

# Why the Asian Bond Fund matters

President Richard Nixon put it best when he took the United States off the gold standard: "The dollar is our currency, but your problem"

Thirty-three years later, President George W. Bush's economic policies and overspending seem to imply that he is adopting the same philosophy and attitude, spurring Asian governments into co-ordinated action.

Asian policymakers now truly realise that there is a problem with the dollar as the world's reserve currency, given that America is also the world's largest debtor country. On the back of the US dollar it says, "In God We Trust". Trust in the US dollar, however, is increasingly being shaken by a very fiscally irresponsible American government.

Hence the renewed sense of urgency among Asian central bankers and finance ministry officials that something needs to be done. Asia now has about two-thirds of the world's reserves, most of them in US dollars. By any account US debt levels are unsustainable and sooner or later the day of reckoning will come. Net capital outflow from Asia means that Asia is providing savings to the rest of the world.

The answer to Asia's problem is in how to best co-ordinate to diversify out of the dollar after Asian nations have become the marginal buyers, or de facto buyers of last resort, of excess US dollar balances in the global economy. Without these purchases, the dollar would be much lower in value versus Asian currencies and US interest rates would be higher.

Today, Asia's markets are stuck in a vicious circle. Asians tend to save for the future, while Americans tend to borrow from the future. This is an unstable relationship, as is the export-growth

model of development on the other side of the equation in Asia.

The purpose of the Asian Bond Market Initiative is to invest part of Asian savings directly in Asia and promote financial intermediation in Asian markets. The opportunity cost of "round tripping" capital transactions through the United States is estimated to amount to around 2%.

The Asian Bond Market Initiative is based around four pillars:

- ◆ At the government level: Asean plus 3 (Japan, South Korea, China);
- ◆ At the central bank level: EMEAP (Executive Meeting of East Asia Pacific Central Banks);
- ◆ At the finance ministry levels: ACD (Asian Co-operation Dialogue);
- ◆ At the private sector level: ABFM (Asian Bond Market Forum).

India, as a member of the 22-member ACD, is increasingly becoming a key player in the discussions and one of the initiative's main architects.

The Reserve Bank of India sits on \$120 billion worth of reserves. After deducting for short-term liabilities it has \$85 billion available. Part of this money is to be invested in infrastructure and some in the Asian Bond Fund 2. India's finance ministry is increasingly willing to "think outside the box" and says that India, like Thailand, is just waiting for other Asian countries to join the ABF2 in earnest.

The ultimate size of the fund should amount to \$8 billion to \$32 billion to make it worthwhile and to create enough liquidity and market depth. To start with and to create the needed momentum, EMEAP last week announced the first tranche of the ABF2 is starting with \$2 billion equivalent to be invested in local-currency bonds of Asian government and quasi-sovereign issues.

The Asian Bond Fund 1, launched in

June 2003, is a forum of 11 central banks that are investing part of their international reserves in a basket of liquid US dollar-denominated bonds of Asian economies through a fund managed by the Bank for International Settlements, the central bank of the world's central banks. One billion dollars seemed small compared with the size of the reserves, estimated at around \$1.7 trillion. But it is not small given the size of the investing universe at \$70 billion to \$80 billion.

The ABF2 is designed to comprise a Pan-Asian Bond Index Fund and a Fund of Bond Funds. The funds are aimed to be open to private-sector investors in future, with the Pan-Asian fund to be listed in Singapore first and eventually also in Hong Kong.

In the search to reduce the skewing of portfolio returns, international fund managers increasingly look to diversify their holdings into instruments with low sensitivity to movements in US interest rates, hence the attraction to Asian bonds.

Recent research has suggested that Asian local-currency bonds might play a valuable part in international fixed-income portfolio management since they exhibit a much lower correlation with US interest rates than other fixed-income asset classes.

Despite these positive attributes there is still a significant "home bias" in investment decisions. This suggests that in order to get Ahead of the Curve, continuing responsible development policies will be the key to further acceptance of Asian local-currency bonds by international portfolio managers.

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