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Local currency bond markets as an integral part of a developed financial system

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A functioning financial system is crucial to a country's economic development. This also includes a local bond market through which the public and corporate sector can raise funds in local currency. In many countries, the local currency bond market has scope for expansion. The public and corporate sector would benefit from the opportunity to borrow for long maturities in their own currency. At the same time, sufficient attention should be given to the stability of the financial system to prevent it from becoming the starting point and amplification mechanism of crises.

The development of a local bond market differs from one national economy to another and measures aimed at improving the framework and regulations must be aligned with the level of development and needs of the respective country. Development measures ranging from support in expanding the capacities of the system to support for individual transactions must be tailored to the specific financial system and take the stability of the system into account.

A functioning financial system is important for a country's economic development. When the financial system develops, the economy can grow faster and becomes more resilient to shocks. This is because a country's own financial system can balance the volatility of international capital flows and reduce financing limitations for households and enterprises. A fully developed financial system comprises financial institutions such as banks and insurers, as well as financial markets, including a local capital market. The latter opens up long-term funding opportunities in particular for the public and corporate sector, while offering investment opportunities for institutional and private investors.

Tailored development of functioning financial systems in developing and emerging market economies is important

For most emerging market economies and developing countries the expectation is that the expansion of their financial system – providing larger and more liquid markets, improved access to financial services, more efficient financial institutions and capital markets – delivers positive impetus.[1] Additional mobilisation of capital via local financial markets would make important financial resources available to finance investments that are critical to achieving the Sustainable Development Goals (SDGs). In addition, the expansion of local financial systems can be expected to:

- improve financial stability by reducing currency mismatches and providing longer maturities (i.a. through bonds) as this improves debt sustainability

- improve economic efficiency through qualified decisions on resource allocations in lending and market-based pricing which also serves as reference for capital costs and long-term bank loans

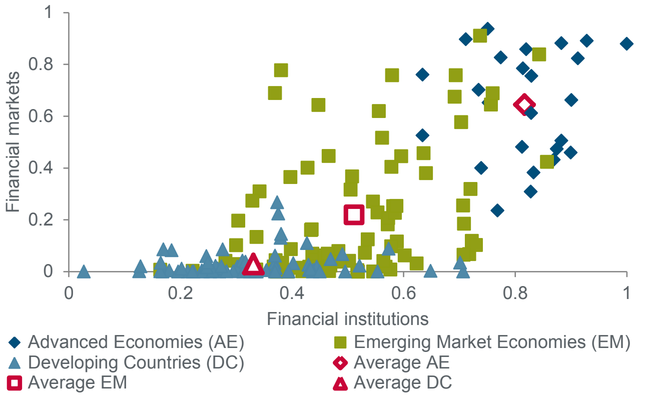
- take the pressure of credit and maturity risks from the banking system, diversify capital flows and, in this way, mitigate international financial market turmoil.

Excessively rapid development, however, can overwhelm financial institutions, regulatory and supervisory authorities. As the financial crisis of 2008 demonstrated, particularly for industrialised countries, financial markets can also generate financial and macroeconomic stability risks. What matters is that measures designed to develop financial systems – including bond markets – take into account the development stage of the local market and that the local government embraces development and accepts such endeavours – including providing support for measures of development financiers.

The financial systems of industrialised, emerging and developing economies differ quite significantly in their average level of development (see Figure 1).[2] The gap between industrialised and emerging economies is more pronounced for financial markets than for financial institutions. The financial markets of low-income countries are particularly weak. Their financial institutions, however, are comparatively efficient, albeit less deep[3] than those of industrialised countries. Between the mid-1990s and the early 2000s, the financial systems of industrialised countries experienced a development surge brought about by the expansion of cross-border banking operations in Europe and the development of investment and internet banking. The expansion of financial systems in emerging economies, by contrast, progressed only at a moderate pace while the financial systems of low-income countries stagnated. After the global financial crisis of 2008, industrialised countries experienced deleveraging, thereby reducing the depth of the financial system and slightly closing the gap to the emerging economies.

Figure 1: Level of financial system development

Index, 0 – minimum, 1 – maximum



Note: The index comprises measures of depth, access and efficiency for financial institutions (banks, insurers, investment funds, pension funds and other non-bank institutions) as well as for financial markets (stock markets and bond markets). It covers 176 countries in the period from 1980 to 2013. The values for 2013 were used.

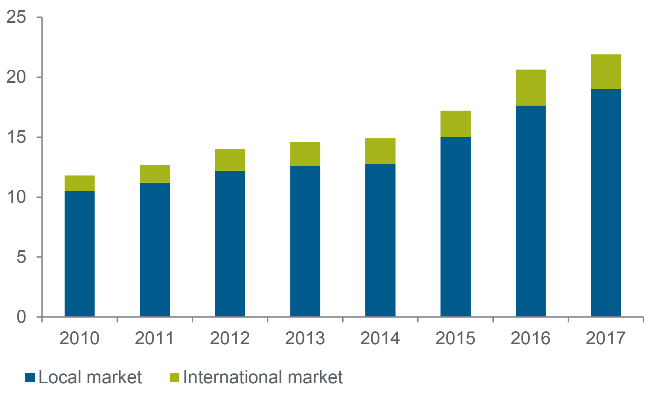
Source: Sahay et al. (2015), Rethinking Financial Deepening: Stability and Growth in Emerging Markets, p. 16.

Increasing local currency financing through local capital markets

In the emerging economies, the share of local currency in public and corporate sector debt already increased since the mid-1990s parallel to their financial development. The corporate sector of emerging economies in particular has been able to increase local currency debt in the past years.[4] However, the share of local currency funding did not increase at the same rate in all countries. Rather, it is particularly the large countries that succeeded in making progress.[5]

Figure 2: Bond markets of emerging economies

(in USD trillion)



Sources: IMF (2016), Development of Local Currency Bond Markets, Staff Note, IMF (2018), Recent Developments on Local Currency Bond Markets in Emerging Economies, Staff Note for the G20 IFAWG.

The need for these countries to develop local currency bond markets is based on the observation that they – particularly developing countries – still have limited options to borrow in their own currency. The resulting need to raise foreign currency funds comes with exchange rate risks for these debtors and increases the risk of currency and debt crises. In order to reduce the likelihood of crises resulting from foreign currency debt, it is necessary to tackle the causes:

- Poor institutional frameworks, as well as a history of defaults and high inflation, mean that developing countries can come under pressure when they have even less foreign debt than industrialised countries.[6] The countries must make efforts to improve their own debt tolerance by adopting reforms and a suitable economic policy. This will create positive conditions for the development of local capital markets at the same time.

- When high transaction costs prevent international investors from diversifying their financial investments – beyond a handful of currencies of large countries and financial centres – developing countries can borrow only in these foreign currencies in the international capital market (original sin). This effect may be exacerbated by the fact that the possibilities for states and enterprises in developing countries to take up long-term local currency debt even in their local capital market are limited or non-existent.[7] The targeted development of capital markets can lower transaction costs here and create possibilities for long-term local currency debt as well.

Potential risks of local bond markets

Developing countries increase their funding in local currency as they develop their local capital markets. As local bonds are typically issued in local currency, the debtor has no exchange-rate risk. This is just as important for the state as it is for enterprises and banks or individual infrastructure projects. However, local bonds typically have shorter maturities than bonds in foreign markets which increases the interest-rate and refinancing risk. The Committee on the Global Financial System, however, deems this to be less severe than the risk of pronounced currency mismatches.[8] Besides, the maturities situation has improved, as the highest increase in average maturities from 2.4 years in 2010 to 4.2 years in 2016 was recorded in government bonds of lower middle income countries.[9]

Empirical studies have found that a higher share of foreign investors goes hand-in-hand with lower bond yields in emerging economy markets. Instead of exchange-rate risk, however, states must accept the risk that foreign private investors sell their titles when sentiment turns negative, which can cause a surge in volatility in bond markets. But studies show that a stronger preference of foreign investors does not necessarily increase volatility in local bond markets.[10] This is because foreign investors typically hold local bonds as part of their diversified portfolio, which implies higher risk tolerance and mitigates the risk mentioned above.[11]

A broad investor basis that includes foreign investors is important because, among other things, it contributes to higher liquidity and an improved pricing process. Nevertheless, rising global risk aversion is still a good reason to keep a close eye on the behaviour of foreign investors in local markets. Economies with macroeconomic imbalances and high budget deficits in particular may see themselves exposed to funding risks resulting from capital outflows and tightening international financing conditions. In 2017, an average of around one fifth of the government bonds of emerging economies that were denominated in local currency were already in the hands of foreign investors.[12]

Approaches to develop local bond markets

The standards for the development of local bond markets are high. They demand policymakers to provide consistent and credible support, stable macroeconomic conditions, especially a stability-oriented monetary policy and financial stability, as well as a healthy banking sector with appropriately developed financial system regulation and supervision. Investors demand liquid markets, investor protection, rules for insolvency proceedings and a developed market infrastructure. Access to financial services, for example in the form of loans for small and medium-sized enterprises on-lent through commercial banks, is traditionally at the heart of development financiers' support. Support for the development of local capital markets is gaining importance, however, not least since the G20 launched an initiative in 2011 aimed at promoting the development of local currency bond markets in emerging economies. In addition, international organisations and multilateral and bilateral development financiers are also pursuing this topic more vigorously, among other things as a conceptual framework of the development policy, through technical support or through the issuance of debt securities denominated in local currency.

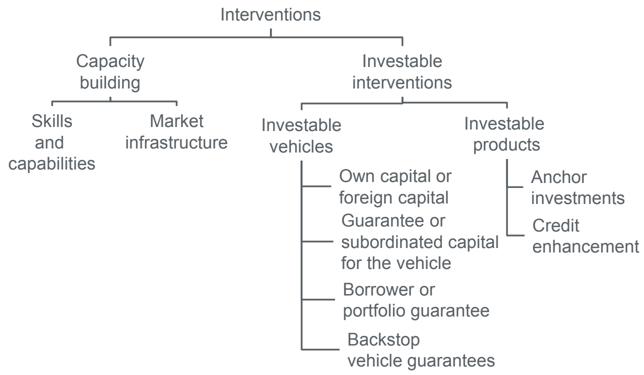
Investment approaches to support the development of local bond markets that are relevant to financial cooperation can be divided into two basic categories: (1) financing for setting up the framework and capital market infrastructure (e.g. developing a rating system) and (2) direct support for capital market transactions (see Figure 3). The latter support options can be further broken down into:

- anchor investments or credit enhancements aimed at improving bond issuances. This is of particular interest for the issuance of special bonds such as green bonds, for example. Credit enhancements comprise both guarantees and securities with a subordinated character.

- the development and financing of investment vehicles. As intermediaries for market development, these take a long(er)-term approach to addressing a range of deficits in the capital market, e.g. through (i) (anchor) investments in local currency issuances, (ii) the issuance of pooled bonds of various smaller issuers or (iii) the provision of liquidity facilities to bridge liquidity bottlenecks in the market.

The type of support and the level of development of the local bond market together determine whether more specific or more systemic impacts will be achieved. As a rule, measures aimed at capacity building, as well as investible interventions in less developed markets, will generate stronger systemic effects. In such markets, supporting the first bank bond can already generate a substantial effect, for example. It may also be the case that the market is so underdeveloped that investible interventions only make sense in combination with capacity building measures. Or the market is already well developed and measures of this type show meaningful effects only when innovative products are introduced to the market. In this case, an anchor investment in a single bond or a corresponding credit enhancement (provision of guarantees or subordinated instruments) will tend to generate fewer systemic effects but provide the greatest benefit to the direct participants in the transaction.

Figure 3: Approaches for supporting local bond markets through development banks



Source: Own illustration.

Outlook

At present, the global financial safety network is designed primarily to mitigate the effects of global financial crises. But it is in need of improvement because systemically relevant emerging economies, in particular, are not sufficiently protected.[13] Instead of mitigating crises it would be even better to prevent them. This is where local currency bond markets can help. They enable the public and corporate sector to mobilise funds in local currency and can thereby reduce the exchange-rate risk and increase financial stability. But bond markets can also harbour risks when they grow too large or too fast for supervisory authorities and frameworks to keep pace with their development.

Apart from acting as stabilisers, local currency bond markets are an integral part of a developed financial system that has the capacity to support the growth of an economy. Developing such markets presupposes that the public and corporates sector have sufficiently high funding needs and it requires patience and stamina. Not every country will therefore be willing and able to set up and develop its own local currency bond market.

Local currency bond markets in developing and emerging economies are at very different stages of development and it is above all the larger countries and Asian countries that are capable of raising local currency funds in local financial markets. When development financiers support local bond markets, the measures need to be in line with the relevant development level. Depending on the conditions and market, a variety of instruments can be used, ranging from support for individual transactions to capacity building and improvement of frameworks such as financial market regulation. ■

[1] Sahay et al. (2015), Rethinking Financial Deepening: Stability and Growth in Emerging Markets.

[2] Sahay et al. (2015), Rethinking Financial Deepening: Stability and Growth in Emerging Markets.

[3] The depth of the financial institutions is determined by private sector debt, the assets of pension funds, the assets of investment funds and the insurance premiums of life and other insurance policies, all in relation to GDP. See Sahay et al. (2015), Rethinking Financial Deepening: Stability and Growth in Emerging Markets, p. 34.

[4] After the financial and economic crisis of 2008/09, enterprises in emerging economies have also raised more funds in USD in the international capital market, so they are being monitored accordingly for risks to financial stability (see **Keeping a watch on emerging market corporate debt**, Economics in Brief No. 117, KfW Research).

[5] IMF (2016), Too slow for too long, World Economic Outlook.

[6] Reinhart, C., Rogoff, K. and Savastano, M. (2003), Debt Intolerance, Brookings Papers on Economic Activity 1, pp.1–74.

[7] Eichengreen, B., Hausmann, R. and Panizza, U. (2003), The Pain of Original Sin, in Barry Eichengreen and Ricardo Hausmann (eds.), Debt Denomination and Financial Instability in Emerging-Market Economies, Chicago: University of Chicago Press. Eichengreen, B.; Hausmann, R. and Panizza, U. (2007). 'Currency Mismatches, Debt Intolerance and Original Sin: Why They Are Not the Same and Why it Matters'. Capital Controls and Capital Flows in Emerging Economies: Policies, Practices and Consequences. University of Chicago Press. pp. 121–170.

[8] Committee on the Global Financial System (2007), Financial stability and local currency bond markets, CGFS Papers No. 28.

[9] IMF (2018), Recent Developments on Local Currency Bond Markets in Emerging Economies, Staff Note for the G20 IFAWG.

[10] U. a. Hyung-sok M. L. (2014), Effects of Foreign Investor Participation on Emerging Market Sovereign Bond Yields and Volatility, MMSS Senior Thesis;
Peiris, S. J. (2013), Foreign participiation in local currency bond markets of emerging economies, Journal of International Commerce, Economics and Policy 4 (3);
Ebeke, C. H. and Lu, Y. (2014), Emerging Market Local Currency Bond Yields and Foreign Holdings in the Post-Lehman Period - a Fortune or Misfortune?, IMF Working Paper No. 14/29.

[11] Committee on the Global Financial System (2007), Financial stability and local currency bond markets, CGFS Papers No. 28.

[12] IMF (2018), Recent Developments on Local Currency Bond Markets in Emerging Economies, Staff Note for the G20 IFAWG.

[13] Hackemann, L. and Ullrich, K. (2016), **The decentralised global monetary system requires an efficient safety net**, Focus No. 147, KfW Research.