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Bond Market Developments in Emerging Markets: Propsects and Challenges for Pakistan

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This paper investigates the development of bond market in emerging economies with a focus on Pakistan. The main objective of this paper is to explore the reasons for a slow development of bond market in emerging economies. To achieve this objective, we first provide a comprehensive survey of the bond market developments in a sample of Asian countries. For comparison purposes, we split the sample into two: (i) the early reformers, and (ii) the hesitant or late reformers. We present a case where bond market developments become an integral part of the financial market development. We also discuss the stages of market developments in a sample of emerging market economies. We compare both sets of countries and then draw lessons for Pakistan. We observe that Pakistan needs to satisfy a set of pre-requisites before some meaningful progress in domestic bond market development is made.

1. Introduction

During the period of early 1980s to mid-1990s, many East-Asian and Southeast Asian countries embarked on policies of financial sector reforms, liberalization, deregulation and financial market developments. By mid-1990s, most of these countries were enjoying the benefits of a liberalized financial market and an open economy. However, until recently, these countries lacked a well-established and well-functioning domestic bond market, especially a secondary market for government bonds.

The main question is why the development of bond market so important for emerging economies? Bond market has significant importance in any economy but more so in emerging economy where saving and investment opportunities are limited. As such the question is not 'why to have a bond market?' but 'when to have a bond market?' The benefits of the development of a market for domestic bonds include both the macroeconomic and microeconomic perspectives. Within macroeconomic perspective, the primary benefit of government bond market is to provide a channel for the financing of fiscal deficits. This is, probably the most

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important benefit for emerging economies such as Pakistan with a history of high fiscal deficits and the failure of other possible sources of financing the fiscal deficits. Another benefit of developing a market for government bonds is to strengthen the transmission mechanism of monetary policy with the use of government securities market. The market for domestic bonds also helps in the use of monetary policy instrument and to keep inflation within desired target. The literature also suggests that domestic bond markets help to sterilize large capital inflows.[1] Bond market also helps to make efficient investment and financing decisions, improve efficiency in the design and implementation of monetary policy, risk management, liquidity management and foreign exchange risk management.

In view of some recent financial sector developments in emerging economies, it is imperative to assess why the development of bond market could not keep the same pace as other sectors of the financial market in the emerging economies. While doing so, one should also look at the state of sample economies and the challenges ahead. These are the main objectives of this paper. We plan to present a case where bond market development becomes an integral part of the financial market development. We also provide a complete sate of a sample of emerging market economies. For comparison purposes, we split the sample into two: (i) the early reformers, and (ii) the hesitant or late reformers. We compare both sets of countries and then draw lessons for Pakistan. The paper is organized in the following manner. In section 2, followed by this introduction, we provide an overview of the developments of bond market in a selected sample of Asian countries. Section 3 presents a case for the need and importance of bond market in emerging economies. Specifically, we discuss the pre-requisites for the development of a domestic bond market. Section 4 focuses on Pakistan using a set of social and institutional factors in domestic bond market development. Finally, some concluding remarks are made in section 5.

2. Bond Market Development in Emerging Asia

In this section, we present an overview of the developments in establishing a bond market in a sample of selected Asian countries. For comparison purpose, we split the sample into two groups. The first group is a called ‘Early Reformers’ and include counties such as Malaysia, Singapore, and South Korea. The second group is called, ‘Emerging Markets’ and includes China, India and Pakistan.

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[1] See Turner (2002) for details.

2.1. Early Reformers

Malaysia

Capital market development in Malaysia started in 1960 with the trading in Kuala Lumpur of the dual listed stocks and bonds in Singapore. The real impetus came only when the ringgit was adopted in June 1973 as the Malaysian currency and Kuala Lumpur traded the shares in the local currency. Dual listing arrangement with Singapore stock exchange worked both ways in the earlier period. With the development of the local market, more and more firms continued to restrict listing to the local market even though the more established firms were actively traded in both markets. With the dual-listing coming to an end in 1989, and other reforms made the local market extremely attractive to foreign portfolio investments. Liquidity surged very high and the market gained substantial growth in all aspects. The total traded volume in 1993 represented the cumulative total volume of the previous 20 years! The market yield in that year was an enormous 104 per cent in this, the fourteenth largest market. This made foreign interest in the local market a very significant destabilising force. Since the withdrawal of foreign interest in the market starting in 1994, the market drifted down to lower levels, and was also badly affected by the currency crisis.

The structure of the capital market changed rapidly in the late 1980s and 1990s. The number of firms listed almost doubled in the period and capitalization soared with high-priced stocks: in 1999, there were 702 firms. The bond market also expanded with two rating companies providing rating services. To these were added few derivative securities. Interest rate derivatives were added soon in 1995 followed by the offer of stock index futures on a 100-stock based index in December 1995. Plans were afoot at that time to include options markets. With the crisis affecting the market sentiments, some of these plans have been put on hold.

The share market bore the worst effects of the financial crisis. The immediate effect of the currency crisis – worsened by the exposure of this market to foreign and local individuals holding a large portion of the market – led to the collapse of the share market. It plummeted by almost 80 per cent, and languished between 350 to 500 index values for almost three years. Only in 2000 did it recover to a level about half way to the point it was at the onset of the crisis. The exit of foreign portfolio investors, especially in the face of strong capital controls on portfolio flows, meant that the market was deprived of the demand push, which was a basic reason for this market's attraction for both foreign and local investors.[2]

Credible reforms to liberalize the financial sector were also noteworthy features of development experience. Not only did the reforms help to build a financial institutional framework from scratch, they also helped to build a diversified financial structure that delivered the capital at low interest rate to assist the development process. In the 1990s, there were too many capital flows into the country because of this very openness. Attempt by the central bank to mop up the liquidity to prevent the private sector taking on too many imprudent investments failed. This failure at the time of worsening current account deterioration weakened the exchange rate, which was held artificially high by the basket pegging in place since 1978. When the policy responses did not restore the confidence of the investors, both local and short-term fund owners withdrew their funds to safer currencies, and the exchange rate went on a free-fall that exhausted the ability of the country to sustain the shock. The adoption in September 1998 of a fixed exchange and capital controls on short term cash inflows reversed one aspect of the liberal policies in the financial sector on its track. It has nevertheless brought in some stability at a time after 12 months of instability. Would it deliver the long-term needs of an economy dependent on the external sector for development?

Singapore

Singapore has been a traditional location for capital market activities in the Malay Peninsula. However, since the cessation of currency convertibility in 1973 and especially after Malaysia's cessation of double-listing since 1989, the capital market activities in Singapore are very much connected with the domestic economy. Prior to these dates, a significant quality of the transactions in Singapore was on Malaysian-origin companies. With the development of a large capital market of its own, Malaysia required its corporations to seek listings only in the national exchange. As a consequence, the size of the capital market in Singapore declined in 1990. However, with more firms including government-linked ones seeking listing on the stock market, the size of the market has increased substantially by the end of 1997. At the end of 1997, there were 259 listed firms on the share market capitalized at around US$170 billion. The share market had intense activity: turnover per firm per year was US$565, which figure compares

[2] Regulations permitted banks to lend money to individuals for share purchases. At the height of the crisis, the exposure from this source accounted for about 15 per cent of the loans!

favorably with most developed capital markets. As at 2002, the market has grown to about 400 listings, and capitalization has increased to over US$200 billion.

The debt market is less developed than the share market. The government issues Treasury securities periodically to determine the going interest rates through regular auctions of the issues on Thursdays. Since the government has perennial surpluses, it is not able to issue large debt issues. Corporations have found that they could borrow money from banks at reasonable interest rates given the interest suppression noted earlier. Thus, businesses do not have incentives to issue public debt in large amounts. As a result, the public debt market has been very small and is at best inactive over the study period. The current face value of the debt market is under 15 per cent of the GDP, one of the smallest international centres for debt issues. But official statistics include a huge listing of the Ginnae Mae on the board, which masks the fact that the debt market is at best non-existent in this otherwise large international money centre. This remark also does not take into account the syndicated loans that originate as private placements of debt from the region's government's and the private sector in the banking system: there is a large position in this market.

Singapore International Monetary Exchange was set up in 1982 to specialize in financial futures contracts. This market has now established itself as a very successful risk management centre for investors in the region. Two-thirds of the value of the contract is some forms of interest rate instruments, e.g. Eurodollar futures and the Euro-Yen futures. There are 17 instruments traded. These and other developments had made Singapore into a successful international financial centre linked to the major centers in Tokyo, New York and London.

The development of bond market in Singapore was not a high priority partly due to consistent budget surpluses the government enjoyed until 1997. However, the Monetary Authority of Singapore (MAS) took some initiatives to develop a domestic bond market to deal with any future crisis similar to the 1997 Asian crisis and to create liquidity. In the year 1998, MAS launched a series of Singapore Government Securities including $1 billion of government bonds and $2.9 million of treasury bills, 10-year bonds. The MAS also decided to create a repo market. These measures increased the trading volume by about 20 percent.[3]

[3] Fock and Wong (2001).

South Korea

Capital market development was the most striking in that the asset growth of listed companies was very high, 31 per cent per annum. The capital market reform is noteworthy also in that the reforms were directed more in the domestic economy. Reforms to open the capital market to the rest of the world were delayed as long as possible, in fact till the late 1980s. Domestic capital market reforms were aimed at achieving capital formation to reduce the high level of debt in Korean firms. This took the form of organizing the market rapidly to provide a clearing house for the listing of good quality firms on the exchange. These firms could then raise capital and reduce their dependence on bank debt. The second aim of developing the capital market was to ensure that, with the rise of large shareholding across other firms, the undue control of the *chaebols* of the economy can be reduced.

A brief summary of key capital market developments during 1980 to 1997 is useful. The number of listed firms grew from 352 in 1980 to the present number of about 800. The bond market also increased its listed bonds at face value of 1,649 billion won to close to 35,000 billion won. The Treasury issues have also grown substantially. Traded value in shares is moderate at US$450 million traded value per firm per year, which is about the level in Tokyo, but about a third less than that in the New York stock market. Share market capitalization is about 55 per cent of GDP, which is lot less than those found in markets such as Japan (91 per cent), Thailand (96 per cent), etc.

The importance of the capital market may be judged by one indicator. An average of 25 per cent of the capital needs was raised through the organized capital markets. This ratio is far higher than is the case with most countries, the exception being Malaysia, where the capital market, much more open to the outside world than the Karachi Stock Exchange, provided about 45 per cent at some times.

More and more firms were listed on the exchange. In fact the number doubled in ten years. The depth of the market increased from a mere 6.9 per cent of the GDP to about 35 per cent in 1996: after the collapse following the crisis, it was a mere 12 per cent. As a comparison, examine the ratio in China. After 20 years of capital market development in China, the depth of China's regulated market is still under 30 per cent.

South Korea also developed a viable public debt market. The corporate bond market has attained a high rate of growth. From its base of just 1.7 trillion won, the corporate bond market grew at a very high rate of 27 per cent per annum. The

Treasury bond market also grew in steps. South Korea's bond market is reputed to have developed faster than most bond markets in developing Asia.

The share market was used as a tool to broaden the share ownership structure of firms, particularly the non-*chaebols* in order to lessen the control of the economy by the *chaebols*.[4] At times by forcing divestment across broader share ownership, the government was able to bring these firms to more diversified ownership. From a high of 12.4 per cent individual ownership in the 1980s, the ratio has been brought down to about 4 per cent in the 1990s. With the 1987 reforms to investment banking the cost of going public was brought down, which led an upsurge in listing activities. The institutional impediment to issuing stocks priced higher than the par value was removed in 1986. As a result, 47 companies were listed in one year in 1987.

2.2. Emerging Markets

China

The primary market for securities started in 1981 with the first issue of treasury bonds sold by the government to enterprises and individuals. During 1988-90, the authorities developed a secondary market for securities. During the same period, the government established the National Electronic Trading System (STAQ) in Beijing. In 1991, the Ministry of Finance changed the administrative placement of bond system to marketing through underwriting by financial institutions.

The basic reason for establishing the securities market was the change of focus from inflationary financing to bond financing. In the past, the government had adopted the policy of printing money (and unsterilised currency inflows) to finance consistent fiscal deficits, which had resulted in rising inflation. Since the early 1990s, the focus has changed to finance the deficits through bond financing. Accordingly, it was decided to take measures to develop money and capital markets to sell short and long-term Treasury bonds. In 1990, the government initiated the issuance of such bonds underwritten by financial institutions. In 1997, the first interbank bond market was established, allowing commercial banks and some other financial institutions to trade in repo and spot transactions of

[4] It is reported in recent years that the top 50 chaebols produce 85 percent of the GDP. Of these, the five biggest ones have been the targets of reform by different governments depending on how a particular government felt towards a given set of *chaebol* families. Hence there is a political dimension to this policy as well.

government securities and financial bonds issued by policy banks. By the end of June 2002, inter-bank bond market registered a turnover of RMB10.7 trillion.

Another important institution is the interbank market. This is one of the most important sources of lending and borrowing among banks and other financial institutions. Prior to the reforms, China had a system of vertical allocation of credit from the State Council through the central bank. Under this arrangement, banks with surplus funds would hold onto them while banks with shortages were not given access to credits. Though some efforts were made to ease the credit allocation as early as 1979, it was only during 1983-85 this system was transformed to a horizontal allocation of funds across banks and industrial sectors. In 1986, the PBC issued a notice on Provisional Regulation on Management of Banks in the PRC under which the interbank market was formally established and all financial institutions were given the right to handle interbank borrowing and lending. Branches with temporary excess of funds would lend to those branches in need of funds. In 1990, the PBC issued Provisional Measures on the Management of Interbank Business. These markets were established in economically and financially advanced cities with the restriction of one market in each of these cities. The PBC supervises the activities and operations of these markets.

In January 1996, a centralized interbank market was established and the China Inter-Bank Offered Rate (CHIBOR) was initiated. As a result of these measures, the interbank market has shown steady development during the last five years. By the end of June 2002, this market reached an accumulative turnover of RMB 3.4 trillion.

Securities institutions provide long-term capital financing. Under the central government's aim of increasing the channels and proportion of direct financing, these institutions were developed at a fast pace. Securities exchanges were initiated in 1990-91 in Shanghai and Shenzhen allowing trading in government and enterprise bonds and shares of joint stock companies. This was only done after about four years of experimental trading with Western instruments such as shares and bonds in two cities, Shenzen and Shanghai. In 1992, the policies were further relaxed to allow foreigners to participate in this trading, which led to the creation of A and B class instruments. To further boost investors' confidence, the China Securities Regulatory Commission was established in 1992 to oversee and supervise the development of the securities industry. The National Security Law was implemented. These measures helped to boost the stock market and as a result, the number of shares listed rose from 15 to 113 by mid-1993 with the combined capitalization estimated at under 10 per cent of the GDP. In 1998, these two exchanges had almost 350 stocks traded. By the end of 2002, China had 109 securities firms and 15 fund management companies with a net asset value of above RMB100 billion. During the same time, the capital market had 1197 listed companies with a total market capitalization of RMB4.65 trillion and negotiable equity value of RMB 1.53 trillion. The domestic and overseas Securities market has helped to raise RMB 827 billion since 1991.

India

The stock markets have a long history since these markets developed over a long time. In 1996, the share markets were capitalized at about 48 per cent of GDP. The stock exchanges are served and managed by around 4,000 brokers and 20,000 sub-brokers, who are equivalent to the dealers in a modern market. These statistics indicate a higher level of development of the stock markets, all of which have been in the private sector. India's capital market is a very large one: among the 53 emerging markets in the world. Most emerging share markets are capitalized at about 20 per cent of GDP. The stock markets are situated in several major Indian cities and are not integrated in so far as there are no integrated trading procedures and communication links similar to, for example, the associated exchanges in Australia. There are 23 separate exchanges with the Bombay exchange accounting for two-thirds or more of the trading volume and value. A national integrated stock exchange with screen trading and automated operation is developing fast. There are some 12,000 stocks listed and traded. Of these, the exchanges in Bombay, Calcutta and Delhi account for more than 50 per cent of the listing. Trading is more intense in Bombay. The exchanges at Kanpur, Ahmedabad and Madras are also active and large.

Recent good performance provides important descriptive statistics on the Bombay Stock Exchange. The total capitalization of all the world's 53 emerging markets in 1996 was about US$1,900 billion. India's stock market ranks among the top 10 with a capitalization of US$150 billion in 2002. This high capitalization to GDP makes the share market a far deeper market than most of the emerging markets. The Bombay exchange may be counted as being among the top six following South Korea, Taiwan, Mexico, Thailand and Malaysia. The value traded in Bombay is 3.5 per cent of the average of the 30 top markets of the world in the 1990s (IFC reports). The stock market has provided an average yield of about 38 per cent over the last 15 years. But its risk is also high, about 40 per cent standard deviation of returns per annum. In terms of price-earnings ratio, the Bombay market is about a third higher in risk than a typical market average for the world. Therefore, the coefficient of variation of 1.05 for India compares favorably with most developed markets (which have average coefficients of 0.9) as well as the developing markets (which have average coefficient of 1.7). The average price-earnings ratio in the 1990s of 25 to 33 makes the Bombay market in recent years about one-third times more risky than the world average (the International Finance Corporation, IFC reports).

India's bond market is not well developed though the government bond issues are traded within the financial institutions. There is a potentially large private market to be made with Rupee 2,700 billion worth government bonds. There is also a tax-exempt bond mutual fund scheme with government securities. The capital market is still not international enough to attract foreign capital inflows. This changed in 1995-96 when much of the disinvestment in Southeast Asia led to large capital flows into the Indian markets. This is in a sense not comforting as markets such as those in Karachi and Bombay that liberalized faster went through speculative capital inflows, which, when withdrawn, destabilized their ability to provide steady streams of financing.

While the Indian companies can access foreign markets for funds, likewise, foreign companies can invest in the Indian financial institutions as well as by obtaining licenses to run financial institutions. This is designed to improve efficiency while also making it a lot cheaper to trade in the market. An OTC market has been in operation since mid-1994, giving access to smaller firms to list their shares: since then, small firms have another access through the automated national exchange, which is growing very fast as the number of newer firms are listing in the screen-traded exchange. Eventually, this screen-based trading system is expected to unify the exchanges. These and other reforms on capital adequacy for brokers, greater and more frequent disclosures, etc. are expected to provide opportunities for the large capital market in that region to develop into a financial centre for that time zone in the future.

Pakistan

The slow growth of the stock market relates to events in 1970s when massive nationalization led to a negative effect on stock market performance. During the next two decades, the market was functioning without any regulatory structure and had very poor dividend records. Individuals or a group of families retained most of the equity. The investors had evidence of insider trading and market manipulations.

Some regulatory measures were also put in effect in 1991 to improve the effectiveness of the stock market and to have a better monitoring system. The government established an auction market for short-term Treasury bills and long-term federal investment bonds. The secondary market for government securities was also established. The Securities Department within the SBP was set up to

Table 1. Capital Market Development in Pakistan (1992-2002)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002*
No. of new companies listed	178	110	112	155	90	36	6	2	5	12	9
Fund mobilized (By new companies, Bill. Rs)	25.9	15.3	13.5	59.7	52.4	19.5	13.8	6.6	20.9	6.92	26.5
Total turnover of share (Bill Rs)			2.21	3.3	7.92	11.0	21.1	38.7	67.5	38.4	34.5
Market capitalization (By ordinary shares, Bill. Rs)	218.4	214.4	404.6	293.3	365.2	469.1	259.3	289.2	391.9	339.3	428.0
Market capitalization (percent change)	219	(1.8)	88.7	(27.5)	24.5	28.4	(44.7)	11.5	35.5	(13.4)	26.2

Source: Government of Pakistan, Economic Survey, 2001-2002.
* Figures for July 2001 to March 2002

implement debt management reforms. The first credit rating agency was established in 1994 and a second one in 1997. The Central Depository Company (CDC) was formed in 1994 to facilitate the automated stock trading system. A Capital Market Development Program (CMDP) was formulated in 1997 to strengthen capital market activities. Further, the Securities and Exchange Commission was established to supervise activities of this market. The stock market reacted positively to these policies, and began to attract domestic and foreign capital. The Karachi Stock Exchange index reached a peak around 1500.

In 1998, there were three stock exchanges, in Karachi, Lahore, and Islamabad. The KSE is the oldest, established in 1948, and accounts for the bulk of the country's trading. As stated earlier, the 1991-93 period saw a major increase in trading at all three stock markets. Market capitalization at KSE alone increased from Rs 38 billion in 1987-88 to Rs 200 billion in 1991-92. Similar trends were noticed at the other two markets in Lahore and Islamabad. This pattern continued but was broken by downturns mainly due to political instability and economic crises. However, stock market trading has shown the highest performance during the first years of this century. One of the domestic markets, Karachi Stock Exchange, is rated as the best performing stock market in the region.

3. Developing a Bond Market: Issues and Challenges

There are several issues that need to be addressed to discuss the development of bond market in an emerging economy. Some of these issues are general, in nature, but are more related to overall macroeconomic conditions and economic policies in practice. The second set of issues is micro aspects of the market development and closely looks into the prevailing economic environment and market conditions.

Macroeconomic Issues

The set of macroeconomic conditions include fiscal discipline, monetary conditions, choice of exchange rate regime as well as overall financial sector development. It seems to be unrealistic to plan policies for bond market development without establishing certain norms of macroeconomic stability and financial sector reforms. Within these macroeconomic conditions, fiscal discipline takes the first preference. Economic theory suggests that high level of fiscal deficits will increase interest rates. These deficits will also increase the risk of default and the cost of government debt, thus making it difficult to develop a liquid nominal bond market. In order to reduce market uncertainty, the government must ensure a fiscal disciple. Monetary stability is another important pre-requisite. High fiscal deficits financed through central bank leads to high inflation and high inflationary expectations. High inflation and large fiscal deficits discourage the long-term investment projects needed for a sustainable

Table 2. Basic Economic & Social Indicators of Development in Pakistan

Indicators	**1961-1970**	**1971-1980**	**1981-1990**	**1991-1995**	**1996-2000**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
National Accounts:											
GDP growth (%)	3.4	4.8	6.2	4.9	3.1	4.3	2.7	4.4	5.0	6.4	7.8
Per capita GDP (US$)	138.9	180.2	327.1	404.9	438.8	426.6	380.5	439	542	610	709
Private consumption/GDP	77.7	79.0	76.9	70.8	74.0	74.4	75.2	75.0	73.6	73.3	80.0
Government consumption/GDP	12.5	13.8	17.1	18.2	15.5	15.0	13.7	15.3	8.9	8.4	7.8
Financial indicator (%):											
Gross domestic savings/GDP	-	13.8	13.8	14.8	13.3	14.4	14.6	13.6	17.5	18.4	12.2
Fixed capital formation/GDP	15.4	15.9	17.0	18.1	15.4	14.4	14.3	12.3	16.9	17.3	17.8
Inflation (per year)	3.5	12.4	7.0	11.2	7.3	4.4	3.2	3.3	3.2	4.5	9.3
M2/GDP	36.1	41.8	41.3	43.4	46.6	46.9	48.3	51.7	47.0	49.4	48.9
Fiscal balance/GDP	-5.2	-7.4	-6.7	-7.7	-6.9	-5.5	-4.7	-4.6	-4.1	-2.1	-4.1
Trade balance/GDP	-	-8.1	-9.3	-5.2	-3.7	-2.4	-2.3	-0.5	-0.4	-1.3	-4.1
Current account balance/GDP	-	-5.4	-2.9	-4.5	-3.2	-0.1	3.4	4.5	4.9	1.9	-1.4
Total trade/GDP	21.2	28.0	33.6	36.7	35.2	34.3	37.4	35.8	-	31.7	34.1
Debt/Exports	403.9	606.1	509.3	-	-	550.7	260.7	211.2*	189.1*	176.3*	-
Debt/GDP	33.9	62.0	64.2	-	-	90.0	45.7**	48.7**	44.8**	38.0**	-
Foreign reserves/Imports	21.3	18.0	11.5	14.2	10.6	14.2	34.1	71.9	-	-	-

* Numbers are for external debt to exports ratio. ** Numbers are for Debt to GNI ratio.

Source: IMF International Financial Statistics (CD-ROM), World Development Report (Various Issues) and Asian Development Outlook (various issues); Ariff and Khalid (2005).

development. Spread between expected and realized inflation discourage investors, increased cost of funds and thus affects market efficiency. Credible commitment on the part of central bank to contain inflation helps to reduce such uncertainties. Third pre-requisite is the exchange rate stability. Exchange rate and capital account policies impact government bond yield and increase exchange rate and default premiums. The central bank and the monetary authority should be careful in designing and implementing exchange rate and capital account policies. For instance, too many restrictions on capital account will be categorized as financial repression while no restrictions could expose the economy.

Micro Issues

Market development for domestic bonds faces a variety of challenges. At the initial stage, the first and most important problem in developing a bond market is building market participants. Emerging economies face numerous problems in building market participants such as lack of incentives for issuers, strict regulatory structure, absence of a diversified portfolio, lack of sufficient finances for dealers, and the absence of a hedge market and instruments. The experience of some early reformers shows that a balanced regulatory structure without sacrificing prudential standards and removal of unnecessary information disclosure would help the development of a bond market. The new regulatory structure should also address the needs of a derivative market for securities. Corporate governance and establishment of international standards for best practices is equally important. At the same time, steps should be taken to establish credit rating agency (ies) that would help issuers to understand the risk of investment in a variety of investible options as well as diversify risk. Efforts should be made through courses and advisory services where market participants can fully understand the risk-return trade-off. These measures would provide incentives to market participant and are expected to initiate some trading activities.

The problems faced at the intermediate level include the presence of hesitant investors, statutory requirements restricting institutions to buy government bonds, too risk-averse attitude of investors, lack to incentives to buy corporate bonds, weak distribution channels, high capital requirements, imbalance competitive market, lack of necessary skills and experience to attract issuers and investors, etc. At this level, policies should be focused to develop a mechanism to provide incentives for trading securities, encourage new private sector entities to involve in securities trading, and implement regulatory changes including minimum capital requirements consistent with international standards.

The second issue in the development of a domestic bond market is the lack of commitment on the part of the government. The existence of multiple regulatory authorities as well as a lack of coordination among them hinders the development of a bond market. The most efficient way is to have one single authority that would create a balance in regulatory structure and would have a better coordination between market participants and policy makers. Another related issue is the unstable macroeconomic environment which creates uncertainties among investors. This is, probably, a tough call and would require a set of measures of internal economic management without which any activity of medium to long-tem investment would not take place. Policies should also be implemented for a system of non-distortionary taxation system to encourage market growth and promote market participants. Banking sector development takes a central role. A weak banking system cannot support the corporate bond market. At the same time, a dominant banking system hinders the development of corporate bond market.

Finally, these emerging economies should also establish some policies for developing a market for government bonds. The problem faced by even some early reformers is the lack of auction schedule, market pricing mechanism, and yield curve. Markets like Singapore had no secondary market for government bonds until recently. This makes it difficult for issue holder to determine the profitability of the issue. In some emerging economies, interest rates are influenced to control debt finance costs.

Stages of Bond Market Development

The development of a bond market in a country may take three stages. At the initial stage (Stage I), the market does not have a sizeable saving and investment opportunities available, the intermediaries lack the skills and experience, banks are wither weak or so dominant that other market players are not encouraged to enter and the capital market is underdeveloped. Also, common signs of this initial stage are the absence of macroeconomic stability, financial fragility and a well-structured regulatory system. As such, the government and the policy makers need to establish the basic norms for a bond market to function in the most efficient manner. The policies of financial liberalization should be combined with deregulation, market determined pricing mechanism, macroeconomic stability, central bank reforms, incentive mechanism for market participants and banking sector reforms. At the same time, the country should initiate measures needed for the creation of a money and capital market.

At Stage II **a** country seems to have attractive issuers but limited investor base, developing capital markets and finally good macroeconomic and political environment. At this stage, further measures should be taken to develop a primary market of public and private securities. Country would also need public company, disclosure regulations, credit rating agency, and OTC arrangements to support trading. Finally, the country should have a Benchmark for pricing long maturities.

Finally, at Stage III, a country must have sufficient issuers and investors, skilled intermediaries, favorable macroeconomic and political environment. At this stage, the country should develop a secondary market for securities. This will help pricing new issues. Credit rating agency must be able to handle a large number of issues. Disclosure rules have to be strengthened. Training of individuals involved is important to clearly understand the market risk, the reward, best practices and other related issues.

4. The Role of Social and Institutional Factors

The discussion in Section 2 shows that many early reformers in Asia have been able to develop a reasonable market for domestic bonds, both government and corporate. However, many emerging economies made a slow progress. In Section 3, we elaborate certain pre-requisites for the development of domestic bond market and observe that, again, emerging economies in Asia do not satisfy some of these pre-conditions. In this section, we analyze the same issue using a different perspective. Here, we compare the state of various institutional developments and social norms that exist in our sample of country. Specifically, we discuss the prospects of the development of a market for domestic bonds in Pakistan using a set of social and institutional factors.

The first comparison is by using the Capital Access Index (CAI) developed by Barth et al (2004) and published by Milken Institute. The CAI assigns scores to countries around the world based on the ability of entrepreneurs within their country to gain access to financial capital. These comparisons show that Pakistan does not have the environment and infra-structure needed to have an efficient bond market. Pakistan scored poorly in all categories. Pakistan is ranked 74 on the basis of overall CAI index as compared to Singapore (3), Malaysia (16), China (38) and India (53). Further disaggregation of the CAI suggests that Pakistan is ranked 112 in Macroeconomic Environment, 79 in Economic Institutions, 64 in Financial and Banking Institutions, 52 in Bond Market, 82 in Alternative Capital and 85 in International Access. Pakistan, however, is ranked 15 in Equity market, better than India (20), Malaysia (23) and China (59). In general, Pakistan's performance in South Asia is just above Bangladesh.

Table 3. Market Capitalization

	Ownership by the 3 Largest Shareholders		Market Capitalization	Market Capitalization (% of GDP)		
	Means	Medians	of Firms	2003	2004	2005
Early Reformers						
South Korea	0.23	0.2	1034			
Taiwan	0.18	0.14	2186			
Malaysia	0.54	0.52	2013	161.98	160.59	139.26
Thailand	0.47	0.48	996	83.3	71.37	69.95
Singapore	0.49	0.53	1637	157.97	159.59	178.39
Emerging Economies						
Bangladesh				3.12	5.86	5.06
China				41.51	33.12	35.03
India	0.4	0.43	1721	46.46	55.83	70.41
Pakistan	0.37	0.41	49	20.13	30.17	41.48
Sri Lanka	0.6	0.61	4	14.86	18.23	24.36
Developed Markets						
Australia	0.28	0.28	5943			
Canada	0.4	0.24	3015			
New Zealand	0.48	0.51	1019			
U. K.	0.19	0.15	18511			
U. S. A.	0.2	0.12	71650			

Another comparison based on a set of social indicators suggests that Pakistan did not perform any better. On Corruption Index, Pakistan (1.79) only ranked above Bangladesh (0.85) within the region. Sri Lanka seems to be the least corrupt country in the South Asian region. Pakistan's record is not so good 'for Risk of Expropriation (4.88); Rule of Law (3.04); Contract Enforceability (1.69); Risk of Contract Repudiation (4.87); Efficiency of Judicial System (5); and Bureaucratic Quality (2.71). Pakistan, however, did reasonable on Index of Restriction on Press (57.8) as compared to China (83.8) and Singapore (63.6).[5]

The third comparison, we present here is the market capitalization. Again, Pakistan's performance is not promising. For instance, market capitalization (as a percentage of GDP) in 2005 was recorded at 42 percent for Pakistan as compared to 70 percent for India, 139 percent for Malaysia and 178 percent for Singapore. Pakistan however, did better than China (35%), Sri Lanka (25%) and Bangladesh (5%). On a positive note, we observe that market capitalization (as a percentage of

[5] It is important to note here that these comparisons are based on pre-2001 data. However, the progress Pakistan has made recently is not expected to have significant relative impact on these rankings.

GDP) more than doubled in Pakistan since 2003. Specifically, it increased from 20.13 percent in 2003 to 30.17 percent in 2004 and then reached to 41.48 percent in 2005. No other country in our sample shows such a remarkable improvement. However, market capitalization by firms in extremely low (49) as compared to India (1721) and Malaysia (2013).

Finally, we look at the status of domestic debt securities for 2003-2006 (as of March) period. In Pakistan, debt securities increased from US$29 billion in 2003 to US$34 billion in 2006. The same more than tripled in China over the same period. It increased from US$289 billion in 2003 to US$1015 billion in 2006. Table 4 shows that domestic securities are only issued by the government in Pakistan. Financial institutions and corporate sector do not participate in debt securities.

All these comparisons suggest that Pakistan has a long way to go to have a reasonably efficient bond market. Given a history of high fiscal deficits, policy makers should make it as the first priority to lessen the burden of deficit financing through central bank.

Table 4. Domestic Debt Securities (As of March)

Countries	All Issuers (in billions US$)				Governments (in billions US$)				Financial Institutions (in billions US$)				Corporate Issuers (in billions US$)			
	2003	**2004**	**2005**	**2006**	**2003**	**2004**	**2005**	**2006**	**2003**	**2004**	**2005**	**2006**	**2003**	**2004**	**2005**	**2006**
Early Reformers																
South Korea	373	479	605	696	80	130	186	241	137	182	264	298	155	167	156	157
Taiwan	146	174	195	198	73	83	97	100	18	27	34	38	55	63	63	60
Malaysia	92	100	115	127	37	42	49	53	12	13	20	25	43	45	45	49
Thailand	47	59	69	88	28	31	37	42	4	7	10	19	15	21	22	27
Singapore	54	59	66	71	34	39	44	49	16	15	16	16	4	5	6	6
Emerging Economies																
China	389	528	732	1015	260	373	520	711	121	143	197	254	9	12	15	50
India	164	221	257	287	163	218	251	275	0	1	3	10	1	2	3	3
Pakistan	29	31	31	34	29	31	31	34	-	-	-	-	-	-	-	-
Developed Markets																
Australia	229	320	370	369	77	94	94	84	84	135	172	173	68	91	104	112
Canada	620	698	765	804	448	512	565	587	98	100	102	115	74	86	98	102
New Zealand	19	23	23	20	19	23	23	20	-	-	-	-	-	-	-	-
U.K.	748	938	1032	1069	451	594	665	716	271	313	337	331	26	32	30	22
U.S.A.	16540	17892	19448	21168	4693	5202	5721	6101	9378	10147	11093	12335	2470	2544	2634	2731

5. Concluding Remarks

This paper investigates the current status and future prospects of domestic bond market in Pakistan. Until recently, even the countries categorized as newly developed East-Asian economies with a history of stable economic environment and reasonably established money and capital markets had difficulties in setting up a market for domestic bonds. The relatively more developed market in Asia has made some progress in developing a market for domestic bonds. However, we observe that the pace of bond market development did not follow the pace of overall financial market development in many early reformers. We look into the reasons for a slow development of bond market in South Asian region with a focus on Pakistan. Given the unstable macroeconomic environment in Pakistan, financial market development including a market for domestic bonds are of significant importance. We use macroeconomic and microeconomic factors to discuss the development of domestic bond market, both in general and with reference to Pakistan.

The list of pre-requisite indicates that the country does not meet most of the pre-conditions needed to develop an efficient bond market. The macroeconomic uncertainties and lack of complete information makes the decision making process difficult for market participants. Within microeconomic perspective, it is well-understood that the market for government bonds helps in the development of financial infrastructure, improvement in the efficiency of channels for saving and investment, active and competitive role of banks in the financial industry, and building long-term financial sustainability. The government could use the domestic bond market to meet the short-term cash flow needs of the financial system. At the same time, the central bank can use these markets to pursue a targeted monetary policy. However, a good coordination between the government (ministry of finance) and the monetary authority (the central bank) is essential to reap this benefit. This would also require a good information dissemination system related to the money market conditions and the state of fiscal budget on a regular basis. The comparison based on some social indicators and institutional factors shows a gloomy picture of Pakistan. Not surprisingly, Pakistan performed poorly in most of these rankings even within the South Asian region. This comparison shows that Pakistan needs to make a good effort to put necessary infra-structure to ensure market efficiency.

The discussion and comparisons in this paper makes it very clear that Pakistan has made a reasonable economic progress in the recent past but still lacks macroeconomic stability. Given the high level of fiscal deficits, it is difficult to establish and maintain a fiscal discipline. The high level of fiscal deficits and internal and external debt put enormous pressure on domestic economy and makes it difficult to plan and pursue an independent monetary and exchange rate policy. On a positive note, the State Bank of Pakistan has been enjoying some autonomy lately which has minimized central bank intervention in the foreign exchange market. This coupled with high level of foreign reserves (since 2001) has provided stability to domestic currency. Given, this certainty, it is, probably, an appropriate time to initiate policies for the development of a domestic bond market. We believe that the analysis presented in this paper would help to design and implement some policies in this direction.

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