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Bond issuers' trade-off for common currency basket denominated bonds in East Asia

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Abstract

This paper is to investigate advantages and disadvantages of common currency basket denominated bonds over single international currency denominated ones for bond issuers in East Asia in terms of both foreign exchange risks and liquidity. Our empirical analysis obtained the following results: (i) the currency basket denominated bonds would be able to decrease foreign borrowing costs and their risks in many cases; (ii) the US dollar has the highest degree of liquidity for bond issuers in all of the nine East Asian countries; (iii) bond issuers in East Asia face trade-off between foreign exchange risks and liquidity in choosing currency denomination of issued bonds.

JEL classification: F31; F33; G15

Keywords: Asian bond market; Currency basket denominated bond; Foreign exchange risk; Liquidity

1. Introduction

It is said that there are both an abundance of savings in East Asia and profitable investment opportunities in East Asian emerging market countries. However, we have a problem of how efficiently we should match the savings with the investments within East Asia through regional financial markets. One of its solutions may be to establish and activate regional bond markets in East Asia. On one hand, it is a problem that especially borrowers in East Asia have been facing foreign exchange risks because they have had debts denominated in terms of a foreign currency in borrowing money from foreign

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countries. They would face foreign exchange risks if bonds were denominated in the regional bond markets in contrast with local bond markets.

Bond issuers would have the problem that is associated with the foreign exchange risks even if we established the regional bond markets. It is usual for bond issuers to select an international currency as denomination currency of the bonds when they issue them in international bond markets. The US dollar is dominant as an international currency in the world economy. If a local currency of the bond issuers is different from the denomination currency in the issued bond, they face foreign exchange risks that are volatility of exchange rate of the local currency in terms of the denomination currency in the issued bond.

Risk-averse bond issuers prefer smaller foreign exchange risks, given expected rates of return. It might be more desirable for them to select any other currency in issuing from a viewpoint of foreign exchange risks. However, bond issuers should face another problem that is associated with liquidity because network externalities might work in bond markets in terms of liquidity. Accordingly, they might face trade-off relationship between foreign exchange risks and liquidity when they issue regional bonds as well as international bonds.

It is discussed whether the monetary authorities in East Asian countries should make regional cooperation in a field of exchange rate regimes and policies and create a common currency basket in order to prevent another currency crisis in the future (Bénassy-Quéré, 1999; Ito, Ogawa, & Sasaki, 1998; Ogawa & Ito, 2002; Ogawa, Ito, & Sasaki, 2004; Williamson, 2000). It is suggested that a common currency basket as a region currency is needed for the regional cooperation. It is an implication for the Asian Bond Market Initiative that establishing currency basket denominated bond markets should be more desirable for borrowers or bond issuers in East Asia. This paper is to investigate both advantages and disadvantages of choosing a common currency basket over a single international currency for bond issuers in East Asia by taking into account both foreign exchange risks and liquidity.

This paper is composed of the following sections. The following section focuses on foreign exchange risks to investigate what kind of currency is desirable for bond issuers in term of foreign exchange risks. The third section considers about liquidity in regional bond markets from a viewpoint of denomination currency. The fourth section is a summary and conclusion of this paper.

2. Foreign exchange risks

2.1. Methodology and data

We investigate how much foreign exchange risks bond issuers would face when they issue bonds denominated in terms of various currencies. Our analysis focuses on the volatility of foreign borrowing costs for various currencies denominated bonds.[1]

[1] Usually ex ante borrowing costs in the real world should be calculated from the prevailing benchmark interest rate, risk premium, and foreign exchange rate fluctuations. However, our aim is comparing the risk of several currency types of borrowing costs for one country, so we regard that risk premium is common for one country and concentrate the foreign exchange risk only here.