

Unlocking debt market development in times of crisis

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A CLEAR LESSON FROM THE CURRENT CRISIS IS THAT EMERGING MARKET ECONOMIES (EMEs) CANNOT AFFORD NOT TO DEVELOP LOCAL CURRENCY GOVERNMENT BOND MARKETS. *CETERIS PARIBUS* COUNTRIES WITH THE MORE DEVELOPED DOMESTIC BOND MARKETS ARE HAVING THE ADVANTAGE OF A BROADER RANGE OF TOOLS TO MANAGE THE CRISIS, ARE BENEFITTING FROM A CUSHION AGAINST EXTERNAL FINANCIAL SHOCKS AND ARE BETTER POSITIONED FOR THE END OF THE DOWNTURN. IN THIS SCENARIO, IS THERE ANY HOPE FOR COUNTRIES CAUGHT BY THE CRISIS IN THE MIDDLE OF THEIR BOND MARKET REFORM PROGRAMMES? THIS CHAPTER PROPOSES A FRAMEWORK OF FOUR SELECTED AREAS OF WORK IN DEBT MARKET DEVELOPMENT THAT HAVE A DOUBLE ADVANTAGE: THEY PROVIDE TOOLS TO ADDRESS THE MOST IMMEDIATE FIRES, AND THEY INTERACT AS CATALYSTS IN PROMOTING MARKET LIQUIDITY AND CREDIBILITY TO SUSTAIN DEEPER AND BROADER CHANGES IN DOMESTIC GOVERNMENT DEBT MARKETS.

As the financial crisis continues to unfold, a major concern in EMEs is that existing market short-comes, which were partially concealed by past massive capital inflows, are becoming a potential source of financial risk and are limiting the authorities' margin of manoeuvre to handle the crisis at home.² Against this background, policy makers in most EMEs are recurring to contingency measures of both conventional and unconventional nature, similar to those used in advanced economies, to restore the normal functioning of the financial system in terms of sustaining minimum liquidity and credibility conditions.³

While contingency measures to weather the financial storm are essential, certain specific structural changes related to the efficient functioning of local currency government bond markets are also badly needed for three reasons:



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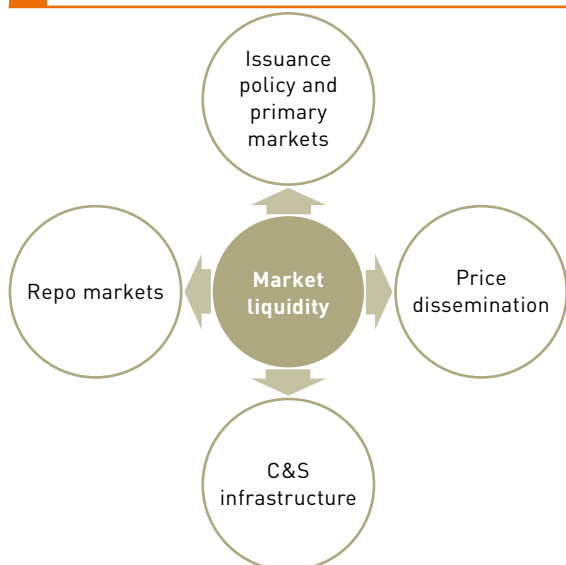
- First, they would make the handling of the current crisis easier, and some changes may be implemented now with immediate effects;
- Second, they would prevent some EMEs from losing valuable achievements in debt market development. In some markets day-to-day pressures may lead to postponing reforms that are still half way through until the aftermath of the storm;
- Third, once the downturn is over, there will be more competition for funds than in pre-crisis times, and it is likely that markets with the most solid framework and institutions will be in a better position to attract sustainable capital flows at lower cost.

A local currency debt market work agenda for the crisis

So the challenge is to strike the right balance between firefighting measures and structural changes that would have both an immediate impact on improving the margin

Catalysts of liquidity in debt market development policies

Exhibit 1



Source: The World Bank

of manoeuvre of policy makers, and act as catalysts for developing quality local debt markets.

Based on experience in EMEs and advanced economies, as well as on reform priorities expressed before the crisis by leading EMEs,⁴ four major areas of work have been identified:

- i) government issuance policy and primary markets;
- ii) price dissemination schemes;
- iii) repo markets; and
- iv) clearing and settlement infrastructure.

The rationale for the choice of these four areas of work is two-fold. First, if tackled together, they would be addressing immediate problems raised by the crisis such as liquidity and counterparty risk, as will be explained later.

Second, there are specific synergies between these four areas which could have a spillover effect on debt market development with a longer-term horizon. The four areas mentioned are mutually supportive to achieve market quality in the pricing of issues, market liquidity, mitigation of counterparty risk and market efficiency and safety.

The proposed set of reform areas enables the development of a coherent and common work agenda for EMEs without falling into the 'one-size-fits-all approach'. Most EMEs have already done very relevant work in all four areas with diverse degrees of success depending on the country.⁵ Therefore, the pending agenda on each area varies in different countries. Furthermore, the right interaction between the four areas of work so that synergies are fully achieved is dynamic across time and market contexts.

Issuance policy and primary market organisation: focusing on lowering the liquidity premium/market liquidity risk

As the crisis outcomes feed into widening fiscal deficits and increased uncertainty, governments face a complex scenario from multiple angles. Be it due to reduced expected revenues from the economic slowdown, fiscal stimulus or other crisis related consequences, demand for funding as a percentage of GDP is expected to grow almost

three-fold in both advanced and developing economies at the end of 2009 (from 3.4% to 7% in advanced economies and from 0.3% to 3.2% in EMEs);⁶ predominance of short-term funding is rapidly deteriorating refinancing risk; pricing government issues is becoming uncertain and penalised by higher spreads as liquidity dries up.

Against this grim scenario, many EMEs are covering their most pressing fiscal needs by using direct multilateral and bilateral funding (e.g., Indonesia will replace a third of its local currency bond issues with direct funding for 2009), or succumbing to the temptation of placing unattractive debt to captive local investors such as pension funds or state owned institutions. While non-market oriented funding may be justified in exceptional times, it is also essential that achievements in issuance policy and primary market organisation are sustained through creative and proactive policies.

The new environment requires an even more focused issuance policy in fewer maturities and benchmarks. Debt managers need to reinforce active liability management aiming at reducing re-financing risk and increasing liquidity of outstanding issues through a regular policy mix of re-openings, buybacks and issue switches. This strategy should be linked to a dynamic alliance with primary dealers (which are genuinely interested in preserving a well functioning local currency debt market), aiming at establishing performance based incentives depending on evolving market conditions and policy objectives.⁷

Price dissemination schemes: the struggle against elusive liquidity

Vanishing liquidity is taking its toll on already irregular market price references. Market intermediaries and market makers in particular, with reason, are weary of providing prices after growing uncertainty and stretched liquidity.

A successful work agenda on this front would require a combination of fine and resolute actions from policy makers on two complementary fronts. First, a clear cut formalisation of price reporting and dissemination rules adapted to times of stressed markets. In some countries a formal price dissemination scheme did not exist at all in pre-crisis times, but

with abundant liquidity finding reliable prices was not an issue. In other countries, price dissemination rules were in place, but had not been designed for exceptional market conditions.

Second, the design of innovative options of cooperation with market participants to establish meaningful market prices. A successful scheme followed in some countries, even in pre-crisis times, is a 'price fixing' scheme for a selection of the most significant government issues, in similar terms to the one used in some interbank markets such as the Libor (e.g., Poland, Singapore, Sweden, Hong Kong). The 'fixing scheme' could be dynamic and linked to the government issuance policy objectives and used for performance evaluation of the incentives offered to primary dealers.

Repo markets: a multipurpose tool in times of stretched markets

Repos with government securities as collateral have become key in the crisis environment to handle various fundamental problems: growing fears of counterparty risk, particularly in money markets; the need to inject liquidity efficiently and safely by central banks; and the drying up of liquidity for medium- and long-term bonds. The latter would have a direct impact on the government's refinancing risk, so a reliable repo market would make the issuance of longer-term bonds more viable.

In spite of their relevance for market development, repos have been for some time a pending task in most EMEs, even the most developed ones.⁸ In the current market context, the need for an immediate work agenda on repos is more pressing as a crisis handling tool and for its spillover effects on other important fronts: more flexibility in the issuance policy and interaction with pricing mechanisms through the valuation of the collateral.

Three broad areas of action are suggested to deal with repo market reforms. First, tackling repos with a comprehensive strategy that includes: business rules, collateral valuation and management, legal framework, accounting and tax regulations.

Second, giving strong consideration and priority to a framework for developing tri-party repos in order to simplify the administrative burden on participants.

Third, opening up the repo market to non-conventional direct participants such as collective investments and large corporations to increase competition and mitigate the hoarding of liquidity in money markets. The existence of a reliable framework for tri-party repos handled by a neutral CSD would facilitate a broader participation of less sophisticated institutions.

Clearing and settlement (C&S) infrastructure: supporting liquidity and OTC risk management

One of the lessons learned from the outbreak of the crisis is that markets are as robust as their weakest infrastructure. The most obvious symptoms of the crisis, namely counterparty risk becoming unacceptable and vanishing liquidity, were either counterbalanced or worsened depending on the quality of clearing and settlement arrangements.

Developing robust C&S infrastructures is probably the most complex and demanding task of the four areas proposed because of the many parties involved, as well as the natural complexity of a mission critical IT system. Here the argument of a firefighting action linked to a strategic vision for market development is probably harder to defend. It is also true that there is a broad range of C&S models in place and therefore the depth of the upgrades required is very different across EMEs.

However, with no doubt 'securities markets are only as good as the infrastructure that supports them'.⁹ This is not only a statement on the IT quality, but also on the market vision that the infrastructure is able to support. And as the crisis deepens new visions are in the making. Specifically in C&S arrangements, the formal settlement of bilateral OTC trades and risk management schemes that keep counterparty risk at bay will soon become part of the minimum standards. This is an area where many EMEs still have significant gaps that are being addressed by some of them (e.g., South Africa with Bond Clear for spot, repo and derivative trades).

Against this framework, policy makers would have to carefully assess how much energy to dedicate to a

fundamental infrastructure that, depending on the country, would take time, but still, it would make a major difference for the stability and development potential of the country's financial markets.

A strategy from two different angles is proposed.

First, the design or adjustment, depending on the country, of the overall C&S strategic vision adapted to the new priorities that result from the crisis. A key change in vision seems to be the importance of formal settlement arrangements for OTC markets, which does not necessarily imply ushering trading into the exchange market, even if, in some cases, it owns the C&S infrastructure. Another change would involve a re-assessment on how to upgrade risk management schemes that include a broader use of central counterparties.

Second, selecting which instruments under current country specific circumstances should take the priority for the C&S upgrades. Recent crisis experience in EMEs would favour infrastructure for tri-party repos, along the lines suggested in the earlier repo section (e.g., pre-crisis tri-party repos in India developed by the Reserve Bank of India and the Clearing Corporation of India)

Conclusion: a local currency debt reform agenda for a market vision in the making

As the crisis continues to unfold and its final outcome is still uncertain, it becomes clearer that new visions and approaches for market organisation are necessary. The proposed work agenda is an attempt to combine short-term policies that are still consistent with the long-term vision of well functioning local currency government debt markets.

The underlying philosophy in the proposed agenda is two-pronged. On the one hand, the guiding thread is the use of the tools that we know have supported reliable markets in advanced economies. But on the other hand, only by approaching them from a creative stance will they be viable in the current uncertain scenario. And this is the opportunity EMEs have in developing viable markets in spite of the bumpy ride.

Note:

1. The authors would like to thank for the comments provided by Alison Harwood. The views expressed in this article are those of the authors and do not necessarily represent those of the World Bank or World Bank policy, nor do they commit the World Bank in any way.
2. Examples of limited margin of manoeuvre include poor monetary policy transmission mechanisms which reduce the impact of lowering interest rates; difficulty to value the collateral for liquidity injection repos; larger price swings of different financial assets out of less liquid and efficient markets; higher interest rate risk in the banking sector because of an uneven distribution of tenors in outstanding government debt that concentrates in the longer tenors without having built a liquid yield curve; difficulty for governments to issue beyond short-term tenors in times of growing fiscal deficits; etc. For interesting references regarding the Indian case see <http://ajayshahblog.blogspot.com/2008/12/policy-responses-to-indias-economic.html>
3. Unconventional measures include relaxing the Central Bank's liquidity injection criteria by broadening eligible collateral and counterparts, or even earmarking liquidity for pre-determined types of credit, such as trade finance. For further analysis see BIS: 'Capital Flows and Emerging Market Economies', CGFS publications N. 33, January 2009.
4. Survey conducted by the World Bank Securities Market Group in 2008 for ministries of finance, central banks and SECs of select EMEs. 45 responses from 22 countries were received.
5. Silva, A. and García-Kilroy, C.: 'The development of deeper and more liquid local currency bond markets' *The Euromoney Emerging Markets Handbook 2008/09*.
6. IMF: World Economic Outlook Update, January 28, 2009.
7. Measures taken by debt management offices in Europe in time of crisis provide relevant examples of measures that may be grouped in four steps: relaxation of quoting obligations by decreasing the number of issues to be quoted; strengthening the issuer's support through credit and securities lending facilities; changing secondary market turnover for price quoting to assess performance quality; increasing the rewards offered to primary dealers, for example through more generous non-competitive bids after the auction (Forthcoming World Bank Technical Note on primary dealers adjustments in times of crisis).
8. Ibid.
9. Peter Norman, 'Plumbers and Visionaries: Securities settlement and Europe's financial markets', Wiley 2007. p.265.

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