# Comments on Nishi and Vergus's paper "Asian bond issues in Tokyo: history, structure and prospects"

Toshiharu Kitamura

As a discussant of the Nomura paper, "Asian bond issues in Tokyo: history, structure and prospects", I would like to focus on a few implications of Japanese experiences for emerging Asian bond markets.

## 1. Division of labour in financial intermediation

Many studies indicate that, in East Asia, the banking sector has generally dominated the function of financial intermediation (with the possible exception of the Philippines). Several factors are responsible for the present situation.

(1) The presence of a government bond market is considered a precondition for the development of a corporate bond market, but government bond markets in East Asia have not been well developed.

(2) In contrast, the banking mechanism from deposit-taking to loan-making has been strongly supported by the legal framework typified by the central bank and a variety of policy measures in many East Asian countries, including Japan.

(3) As economic arguments suggest, information asymmetry existed tenaciously between fund providers (investors) and fund raisers (corporations). In other words, at earlier stages, fund raisers in general failed to provide relevant information to fund providers, and only banks were in a position to be well informed about borrowers' activities and thus able to monitor them. This was the case even in Japan until recently.

Only top-level fund-raising institutions such as blue-chip sovereigns and well established corporations have enjoyed direct access to bond markets. However, the so-called double mismatch in 1997 and 1998 in East Asia revealed the shortcomings of financial intermediation that is overly dependent on the banking sector. As a result, more attention has been focused on fostering corporate bond markets.

Even so, bank domination will remain strong in the so-called middle market in many East Asian countries, including Japan. Therefore, it follows that the basic framework for financial intermediation in East Asia will be based on a double-channel approach, paying due attention to both direct finance (capital markets, including bond markets) and indirect finance (banking business). Emphasising only bond markets in East Asia does not adequately address the region's financial intermediation issues.

## 2. Business conflicts (business territorial disputes) and market competition

In the background of the Tokyo Samurai bond market, which appears to have peaked in around 1996, is the fact that, inside Japan, the traditional financial system has continued to help the banking sector dominate the domestic corporate financing business, securing very close relationships between individual banks and corporations. In general, the Japanese bond market has been predominantly one of government-related bonds (more than 80% of total yen-denominated bond issuance in 2002), and even the issuance of bank debentures has considerably surpassed that of corporate bonds. In this setting, the position of securities firms (investment banks) has been highly biased towards equity business. It is no exaggeration to say that non-resident bond issuers took advantage of Japan's abundant financial resources through the Tokyo Samurai bond market, which has only a small share of Japan's entire financial market.

In contrast, the banking sector has successfully defended its vested interests in corporate financing. This was especially true before the 1990s: the banking sector, notably the Industrial Bank of Japan, had implicitly enforced rigid criteria for issuance eligibility and emphasised the need for a fiscal agent for the public offering of corporate bonds.

Conversely, the securities firms had obstinately interfered in the bond offering business engaged in by bank-affiliated securities subsidiaries both at home and abroad, particularly limits on the lead-manager role. Thus, there had been a battle over the business territory between the banking and securities business sectors in Japan during the 1980s. In these circumstances, the slow process of deregulation of restrictive practices in bond issuance in the 1980s and 1990s led many fund-raising institutions to use the Eurobond market outside Japan. Accordingly, Japan's domestic bond market was seriously hollowed out despite abundant domestic financial resources.

Two lessons for Asian bond markets could be derived from these Japanese experiences. The first concerns vested interests among related parties in financial markets. In many East Asian countries, the banking sector has dominated and established deeply rooted vested interests in the corporate financing business. The banking sector will naturally try to defend its privileged position over the newly emerging financial channel. (Conflicts of business of this type also existed in the United States, involving regulatory controversies, until 2000.) The lesson for the development of Asian bond markets is that the supervisory authorities should have a fair and clear policy perspective and strong commitment to achieving an efficient and balanced financial intermediary process - one that balances the direct (capital market) and indirect (banking business) finance channels.

The second lesson is related to the competition among bond markets: if a local bond market fails to catch up with international standards, potential corporate issuers will quickly turn to other bond markets. (International standards include disclosure requirements, accounting standards, price transparency, trading and clearing/settlement procedures, and taxation harmonisation, as well as related documentation requirements and effective enforcement.) Financial markets are intensifying competition among themselves. (European stock markets have already indicated some movement in this direction, and perhaps bond markets have similar reasons to do so.) The Eurobond market and the Yankee bond market are already widely used and have been predominant around the world. Similarly, in Asia, Tokyo, Hong Kong, and Singapore have gained good bond market reputations. A bond issuer successful in any local Asian bond market will compare emerging local markets with the leading international bond markets. If there is any inefficiency in the local bond market, potential bond issuers will be easily attracted to those sophisticated leading markets.

The dispersion of both the Shogun (foreign currency-denominated bond offerings in the Tokyo market) and the Daimyo bond market (yen-denominated bonds offered in the Tokyo market but settled in the Euro market) could be interpreted in line with this market competition. The public offerings through Uridashi described in the Nomura paper could be interpreted as a new approach rather than an heir to the Shogun and Daimyo bond markets.

## 3. Currency constraints

Basically, bonds are offered because the issuers are eager to raise funds and the investors are seeking safe yet lucrative securities. However, for cross-border transactions, there arises another factor, related to currency sovereignty. For yen-denominated bonds, the Samurai and the Euroyen bond markets have coexisted since the 1970s. The Samurai market aims at mobilising financial resources from domestic investors of the issuing market, whereas the Euroyen bond market aims at mobilising financial resources from the broader base of international investors. Behind them is a crucial currency issue for the Japanese monetary authorities: whether the yen can be freely used outside Japan for financial transactions among non-residents. The process of using the yen outside Japan was called the Euroisation of the yen. (Nowadays, the common terminology for the process of using or not using an individual national currency outside its original currency territory is the "internationalisation" or "non-internationalisation" of the currency.)

Even the US monetary authorities were cautious about the free use of the US dollar outside the United States in the 1960s, and the German monetary authorities were even more cautious about the free use of the Deutsche mark outside Germany. Japan first faced this issue towards the end of the 1970s. The non-internationalisation of a national currency is generally intended to segregate a country's domestic economic and financial transactions from international turbulence arising from the free use of the national currency in transactions outside its territory. However, Japan decided to internationalise the yen in the 1980s.

The currency internationalisation issue is not an easy one. For instance, the Swiss monetary authorities have long been cautious about it, and in Asia, Singapore has had a long tradition of non-internationalisation of the Singaporean dollar. The Singaporean approach has impressed monetary authorities in many Asian countries, including Malaysia, Indonesia, and Thailand. Taiwan, China has also strictly maintained this approach for many years. Most recently, many Asian economists have focused on the offshore restrictions on the deliverability of currencies (which give rise to non-deliverable forward (NDF) transactions in several Asian currencies) - which are intended to ensure the exchange rate stability of those currencies. (Offshore NDF transactions provide an offshore margin-based mechanism to hedge those currencies that are considered "unhedgeable" due either to the absence of a local forward market or to limited access to a local currency market.)

In these circumstances, monetary authorities in East Asia will likely remain conservative about the free use of their currencies outside their territories. If so, Asian bonds denominated in local currency will be transacted only inside the territory of the issuing market; thus, it follows that there will be no cross-border transactions of local currency-denominated Asian bonds.

If Asian bonds are denominated in a unit reflecting a regional currency basket such as an Asian Currency Unit (ACU), the question remains whether or not those currencies that compose the currency basket will become freely available for smooth bond trading across borders. Another serious problem is the determination of parities among the component currencies.

If local bond markets have to face severe competition with the sophisticated international bond markets, and if the above-mentioned currency issue remains unsolved, Asian bond markets may have to confine themselves to locally segregated bond markets where local issuers raise funds only from local investors. This may sound most pessimistic, but it is a reality learned from past experience.

A long-term policy perspective will have to be stressed for the successful development of Asian bond markets.