A Tale of Two Markets: Bond Market Development in East Asia and Latin America

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Summary

Fostering local bond markets is a priority of policy makers in both East Asia and Latin America. This Occasional Paper provides a comparison of market developments in the two regions. It shows that Asian bond markets are larger and better capitalized and that the tenor of Asian bonds is longer, reflecting the region's high savings rates, history of stable policies and relatively strong investor protections. On the other hand, Latin American bond markets are more liquid by most measures, and they have had more success in attracting foreign investor participation. But in East Asia and Latin America alike, progress remains slow, especially for corporate bonds. Fundamentally this reflects the fact that bond market development is part of the larger process of financial development and that financial development cannot be separated from the still larger process of economic development. Policies to strengthen and harmonize financial structure may help, but by themselves these cannot relax these fundamental developmental constraints.

A further obstacle is that small developing countries lack the scale needed to support deep and liquid markets. Although countries in both regions have responded by

seeking to encourage foreign investor participation, the two regions are pursuing this objective in different ways. Latin American countries are each seeking to enhance the efficiency of market infrastructure, the predictability of transactions, and the transparency of regulation. Each Latin American country is, in effect, competing with its neighbors for foreign investors. While East Asian countries are pursuing many of the same initiatives, in addition they are seeking to harmonize their institutions and regulations and to overcome the obstacle of inadequate scale by creating an integrated regional bond market.

Although Latin America's decentralized approach promises an immediate payoff to countries implementing ambitious reforms, it threatens to run up against limits of minimum efficient scale. Even relatively large countries like Brazil and Mexico may be too small to support a bond market with extensive capitalization that is a prerequisite for world-class efficiency and liquidity that are characteristic of the global financial centers. The East Asian approach of attempting to build an integrated bond market on a regional platform has the potential to relax this constraint, but this approach requires a consensus on the design and implementation of the relevant reforms, rendering progress painfully slow.

Which region will do better going forward? The answer will depend, in part, on how successful they are in pursuing further reforms. Latin American countries have further to go in strengthening investor protections, enhancing market transparency, and building efficient bond market infrastructures. East Asian countries have further to go in encouraging retail participation and reducing the dominance of pension funds, provident funds, and other buy-and-hold investors and in putting out the welcome mat to foreign investors.