

The development of deeper and more liquid local currency bond markets

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EMERGING MARKETS LOCAL CURRENCY BONDS ARE AMONG THE FASTEST GROWING ASSET CLASSES INTERNATIONALLY. WHEREAS ITS GROWTH, FUELLED BY ATTRACTIVE RETURNS AND DIVERSIFICATION BENEFITS, HAS HELPED THEIR ONCE AND LONG-CHALLENGED CONSOLIDATION, THERE REMAINS SUBSTANTIAL WORK TO BE DONE TO BUILD DEEPER AND MORE LIQUID MARKETS. NEED FOR FURTHER DEVELOPMENT OF THESE MARKETS HAS ARGUABLY BECOME A CONSENSUS² TO ENHANCE FINANCIAL STABILITY, MEET DEMANDS OF A BROAD POOL OF ISSUERS AND INVESTORS, AND ULTIMATELY SUPPORT SUSTAINABLE GROWTH IN EMERGING MARKET ECONOMIES.

Domestic debt markets in emerging market economies (EMEs) have grown more than fourfold in the last decade, from US\$1.4 trillion at the end of 1997 to US\$6.5 trillion at the end of the last quarter of 2007.³ Such spectacular performance has been driven especially by shifts from external to domestic borrowing⁴ and a higher proportion of local currency fixed-rate debt issuances at longer maturities. These have diminished currency mismatches, refinancing risk and volatility of interest expenditures. Strikingly, and for the first time in history for emerging economies across all regions, issuance in local currency bond instruments has expanded to at least (and, for some, significantly beyond) 10 years.⁵

Not surprisingly, these impressive figures have not escaped the eyes of the international financial community, capturing unprecedented interest globally from a wide scope of actors. Policy makers from developed and developing countries have clearly moved the need for deeper and more liquid local currency bond markets in emerging economies to the top of the global financial policy agenda.⁶ Academics

and practitioners have engaged in a fruitful search and discussion to bring explanations for the determinants of such events, and forecast future developments.⁷ Multilateral organisations (and several other institutions), in turn, have strengthened existing programs and launched ambitious initiatives to support the consolidation of this asset class.⁸ Despite much debate, very few challenge evidence that a structural shift has taken place.

Looking forward, focus should be given to building and streamlining solutions to support policy-makers' drive for a complex agenda of actions and reforms. These most frequently involve significant policy dilemmas, technical challenges and need for clever sequencing and coordination across several actors – tailored to country-specific circumstances. The remainder of this chapter describes such agendas, based on widespread international understanding of relevant issues, and describes a framework being used by multilaterals to support EMEs in debt market development.

The agenda for strengthening EMEs' debt markets

It is well acknowledged that development of debt markets involves a complex and interrelated set of issues. The agenda below underscores key areas of work identified through multiple sources, assessments and debates,⁹ with focus on Government debt markets¹⁰ including: money markets; issuance policy and primary markets; secondary markets; derivatives; investor base; infrastructure and regulations.

Money markets

“The money market is the cornerstone of a competitive and efficient system of market based intermediation, and should normally be in good working order before a Government bond market is developed”.¹¹ There are at least two key areas of work in money markets. The first one is the development of liquid repo markets, which involves in many cases legal and operational issues on the management of the collateral. Repo markets have been identified by policy makers and market participants as a top priority.¹² Even countries such as Mexico, Brazil, China and India that have relatively well developed money markets are lagging behind in repo markets.

The second area of work is the impact of operational liquidity management on money markets. This is a highly complex topic that in many countries goes well beyond pure technical issues and involves ad-hoc institutional and monetary policy dilemmas. Well functioning money markets require accuracy in liquidity forecasting and management so that market participants prefer to trade, rather than hold precautionary reserves to be protected against uncertain liquidity swings. Policy dilemmas linked to operational liquidity management include the choice of exchange rate regime, capital account controls and sterilisation strategy.¹³ The latter covers the coordination agenda between the Central Bank and the Ministry of Finance on the choice instruments and maturity, the issuing calendars, and the distribution of sterilisation costs.

Issuance policy and primary markets

Most Governments in EMEs have made positive progress in shifting from opportunistic to planned issuance strategies

of tradable instruments. Countries are issuing long-term instruments unseen in previous periods, but these generally lack the volume and regularity to become true benchmarks. Promoting the consolidation of these issues requires improving mechanisms for primary issuance that would favour market allocations, price discovery and liquidity.

Secondary markets

Secondary market liquidity is a good indicator for quality debt market policies on many fronts. EMEs show very uneven liquidity patterns and generally, in countries where figures look best, it is concentrated in a very limited number of issues. An active secondary market requires capitalised market intermediaries with the right incentives to trade, and therefore to invest, in the human resources and systems that support their operation. Creating the right trading environment may cover a broad array of issues such as effective liquidity management to reduce trading risks; a regulatory framework that is conducive to active portfolio management (e.g., valuation methodology, liquidity ratios rules, tax regulations) and transparency standards that allow more efficient price discovery. The institutional organisation of secondary markets under market-makers schemes would also be very relevant, but only as a natural outcome of the right trading environment. In some countries this is happening through the development of electronic trading platforms. These are introducing to EMEs, hybrid distinctive features between OTC and organised markets.

Derivatives markets

Derivatives markets allow the efficient re-allocation of risks in the underlying cash market across a broad group of market participants. They are also useful complements to cash markets in order to tailor portfolio strategies and exposures according to specific needs. The development of derivatives markets is mainly of concern in the large EMEs where some critical mass in the cash markets has been achieved (e.g., Malaysia, Thailand, China, India, Mexico, Chile, Brazil). Common areas of work include the right sequence and interactions between cash and derivatives markets, and whether derivatives should be exchange or OTC traded.

Investor base

A broad and diversified investor base avoids one-side markets and stimulates liquidity by having a variety of players with distinct strategic objectives and trade patterns. It also facilitates channelling domestic savings to the sovereign and corporate market. Similar to money markets, the diversification of the investor base has been identified as a priority by policy makers and market participants. The latter, for example, have ranked it as at least a top two priority across seven items in nine out of ten Asian bond markets.¹⁴ Three points need to be taken into consideration to frame the reform agenda. First, the fact that a diversified investor base (banks, mutual funds, insurance companies, pension funds and international investors) is the result of the development of the financial sector, which is the process EMEs are involved in.

Second, the development of institutional investors to channel savings may cannibalise the banks' deposit base. For example, in many countries the growth of the mutual fund industry will be linked to financial groups that include major banks. In this scenario, incentives may have to be designed for the development of competing saving schemes within the same corporation. In this context, the regulatory framework needs to be well planned to balance the incentives and eventual risks of this new type of investor.

Third, institutional investors at the early stages of financial sector development tend to follow buy-and-hold strategies¹⁵ and therefore reduce market liquidity. In an environment of limited supply of securities, or of regulatory restrictions, they can become captive investors and even introduce distortions in market pricing.

Adequate policies to diversify the investor base need to take into account the issues described above in order to extract the full potential that diversification can bring to deepen bond markets.

Infrastructure

Efficient settlement infrastructure facilitates the smooth flow of transactions in the primary and secondary markets, strengthens investors' confidence, stimulates the pace of market expansion, and limits exposure to systemic risk.¹⁶ Most trading and settlement arrangements in EMEs are suitable for their degree of development. Challenges on this front are related to

keeping pace with new market developments in terms of risk management and processing capacity. There are also issues on the connectivity between the local and the international settlement arrangements (ICSD and global custodians), which include the impact on enhanced liquidity and the capacity of local authorities to monitor off-shore transactions.

Regulations

Regulatory frameworks for debt markets in EMEs need to be prepared for a changing environment as the financial system evolves. The right balance between market transparency, reduction of systemic risk and investor protection may not be the same as in developed markets. A key topic is the valuation methodology of assets, which may not always be able to follow mark-to-market principles. The transition from cost or model based to mark-to-market valuation is a complex process that can impact systemic risk and fair treatment of investor's assets.

The development of a country specific agenda requires the assessment and consensus across institutions, such as the Ministry of Finance, Central Bank and Securities Regulator, on this broad set of areas. Exhibit 1 describes an approach currently being used by the World Bank to map the key priorities across these three institutions in 20 leading EMEs for the development of local currency bond markets.



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Potential areas of work	a. Critical areas for your local currency market development	b. Rank the areas of work by their priority
1. Macro and micro interactions and trade-offs		
1.1. Capital controls and currency convertibility		
1.2. Options for excess liquidity sterilisation		
1.3. Market taxation structure and financial neutrality		
2. Primary markets		
2.1. Debt management strategy		
2.2. Organisation of primary market and issuance mechanisms (benchmark building)		
3. Money markets		
3.1. Repo markets		
3.2. Operational liquidity management for money markets efficiency		
4. Secondary markets		
4.1. Price dissemination and liquidity		
4.2. Trading and institutional organisation		
4.3. Valuation schemes		
5. Derivatives markets		
5.1. Sequence and interactions between cash and derivatives markets		
5.2. Exchange and OTC markets		
6. Investor base		
6.1. Strategies for diversification		
6.2. Prudential regulations		
7. Custody, clearance, and settlement		
7.1. Local and international central securities depositories (CSD)		
7.2. Risk management upgrades		
8. Regulations for debt markets		
8.1. Systemic risk		
8.2. Investor protection		
8.3. Enforcement capabilities		

Source: Survey currently conducted by World Bank Capital Markets Advisory Group with 20 leading EMEs

A framework for effective multilateral support to debt market development

Multilateral organisations such as the World Bank can play a relevant role in supporting current efforts in the analysis and exchange of knowledge on the debt market development challenges presented in Exhibit 1. Complexity, specificity and the lack of ‘one-size-fits-all’ solutions are distinctive features of the pending agenda to reduce EMEs debt markets vulnerabilities.

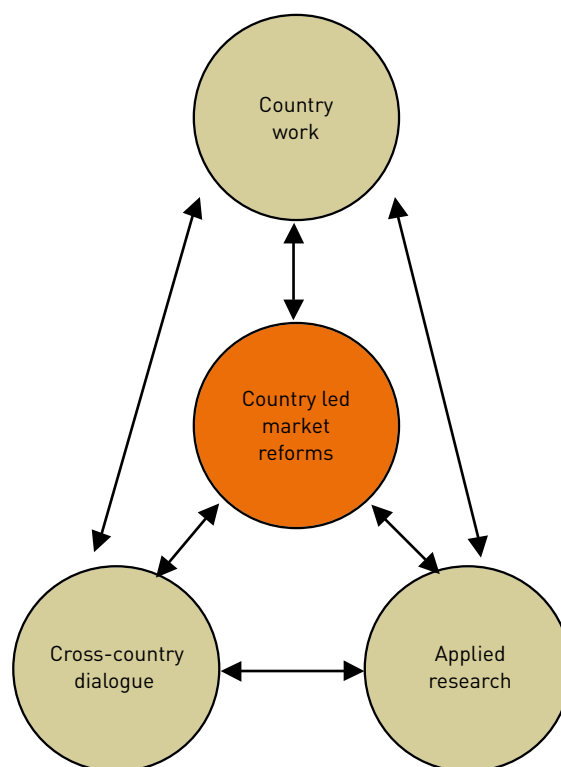
In most EMEs debt market reforms were initiated several years ago and have seen already promising results as acknowledged by their relevance in global investment portfolios. One of the positive outcomes of these efforts is a critical mass of case studies, and of policy makers and professionals that have been directly involved in assessing, planning and implementing reforms. Ongoing efforts by multilaterals are contributing to support EMEs in developing their local debt markets in three major areas:

- **Peer-country analysis for policy dilemmas;** in the form of institutionalised frameworks that facilitate in-depth policy and technical discussion of common issues of concern among peer-countries. Policy dilemmas can only be solved within the context of each country, but the exchange of experiences and of best practices may be used as a valuable platform of analysis to support countries in their decision process.
- **Quality technical expertise for market and institutional reforms;** to support countries in the good use of their human capital and the accurate assessments of alternative ways of addressing reform issues. Multilaterals are in a position to contribute to this effort by drawing from a network of in-house and outside experts with know-how of international best practices applied in very different contexts.
- **Input for empirical research of trends and past experiences;** from individual countries and peer-country discussion groups to help researchers (academics and practitioners) to focus on the main issues of interest to policy makers.

Governments have increased human capital and technical resources to go ahead with their policy agenda with greater autonomy than in the past. The new context reflects a trend towards intra-regional integration and enhanced South to South financial flows. This means that the way forward in handling financial market reforms, would be putting more emphasis on a multilateral peer-group country approach to complement traditional direct technical assistance programs. This is consistent with the growing role of EMEs in the global economy and in international financial markets. Further progression requires a framework that would leverage and enhance the probability of success of country led market reforms.

Leveraging country-led market reforms

Exhibit 2



Source: Brochure for Gemloc Advisory Services

Notes:

1. The authors would like to thank Barry Eichengreen for access to his forthcoming Policy Notes with useful insights as well as for comments from Alison Harwood and Clemente del Valle from the Capital Markets Advisory Group. 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. See Barry Eichengreen (2008 a) 'Rationale and Obstacles to the Development of Bond Markets in Emerging Economies'; and (2008 b): 'Field of Dreams: Measures for Overcoming the Obstacles to Bond Market Development', forthcoming Gemloc Advisory Services Policy Notes for the World Bank (Washington DC, The World Bank);
3. See BIS (2007) 'Financial Stability and Local Currency Markets', CGFS Paper No.28
4. See quantitative and qualitative overviews of this shift in World Bank Global Development Finance Reports for 2006 and 2007.
5. A clear example of the potential that the new environment offers for local currency debt is Mexico's successful placement of a large 30-year fixed coupon bond issue denominated in pesos in October 2006.
6. See G-8 meeting of Finance Ministers in 2007 on the action plan for further progress in debt markets that may be taken as a consistent summary of policy issues of concern to their partners from emerging countries and international financial institutions (World Bank, IMF, BIS, OCDE).
7. See Burger, J., and F. Warnock, 2007. Foreign participation in local currency bond markets; Broner, Fernando A. & Lorenzoni, Guido & Schmukler, Sergio L., 2004. 'Why do emerging economies borrow short term?', Policy Research Working Paper Series 3389, The World Bank
8. Relevant initiatives on this front are the Asian Bond Fund 2 (ABF2) launched in 2005 by the Executive's Meeting of East Asian Pacific Central Banks (EMEAP), or the more recent Global Emerging Markets Local Currency Bond Program (GEMLOC) by the World Bank Group, as well as relevant studies such as the BIS with the CGFS Paper (2007) 'Financial Stability and Local Currency Bond Markets'.
9. World Bank (2007) 'Developing the Domestic Government Debt Market: from diagnostics to reform implementation' (Washington DC, The World Bank).
10. Most of the issues described in this agenda for Government debt markets are also relevant for corporate bond markets, as they create a favourable setting for other fixed income asset classes
11. World Bank and IMF (2001) 'Developing Government Bond Markets: a Handbook', Washington DC: World Bank and IMF.
12. For market participants input on the strategic relevance of money markets see Asian Bond Online Survey conducted in 2006.
13. For details on the issues addressed in India see in Dr. Y.V. Reddy, Governor of the Reserve Bank of India (RBI): BIS Papers N. 11 (2002) 'Issues and Challenges in the Development of the Debt market in India' and (September 2007) 'Monetary Policy Developments in India: an overview', address at the Sveriges Riksbank.
14. See Asian Bond Online survey with market participants conducted in 2006.
15. Buy-and-hold behaviour by institutional investors may generally be reinforced by a combination of three causes: the nature of the investor base; lack of supply of assets; and regulation.
16. World Bank (2007), "Developing the Domestic Government Debt Market: from Diagnostics to Implementation", Washington DC, The World Bank
17. The exhibit shows the questions in a survey that is being conducted by the Capital Markets Advisory Group from the World Bank with Ministries of Finance, Central Banks and Securities Commissions of 20 leading EMEs (Brazil, Chile, China, Colombia, Egypt, Hungary, India, Indonesia, Malaysia, Morocco, Mexico, Nigeria, Peru, Phillipines, Poland, Russia, Slovakia, South Africa, Thailand, Turkey). Results will be disseminated on a consolidated basis in June 2008.

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