1. Issues Concerning the Indian Bond Markets

1.1 Overview of the Asian Financial Markets

Generally speaking, the level of dependence on indirect financing in the countries of Asia is high. The background to this is that there are a great many small and medium size businesses that do not have stable sources of revenue. The prevailing opinion concerning such situation is that this is due to the lack of markets for direct financing. It is also said that in terms of their financial requirement, it would be desirable if the banks would conduct monitoring of the financial condition of these small and medium size businesses given the banks' ability to contact them periodically.

The Asian currency crisis occurred in 1997 caused by the speculative selling pressure on Thai baht. The causes for the crisis were (i) the high level of dependence on indirect financing, and (ii) a two-fold mismatching present in bank lending (referring to the mismatching of both loan terms and currencies).

Regarding the first problem, since Asian companies depended excessively on indirect financing and local banks were also relying on foreign financial institutions for their source of funding, liquidity of local banks dried up when these foreign financial institutions repatriated funds which resulted in a severe contraction of loans from the local banks. This in turn resulted in a severe worsening in the ability of companies to obtain funds and many such companies were driven to the point of insolvency.

Regarding the second problem, although Asian countries have the resources to finance most of their growth from their savings, a large portion of their savings is invested in US dollars or Euros assets. As a result, significant portion of Asia's borrowings is intermediated through foreign capital market. With local banks procuring funds with short term maturities while lending these funds out over the longer term, the cash flow of these local banks themselves experienced pressure (mismatching of loan terms). In addition, since the borrowing was denominated in US dollars while the lending was denominated in local currency, the selling of local currency to buy US dollars for repayment purposes caused the collapse of local currency as well as increase of the amount of the repayment obligation (mismatching of currencies).

In view of this, together with reinforcing the weaknesses of indirect financing, it has been proposed that the importance of direct financing be acknowledged as an alternative means of financing and such measures as the Asian Bond Markets Initiative as policy for activating the bond market were initiated. Recently, we have started to see results such as the issuance of bonds by international organizations denominated in local currencies.

As a result, following the currency crisis, Asian countries have increased their issuances of both government bonds and bonds in the private sector in relation to GDP.

Actually, a significant portion of the increase in the outstanding balance of issuances of government bonds has come from the need for fiscal financing, particularly for the purpose of rebuilding local financial institutions which were adversely affected by the outcome of the currency crisis. Thus, preparations for both the bond issuing market and secondary market to allow for the stable consumption of large volumes of government bonds have made progress.

In the private bond market as well, learning from past mistakes caused by the high level of dependence on indirect financing, the bond market has been utilized much more as an alternative means of financing.

Moreover, Central Banks are also paying greater attention to the bond markets as a means of carrying out financial adjustments.

Although the equity markets experienced a large but temporary decline in the wake of poor corporate performance following the outbreak of the Asian currency crisis, economic conditions subsequently improved for the countries of Asia, and together with rising corporate performance and better evaluations based on high growth, the markets are beginning to thrive.

On the other hand, because of its strict controls on capital, the effects of the Asian currency crisis in China were only minimal. However, at the same time, it can be said that preparations for establishment of financial markets in China is progressing at a slower pace.

1.2 The Financial Markets of India and its Relationship to Infrastructure-related Funds

The current condition of the financial markets in India is one where the level of dependence on indirect financing is approximately 50%. However, the trend over recent years has been a rapid increase of lending relative to deposits, and as a result, it is quite likely that the future will see a situation where lending by itself will be unable to meet the demand for funds. For this reason, in addition to the markets for indirect financing, it will be necessary to establish markets for direct financing as well. Since the equity market is becoming a relatively large component of the direct financial markets, laying the groundwork for the bond markets will be particularly important for attracting investors. Within the Indian bond markets, the scale of the private bond markets is still extremely small, thus leaving room for further expansion in the future.

Also, according to the current government administration in India, the development of infrastructure is indispensable for future stable economic development, and the funding required to achieve this will be US $150 billion over the coming 10 years. Nevertheless, in addition to being confronted with constant fiscal deficits, the government is also limited in its ability to contribute funds because of the Fiscal Responsibility and Budget Management Act (this law obligates the government to hold fiscal deficits within a specific rate of GDP). For this reason, fostering the bond markets will become important from the standpoint of being able to channel a stable source of funds from the private sector to meet the great demand for funds in India so as to address its infrastructure project needs.

In terms of the Asian currency crisis, like China, since India placed strict control on capital regulation, its effects were relatively mild. However, at the same time, progress made toward the establishment of bond markets is still slow.

1.3 Issues Concerning the Indian Bond Markets

The scale of the current Indian bond markets, particularly in the private sector, is small leaving much room for future expansion. The major issues that exist are the following.

(1) Banks

A. Market Prices for Bonds

While banks are obligated to provide market prices for their holdings of bonds, there is no need to do so for their loan portfolio, and with the banks' distaste for posting appraisal profits and losses, banks tend to place priority on measures related to loans. Additionally, particularly in a climate of rising interest rates (i.e., one where bond prices are falling), banks are bound to be reluctant to invest in bonds.

B. High Liquidity at Banks

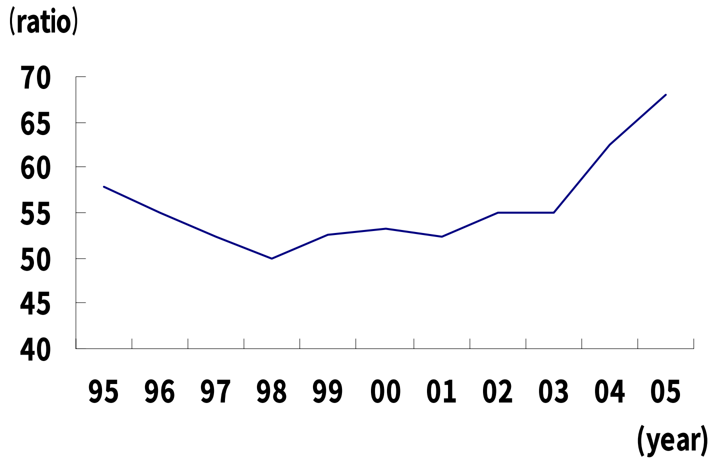
Presently, given the fact that banks have sufficient financing capacity, there is little incentive to place priority on investment into high-liquidity bonds relative to loans where liquidity is lower. However, as mentioned above, the balance of loans at banks has increased in recent years, and if there is any threat of banks encountering a tightening in funding in the future, there will be greater incentive among banks to hold bonds with their higher liquidity.

【Table 1】

Ratio of Credit to Deposits (Credit/Deposits)

（Unit:%）

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
India	57.9	55.1	52.3	49.9	52.5	53.3	52.3	54.9	55.1	62.5	68.1



C. Issuance of Long Term Bonds by Banks

At present, except for infrastructure projects, banks are not allowed to issue bonds with long maturities as a measure to raise funds such as for purpose of long term working capital. This has created a problem in that there are not enough issuers of bonds.

(2) Investors

A. Life Insurers and Mutual Funds as Investors

In India, restrictions have been imposed on investment activity conducted by life insurers and mutual funds, and these restrictions are one of the reasons for the lack of growth in the balance of bond investment. In order to meet the needs for long term investment funds, it will be necessary to bring about greater utilization of the bond markets by relaxing the restrictions imposed on investors such as life insurers, pension and individuals.

B. Upper Limit on Foreign Institutional Investor (FII) Investment

FII investment into private bonds is subject to an upper limit of US$ 500M. While this may be because of concerns related to capital control, although one response would be to set up regulations for other alternative measures that can be taken (e.g., restrictions on speculative transactions by requiring prior notifications and/or prohibiting short term sales), by relaxing the upper limit imposed on FII investment, greater vitality can probably be brought to the bond markets.

(3) **The Market and Other Factors**

A. Data

Due to the current inadequate maintenance of data concerning bond transaction, there is a need for data sources capable of providing timely and accurate information that allow investors to make informed investment decisions.

B. Complementarity between Private Placement and Public Placement

The costs of public placement of bonds are high, also requiring much time do so, while there are no restrictions on private placement of bonds which occur quite frequently. It is for this reason that the balance of public issues has shown no growth. The following measures should be taken to increase the balance of public issues:

- Reduce the costs for bond issuance through public placement and shorten the time for issuance
- Establish restriction for a certain length of period on frequency of bond issuance through private placement

C. Hedging Mechanisms

With the lifting of existing prohibitions against certain markets such as the Repo and bond futures markets, deregulation which will make it possible to hedge price fluctuation risks of bond holdings will be required. This would allow bondholders to take other hedging approaches besides holding bonds to maturity and also help invigorate trading in the secondary market.

D. Settlement Problems

The presence of settlement risk is particularly apparent since settlement on an one-to-one basis is required for private bonds. By organizing the system for settlements, systems such as Delivery versus payment that do not entail any risk should be allowed.

E. Asset Backed Securities (ABS) not Treated as Securities Under the Law

Since ABS do not fall under the definition of securities under the law, they are imposed with various restrictions such as not being able to be listed for public trading on Exchanges. By treating ABS as securities under the law, restrictions can be lifted and trading can be expected to become more active.

F. Stamp Tax

The stamp tax differs from state to state. It would be desirable to have a uniform stamp tax system.

【Reference】

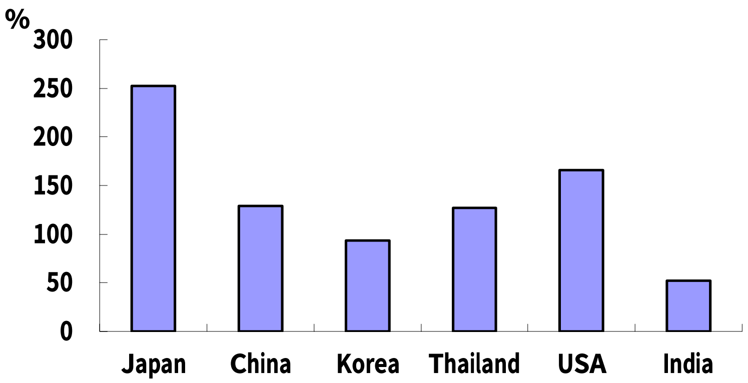
The following shows the comparison between Japan, China, Korea, Thailand, USA and India with respect to the percentages of Exposure / Equities / Government Bonds / Private Bonds balance against GDP. The result shows that India rates relatively high in its percentage of Exposure, Equities, Government Bonds balance against GDP, but extremely low for Private Bonds. Furthermore, from the late 1990's to the present, no increase has been observed in the percentage for Private Bond balance.

【Table 2-1】 Exposure/GDP (%)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	Average
Japan	295.9	295.1	296	139.4	144.0	310.5	317.5	312.5	157.3	252.0
China	90.9	98.0	106.3	120.2	130.6	132.7	140.6	166.4	177.9	129.3
Korea	69.9	74.5	86.1	78.1	96.6	104.0	110.4	116.9	105.6	93.6
Thailand	136.5	98.8	140.4	164.9	141.9	121.7	112.0	116.0	113.0	127.2
USA	132.1	137.5	148.7	162.2	164.2	161.7	163.9	159.4	261.8	165.7
India	48.5	49.8	49.7	45.1	49.6	53.4	54.7	58.5	57.3	51.8

(Source: World Development Indicator)

【Table 2-2】 Exposure /GDP (%) (Average for 1995~2003)

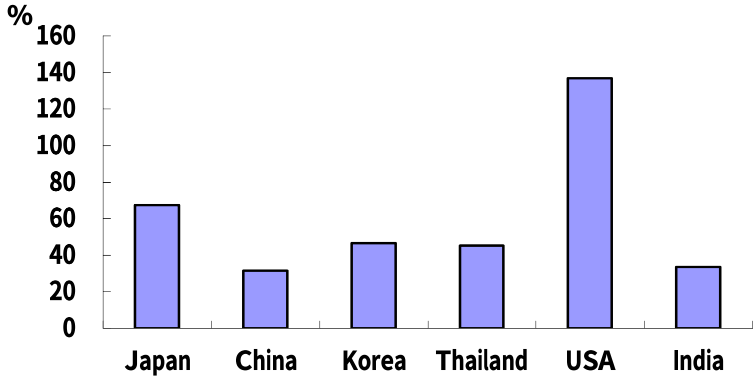


【Table 3-1】 Total Market Value of Equities/GDP (%)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	Average
Japan	71.8	67.2	52.9	66.0	104.6	65.2	54.4	53.2	70.7	67.3
China	6.0	14.0	22.9	24.1	33.4	53.8	45.2	36.6	48.1	31.6
Korea	39.9	28.6	NA	35.7	75.8	32.5	55.0	52.2	54.5	46.8
Thailand	84.7	53.9	15.3	31.4	46.9	24.1	31.7	36.3	83.0	45.3
USA	98.6	115.6	144.4	163.4	181.8	153.5	137.2	106.4	130.3	136.8
India	39.2	34.4	33.7	24.5	41.3	32.4	23.1	25.7	46.5	33.4

(Source: World Development Indicator)

【Table 3-2】 Total Market Value of Equities /GDP (%) (Average for 1995~2003)

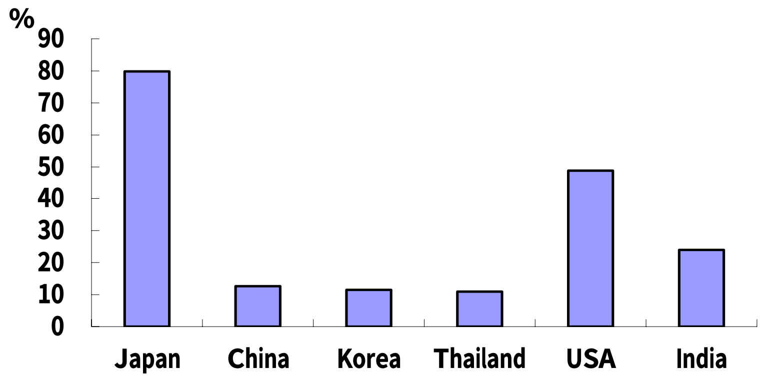


【Table 4-1】 Government Bonds Balance/GDP (Domestic Market) (%)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	Average
Japan	46.7	50.9	52.9	71.8	81.9	76.1	87.2	117.1	135.6	79.7
China	5.6	6.4	7.5	10.1	12.9	15.3	17.1	19.1	20.3	12.7
Korea	6.7	6.7	4.1	12.5	13.9	12.2	13.6	15.1	18.8	11.5
Thailand	1.0	0.4	0.2	10.1	13.3	13.7	16.0	22.9	21.6	11.0
USA	45.6	56.6	53.6	50.6	47.5	41.8	41.4	43.2	45.6	48.7
India	18.6	20.9	17.8	20.4	22.9	24.3	27.2	31.1	33.7	24.1

(Source: BIS Statistics, World Bank)

【Table 4-2】 Government Bonds Balance/GDP(%) (Domestic Market)
(Average for 1995~2003)

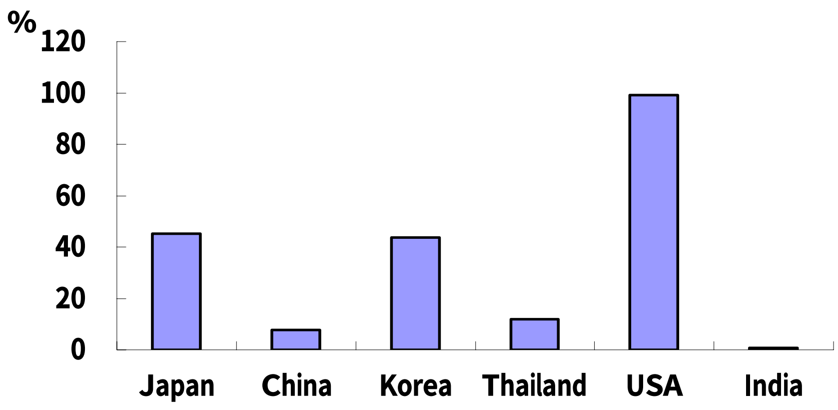


【Table 5-1】 Financial Institution plus Corporate Bonds Balance/GDP (Domestic Market) (%)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	Average
Japan	36.8	43.9	43.2	51.2	52.3	43.8	44.3	47.1	46.2	45.3
China	3.9	4.2	5.4	7.5	8.6	9.2	9.7	10.5	10.8	7.8
Korea	37.1	36.1	20.6	56.5	45.8	40.4	47.1	54.5	54.8	43.6
Thailand	7.9	9.7	6.7	11.2	12.3	11.6	15.1	14.2	19.2	12.0
USA	83.5	86.7	89.3	96.9	102.1	103.9	107.2	109.7	113.1	99.2
India	1.3	1.0	0.8	0.6	0.5	0.4	0.4	0.4	0.5	0.6

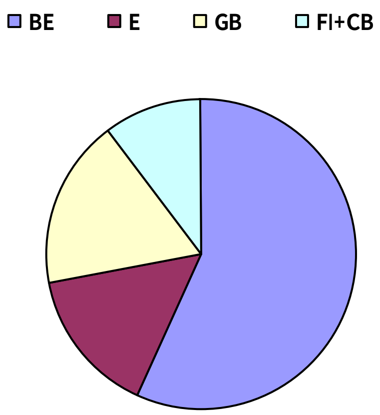
(Source: BIS Statistics, World Bank)

【Table 5-2】 Corporate Bonds Balance/GDP(%) (Domestic Market)
(Average for 1995~2003)

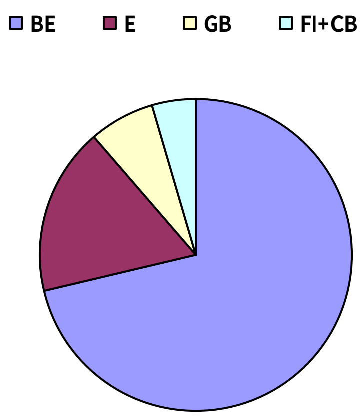


【Table 6】 Structure of Sources of Funding in Each Country (Average for 1995~2003)

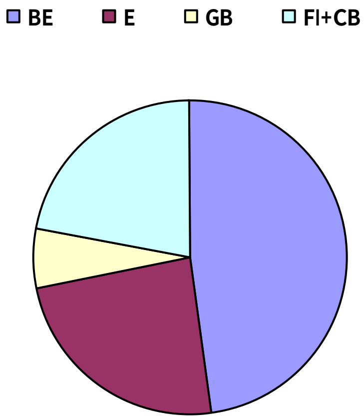
Japan



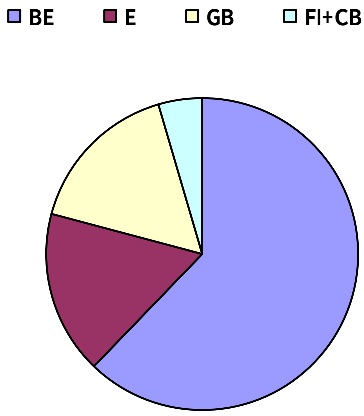
China



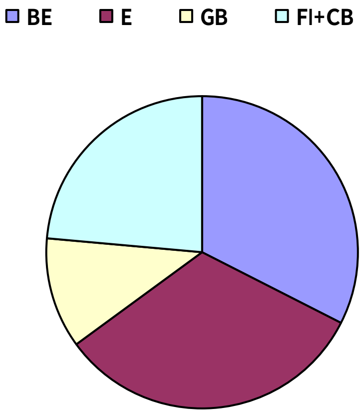
Korea



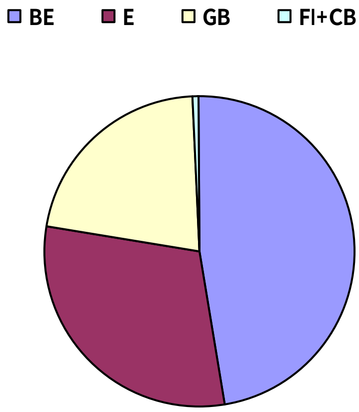
Thailand



USA



India



BE＝Bank Exposure　E＝Equities　GB＝Government Bonds　FI+CB＝Financial Institution+Corporate Bonds