

AGENDA ITEM 3 – ATTACHMENT 2

GENERAL PRINCIPLES FOR EFFECTIVE BOND MARKET DEVELOPMENT COOPERATION IN THE ASIA-PACIFIC REGION

PREAMBLE

The development of local currency bond markets is essential to sustained economic growth in the Asia-Pacific region. Robust bond markets strengthen economies against financial instability. They play a crucial role in development, providing critical financing for infrastructure and meeting the needs of expanding enterprises and ageing populations. Increased cross-border investment and issuance in these markets would help accelerate their development and make the region more attractive to international investors by providing wider choice, diversification opportunities and higher returns.

The following general principles are being proposed as a guide to effective cooperation in developing these markets based on the views and experiences of public officials, private sector experts and market players. These principles are also intended to promote consistency among the number of initiatives that are currently being undertaken within various organizations, and to ensure the consistency of their outcomes with the broader vision of free and open trade and investment throughout the Asia-Pacific region.

I. PUBLIC-PRIVATE PARTNERSHIP

1. The public and private sectors should work to enhance each other's effectiveness in playing their respective roles in the development of the market and collaborate in those areas, whether at the domestic or regional level, where partnership between them can be fruitful.

In general, the public and private sectors each have proper roles to play in development. In a healthy market economy, the private sector normally engages in innovation and competition, while the public sector provides sound legal and policy frameworks, regulation and supervision. However, there is much scope for both sectors to enhance each other's effectiveness in playing their respective roles.

Markets and institutions have developed more rapidly where the private sector has been properly involved in the design of regulation and market infrastructure, and where it has been engaged in promoting ethical and efficient market practices and conventions, market surveillance and competitive pricing. Policies that encourage the involvement of foreign expertise in bond market activities, such as in the development of the credit rating industry, bond indices and sophisticated financial instruments, reinforce these benefits.

There are also areas where direct collaboration between the public and private sectors can be fruitful. Experiences of emerging markets in the region illustrate that without a robust investor and issuer base, as well as a sufficient number of market makers and a wide variety of financial instruments, it would be difficult to achieve market depth and liquidity. Coordination between government and private sector can thus be instrumental in expanding the investor base and the variety of product types.

II. GLOBAL AND REGIONAL INTEGRATION

2. Economies should aim to eliminate unnecessary restrictions, omissions of law or practice and legal, fiscal and regulatory discrepancies that hinder cross-border investment and issuance in bond markets. Where they exist, capital account restrictions should be reduced and eventually removed, in tandem with measures to strengthen the domestic financial system.

Intra-regional cross-border investment and issuance in Asia-Pacific bond markets are limited by various restrictions, omissions of law or practice and legal, fiscal and regulatory discrepancies. Restrictions that apply to foreign firms, which impede their participation in domestic bond market making processes, also hinder the flow of investor funds and issuance. Cross border investment and market liquidity are severely impacted by capital controls aimed at restricting the movement of capital in and out of markets.

Reducing and eventually removing these restrictions will help promote long-term capital flows. However, they may also give rise to increased flows of volatile short-term capital, and should therefore be accompanied by measures to strengthen the domestic financial system against instability. In addition to capital account liberalization, each economy should also adopt a foreign exchange regime that best facilitates cross-border capital transactions within the context of its own development strategy.

3. In developing domestic and regional bond market infrastructure, economies should aim to achieve region-wide convergence toward relevant global standards and practices. Where current international norms do not sufficiently take into account important characteristics of markets in the region, regional efforts should be undertaken toward appropriate improvements in these global norms.

Capital flows from within and outside the region will be crucial for the development of the region's bond markets. Thus, economies should aim for convergence with global standards and practices that govern various aspects of bond market activity, including standards for financial reporting and auditing, market regulation and supervision and credit rating practices, among others, rather than the establishment of regional standards. However, in order to promote intra-regional capital flows, efforts should be made to coordinate convergence efforts on a region-wide basis.

Asia-Pacific economies should also be involved in the process of setting and further developing global standards and norms in order to ensure that these adequately reflect local realities and that they are effective in promoting stable and robust financial systems in the region. Economies should make use of regional collaborative mechanisms among relevant agencies, creating or expanding them where necessary, to provide regional contributions to the work of global standard-setting bodies.

III. DOMESTIC-LEVEL COORDINATION

4. Each economy should ensure effective coordination of measures undertaken by various agencies related to the development of the bond market, establishing, where necessary, a high-level coordinating body with clear terms of reference for this purpose.

Coordinating bodies overseeing efforts to develop bond markets could be very useful given the fact that the range of issues involved spans a number of public sector agencies. Among these are agencies responsible for funding, debt management, taxation and macroeconomic management,

economic planning agencies, central banks, securities market regulators, budget ministries, and public sector and local government debt issuers.

This reflects the fact that bond market development is closely inter-related with other economic activities and may involve trade-offs with sovereign debt management and macroeconomic policy objectives, as well as overall financial sector development strategy. The *APEC Compendium of Sound Practices*, endorsed by the APEC Finance Ministers in 1999, which outlined a road map for bond market development, suggests the creation of high-level coordination committees at the initial stage of the process, involving these various institutions.

IV. REGIONAL-LEVEL COOPERATION

5. Economies should put in place effective mechanisms for regional policy coordination and cooperation to address the various interlocking measures required for the development of local currency bond markets and of cross-border investment and issuance in these markets.

Regional policy coordination and cooperation are required to address a number of interlocking measures required for bond market development. Among these are the convergence of market infrastructure and practices including credit rating practices and accounting standards, the establishment of arrangements for cross-border recognition of insolvency administrations, promoting a regional framework as well as improving the environment for informal workouts, and capacity-building measures in various areas.

Regional cooperation has proven to be a useful instrument in accelerating reforms in individual economies through peer pressure, in promoting convergence of standards and practices, and in addressing cross-border issues. Maintaining effective cooperation mechanisms within the framework of existing regional bodies, supported by adequate resources, is important for sustained progress over the long-term time frame of capital market development in developing economies.

6. Efforts should be coordinated among various regional and sub-regional organizations that are actively involved in regional cooperation for bond market development, with the aim of promoting complementation and synergy among their activities and ensuring the consistency of all efforts with the vision of free and open trade and investment throughout the broader Asia-Pacific region.

The existence of a number of regional organizations within the Asia-Pacific region, with different but overlapping memberships and activities, reflects the region's diversity and complex history. Several of these organizations undertake various activities that contribute to bond market development. Ensuring that these activities are mutually complementary, consistent with each other and well-coordinated are important to achieve smooth progress and the eventual success of their efforts. Of particular importance is the objective of ensuring the consistency of all these efforts with APEC's vision of free and open trade and investment throughout the broader region.

As the emergence of deep and liquid bond markets is dependent on the participation of a sufficiently large base of investors and issuers, as well as market makers and other key participants such as credit rating agencies, the involvement of economies from both sides of the Pacific should be encouraged. Mechanisms for continuous information exchange, coordination and undertaking of mutually-reinforcing activities among regional organizations will be useful in ensuring the effectiveness of these efforts.

V. STRENGTHENING MARKET MECHANISMS

7. Bond market development efforts should be focused on the development of efficient, transparent and competitive markets that are supported by a robust system of complete, timely and meaningful disclosure, open to many players, both domestic and foreign, and enable participants to properly price risk.

Markets will attract investors if there is competition among market participants and if they are open to many players, both domestic and foreign. Such markets are generally characterized by a robust investor and issuer base, a sufficient number of market makers, a wide variety of financial instruments, sound macroeconomic policies and an open economy and financial sector. Open financial sectors also allow economies to benefit from foreign expertise in the development of market infrastructure and financial instruments. Ideally, jurisdictions should have a competition regulator with full authority to intervene against anti-competitive market activity.

Regulation should focus on maintaining and enhancing transparency and market integrity, which are important for the soundness of market-based structures with multiple participants such as bond markets, as well as for investor confidence. This involves maintaining a robust system of clear, complete, timely and meaningful disclosure and developing transparent processes and a conducive environment for assessing the risk and return in trade instruments.

Enabling the appropriate pricing of risk by market participants is a key objective that is crucial for facilitating genuine risk assessment and efficient capital allocation, avoiding moral hazard and ensuring financial stability. Subsidies that could distort market pricing signals should be avoided. Any credit enhancement scheme deemed necessary should be carefully designed to avoid moral hazard and corruption of markets.

VI. THE ROLE OF GOVERNMENT

8. Governments should provide an enabling environment for market participants to engage in bond investment, issuance and trading. This includes sound macroeconomic policies, tax regimes that are conducive to the growth of the market, the promotion of good corporate governance, the formulation and enforcement of clear and sound laws, market rules and regulations, and the development of robust clearing and settlement systems.

The success of bond market development efforts will depend on the extent to which liquid and efficient markets adequately providing cost-effective long-term capital to issuers and attractive financial instruments to investors are created. Necessary prerequisites to the creation of such markets include sound macroeconomic policies, a sound legal and institutional framework that offers adequate protection to investors' rights, and good corporate governance. Taxation treatment is highly influential in market players' decisions, and should be reviewed to determine whether tax regimes are conducive to the holding and trading of bonds.

Areas where government can support the development of the market include providing effective insolvency and creditor rights systems, supervisory arrangements; a framework for promoting corporate governance, financial controls and integrity through clear rules and penalties; robust accounting standards and practices, effective regulatory oversight, judiciary systems and civil procedures. The government also needs to promote the development of the supportive infrastructure (repurchase market, securities laws, documentation standards). Regulators must be able to balance the treatment of interests of all key market participants.

9. Economies should maintain a government bond issuance program to support the yield curve, involving the issuance of bonds across a broad range of maturities in

sufficient sizes to attract wide investor participation and effective communication with investors to understand their needs.

Sound policies and institutional frameworks are not necessarily sufficient to ensure the provision of adequate market supply and demand by market participants. A broad institutional and retail investor base is needed, and government bond markets usually play an important role in the development of private long-term debt markets through their role in ensuring market liquidity and facilitating risk management.

A common thread in the recent development of most markets in the region has been a steady development with sovereign bonds as the central focus of the market continuing as a major but diminishing component with the growth of commercial debt issues. Experiences of economies in the Asia-Pacific region illustrate how government bond issuance may be used for market development purposes even in a situation of fiscal surplus. However, care should be taken so that corporate borrowers are not crowded out by government bond issuance in times of large fiscal deficits and low savings.

VII. COOPERATION IN THE CONTEXT OF REGIONAL DIVERSITY

10. Collaborative efforts should be designed to take into account the disparities in levels of market development among economies while promoting progress toward region-wide integration.

There are wide disparities not only between developed and developing economies within APEC, but also among developing economies with respect to the level of development of local currency bond markets. A number of emerging markets have made significant advances in developing robust policy and regulatory frameworks, market infrastructure and key components of deep and liquid bond markets. Others are still in the early stages of development where many key requirements have not been adequately met.

For emerging markets that have reached a more advanced stage of development, collaborative efforts should focus on enhancing market depth and liquidity, as well as promoting reforms to facilitate cross-border investment and issuance. For the less-developed markets, the focus should be on addressing more fundamental issues such as disclosure and accounting standards, reducing barriers to issuance, protection of creditor rights, increasing the savings rate and enforcement of laws and regulations.