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## *Analysis*

# The Asian Bond Fund Initiatives and Reform through Learning by Doing

Guonan Ma *

In June 2003, the Executives' Meeting of East Asia and Pacific (EMEAP) central banks forum launched the Asian Bond Fund 1 (ABF1) initiative. The eleven EMEAP members are Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore and Thailand. ABF1 pooled $1 billion in international reserves from the 11 EMEAP member central banks, investing in US dollar denominated bonds issued by sovereign and quasi-sovereign borrowers in eight of the EMEAP economies. By design, ABF1 was set up to be restricted to EMEAP central bank investment only and thus was not open to other investors. Nonetheless, it was the first regional pooling of international reserves in Asia.

In June 2005, the EMEAP central banks launched the second fund, the Asian Bond Fund 2 (ABF2), which has invested $2 billion of EMEAP central bank reserves in local currency denominated sovereign and quasi-sovereign bonds in the same eight EMEAP member markets. After the investment of the $2 billion seed money, the ABF2 funds are to be listed in the markets individually and become open to investors from both within and outside Asia.

Since the Asian financial crisis in 1997 there have been a number of efforts, both regional and domestic, aimed at promoting bond market development in the East Asian region. There is a broad consensus among regional policymakers that a well functioning local-currency bond market can help intermediate between domestic savers and borrowers in the region and mitigate currency mismatch. However, the ABF1 and ABF2 initiatives have been unique on a number of grounds. Firstly, they have involved the creation of actual bond funds, with real financial contributions from each of the parties concerned to invest in the Asian hard- and local currency bond markets. Secondly, the bond funds have been created by actual policymakers and regulators of the EMEAP forum throughout the region.

One key advantage of this approach has been that it has allowed policymakers and regulators to appreciate more market impediments in their actual operations of establishing bond funds, creating an important element of 'learning by doing'. Another advantage of the ABF2 project is to facilitate public-private sector cooperation, as the ABF2 is initially seeded by central banks, administered by the Bank for International Settlements, managed by private-sector fund managers and eventually open to all investors, public and private alike.

In principle, private investors could have also lobbied for reforms. However, market reform is a public good in the sense that the benefits are enjoyed by many investors. Individually, investors would be unwilling to bear the costs of lobbying fully for such reforms, because they would not be able to keep the benefits to themselves.

In actually setting up ABF2, the EMEAP central banks encountered a myriad of market

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The paper of the month for November was **Regional vs. Global Risk Sharing in East Asia** by Soyoung Kim, Sunghyun H. Kim, and Yunjong Wang.

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impediments such as capital controls, withholding tax, regulatory obstacles and weak infrastructure. Even when policymakers and regulators had been aware of the impediments before the exercise, they found some of them to be more significant than initially thought. By undertaking the initiative as a group, the EMEAP central banks improved their understanding of specific impediments in their local bond markets and came up with ways to overcome them. Seeing that the authorities in neighbouring jurisdictions had already instituted certain market reforms encouraged the relevant authorities to 'fast-track' their own initiatives. It has been this collaborative process which has made the ABF initiatives an effective mechanism for regulatory and market reform across the region. The ABF projects have also facilitated different regulatory authorities in the same jurisdiction to cooperate better in market development.

Recognizing that their job is far from complete, the participating central banks also agreed on an incentive mechanism for further reducing market impediments. In particular, the scheme for allocating the portfolio to the various local bond markets will regularly take market impediments and subsequent liberalisation into account. For example, the portfolio weight in ABF2 for an individual market may rise as cross-border and local market impediments in that market are reduced.

For such relatively small sums of EMEAP central bank investment, the ABF2 initiative has been quite effective in promoting the reform of local currency bond markets. This is a testament to the importance of the learning by doing approach of the initiatives and the lessons that this has generated for policymakers across the region.

The most apparent area for reform has been in capital controls. Malaysia, for example, has announced measures to liberalize its foreign exchange market, so that it has now essentially restored the regime that was in place before it imposed capital controls in the Asian financial crisis. Korea has also recently announced a series of measures to further liberalize foreign exchange regulations. In China, ABF2 is the first ever foreign fund entering the local inter-bank market, and the investment quota on portfolio inflows by qualified foreign institutional investors has been raised from the initial $2 billion in 2003 to $7 billion as of May 2006.

Withholding taxes and other taxes are another important area of reform. So far, five of the eight EMEAP member markets have either implemented or offered exemption from the withholding tax to non-residents investing in local currency sovereign or quasi-sovereign issues.

The ABF2 initiative is a regional cooperative effort aimed at fostering local currency bond markets in Asia. It involves actually setting up bond funds and thus contains an important element of 'learning by doing'. To date, this process has helped ease a variety of market impediments, both cross-border and local, and encouraged regional regulators to provide incentives to further reduce market impediments. So far, most of the ABF2 funds have been listed or become open-end funds, with the total fund size of the ABF2 increasing by about 50 per cent to $3bn. It has probably also inspired a forthcoming World Bank global emerging market fund.

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