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Developing the Market
for Local Currency Bonds
by Foreign Issuers:
Lessons from Asia

Tobias C. Hoschka

February 2005

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Tobias Hoschka is a Treasury Specialist in the Treasury Department, Asian Development Bank. The author would like to thank Richard Werner, Patricia McKean, and Jonathan Batten on the country case studies, and Jim Turnbull for useful comments and suggestions.

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FOREWORD

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CONTENTS

Abbreviations	vii
Abstract	ix
I. INTRODUCTION	1
II. THE RECORD: LOCAL CURRENCY BOND ISSUANCE BY FOREIGN ISSUERS IN SELECTED ASIA-PACIFIC ECONOMIES	4
A. Bond Markets, Policy and Infrastructure Environment at the Time of LCBFI Launch	4
B. Scale and Type of Local Currency Bond Issuance since Launch	7
C. Assessment of the Development Strategies Adopted	15
III. ASSESSMENT: BENEFITS AND POTENTIAL ISSUES OF LCBFI	22
A. Microeconomic Benefits	22
B. Macroeconomic Benefits	24
C. Potential Issues	25
IV. CONCLUSIONS	25
REFERENCES	26

ABBREVIATIONS

ADB	Asian Development Bank
AFMA	Australian Financial Markets Association
CDs	certificates of deposit
CMU	Central Moneymarkets Unit
EBRD	European Bank for Reconstruction and Development
EFN	Exchange Fund Note
GDP	gross domestic product
HKD	Hong Kong dollar
IBRD	International Bank for Reconstruction and Development
LCBFI	local currency bond issuance by foreign issuers
MAS	Monetary Authority of Singapore
MDB	multilateral development bank
MNC	multinational company
Mof	Ministry of Finance
NIB	Nordic Investment Bank
PRC	People's Republic of China
RTGS	Real Time Gross Settlement
SGS	Singapore Government Securities
SIMEX	Singapore International Monetary Exchange

ABSTRACT

This paper surveys the experience of countries in the East Asian region that have introduced local currency bonds by foreign issuers. The countries that are examined include Australia; Hong Kong, China; Japan; Republic of Korea; and Singapore. It is suggested that there are sound reasons for many countries to develop the market for foreign issuers. Benefits and potential issues are analyzed, development policies are reviewed, and concrete policy options are discussed for those countries that are currently considering opening their domestic markets to foreign issuers.

I. INTRODUCTION

Since the Asian financial crisis, East Asian countries have taken important steps at both national and regional levels to develop local currency bond markets. The objectives of these efforts are (i) to reduce the risks associated with excessive reliance on short-term external financing; (ii) to provide an alternative vehicle for channelling domestic savings into productive investment and reduce dependence on bank lending; and (iii) to support economic and financial integration in East Asia.

The results of these efforts have been impressive: Table 1 shows that total local currency bonds outstanding in East Asia have tripled from \$356 billion in 1997 to \$1.2 trillion in 2003, an annual growth rate of 22.5 percent. Growth was particularly impressive in Thailand at 35 percent, 25 percent in People's Republic of China (PRC), and 23 percent in Republic of Korea (Korea). Measured as a percentage of gross domestic product (GDP), East Asian local currency bond market growth was equally impressive. At the end of 1997, local currency bonds outstanding as a percentage of East Asia's combined GDP was 19 percent. This increased to 44 percent by the end of 2003. The rapid growth of bond markets was led by government bonds, which grew at an annual rate of 27 percent (see Table 2). Corporate and financial bond growth was slower at annual rates of 18 and 20 percent, respectively.¹

While bond markets have developed quite rapidly across virtually all countries in East Asia, local currency bond issuance by foreign issuers (LCBFI) is concentrated in a small number of advanced countries, namely the existing financial centers of Hong Kong, China; Singapore; as well as the developed countries of Australia and Japan. While Korea allowed LCBFI in 1995, there has been little issue activity since then. Table 2 illustrates that LCBFI is still very limited in most East Asian economies. This is in contrast to the more developed economies where foreign issuance has become a regular feature of domestic bond markets.

Several issues arise in the context of LCBFI: What are the benefits of allowing foreign issuers to issue bonds locally both from a macro and microeconomic perspective? Are there macroeconomic concerns that need to be addressed? What strategy should be pursued to target the development of the LCBFI market? This paper aims to address these key questions in the context of five country case studies in East Asia.

Section II looks at the track record of introducing LCBFI in five economies in the region: Australia; Hong Kong, China; Japan; Korea; and Singapore. It analyzes the economic situation at the time of introduction of LCBFI and the scale and type of LCBFI, and provides an assessment of the development strategies adopted to encourage LCBFI development. Section III provides an assessment of the benefits and potential issues of LCBFI in the context of the country case studies. Finally, Section IV concludes.

¹ See ADB's *Asian Bond Monitor* (ADB 2004) for more details on Asian bond market development.

TABLE 1
SIZE OF EAST ASIAN LOCAL CURRENCY BOND MARKETS, 1997 AND 2003

	1997		2003	
	SIZE (\$ BILLION)	PERCENT OF GDP	SIZE (\$ BILLION)	PERCENT OF GDP
PRC	116.4	12.9	440.4	31.3
Indonesia	45.1 ¹	29.1 ¹	64.4	26.4
Korea	130.3	25.1	445.7	73.6
Malaysia	57.0	56.4	98.8	95.3
Philippines	18.5	22.4	25.0	31.6
Singapore	23.8	24.9	67.2	73.6
Thailand	9.6	6.1	58.4	40.7
Viet Nam ²	—	—	2.9	7.4
East Asia	355.5	19.1	1,202.8	44.3
Japan	4,421.9	110.8	8,201.7	176.7
Hong Kong, China	45.8	26.4	71.8	45.7
US	11,997.5	144.5	17,644.8	160.3
EU15	7,094.7	85.8	10,357.3	98.6

¹Refers to 1999.

²Refers to government bonds only.

Sources: All economies: *Asian Bond Monitor* (ADB 2004); for PRC, Korea, Malaysia, Philippines, Thailand: Bank for International Settlements *International Financial Statistics* Table 16A and local currency portion of Table 11; for US and EU15: Bank for International Settlements *International Financial Statistics* Table 16A; for Hong Kong, China: Hong Kong Monetary Authority; for Indonesia: Bank Indonesia and Surabaya Stock Exchange; for Singapore: Monetary Authority of Singapore; for Viet Nam: Ministry of Finance.

TABLE 2
SIZE OF INDIVIDUAL EAST ASIAN LOCAL CURRENCY BOND MARKETS

	ANNUAL GROWTH RATE	AMOUNT IN 2003	
	1997–2003	\$ BILLION	PERCENTAGE OF GDP
PRC	24.8	440.4	31.3
Government	27.3	287.4	20.4
Corporate	11.6	12.2	0.9
Financial Institutions	22.0	140.8	10.0
LCBFI	—	—	—
Indonesia ¹	9.3	64.4	26.4
Government	8.1	58.9	24.2
Corporate and Financial Institutions	28.8	5.5	2.3
LCBFI	—	—	—
Korea	22.7	445.7	73.6
Government	30.3	124.3	20.5
Corporate	19.8	157.3	26.0
Financial Institutions	21.2	164.1	27.1
LCBFI	n.a.	0.3	0.05
Malaysia	9.6	98.8	95.3
Government	13.0	40.4	38.9
Corporate	13.7	44.9	43.3
Financial Institutions	-3.6	13.5	13.0
LCBFI	—	—	—
Philippines	5.2	25.0	31.6
Government	4.5	24.0	30.3
Corporate	50.6	1.0	1.3
Financial Institutions	—	—	—
LCBFI	—	—	—
Singapore	18.9	67.2	73.6
Government	19.0	37.1	40.6
Corporate and Financial Institutions	18.8	30.1	33.0
LCBFI	n.a.	1.2	1.3
Thailand	35.2	58.4	40.7
Government	116.3	30.7	21.4
Corporate	13.5	19.3	13.5
Financial Institutions	83.0	8.4	5.8
LCBFI	—	—	—
Viet Nam	—	2.9	7.4
Government	—	2.9	7.4
Corporate	—	—	—
Financial Institutions	—	—	—
LCBFI	—	—	—

¹Earliest available data are for 1999. Growth rate is computed over 1999–2003.

Sources: *Asian Bond Monitor* (ADB 2004); Bank for International Settlements *International Financial Statistics* Tables 16A, 16B, and local currency portion of Table 11; Indonesia: Bank Indonesia and Surabaya Stock Exchange; Singapore: Monetary Authority of Singapore; Viet Nam: Ministry of Finance.

II. THE RECORD: LOCAL CURRENCY BOND ISSUANCE BY FOREIGN ISSUERS IN SELECTED ASIA-PACIFIC ECONOMIES

A. Bond Markets, Policy and Infrastructure Environment at the Time of LCBFI Launch

(i) Japan

A brief chronological discussion of the introduction of local currency bonds by foreign issuers in the Asian region must begin with Japan. The first such bonds—quickly dubbed “Samurai bonds”—were issued in 1970 by the Asian Development Bank (ADB). At the time, the local bond market was still at a nascent stage: the government bond market was hardly in existence (total amount of bonds issued in the primary market amounted to only ¥6,300 billion in fiscal year 1970) as the first Japanese government bonds were issued only in November 1965. There was no complete benchmark yield curve. Exchange rates were fixed to the US dollar. Capital flows were restricted and remained tightly regulated until 1980. Under Ministry of Finance (MoF) auspices, the *Kisaikai* (Bond Notation Committee composed of major city banks) set the guidelines for Samurai bonds, governed the eligibility standards for bond issuers (*Tekisai Kijun*) and the capital adequacy requirements (*Zaimu Seigen Joku*) for nonsecured corporate bonds, as well as other related criteria.

The eligibility standards for issuing Samurai bonds were not relaxed until April 1985, at the same time as those relating to Euroyen bonds issued by foreigners. In reviewing applications from potential samurai issuers, the MoF took into consideration the trend of the Japanese capital account balance and the liquidity in the Japanese economy. For the actual issuance of Samurai bonds, the MoF set a quota per quarter year, and employed a queue system. Borrowers, if they agreed upon the terms of underwriting, entered the quota by rotation from the top of the queue. The close regulatory control of the MoF, including over market entry, was not abolished until 1998.

Until 1991, over 20 years after the first Samurai issuance, the Japanese economy and resource allocation was tightly controlled through the Bank of Japan’s window guidance credit control and allocation mechanism. For years, banks remained key players in the bond markets, underwriting between 60 and 90 percent of government, guaranteed, or local government bonds issuances. They also tended to subscribe to about a quarter of Samurai bonds (and corporate bonds) because the Japanese market lacked a sufficient investor base, although this practice was abandoned in 1992.² The bond market structure was therefore one in which banks were both subscribers and underwriters. Nevertheless, banks were initially not allowed to trade in bonds. This was deregulated only in 1983, when the MoF also authorized them to sell government bonds over the counter. Until 1985, bond futures were not traded. Foreign securities companies were not admitted as members of the Tokyo Stock Exchange until 1985. Settlement rules proscribed liquidity severely: until 1987, only three settlement days per month were scheduled.

It is thus clear that the introduction of local currency bonds issued by foreign issuers occurred at a relatively early stage in the evolution of Japan’s financial system, significantly in advance of deeper structural reforms toward less government intervention.

² The samurai market had its own selling system of block purchase by banking syndication. Banks would form syndicates for samurai bonds issued by sovereign entities and international organizations and absorb 25 percent of the issue amount. See Nikkei (1992).

(ii) Hong Kong, China

After Japan, the next domicile of local currency debt issuance by foreign issuers was Hong Kong, China, when in September 1977 Chase Manhattan Bank issued Negotiable Certificates of Deposit (CDs) amounting to HKD100 million with a 5-year maturity. This was the forerunner to the Hong Kong dollar (HKD) corporate debt market. During the 1980s, international banks issued increasing amounts of CDs in Hong Kong, China to secure medium term funding, both for corporate borrowers as well as for project lending (short dated funding was available through the Commercial Paper market).³ The first multilateral development bank (MDB) foreign bond issue took place in 1989. This was undertaken by the International Bank for Reconstruction and Development (IBRD), which launched one issue each year from 1989 to 1992, after the administrative government granted tax exemption on interest and capital gains for supranational bonds. The ADB became the second MDB issuer in 1992, launching a 7-year bond.⁴

At that time, all trading was still over the counter (OTC), no formal market-making system had developed, and liquidity was modest. It was a dealers' market. The corporate bond market remained embryonic at the time, as bank financing dominated. There was a complete absence of a risk-free benchmark yield curve. Indeed, there hardly was a government bond market, as the administrative government was not a regular issuer in the market. Nor were there any computerized clearing and settlements systems in the 1980s. Volumes were initially very low. The fees adopted in the market were driven by existing practice elsewhere (the euromarkets). Furthermore, the regulations for debt issues, in particular prospectus requirements, were not supportive of the bond market's development. Other obstacles included a poorly developed investor base for fixed income products and, as importantly, small and inefficient derivatives markets limiting hedging opportunities.

The Hong Kong dollar bond market received a major boost with the introduction of the Exchange Fund programme in 1990, which had the explicit aim to develop the bond markets. Central to the development of the Exchange Fund program was the presence of an efficient centralized clearing system, the Central Moneymarkets Unit (CMU), which was set up in March 1990, at the same time that the Exchange Fund program was introduced with the aim of developing Hong Kong, China's financial market infrastructure.

(iii) Australia

Given the state of its economic development, Australia should probably be considered a latecomer to LCBFI. The first foreign issuer of Australian dollar bonds, dubbed "Kangaroo" bonds, was Credit Local de France in 1991. At the time, the Australian economy resembled the continental European economies more than that of the United Kingdom or United States, in the sense that bank finance was predominant. Relative to GDP, Australia's domestic credit provided by the banking

³ In July 1980, Banque Paribas launched the first fixed-rate bond issue for HKD70 million with a maturity of 18 months. This was followed by Arab Banking Corporation, CITIC, and Toyo Communications in 1985; CITIC in 1986; BNP Paribas in 1987; and Bank of Communications and Qantas Airways in 1988.

⁴ ADB's issue provided a major fillip to the market as it was the first issue with a maturity exceeding the date for the handover of Hong Kong sovereignty from the British government to the PRC government. By demonstrating confidence post handover, this transaction underpinned the development of the longer end of the curve.

sector was over 90 percent, stock market capitalization about 100 percent, and domestic securities less than 50 percent. The introduction of LCBFI also occurred many years before the significant regulatory reforms that were implemented in Australia in the late 1990s. However, at the time of the introduction of the first Kangaroo bonds, a number of self-regulatory organizations were already in place and the market infrastructure was relatively advanced. For instance, the Australian Financial Markets Association is the national industry body representing almost 200 organizations that participate in the Australian OTC wholesale financial markets. It was formed in 1986 to streamline market practices and establish trading standards in OTC markets, which included trading in foreign exchange, interest rate products, financial derivatives, repurchase agreements, commodities, equity, and electricity derivatives.

(iv) Korea

In Korea, the first local currency bonds by foreign residents called “Arirang” bonds were issued by ADB, International Bank for Reconstruction and Development, and European Bank for Reconstruction and Development (EBRD) from 1995 to 1997. Total issuance, however, has remained limited. Since 1999, foreign subsidiaries of *chaebols* have been entering the market. Bonds issued by Indonesian chaebol subsidiaries now account for the bulk of Arirang bonds. Such issuance appears to minimize their cost of funding for Indonesian ventures. This way they seem to be able to capitalize on information imperfection, in the form of a reputation advantage for their issuance in their home market, whose proceeds are then swapped into Indonesian currency and used for investments there. Since the Indonesian subsidiaries of Korean firms are likely to have difficulty in accessing local debt and banking markets, this is an example where an advanced financial market can support the competitiveness of domestic firms abroad.

(v) Singapore

Singapore allowed LCBFI even more recently, when the Monetary Authority of Singapore (MAS) permitted foreign borrowers to issue debt denominated in Singapore dollars (SGD) in August 1998 although they were required to swap the proceeds immediately out of the Singapore dollar for use outside the country. The International Finance Corporation became the first foreign issuer in the Singapore corporate debt market in 1998, launching a SGD300 million 3-year bond issue. Prior to August 1998, foreign issuers were prevented from borrowing in the local corporate bond market by the government’s policy on noninternationalization of the Singapore dollar. Government bond issuance had not previously been aimed at developing large liquid lines in key benchmark maturities. Hence at the time of launch there was little secondary market liquidity in government bonds due to the absence of a sizeable free float, and there was no benchmark bond yield. In terms of liquidity management and hedging, the repo market was immature thereby making it more difficult and costly for primary dealers and investors to finance bond inventories and hedge SGD bond positions. The swap market was undeveloped and illiquid. With the lack of depth in repo and futures and an illiquid swap market, there were very few hedging opportunities to support either the demand or supply sides of the market.

With Singapore property companies the dominant issuers, there was no broad range of issuers on offer and the investor base remained similarly concentrated. Issue sizes were small which,

combined with the buy-and-hold nature of the investors, resulted in an illiquid secondary corporate bond market. A further disadvantage was that trading in the OTC market lacked not only liquidity but also transparency.

In conclusion, it is clear that the introduction of local currency bonds issued by foreign issuers occurred in virtually all cases at a time when the bond markets were hardly developed; the market infrastructure was in its infancy (no benchmark yields, nil or few derivatives and swap markets, nil or few indigenous rating agencies, dominant OTC trading, no market-making); the regulatory environment remained stringent; and government intervention was prevalent. In all cases, a few, illiquid issues started the markets, after policy decisions were taken to pave the way for such issues.

The Asian experience demonstrates that LCBFI can be established—and successfully, at that, as is seen in the next section—even in what would appear to be an adverse environment, where economies remained tightly controlled and not deregulated.

B. Scale and Type of Local Currency Bond Issuance since Launch

(i) Japan

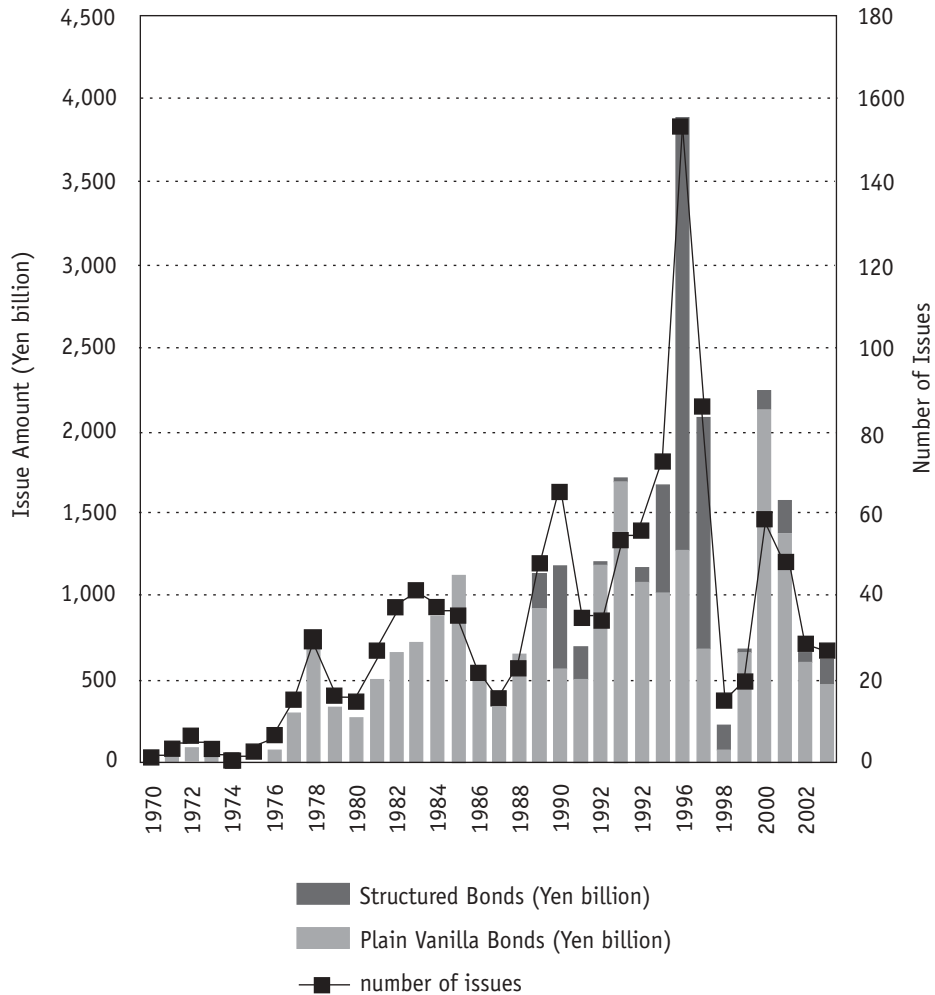
In Japan, the Samurai bond market grew rapidly from its modest origins in 1970. In the first 10 years, over 100 issues took place, raising over Y2 trillion (see Table 3 and Figure 1).

TABLE 3
THE FIRST TEN YEARS OF LCBFI IN JAPAN: YEN-DENOMINATED FOREIGN BONDS ISSUED IN TOKYO MARKET, 1970-1980, (IN ¥ BILLIONS)

ISSUER	PUBLIC OFFERINGS		PRIVATE PLACEMENTS		TOTAL		
	NUMBER OF ISSUES	AMOUNT	NUMBER OF ISSUES	AMOUNT	NUMBER OF ISSUES	AMOUNT	PERCENT
International Institutions	24	474	4	38	28	512	22.9
Foreign Governments	57	1160	9	82	66	1242	55.7
Foreign Local Governments	8	124	0	0	8	124	5.6
Government Institutions	11	183	13	128	24	311	13.9
Private Sector	1	20	3	23	4	43	1.9
TOTAL	101	1961	29	271	130	2232	

Source: The Industrial Bank of Japan.

FIGURE 1
AMOUNT AND NUMBER OF ISSUES OF SAMURAI BONDS, 1970-2002



Source: Nomura Securities.

Over time, the product range also became more sophisticated to suit investors' needs (see Box 1). Domestically, the largest group of Samurai investors were institutional investors, including various banks, life insurance companies, other types of insurance companies, credit unions, credit cooperatives, and agricultural cooperatives. Other investors were individual investors and enterprises. The amount purchased by the banking system and institutional investors at the inception of the Samurai market formed the major part of the issues whereas the ratio of retail investors was initially quite low.

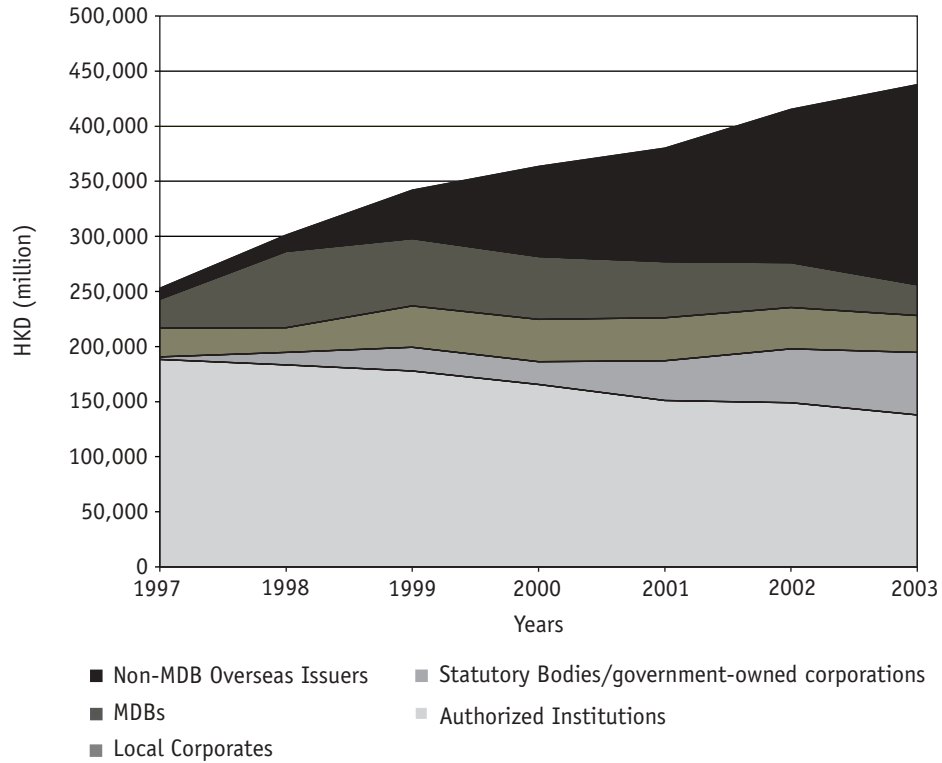
Box 1
PRODUCT INNOVATIONS IN THE SAMURAI MARKET

Over time, the product range in the Samurai market has become more sophisticated to suit investors' needs. The level of innovation has remained high, with the continuous introduction of new types of LCBFI, such as dual currency bonds, with the principal denominated in foreign currencies, but yen-denominated coupons (introduced between 1995 and 1999 and offered to retail investors in an environment of a weak yen and low yen yields). In 1996, this type accounted for almost half of Samurai volume. "Knock-in" dual currency bonds were pioneered in 1998, specifying that redemption would be in yen unless the dollar-yen rate fell to or below a trigger value during the life of the bond. "Power reverse dual currency" bonds have been offered since 2000 in an environment of close to zero short-term yen rates. They offer a high fixed coupon for an initial period, followed by variable interest rates that are proportionate to the ratio of the current dollar-yen rate to a reference rate set at launch, with coupons consequently increasing in case of yen appreciation and vice versa. In effect, institutional investors are offered more leveraged coupons, thereby taking on a higher level of foreign exchange exposure risk. Other innovative structures include so-called "Survival" bonds (reverse FRN) and Nikkei-linked bonds (already authorized by the Ministry of Finance, but so far not issued).

(ii) Hong Kong, China

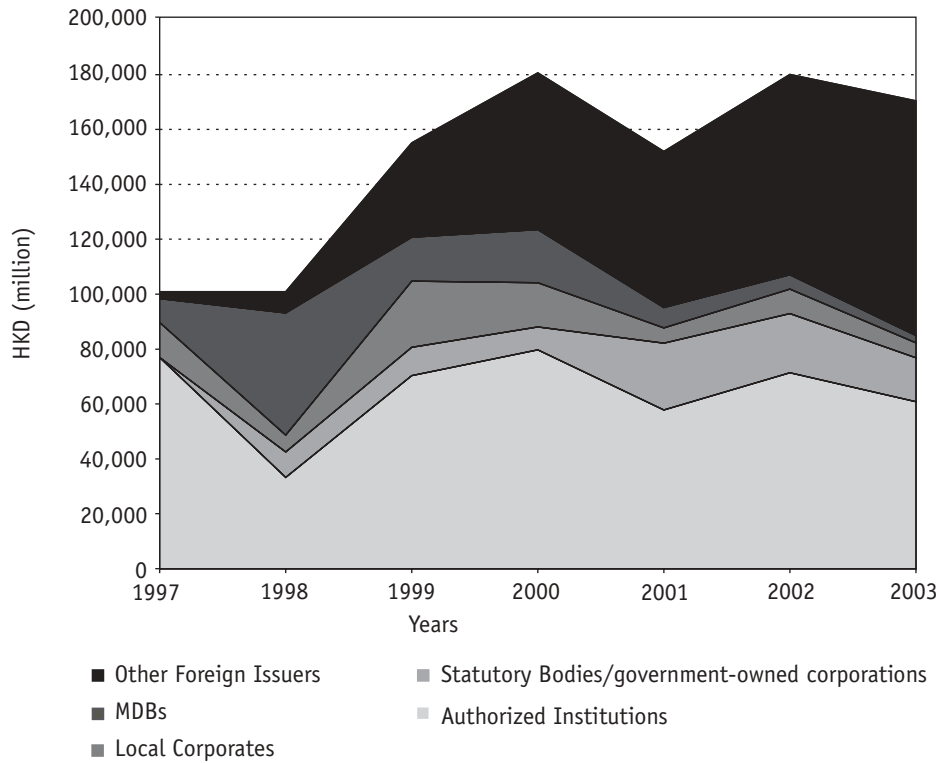
The Hong Kong LCBFI market started in 1977, but has gained significant scale only over since 1996 or so. Figure 2 shows the substantial growth of the market with outstanding LCBFI issues accounting for 38 percent of all outstanding bonds in the HKD market (excluding Exchange Fund Notes [EFN]). Figure 3 indicates that LCBFI account for around 50 percent of all new issues (excluding EFNs) over the last years.

FIGURE 2
OUTSTANDING BOND ISSUES IN HKD MARKET



Source: Hong Kong Monetary Authority.

FIGURE 3
NEW ISSUES OF HKD DEBT SECURITIES BY ISSUER TYPE



Source: Hong Kong Monetary Authority.

(iii) **Australia**

Despite their relative late launch, outstanding Australian Kangaroo bonds amount to A\$35.7 billion in 2004. This corresponds to around 20 percent of all outstanding bonds in Australia. Some 40 percent of bonds were issued by the public sector, and 60 percent by the private sector (see Table 4). Financial intermediaries dominate (82 percent), with banks the single largest sector. Most of these institutions are from the United States and 75 percent have a credit rating of at least AA.

TABLE 4
KANGAROO BONDS MARKET SUMMARY, JUNE 2004

Amount Outstanding (A\$ million)	Public sector issuers	14.2
	Private sector issuers	21.4
Issuers by Industry	Banks	37
	Diversified financial services	13
	Utilities	11
	Real estate	3
	Other	4
Issuers by Region (percent)	United States	54
	European Union	28
	United Kingdom	14
	New Zealand	4

Source: Reserve Bank of Australia.

Foreign issuers in Australia tap the market when cross-currency swap spreads offer attractive arbitrage opportunities: after a two-year absence, nonresident issuers returned to the Australian bond market in mid-2003. While these issuers' total Australian dollar borrowings typically represent a small share of their overall borrowings (around 5 percent in the case of supnationals, for example) they are an important source of local currency credit diversification for domestic investors.

The increase in issue activity over the last two years can be attributed to a fall in the relative cost of raising funds in Australian dollars. This cost is driven by corporate bond spreads and cross-currency swap spreads (since issuers typically swap out). Corporate bond spreads have started to fall quite drastically in early 2003 from around 60 basis points over government securities to an average of 20 basis points since then. This tightening of corporate bond spreads can be explained by a shortage of government securities (since the Australian government has reduced borrowing activities due to its fiscal surplus) and by the high credit ratings of issuers that allow investors to view such issues as a close substitute to government securities.

Cross-currency swap spreads have been driven by the increased volume of Australian issuers tapping overseas markets, i.e., borrowing in foreign currency and swapping into Australian dollars (Box 2 provides an overview of swap market dynamics). Record foreign currency bond issuance by Australian entities in 2004 has pushed up the cost of converting foreign currency to Australian dollars and made it cheaper for foreign issuers to do the opposite.⁵ At least partly as a result of the record offshore issuance by Australian issuers, the basis swap spread has increased from around 2 basis points late 2002 to almost 12 basis points by mid-2004, making local currency issuance by foreign issuers more cost-efficient.

⁵ The strong offshore demand for Australian dollar bonds was driven by the relatively high interest rates and the expected appreciation of the Australian dollar. Three quarters of the offshore bond issues were by non-Australian issuers, and around two thirds of the bonds were sold to Japanese retail investors (so-called "Uridashi" bonds).

(iv) **Korea**

The LCBFI market in Korea has so far remained an insignificant component of the domestic corporate bond market. There have been 30 issues since inception, with an average maturity of 2.4 years and an average issue size of WN45 million (about US\$40m). The market has total current outstanding bonds of only US\$300million equivalent and is thus by far the smallest of the five economies studied. The LCBFI remain dominated by the foreign subsidiaries of chaebols. According to the Reuters Fixed Income Database, apart from the three MDB issues (EBRD, IBRD, ADB), the remaining bonds were all issued by subsidiaries of Korean chaebols and were largely BBB-rated. Five of these had put features and two were privately placed.

Box 2
SWAP MARKETS IN ACTION: THE AUSTRALIAN EXAMPLE

The LCBFI market is critically dependent on the availability of well-developed and liquid swap markets. Foreign issuers that raise local currency for domestic purposes typically issue fixed-rate bonds and swap the proceeds into floating-rate liabilities as part of their asset-liability management to reduce interest rate risks.

Foreign issuers that tap local currency markets but do not require local currency for their operations need to swap bond proceeds into a currency of their choice. A cross-currency swap transforms the currency denomination of a debt obligation, for example, from Australian dollars into US dollars. Similar to the United States Internal Revenue Service, borrowers make regular payments in the US dollar floating rate and receive the Australian dollar fixed interest rate to service the underlying bond liabilities. In addition, at the outset of the bond and at the same time as the bonds are issued, the foreign issuer undertakes a principal exchange of the Australian dollar bond proceeds against the equivalent amount in US dollars at the prevailing spot exchange rate. This principal exchange is reversed at the end of the swap at a pre-determined exchange rate.

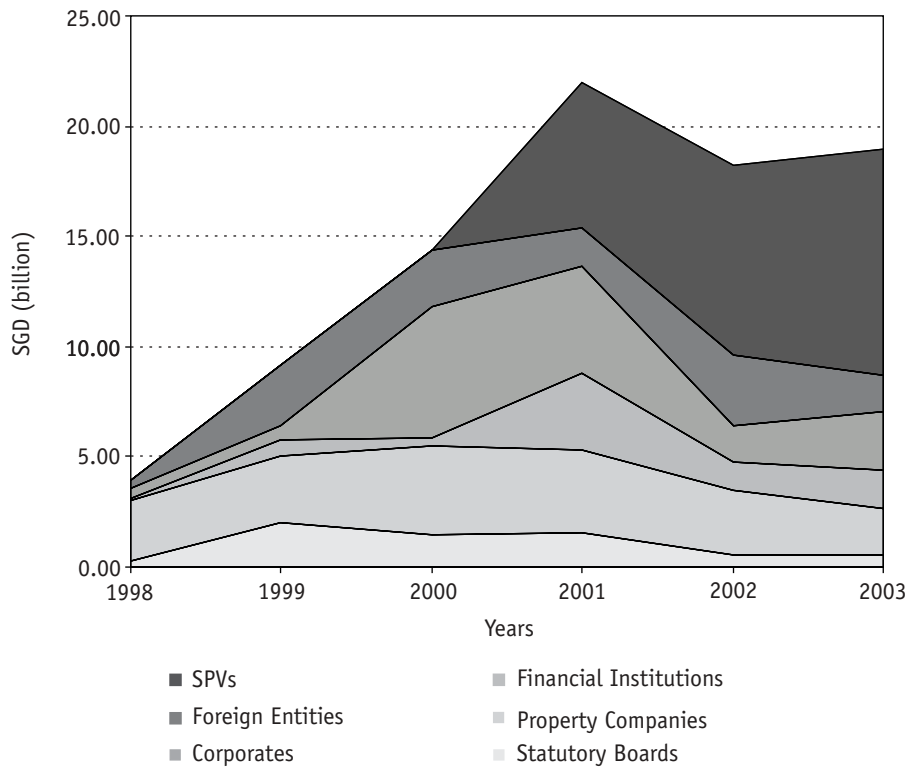
The Australian market is a good example to demonstrate the dynamics and interdependencies of swap and bond markets regarding LCBFI. Historically, there has been more demand for swaps where the counterparty pays an Australian dollar interest rate and receives US dollar interest rate than the other way around. As a result, the counterparty paying the Australian dollars generally has to pay a small premium (the “basis swap spread”) over the Australian floating rate (in addition to demand and supply by issuers, the basis swap curve is also influenced by currency expectations). Thus, the higher the basis swap spread, the more attractive it is to for foreign issuers to issue local currency bonds. On the other hand, if basis swaps become negative, it becomes more cost-efficient for Australian issuers to issue offshore and swap back into Australian dollars. Over the last two years, the dynamics of the basis swap curve have been a key factor determining both LCBFI activity as well as offshore issuance by local investors. Thus, it is important to understand that introducing LCBFI will open the door to local companies raising funds in overseas markets. The end result of such “two-way traffic” in the cross-currency swap market is lower funding costs for both local as well as foreign issuers.

Source: Reserve Bank of Australia.

(v) **Singapore**

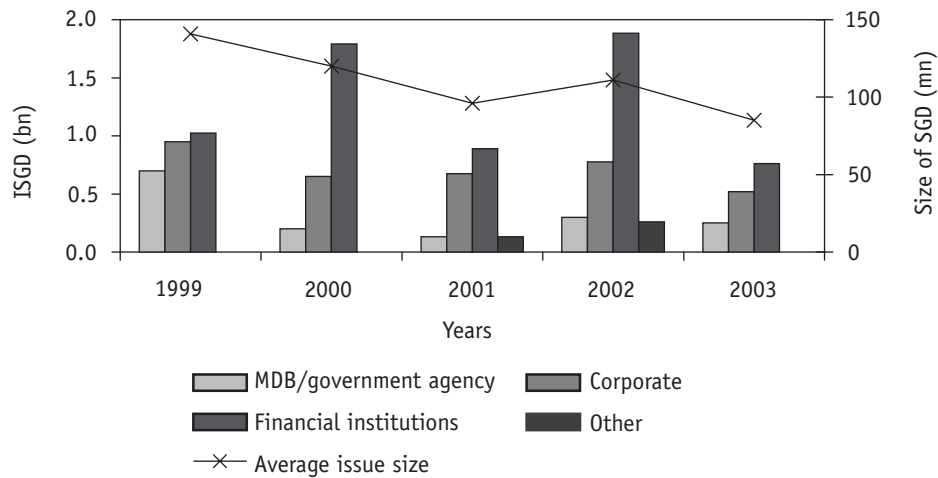
The more recent Singapore market for LCBFI has quickly grown to an annual issuance volume of around SGD2-3 billion, accounting for about 20 percent of annual issues (Figure 4). Since August 1998, a total of SGD15 billion has been raised in the LCBFI market in Singapore. As can be seen from Figure 5, financial institutions have become the dominant issuers and the initially important role of MDBs and government agencies has receded since.

FIGURE 4
SGD BOND ISSUANCE BY ISSUER TYPE



Source: Monetary Authority of Singapore.

FIGURE 5
SGD BOND ISSUANCE BY FOREIGN ISSUERS



Source: Monetary Authority of Singapore.

C. Assessment of the Development Strategies Adopted

In most countries, the first and foremost step to establish LCBFI has been the purposeful government policy decision to create such markets. This was followed by active support and development policies to foster their growth. In this section, we discuss the different strategies that were adopted by governments to develop the LCBFI market.

The first step in encouraging foreign issuance activity is typically to attract supranational issuers to the market, especially MDBs, such as the ADB, IBRD, or International Finance Corporation. In many Asian countries, ADB was the first or among the first to issue local currency bonds. The MDBs serve a valuable function in opening local currency markets because they can increase the volume of outstanding bonds, while offering virtually no credit risk (in 2001, for example, the AAA-rated Samurai bonds by IBRD and EBRD carried lower yields than Japanese government bonds). When there was a dearth of blue chip borrowers, as even in Japan in the early 1990s, the MDBs, especially the ADB and IBRD, acted to revitalize the high-grade bond market. Often, they issued innovative bonds, such as the ADB's 1993 Samurai bond issue, with a maturity of 20 years, at the time the longest in the market. In 1989, the World Bank set up a scheme of guarantees of Samurai bonds, issued by developing countries. In 1993, the ADB issued Samurai bonds in Hong Kong, China; Singapore; and Taipei, China for the first time, encouraged by the yen's strength (these were termed "Dragon bonds"). This initiative was aimed to encourage Asian investors to hold yen assets.

Market participants are generally of the view that it is essential to have MDB issuers act as pioneers in the early stages of the local bond market's development, as these borrowers:

- (i) are well-known issuers in international capital markets;
- (ii) have virtually no credit risk;

- (iii) provide risk diversification for local investors; and
- (iv) bring the presence of local bond markets to the attention of international investors.

Since MDBs manage their funding program on a global basis, competitive funding costs are essential. Typically, MDBs swap bond proceeds into floating-rate liabilities based on US-dollar LIBOR. The MDBs would thus only issue local currency bonds if the after-swap funding cost is competitive with that of other markets. Box 3 lists the requirements that MDBs typically have when issuing local currency bonds.

Box 3
MDB REQUIREMENTS FOR ISSUING LOCAL CURRENCY BONDS

Suprationals such as MDBs typically have a number of requirements to be able to issue local currency bonds. These requirements stem partly from the MDBs' Charter or Articles of Association, and partly from funding cost targets that typically require issuance at very competitive terms and conditions. Requirements typically include the following:

- (i) **Tax exemptions:** Confirmation that interest payments by the MDB and its paying agents will be exempted from withholding taxes. This requirement is based on the fact that MDBs are granted tax-free status in their member countries.
- (ii) **Domestic rating exemptions:** Since MDBs are typically rated by all three major international rating agencies, securing an additional domestic rating adds little additional value for investors.
- (iii) **Broad investor access:** The ability of all major domestic institutional investors, including insurance companies and pension or provident funds to invest in the MDB bonds increases the distribution and liquidity of bonds, and thus lowers funding costs.
- (iv) **Risk weighting:** Risk weightings of MDB bonds should be no more than 20 percent in line with current Bank for International Settlement guidelines ("Basle 1"). Under the new "Basle 2" guidelines this risk weighting will be reduced to 0 percent.
- (v) **Reserve Eligibility:** Similar to government bonds, MDB bonds may be eligible to be counted against statutory reserve and liquidity requirements imposed on financial institutions. This privilege will make it easier for MDBs to achieve their target level of funding costs.

Other development policies have included sequential deregulatory steps that provided a regular and gradual stimulation of the local currency bond market for foreign issuers.

(i) Japan

Again, referring to the country case with the longest history, since 1979, the Japanese MoF has gradually allowed foreign corporations to issue unsecured bonds (beginning with Roebuck's five-year, noncollateralized Samurai corporate issue). Since 1984, further liberalization steps were taken, including a reduction in the required minimum credit rating (from double-A to single A); abolition of an issue ceiling for issues by industrial country sovereigns and international agencies; simplification of issuing procedures for triple A-rated issuers; and from 1986, freeing the issuance of private placements of Samurai bonds by foreign public entities from virtually all restrictions.

In 1988, MoF allowed foreign governments and international institutions to issue yen-denominated Floating Rate Notes by public offering on the Tokyo Stock Exchange for the first time. In 1988, MoF allowed foreign corporations to issue by private placement. The ceiling on a borrower's issuing volume (previously set at a third of a borrower's annual borrowing) was revised and Japanese corporations were allowed to purchase these bonds through private placements (before, only institutional investors could purchase Samurai bonds issued by private placement). In 1991, the minimum rating requirement for foreign governments, central banks, and foreign government-guaranteed institutions was lowered to triple-B, while development policy introduced Japanese government guarantees on bond issuance of emerging market sovereigns (Miyazawa Initiative). In 1996, rating requirements were abolished completely. As a result of the deregulation, the private sector share of the Samurai bond market increased: in 2001 private sector institutions issued about 58 percent of all Samurai bonds.

Another major policy initiative to develop the Samurai market was favorable tax treatment. Until 1988, the principal buyers of Samurai bonds were foreign investors who were estimated to hold around half of all outstanding issues because Samurai bonds were exempted from withholding tax.

(ii) Hong Kong, China

The experience in Hong Kong, China was also characterized by significant government-led initiatives to stimulate the growth of the market for local currency debt by foreign issuers. A milestone was the Exchange Fund Bills program of March 1990, which served as proxy for government debt, providing a reliable, "risk-free", benchmark yield curve for HKD debt. A yield curve was established gradually through the issuance of longer-dated Exchange Fund Bills between 1993 and 1996. By 1996, risk-free benchmarks were issued with tenors up to 10 years, and provided the basis for establishing a yield curve.

As an endorsement of the role of the Exchange Fund Note program in providing a continuous, reliable benchmark yield curve off which other issues would be priced, the World Bank launched the first 3-year bond issue priced over EFNs two weeks after the inaugural 3-year EFN issue, with bonds being priced at a narrow premium to the three-year EFNs. By end-1993 MDBs were becoming increasingly frequent issuers, with a total of six issues launched in 1993 alone. Demand for MDB paper was at least partly driven by regulatory incentives that were provided in the 1990s when MDB paper was made eligible at the discount window, ensuring that banks were keen buyers of these issues. When this privilege was rescinded in September 1998 as part of the government's effort to strengthen the currency board in the face of the Asian financial crisis, MDB issuance became significantly less frequent.

The Exchange Fund program also contributed to growth in the derivatives market. Net daily turnover in OTC foreign exchange derivatives in Hong Kong, China rose by 92 percent in the three years to April 1998 and continued to grow by 14 percent in the ensuing three years to reach USD1.5 billion, largely due to the 42 percent increase in currency swaps. At the same time there was evidence of increasing use of HKD interest rate derivatives between 1995 and 1998 as a result of the high volatility in HKD interest rates caused by the Asian crisis. This trend continued in the three years to 2001 with HKD interest rate derivative transactions increasing by 110 percent due to hedging of interest rate risks associated with greater activity in the debt market and promotion of option-embedded financial products.

Other development policies included the listing of EFNs on the Stock Exchange of Hong Kong (to increase transparency) in 1998, and the posting of official reference prices and yields for benchmark EFNs on Reuters by the Hong Kong Monetary Authority in 2002. Critical to the early development of the Hong Kong bond market was the establishment of an efficient centralized clearing system, the Central Moneymarkets Unit (CMU), which was also set up in March 1990, together with the Exchange Fund program. The latter initiative enhanced Hong Kong's financial market infrastructure, as links with Euroclear and Cedel for HKD-denominated debt helped to promote these bond issues to offshore investors. In December 1996 an interface between the CMU and the Real Time Gross Settlement interbank payment system was established, which enabled the CMU system to provide its members with real-time and end-of-day Delivery versus Payment, significantly reducing settlement risk. Linkages with other Central Securities Depositories in the Asian and Pacific region followed between 1997 and 1999 with Australia, Korea, and New Zealand as well as establishing a "one-stop" debt securities clearing, settlement, and custody platform for Asian investors, placing the CMU at the forefront of cross-border securities trading in the Asian time zone. It is clear that by providing such linkages, access by international investors to trading and settling local currency issues has been made much easier.

(iii) Australia

In Australia it would appear that initially there was no overall development strategy by the government to target foreign bond issuance. The reason for this different emphasis during the first introduction of LCBFI may lie in the situation of the balance of payments. Japan introduced LCBFI soon after it developed a significant trade surplus and hence became a net creditor in the late 1960s. While Hong Kong, China has maintained no significant trade surplus in the past 20 years, it has accumulated significant foreign exchange reserves. Singapore introduced LCBFI in 1998, just when its trade balance surged into surplus. Even in Australia's case, the first LCBFI coincided with a trade surplus in 1991. However, Australia did not have a persistent need to recycle current account surpluses, and therefore did not have to worry about the currency implications of being a creditor nation. More recently, however, government policy has been become targeted at attracting highly rated foreign issuers. This stems from the fact that such issues can be viewed as substitutes for government securities. Moreover, since the Australian government has been reducing its issuance program due to persistent fiscal surpluses, it was keen to ensure that other highly rated issuers enter the market to meet investor demands for high-quality, local currency bonds. Thus, the Reserve Bank of Australia broadened the eligibility criteria for market operations at the margin, to include a wider range of bonds issued by foreign governments and supranationals.⁶

(iv) Korea

In the case of Korea, the current government has vowed to continue reform of the domestic financial system with the explicit objective of ensuring that Korea (by 2010) is an international financial center on par with Hong Kong, China and Singapore. One critical feature of such a plan will be to develop the LCBFI market. Given that there have been virtually no issues by foreign issuers over

⁶ All of these eligible issuers are AAA-rated and include the MDBs as well as other agencies such as KfW, Nordic Investment Bank, as well as some German Landesbanken, and one sovereign (Republic of Austria).

the last years, except for the three issues by MDBs between 1995 and 1997, the government has been studying the reasons for this phenomenon. While one reason is the lack of favorable cross-currency swap spreads, market participants have pointed out that extensive regulatory requirements may have contributed to deterring LCBFI. These include extensive disclosure requirements (most of which require Korean language documentation), onerous approval requirements in case proposed bond terms deviate from standard terms and conditions, and the requirement that foreign issuers need to get credit ratings from at least two out of the three local rating agencies. These extensive regulatory requirements have made it difficult for foreign issuers to tap the Korean market when a window of opportunity arises in the cross-currency swap market. Recently, the government has therefore begun to address some of these regulatory issues. The regulation that limited foreign issuers to an issue size of up to KRW5 billion was lifted in July 2004. Foreign issuers may be exempted from the current requirement to publish financial statements according to Korean accounting standards, and changes to the withholding tax treatment are currently under consideration. It remains to be seen whether these measures will be sufficient to jump-start the nascent Arirang bond market.

(v) **Singapore**

The market for local currency bonds issued by foreign issuers in Singapore started with the decision by MAS to introduce such bonds in August 1998. This decision occurred after careful consideration and the authorities proceeded carefully, adopting a step-by-step approach. Easing the policy of noninternationalization of the Singapore dollar was a critical success factor in opening the local bond market to foreign issuers (Table 5 sets out the liberalization steps).

TABLE 5
MEASURES TO EASE TO THE POLICY OF NONINTERNATIONALIZATION OF THE SINGAPORE DOLLAR

DATE	OBJECTIVE	EVENT
13-Aug-98	Foster development of the capital markets	Notice to Banks MAS 621 replaced by MAS Notice 757.
	Supply side: increase international participation in SGD capital markets	Relaxation of rules to permit bond issuance by foreign entities where the proceeds are to be used outside Singapore, i.e., retain policy that bond proceeds must be swapped out of SGD at the time of launch.
	Enhance liquidity in Singapore government securities market	Allow nonresidents to engage in Singapore dollar repurchase agreements in SGS subject to SGD 20 million MAS consultation limit.
26-Nov-99		MAS Notice 757 revised.
	Demand side: enhance portfolio diversification opportunities	Relaxation of credit rating requirement for foreign issuers (single-A) to allow all sovereigns (rated or unrated), all rated foreign corporates, and unrated foreign corporates provided the investor base is restricted to "sophisticated" investors.
	Extend hedging alternatives	Banks permitted to freely transact in Singapore dollar OTC interest rate derivatives such as interest rate

(continued next page)

TABLE 5 (CONTINUED)

DATE	OBJECTIVE	EVENT
		swaps, forward rate agreements, interest rate options and swaptions without MAS consultation. ⁷ However banks are required to submit monthly reports detailing all interest rate derivative transactions in excess of SGD5 million with non-Singapore counterparties.
	Facilitate trading and deepen bond market liquidity	SGD20 million MAS consultation limit for Singapore dollar repurchase agreements in SGS by nonresidents lifted.
06-Dec-00		MAS Notice 757 revised.
	Broaden investor base for SGD assets	Banks permitted to lend SGD to nonresidents for investment purposes in Singapore. Banks can also extend SGD credit facilities to nonresidents to fund offshore activities as long as the SGD proceeds are swapped to foreign currency.
	Extend hedging facilities	Banks allowed to transact in SGD currency options with other banks and financial institutions in Singapore that are regulated under MAS Notice 757 or its equivalent.
20-Mar-02		MAS Notice 757 revised.
	Improve bond market liquidity	Exempt all individuals and nonfinancial entities (including corporate treasury centers) from SGD lending restrictions of the noninternationalization policy.
	Further deepen hedging opportunities	Allow nonresident financial entities to: transact freely in asset swaps, cross-currency swaps, and cross-currency repos, ⁸ lend any amount of SGD-denominated securities in exchange for both SGD and foreign currency denominated collateral, ⁹ transact freely in SGD foreign exchange options with nonresident entities. ¹⁰
May-04		MAS Policy 757 renamed "Lending of SGD to Non-Resident Financial Institutions."
	Increase flexibility of nonfinancial foreign issuers	Nonresident, nonfinancial issuers of SGD bonds no longer required to swap/convert the SGD proceeds into foreign currency before remitting abroad.

⁷ In September 1999, the Singapore International Monetary Exchange had introduced the SGD 3-month interest rate futures contract with participation open to residents and nonresidents.

⁸ Previously such transactions were treated as forms of SGD lending.

⁹ Previously, lending of SGD securities in excess of SGD5 million had to be fully collateralized by SGD collateral.

¹⁰ Previously, financial institutions had to obtain documentary proof showing that SGD foreign exchange option transactions with nonresident entities were for hedging purposes.

In Singapore's case, MDBs and government agencies have not been particularly active borrowers within the category of foreign issuers, possibly due to the availability of high-quality local credits. Rather, foreign financial institutions have become increasingly frequent issuers, accounting for almost 50 percent of issuance in 2003.

In November 1999, the MAS relaxed the requirement for a minimum issue size of SGD100 million and the average size of issues launched by foreign borrowers quickly fell below SGD100 million. This could be explained by the fact that sophisticated foreign issuers are comfortable launching transactions as small as SGD10 million off Euro Medium Term Note programs.

Tax incentives were also directed to facilitate issuance by foreign borrowers. Thus, in the 1999 budget it was announced that where certain foreign issuers swap the proceeds of a SGD bond issue into a foreign currency with an approved Singapore counterparty, payments under the cross-currency swap will be tax-exempt. In addition, in March 1999 the Singapore government announced a tax incentive scheme to attract financial institutions to boost their local debt teams and base bond origination, trading, and distribution in Singapore under the "Approved Bond Intermediary" scheme. The scheme (which was later folded into the "Financial Sector Incentive" scheme) provides for highly advantageous tax rates for approved institutions and has contributed to international banks building up their Singapore debt teams—an important condition to attract international issuers to the local market.

In summary, measures designed to successfully develop LCBFI markets typically include the following:

- (i) regulatory change to allow LCBFI and broad publication of government intentions;
- (ii) attracting MDBs and other supranationals to issue in the local market by providing regulatory and tax incentives, thus sending a signal to the global market, that the domestic market is "open for business" for foreign issuers;
- (iii) providing a conducive regulatory environment in terms of disclosure and documentation requirements;
- (iv) regulatory flexibility to approve product innovations that meet investor and issuer demands;
- (v) establishing links to international settlement and clearing systems, thus facilitating the purchase of LCBFI by international investors through their own familiar intermediaries.

III. ASSESSMENT: BENEFITS AND POTENTIAL ISSUES OF LCBFI

The development of LCBFI markets has a number of advantages, both from a microeconomic and macroeconomic perspective. Microeconomic issues are first discussed as they form the basis for the macroeconomic discussions. Potential issues related to LCBFI, in particular regarding exchange rate impact and possible crowding out, are then examined.

A. Microeconomic Benefits

Regarding microeconomic benefits of developing the LCBFI market, four main beneficiaries can be identified: domestic and foreign issuers, as well as domestic and foreign investors. Clearly, a national government is concerned with the benefits that accrue to local issuers and investors, and not foreign ones. This section therefore takes the domestic policy lens. It is important to realize, however, that domestic and foreign players are *interdependent*, i.e., unless a “win-win” situation arises for both groups, transactions will not proceed and markets will not develop, and thus ultimately it is the local players who lose out in the process.

Regarding foreign issuers, there are issuers that raise local currency funds for their operations in the host country, and those that tap the local market only if it offers efficient funding opportunities after swapping out the proceeds into another currency. The first type of issuer is typically a local subsidiary of a multinational company (MNC). The impact of issuing a local currency bond is really no different from any other local company raising funds, and there is therefore no reason not to allow such issues. In fact, in most countries, local currency bond issues by subsidiaries of MNCs have been allowed years before foreign issuers were allowed to swap out proceeds. The benefits of allowing MNC subsidiaries to issue local currency bonds rather than forcing them to import capital are clear: MNC subsidiaries provide diversification opportunities for local investors, are often highly rated, and deepen the local corporate bond market. There is little risk of “crowding out” in the capital market by such issues; in fact there may be a “crowding in” effect, as MNCs may be more accustomed to issuing bonds than local corporates and thus set an example for other local corporates.¹¹

Foreign issuers that tap the local market and then convert the proceeds into a currency of choice bring a different set of benefits to the local market: first, as was mentioned in the earlier discussion of cross-currency swap markets, the existence of a swap market has significant potential benefits for local players when hedging offshore borrowings. Unless an active and liquid swap market exists, currency exposures resulting from international borrowings are hard to hedge and can lead to significant currency mismatches (see Box 4). Developing the LCBFI market can thus help to reduce funding costs for local issuers that want to tap overseas markets for their funding needs, for example to raise funding in larger size or longer tenors than are available in the local market. Such local companies require counterparties to hedge the currency risk associated with offshore borrowing, which foreign issuers tapping the local currency market will readily provide. Thus, developing the LCBFI market offers local companies the opportunity to borrow offshore and hedge currency risks by entering cross-currency swaps with foreign issuers, an important

¹¹ The first “Sukuk” or Islamic bond issue in Malaysia, for example, was undertaken by the local Shell subsidiary in the early 1990s, setting off a string of issuances by other local corporates.

improvement over past practices of leaving such borrowings unhedged, which had contributed to the severity of the Asian financial crisis.

Box 4
WHY CURRENCY MISMATCHES MATTER

In a recent publication, Goldstein and Turner (2004) analyze the issue of currency mismatches in emerging markets.¹ Currency mismatches occur when assets and liabilities are denominated in different currencies such that net worth and/or net income are sensitive to changes in the exchange rate. Borrowers in many emerging markets have at times faced currency mismatches on a massive scale. Foreign-currency denominated liabilities have frequently financed local-currency activities, and too often, the stock of foreign currency-denominated assets has been comparatively limited. In such cases, a large and unexpected depreciation of the domestic currency can destroy much of the net worth of firms and households and initiate a wave of insolvencies, a financial crisis, and a deep fall in economic output.

The authors cite extensive empirical evidence that in virtually all of the financial crises in emerging markets in the 1990s, currency mismatches had played an important role. They further observe that the largest output falls have occurred in those emerging economies with large currency mismatches. But currency mismatches not only contribute to causing financial crises, they also make crisis management much more difficult since they constrain the willingness of the monetary authority to reduce interest rates in a recession (for fear of initiating a large fall in the currency that would bring with it large-scale insolvencies). The mismatching also produces a “fear of floating” on the part of emerging economies, sometimes inducing them to make currency-regime choices that are not in their own long-term interest.

So why do borrowers opt to enter into such currency mismatches in the first place? Currency mismatches typically occur when borrowers tap overseas markets, either because there are insufficient local financial resources available, tenors in the local market are too short, or borrowing offshore offers lower interest rates. While borrowers from developed economies are typically able to borrow internationally in their domestic currency (or enter a fully-hedged transaction if borrowing in a foreign currency), borrowers from emerging markets are often unable to do so. In recent research, Eichengreen et al.² refer to borrowing internationally in foreign currency on an unhedged basis as “original sin” and attribute countries’ inability to borrow in their domestic currency from international investors to imperfections in international capital markets. In contrast, Goldstein and Turner argue that countries can reduce the extent of currency mismatches by developing local capital markets, thus reducing the need to borrow offshore, and by strengthening the local macroeconomic and institutional framework, thus attracting international investors to lend in local currency. Interestingly, there is general agreement among all authors that no country has been able to reduce the extent of “original sin” without first developing a deep and liquid domestic bond market.

Another set of benefits of actively developing the LCBFI market accrues to investors, both international and domestic. Foreign investors are typically attracted by the high-quality issuer names that typically issue LCBFI. These include not only MDBs and other supranationals, but also large and highly rated banks, and even sovereign governments and their associated agencies. Once international investors develop coverage of certain local currency markets, they are more likely to start looking at the local issuers as well. Thus, an important benefit for the local issuers is that they are more likely to be able to borrow from international investors in local currencies, once the LCBFI market is developed and international investors have become regular investors in local currency bonds.

Thus, an important “side-effect” of introducing LCBFI is the fact that local issuers will eventually be able to avoid the kind of currency mismatches that they incur when restricted to borrowing from foreign investors in foreign currencies.

Further, LCBFI has important diversification advantages for local investors, as local investors are often overexposed to local issuers whose credit default risk tends to be highly correlated. Foreign issuers typically have credit default risks that display only low degrees of correlation with local events and can therefore significantly improve risk-adjusted returns for local investors and increase the resilience of local investors’ portfolios to local and systemic credit risks. Thus, LCBFI is often highly sought after by local investors, especially when local investors are limited in their ability to diversify their portfolio internationally due to regulatory or capital account restrictions.

B. Macroeconomic Benefits

The previous section has shown that developing the LCBFI market can help to reduce currency mismatches in a number of ways for local corporate issuers, as foreign issuers provide a natural counterpart for local companies borrowing offshore. On a macro level, LCBFI can also help reduce the currency risks that some of the East Asian countries currently face and that are caused by the large current account surpluses in the region. Throughout history, creditor nations have tended to lend to overseas borrowers in the currency of the lender. In contrast, the leading net creditor nations today, which are largely in East Asia, have been extending loans in US dollars, instead of their own currencies. This situation is at least partly attributable to the legacy of the Bretton-Woods system, which used the US dollar as the anchor currency. Unusually, in terms of monetary history, this leaves the creditors open to substantial currency risk. This risk is exacerbated in an era where the outstanding balance of foreign government bonds held by East Asian central banks has reached record amounts, and where leading international policymakers are calling for a devaluation of the world’s leading currencies against the currencies of the East Asian creditor nations. Needless to mention, such dollar devaluation would result in significant losses on the outstanding overseas loans.

In this situation it is advisable to encourage the lending by East Asian investors in their local currencies to foreign entities. A step in this direction would be the introduction and expansion of local currency bonds by foreign issuers. Local currency bonds by foreign issuers allow foreign investment without currency risk—the benefits enjoyed by most creditor nations (such as the United Kingdom and the United States) in the past. In addition, for countries that have significant current account surpluses, the introduction of LCBFI markets has positive implications for the balance of payments as such transactions are booked as capital outflows. Thus, LCBFI helps to reduce the current account surplus through capital account outflows by partially recycling such surpluses, while at the same time shifting currency risk from creditor to debtor.

In countries where the government is running a fiscal surplus, foreign bonds by highly rated issuers, if sufficiently liquid, can substitute as benchmark issues at the margin when the government reduces its borrowing program, as the example of Australia has illustrated where foreign issuers play an important role in meeting local investor demands for highly rated credits.

C. Potential Issues

Policymakers have two primary concerns when considering the LCBFI market: first, that such issues may lead to “crowding out” of local issuers including the government. Second, that swap-driven issuance may have an adverse impact on exchange rate volatility or even lead to depreciation pressure on the exchange rate. Each issue is discussed in turn.

Concerning potential “crowding out”, it is clear from the country case studies that such concerns are unfounded. Foreign and local issuance often goes hand in hand. Specifically, in Australia, for example, foreign issuers offer high credit-rated alternatives otherwise lacking in the market. Similarly, in Hong Kong, China and in Singapore, foreign issuers bring additional diversity to the local bond market that is missing given the low issuance volume of the government and the small base of local issuers. Thus, foreign issuers fulfill an important role in meeting local investors’ demand for highly rated, low-risk bonds, thereby acting as substitutes rather than complements. In Japan, foreign issuers have also played an important role in stepping up issue activity—at least partly encouraged by government policy—when local issue activity was low. Given today’s size of the Japanese bond market (the second-largest in the world), LCBFI, even though playing an important role, is minute compared to total outstanding bonds, accounting for a mere 0.8 percent. Crowding out is therefore clearly not an issue.

Regarding possible effects on the exchange rate when large issues get swapped into another currency in one large outflow, this issue may be relevant for markets where foreign exchange trading is low.

In Korea, for example, there have been some concerns that the exchange rate may be affected by swapping transactions. However, with daily market volume in the exchange rate market at \$20 billion equivalent and issue sizes of LCBFI of, say \$100 million, this would seem highly unlikely. In addition, of course, given that there is significant upward pressure on most East Asian exchange rates at the moment, LCBFI—if it were to have any impact at all—would actually contribute to reducing such pressures. Market participants believe that even in the smaller economies that may have downside pressure on the exchange rate, markets can easily absorb swapping transactions without any adverse impact on the exchange rate. It should be added, of course, that since LCBFI issue volume is ultimately under the control of the government, it can regulate the issuance flow and increase or decrease the volume as required by market considerations.

Thus, in summary, in most cases there would be little reason for policy concern caused by LCBFI. Given that the government can retain regulatory control, a step-by-step approach can be implemented that allows regulators to gradually build up issuance volume and monitor the impact on key policy variables. Should it perceive adverse effects (contrary to our expectations) issuance volume can always be adjusted.

IV. CONCLUSIONS

This paper reviews the experience of five East Asian economies that have permitted local currency bond issuance by foreign issuers. Japan first introduced Samurai bond issues in 1970 and since then the Samurai market has become an important part of the Japanese bond market with total outstanding bonds of Y7,000 billion (\$68 billion equivalent) in 2004. Hong Kong, China was the second market

in East Asia to allow nonresidents to issue local currency bonds in 1977. Since then LCBFI has grown substantially and in 2003 such issues accounted for 23 percent of all local bond issues in the territory. Australia was a relative latecomer to the LCBFI market, only permitting foreign issuers to enter the market in 1990. Since then, and especially over the last few years, LCBFI has taken off rapidly. Today, about 20 percent of all outstanding bonds in Australia are issued by nonresidents. Korea liberalized entry by foreign issuers in 1995. However, after the issue of three supranationals between 1995 and 1997, issue activity has remained marginal, partly due to cumbersome regulatory requirements. In Singapore, entry was liberalized in 1998 and issue activity has picked up steadily with LCBFI accounting for between 10-20 percent of annual issuance volume over the last four years.

The paper has argued that LCBFI has a number of economic benefits. These include microeconomic benefits for local as well as foreign investors and issuers that result in a “win-win” situation for all parties involved. Macroeconomic benefits include the fact that by introducing LCBFI, countries are able to raise funds from international investors without associated currency risk.

From the analysis in the paper, a number of policy conclusions emerge for countries that are considering opening their markets to foreign issuers. First, it is clear that the introduction of foreign issuers occurred at a time when the local bond market was at a relatively early stage of development. Thus, there is no need to wait for the local market to reach an advanced stage of development before allowing foreign issuers to enter the market. Second, the development of the LCBFI market needs to be strategically driven by the government. Government policy and the chosen regulatory approach and incentives provided play a key role in developing the market. At the same time, government can retain effective control over the LCBFI market if considered necessary. Third, the potential issues that are sometimes associated with permitting foreign issuers into the local market, such as an adverse impact on the foreign exchange regime or possible “crowding out”, did not play an important role in the countries studied. Given the relatively small size of the LCBFI market, it is argued that foreign and local issuers have a complementary rather than a competing role to play in developing the local currency bond market.

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