanding issues. Yet, before the 1997 crisis, as Mr Lee has told us, the market was characterised by strict government controls on the amounts of bonds that could be issued, as well as by mandatory bond guarantees. In 1997, guaranteed bonds were 85% of the market. The crisis, however, led to the failure of both the Korea Guarantee Insurance Company and Hankook Fidelity and Surety Company. Since then, the market has become one in which the government generally limits itself to prudential oversight and non-guaranteed bonds dominate issuance. It is a market in which investors seem to be learning very quickly how to monitor issuers' credit quality, and to trade and price default risk.

The experience of the Malaysian market is another good example. I know that Muhammad Ibrahim will talk about this tomorrow morning, but I cannot help but be impressed by the strides this market has made in recent years. So let me just mention two things about it. First, the corporate and government bond markets in Kuala Lumpur have the same market infrastructure: they have the same dealers, the same reporting system and the same real-time gross settlement system. This is certainly not the case for the US Treasuries and US corporate bond markets. But the point is that there are important economies of scale in such infrastructure - dealer networks, reporting and settlement. I think our Malaysian friends are showing us how to exploit these economies. In the United States, each market is already so large that separate systems exploit most of the available economies, and these can only be exploited in smaller markets when these functions are merged across governments and corporates. This is a key area where - it appears - it might not be optimal for Asian countries to import the US model. Second, the Malaysians have put in place a reporting system that has made their corporate bond market a rather transparent one in the sense of what Professor Sundaresan would call "ex post transparency". Tomorrow, we will hear from Amy Edwards about the advantages for liquidity of such transparency.

Finally, how about the smaller markets - what can they do to overcome the disadvantages of their size? I think our Australian friends have much to share in this regard. The Australian corporate bond market seems to owe much of its growth and vibrancy to its openness to foreign issuers and investors. As the paper from the Reserve Bank of Australia points out, foreign issuers are now the second largest sector in their market and this sector - known as the "kangaroo market" - is now A$60 billion, or US$44 billion, in size. Indeed, we have now seen the first foreign bond issues in the Thai baht, the Malaysian ringgit and the Chinese renminbi, although so far these have been only by AAA-rated supranational issuers. On the subject of attracting foreign investors, much has already been said about the importance of further removing restrictions on foreign participation, reducing withholding taxes and developing credible domestic rating agencies. To allow these investors and issuers to hedge against currency risk, the Australian experience also suggests that we will need to develop liquid markets in currency swaps.

I look forward to further interesting discussions tomorrow. Thank you, and let me take this opportunity to also thank the People's Bank of China, both for its efficient arrangements for this seminar and its choice of what I see as a fascinating topic that I hope will occupy all of us in the immediate future.