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East Asian Financial Market Integration: Reality or Illusions?

S. Ghon Rhee

ABSTRACT

The 1997-1998 Asian financial crisis, the agenda for local currency bonds and regional bond markets was a priority as an alternative vehicle for domestic saving mobilization and as a means of mitigating the dual mismatch problems of currency and maturity. To achieve this, the East Asian nations will need to be the main players in the regional bond market. Further, the corporation of Japan, China and Korea as the significant players in the regional bond is necessary to provide further liquidity and volume in the markets. The total investment in bond in the ASIAN, excluding Japan is less than one percent of total global bond investment. The potential development of East Asian bond markets is encouraging considering that the markets have increased from US$401.7b in 1997 to US$1,419.8b in 2004, a 19.8% annual growth. However this is relatively small compared to the size of bond markets in other regions. For instance, the relative size of Asian bonds outstanding as measured by the percentage of combined GDPs amounted to 40% in 2004. The same figures for Japan, USA and the EU are 190%, 160% and 90% respectively. In the ASEAN region, only Korea and Malaysia have a relatively large corporate bond markets. Most of the bonds in the region are government issued. Issues related to bond market are discussed by looking at the weaknesses and what are needed to encourage the development of the market. Three major concerns are identified; a strong sense of regionalism, overemphasis on the public sector's role and preoccupation with the harmonization of rules and regulations. On the hand, two issues need to be done; the creation of necessary infrastructure and the elimination of impediments to cross-border investment.

ABSTRAK

Krisis kewangan Asia 1997-1998, agenda untuk bon matawang tempatan dan pasaran bon wilayah merupakan keutamaan sebagai satu penggerak alternatif kepada mobilasi simpanan domestik dan sebagai satu kaedah memoderasikan masalah ketidakpadanan antara matawang dan kematangan. Untuk mencapainya, negara-negara Asia Timur perlu memainkan peranan utama dalam pasaran bon wilayah. Tambahan lagi, kerjasama antara Jepun, China dan Korea sebagai pemain-pemain utama dalam pasaran bon wilayah adalah perlu untuk membekalkan kecairan dan volum dalam pasaran.

Jumlah Pelaburan bon dalam pasaran Asia tidak termasuk Jepun adalah kurang daripada satu peratus daripada jumlah pelaburan bon global. Potensi pertumbuhan pasaran bon Asia Timur adalah menggalakkan dimana pasaran telah meningkat daripada US$401.7b. pada tahun 1997 kepada US$1,419.8b, pada kadar pertumbuhan 19.8% setahun. Bagaimanapun, secara relatifnya ia masih lagi rendah dibandingkan dengan saiz pasaran bon dalam wilayah-wilayah lain. Sebagai contohnya, saiz relatif bon Asia semasa diukur berdasarkan kepada peratusan KNK gabungan berjumlah 40% pada tahun 2004. Perangkaan yang sama untuk Jepun, Amerika Syarikat dan EU adalah masing-masing 190%, 160% dan 90%. Dalam pasaran Asean, hanya Korea dan Malaysia mempunyai pasaran bon korporat yang secara relatifnya besar. Kebanyakan daripada bon dalam wilayah ini adalah terbitan pihak kerajaan. Isu-isu berkaitan dengan pasaran bon dibincangkan dengan melihat kepada kelemahan-kelemahan dan cadangan untuk menggalakan pertumbuhan pasaran tersebut. Tiga perkara utama yang telah dikenalpasti adalah kekuatan semangat kewilayahan, penekanan yang berlebihan keatas pasaran sektor awam dan keseragaman peraturan dan perundangan. Seterusnya, dua isu yang perlu ditangani adalah pembentukan prasarana yang diperlukan dan penghapusan halangan-halangan kepada pelaburan merentas sempadan.

INTRODUCTION

Subsequent to the 1997-1998 Asian financial crisis, the development of local currency bond markets in each of the East Asian economies as well as regional bond markets was the highest priority agenda among financial market policy makers. They view this development as an alternative vehicle for domestic savings mobilization and also as a critical means of mitigating the dual mismatch problems of currency and maturity. Many conferences and symposia have been organized and numerous policy research papers have been produced in support of the Asian Bond Market Initiatives spearheaded by APEC Finance Ministers and ASEAN+3 Finance Ministers. Many public sector organizations have been active in promoting both domestic and regional bond market activities. They include the Executives' Meeting of East Asia and Pacific Central Banks; the Pacific Economic Cooperation Council Finance Forum; and a number of multilateral financial institutions, such as the Asian Development Bank, Bank for International Settlements, International Monetary Fund, Organization for Economic Cooperation and Development, and the World Bank.

AN OVERVIEW OF EAST ASIAN BOND MARKETS

The size of local currency bond markets in the East Asian economies, excluding Japan, more than tripled from $402 billion in 1997, the first year of the Asian financial crisis, to $1.42 trillion in 2004, at an annual growth rate of 20 percent, which is approximately 2.5 times of the average growth rate of the world's bond markets (Table 1).

TABLE 1. Size of local currency bond markets by region

Region	1997 (in US$billion)	2004 (in US$billion)	Annual Growth Rate
Worldwide	$25,420	$44,049	8.2%
United States	$12,000	$19,187	6.9%
EU-15	$7,013	$11,385	7.2%
Japan	$4,148	$8,867	11.5%
East-Asia excl Japan	$402	$1,420	19.8%
Latin America	$468	$651	7.2%

Source: BIS

Among the East Asian economies, Indonesia exhibited the highest growth rate of 45 percent in long-term bonds outstanding between 1997 and 2004, followed by Thailand with 30 percent, and China and Korea with about over 20 percent each (see Table 2).

TABLE 2. Size of East Asian local currency bond markets

Country	1997 (in US$billion)	2004 (US$billion)	Annual growth (%)
China	116.3	483.3	22.6
Hong Kong, SAR	41.1	46.5	1.8
Indonesia	4.3	57.8	44.9
Korea	130.3	568.4	23.4
Malaysia	57.0	106.6	9.4
Philippines	18.4	25.2	4.6
Singapore	23.7	66.3	15.8
Thailand	10.6	64.9	29.5
Vietnam	-	0.8	-
East Asia excl. Japan	401.7	1,419.8	19.8

Source: BIS

THREE CONCERNS ON THE CURRENT STATUS OF ASIAN BOND MARKETS

Are we happy with this remarkable growth in local currency bond markets in the region? Yes, we should be. However, I would like to share with you at least three of my concerns on the current status:

The market share of East Asian economies (not including Japan) accounted for only three percent (or $1.42 trillion) of the worldwide local currency bonds of $44 trillion in 2004. My first concern is that this three percent could have been greater and here are the reasons why:

1. East Asian economies (excluding Japan) contribute approximately 8 percent of the global GDP. This means that the size of the region's domestic bond markets could have more than doubled.
2. The relative size of Asian bonds outstanding as measured by the percentage of combined GDPs amounted to 40 percent as of 2004. This ratio is much lower than those of Japan (190 percent), the United States (160 percent), and the EU (90 percent) (Figure 1).

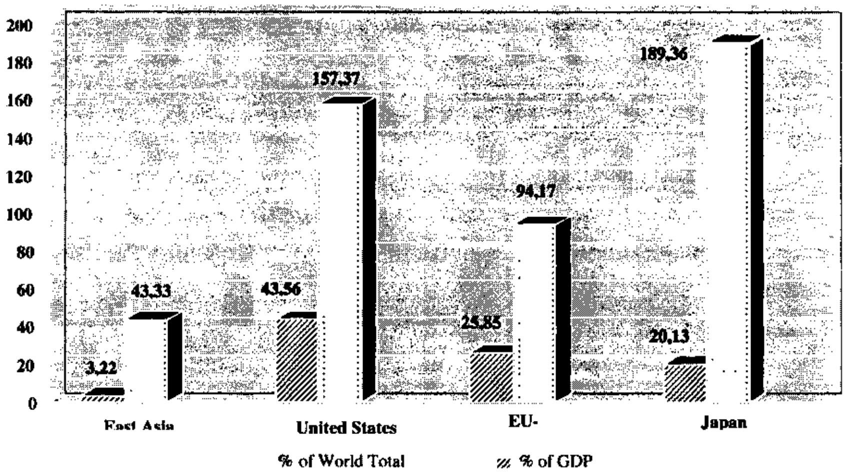

FIGURE 1. Relative size of East-Asian bond markets

Source: BIS

My second concern is that the rapid growth of Asian bond markets is attributed to the expansion of government bonds not corporate bonds. Given the double mismatch problems in maturity and currency faced by the corporate and banking sectors in the East Asian economies during the recent crisis, corporate bond markets should have expanded fastest among the three segments of the bond markets. After all, private sector financing behavior was the main culprit of these mismatch problems, not government fiscal financing (Figure 2).

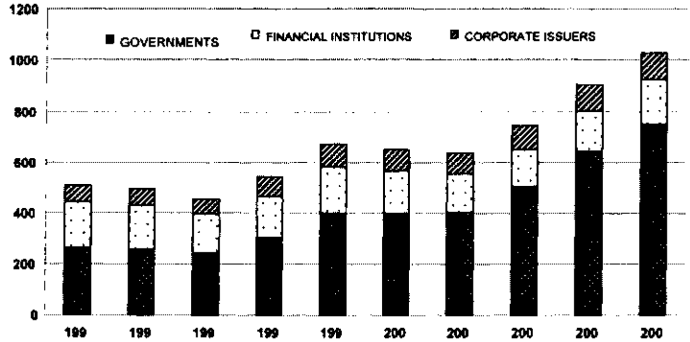

FIGURE 2. Composition of local currency bonds (in US$billion)

My third concern is that the development of corporate bond markets is uneven in the region and the size of corporate bond markets is too small. China, Indonesia, and the Philippines have yet to develop corporate bond markets. Only Korea and Malaysia have relatively large corporate bond markets. Excluding Korea and Malaysia, corporate bonds outstanding in the rest of East Asian economies are less than 2% of their combined GDPs (Table 3). In contrast, Japan's corporate bonds are 17 percent of GDP, whereas the U.S. corporate bonds represent 21 percent of GDP.

TABLE 3. Relative size of East Asian corporate bond markets

Economy	As % of GDP
China	0.73
Hong Kong	3.65
Indonesia	1.47
Korea	23.41
Malaysia	38.14
Philippines	0.12
Singapore	5.14
Thailand	11.74
East Asia excl. Japan	7.70
East Asia excl. Japan, Korea, Malaysia	1.80
Japan	16.86
United States	21.17

Source: BIS

INTRAREGIONAL INVESTMENTS IN ASIAN BONDS

Next, I would like to present intra- and inter-regional investment capital flows into Asian bonds (Table 4). Total global investment in bonds amounted to US$9 trillion or approximately 22 percent of local currency bonds outstanding worldwide. Asia's share of this investment stood at US$190 billion or approximately two percent of global investment in long-term debt securities. Japan is the largest recipient of global investments with US$108 billion and Korea is the distant second with US$25 billion, followed by Malaysia (US$14 billion), Philippines (US$12 billion), Singapore (US$12 billion), and Hong Kong (US$9 billion). If we exclude investment in Japanese bonds ($108 billion), total investment in Asian bonds was only $83 billion or less than one percent of total global bond investment.

TABLE 4. Investors in Asian bonds as of 2003 (in US$billion)

Total Investments in Bonds Worldwide	9,127.8
Total Investments in Asian Bonds	190.5
Japan	107.5 (56%
Korea	24.6 (13%)
Malaysia	14.4 (8%)
Philippines	11.7 (6%)
Singapore	11.5 (6%)
Hong Kong	9.2 (5%)
Indonesia	4.2 (2%)
China	4.1 (2%)
Thailand	3.1 (2%)
Vietnam	0.2 (0.1%)

Source: IMF

Who are the investors in Asian bonds? The EU-15 is the largest investor in Asian bonds with US$70 billion or 43 percent of the total, followed by the United States with US$54 billion or 28 percent (Table 5). Within the region, Hong Kong is the largest investor in Asian bonds with its total annual investment amounting to US$22 billion. Surprisingly, Japan's investment (US$11 billion) in Asian bonds was even smaller than that of Hong Kong.

To place intra-regional investment activities in proper perspective, the size of investments in Asian bonds by each of the East Asian economies relative to its total investment in bonds outside their countries is illustrated in Figure 3. An interesting fact emerges: Japan and Thailand invested disproportionately small amounts in Asian bond markets with three-fourth of one percent and 2.2 percent, respectively, while investment holdings in Asian bonds by Singapore and Malaysia amounted to 17 percent and 15 percent, respectively.

TABLE 5. Intra-Regional investments in Asian bonds

Region	Value (in US$billion)
EU-15	70.2 (37%)
United States	53.8 (28%)
Hong Kong	22.3 (12%)
Japan	10.8 (6%)
Singapore	9.9 (5%)
Korea	1.1 (0.57%)
Philippines	0.2 (0.01%)
Indonesia	0.2 (0.01%)
Malaysia	0.1 (0.00%)
Thailand	0.1 (0.00%)
Others	21.8 (11%)
Total Investment	190.5 (100.00%)

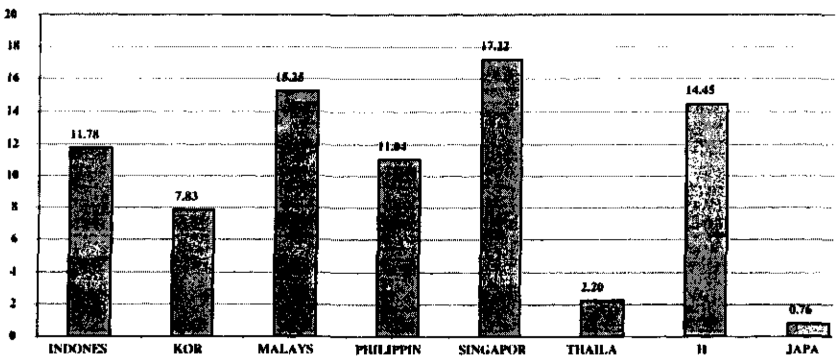

FIGURE 3. Relative size of intra-regional investments

JAPAN FAILURE OF MEETING THE REGION'S FINANCING NEEDS

A couple of questions have to be raised:

- Why are intra-regional investments in Asian bonds so small? A recent study by Arner, Lejot and Rhee (2005) cites two major reasons: First, too many legal and institutional impediments are discouraging investments in Asian bonds within the region. Second, institutional investors avoid Asian bonds because of their concerns about investment risk.
- The second question is "Why isn't Japan more proactive in investing in Asian bonds?"

To answer the second question, the summary statistics for market activities in Japan's *Gaisai* bonds are presented in Table 6. *Gaisai* bonds refer to those bonds issued in Japan by foreign institutions. If denominated in yen, they are called *Samurai* bonds, and if denominated in foreign currencies, they are called *Shogun* bonds. The last time foreign currency-denominated *Shogun* bonds were issued was more than 10 years ago in 1993. The volume of *Samurai* bonds peaked in 1996 with ¥3.8 trillion (or US$32 billion) prior to the Asian financial crisis, but it later declined drastically. Although the issuance of *Samurai* bonds increased in 2000, thanks to lower interest rates in Japan, the amount of issuance had substantially declined to 1.7 trillion yen or a mere US$17 billion last year.

TABLE 6. Gaisai bond markets in Japan (in ¥ trillion)

Japanese Fiscal Year	Number of Issues	Samurai Bonds	Number of Issues	Shogun Bonds
1991	27	0.71	1	0.41
1992	37	1.57	0	0
1993	49	1.23	1	0.59
1994	60	1.26	0	0
1995	85	2.11	0	0
1996	154	3.79	0	0
1997	66	1.53	0	0
1998	10	0.15	0	0
1999	24	0.86	0	0
2000	64	2.40	0	0
2001	41	1.31	0	0
2002	30	0.67	0	0
2003	39	0.94	0	0
2004	45	1.68	0	0

Source: Japan Securities Dealers Association

Hong Kong and Singapore have small bond markets but they are critically important parts of regional bond market activities. How small are they? The size of the Japanese local currency bond market (US$8.9 trillion) is about 130 times greater than that of Singapore bond market with outstanding bonds of US$66 billion and about 200 times greater than that of the Hong Kong market with outstanding bonds of US$47 billion. Despite of its small size, foreign institutions borrowed $34 billion by issuing non-Sing$ denominated bonds in Singapore in 2004, while no shogun bonds were issued in Japan (Table 7). Relatively speaking, HK$ bonds issued by foreign borrowers accounted for over 20 percent of local market while ¥-denominated samurai bonds issued in Japan by foreign borrowers was only 2/10th of one percent. Even the Japan Bank for International Cooperation (JBIC), which is a government-owned financial institution dedicated to overseas economic cooperation, raises capital by issuing long-term bonds not in the Japanese *Shogun* bond market but in the Eurobond markets. JBIC issued long-term bonds denominated mainly in US dollar and the Euro to raise over 5 billion dollars between 2000 and 2004.

TABLE 7. Comparison between Japan and Hong Kong/Singapore

Local currency bonds issued by foreign borrowers in 2004	Amount market	% of total bond
S$ bonds	US$3.5 billion	5.3%
HK$ bonds	US$10.6 billion	22.8%
¥ bonds	US$16.0 billion	0.2%

Foreign currency bonds issued by foreign borrowers in 2004	Amount	% of total bond market
Non-S$ bonds	US$33.7	50.8%
Non-HK$ bonds	No statistics available	
Non-¥ bonds	US$0.00	0.00%

Sources: HKMA, MAS, JSDA

Two major observations emerge: First, during and immediately after the Asian crisis when the *Gaisai* bond market should have been most active, we had a very slow market in Japan. Second, after a series of Big Bang reform measures that were initiated by former Prime Minister Ryutaro Hashimoto, Japan simply cannot make Tokyo serve as a regional financial center.

Why not? It can be attributed to a number of factors: (1) floatation costs and processing costs are higher in Tokyo than New York, London, or Frankfurt. For example, I recall that investment banks add commissions when coupon interest payments as well as principal payment are made in the *Samurai* bond market, while there are no similar charges on the eurobond market; (2) it takes too long to issue bonds in Tokyo. It takes several weeks in Tokyo vs. three or four days in Eurobond market; (3) the recording system and clearing and settlement processes in the *Samurai* bond market are far more cumbersome than the eurobond market, where Euroclear and Clearstream are readily available and utilized for cross-border transactions. Naturally, an interesting question is "If Japan alone were unable to do it, how can we expect the 13 member economies of ASEAN+3 at different stages of capital market development to create regional bond market activities?"

ASIAN BOND MARKET ACTIVITIES ARE MORE GLOBAL THAN PERCEIVED

A recent study by McCauley, Fung, and Gadanecz (2002) examined 71 bonds, with a combined face value of US$41 billion, issued by Asian borrowers during the period between 1999 and 2002. Of course, these bonds were mostly issued in New York, London, and Frankfurt, and only a small fraction in Tokyo. This study reported that about 45 percent of these bonds were purchased by Asian investors in the primary market offering.

According to an academic study, which was presented at the PECC Finance Forum Conference in Honolulu in 2002, borrowers from six Asian countries raised US$53 billion through bond financing in the international markets between 1991 and 2001. Asian investment banks served as lead managers for one-third of this amount and the remaining two-thirds were led by their U.S. and European counterparts. The market share of Asian investment banks is surprisingly large, given that only 2 out of top 20 investment banks are Asian institutions.

It seems that regional market activities are well integrated with global market activities. If this is the case, then what are the justifications for promoting regional bond markets?

What do we mean by a regional bond market? It is the union of the three circles signifying: Asian issuers, Asian investors, and Asian currencies (Figure 4). We may also include another circle that denotes Asian underwriters. My question here is does it make any practical sense to promote such a narrowly defined market?

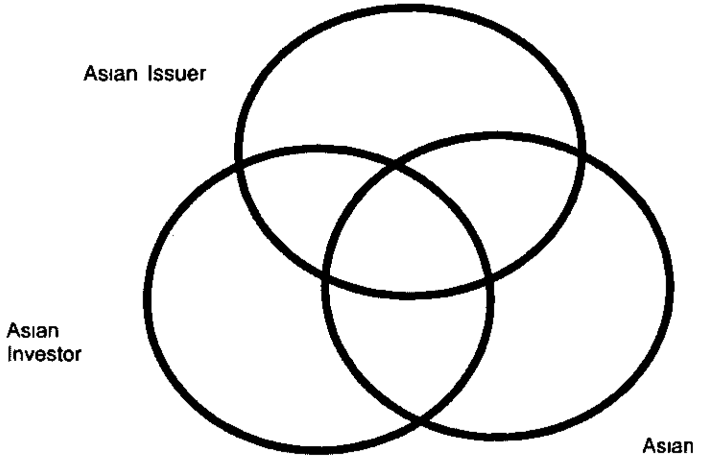

FIGURE 4. Narrow definition of Asian bonds

MAJOR WEAKNESSES OF ASIAN BOND MARKET INITIATIVES

What are the major weaknesses of Asian Bond Market Initiatives?

Please allow me to share with you at least three major concerns about on-going efforts for the Asian Bond Market Initiatives.

1. A strong sense of regionalism
2. Overemphasis on the public sector's role
3. Preoccupation with the harmonization of rules and regulations

1. *A Strong Sense of Regionalism*

The regionalism may be an overreaction to the so-called "Washington consensus" which became the object of resentment during the East Asian financial crisis. But, some of the troubling suggestions that have been under consideration include:

- To have Asian bonds rated only by Asian credit rating agencies;
- To create an "Asia only" market where bonds are issued by Asian borrowers and purchased by Asian investors; and
- To facilitate transactions among Asian issuers and investors, creating regional-level trading and clearing & settlement systems.

As long as Asian borrowers issue bonds at a minimum cost wherever it is and the majority of these bonds are purchased by Asian investors, everything else is secondary. It doesn't matter where they are issued, who rate these bonds, where they are traded, and where they are cleared and settled.

Creating an "Asia Only" bond market will limit the number of bond buyers and discourage competition in the primary and secondary markets, causing borrowing cost to increase and market liquidity to deteriorate. Efforts aimed at creating a business environment sheltered from outside competition will eventually force financing activities to move out of the region in search of lower cost funding alternatives.

2. *Overemphasis on the Public Sector's Role*

The public sector does not have to spearhead the creation of a regional bond rating agency, regional clearing and settlement system, and regional trading system. Some argue that a regional bond market is a public good, so the public sector should move in. But I do believe that this is a misleading argument for a number of reasons.

As long as trading volume is justified, the private sector organizations will jump in no matter what. About 10 years ago, at the invitation of Euroclear, I visited its Brussel headquarters to deliver my speech on inter- and intra-regional capital flows focusing on bond markets in Asia. At that time, Euroclear's senior management wanted to assess whether the trading volume in bond instruments in Asia was large enough to justify its presence in Asia. It has technical know-how and capital resources. As long as the volume is here, Euroclear would come to Asia for its operations without the public sector's help.

Let's take a look at the equity markets in the region. Shareholding of domestic securities by foreign investors amount to 40% in Korea, 30% in Thailand, 24% in Japan, and 11% in Taiwan. I do not believe that the globalization of the region's equity markets was initiated by the public sector in the region. Capital market authorities simply served as facilitators, eliminating impediments to cross-border investments. Under the private sector's own initiatives, we observe global investment activities in the region's equity markets.

3. *Preoccupation with the harmonization of rules and Regulations*
One lesson we should learn from the EU is that achieving financial market integration does not need harmonization of rules, standards, or regulatory integration. Financial market integration should be built on "mutual recognition" and "home country control." A minimum level of harmonization may be useful but harmonization itself is not necessary for regional integration of financial market activities. An overemphasis on harmonization can simply delay the progress towards integration. When we have 13 economies with the ASEAN+3 at different stages of bond market development, any effort for harmonization will be tediously cumbersome and slow.

So far, the regional efforts have been focusing on harmonization of rules and regulations across the region in creating regional bond markets, while the elimination of impediments to capital flows has been largely overlooked. Trying to create regional bond markets before eliminating existing impediments to capital flows in the region is like putting the cart before the horse.

LOOKING FORWARD: WHAT DO WE NEED?

Looking forward, what do we need?
- Create necessary infrastructure for the domestic bond markets
- Eliminate impediments to cross-border investments

At present, no more than one percent of local currency bonds outstanding are held by foreign investors in Korea and Thailand, even though their domestic bond markets are theoretically wide open to foreign investment. The same observation can be made for other Asian economies, including Hong Kong, Indonesia, and Malaysia. Even Japan, with the world's largest amount of government bonds outstanding (US$4.8 trillion at the end of December 2004), is no exception. Foreign holdings of Japanese government bonds account for no more than 4 percent of the outstanding amount.

THE PUBLIC SECTOR'S ROLE

The last question I would like to raise is "What should be the public sector's role?" The public sector's role is needed in at least two areas in connection with the Asian bond market initiatives:

1. Creation of the Asian common currency
2. Credit enhancement and Credit Guarantee Agency

1. *Creation of the Asian common currency*

Valuable lessons can be learned from Europe. The elimination of exchange risk, the harmonization of market practices, the re-denomination of government debt issued by each EU member into euro have introduced a bigger, deeper, more liquid, and more homogeneous bond market in Europe. Similar advantages should be gained in the region through full or partial currency unification as a result of common or partially shared monetary policies in the region's economies.

Movements toward an Asian common currency cannot be done by the private sector. This is one area East Asian governments should be actively engaged. So far, I have not seen any official dialogue in this direction among ASEAN+3 member economies. Because I believe that the Asia-Europe or ASEM Finance Ministers' process would be an ideal forum to discuss the issue of the Asian monetary union, I had a chance to check the ASEM Work Programs 2004-2006, but nothing related to the Asian monetary union was on the programs.

2. *Credit Enhancement and Credit Guarantee Agency*

I have been advocating the creation of the Asian Bond Bank, modeled after municipal bond banks, since the 2nd Annual Meeting of PECC Finance Forum in Hua-Hin, Thailand, in 2003. I also believe that the creation of a multilateral financial institution, such as the Asian Bond Bank, belongs to the public sector's scope of activities.

The municipal bond banks represent a financial innovation in municipal financing that began in Canada in 1956 and was adopted in the United States in 1970. Many small municipalities lack knowledge of financial markets. They suffer from low credit rating and need to borrow relatively small amounts of capital. Municipal bond banks operate as credit enhancing organizations by "pooling" borrowing needs of multiple municipalities into a single bond bank debt issuance. Municipal bond banks have good track record of their success as evidenced by the Municipal Finance Authority of British Columbia or the Bond Bank of Alaska.

The Asian Bond Bank can share the benefits gained from the economies of scale in borrowing cost and greater liquidity with larger size bond issues. Most important of all, the Asian Bond Bank can re-lend funds raised at its higher credit rating to participating Asian sovereign and quasi-sovereign borrowers through its own credit enhancement programs as municipal bond banks do, including structured debt issuance and bond insurance programs.

ECONOMIC LEADERSHIP IN THE REGION

Whenever I had the opportunities to talk in Washington, D.C., I keep reminding the U.S. authorities of the absence of U.S. economic leadership in the region. The lack of U.S. involvement in the regional activities means the loss of future business opportunities for U.S. financial institutions and the U.S. image of uninterested economic partner to East Asian counterparts.

What about Japan's economic leadership? I would not claim that Japan's economic leadership is absent, but it is simply misplaced and misfocused. I expect that China's role in the region's capital markets will remain insignificant until its capital account is completely liberalized. Therefore, we have the vacuum of economic leadership in the region, which provides interesting challenges and opportunities for Malaysia.

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S. Ghon Rhee
K. J. Luke Distinguished Professor of International Finance and Banking
College of Business Administration
University of Hawaii
2404 Maile Way, C304
Honolulu, HI 96822-2282
U.S.A.