

Professor Hermann Remsperger

Member of the Executive Board of the Deutsche Bundesbank

**Developing Bond Markets in Emerging Market Economies:
Conclusions and Political Recommendations**

High Level Workshop 2007

Developing Bond Markets in Emerging Market Economies

Frankfurt

May 10, 2007

Ladies and gentlemen

The main objective of this workshop was to bring together international expertise and practical knowledge about local currency bond markets in emerging market economies (EMEs). I would now like to distil from the presentations and discussions some key recommendations for further strengthening these markets. These recommendations will also be incorporated into an Action Plan which will be discussed by the G8 Finance Ministers in their forthcoming meeting in Potsdam.

I.

Let me start with a few general remarks. I believe one common element in all of the presentations was that well-functioning local currency bond markets can make a vital contribution to strong and sustainable economic growth and to financial stability in EMEs as well as developing countries. At same time, the increasing economic weight of EMEs makes the functioning of these local currency bond markets an increasingly important factor for global financial stability.

Most EMEs have already implemented major reforms to develop their domestic markets in recent years. They have thus reduced their dependence on external credit sources and made their economies less vulnerable to exchange rate and interest rate fluctuations.

However, as new crises seldom emerge from familiar sources, it is essential to look beyond these well-known vulnerabilities. Financial markets, in general, and bond markets, in particular, will certainly

Seite 2 von 18

gain importance over time. The related challenges may test the resilience of the global financial system, including EMEs' still young local currency bond markets. Let me give you three examples of such challenges.

- First, the financing of growing global current account imbalances requires a much more intensive recourse to the financial markets. At the same time, financial markets are now faced with a higher risk of abrupt reversals of global capital flows, which could also affect young local bond markets in EMEs.
- Second, the share of private savings allocated through institutional investors, including pension funds, mutual funds, life insurance companies and hedge funds, is likely to increase further in the coming years. In the process of searching for yield and diversifying risks local currency bond markets seem very likely to provide good diversification vehicles for international investors. These institutional investors will focus increasingly on EME markets, whose infrastructure may not yet be able to cope with these capital inflows. This applies, in particular, to the emerging local currency bond markets of sub-Saharan African countries.
- Third, many EMEs have been liberalising their capital flows. There is a close link between liberalising the capital account and developing the financial system, including local currency bond markets. Experience suggests that greater openness in the capital account tends to place greater demands on the resilience of local currency bond markets.

At the same time, the development of domestic bond markets can facilitate and stabilise the process of capital account liberalisation. However, both processes are closely interrelated and need to be carefully balanced.

Contributions to our workshop have shown that the experience of the EMEs in this context is quite different. The IMF, in particular, would be well placed to further work on these issues.

While it is difficult to foresee the specific challenges which local currency bond market may face in the future, it is safe to say that financial markets with a modern and internationally competitive infrastructure are better prepared to weather a financial storm from whatever direction it may blow. But making financial systems weatherproof is easier said than done.

Further reforms to deepen and broaden domestic bond markets are still needed in a number of areas, and the key question is on which reforms EMEs and developing countries should focus. The presentations and discussions yesterday and today have provided useful insights in this regard.

II.

Now that I have listened to the presentations and discussions in our workshop, the issue seems to me to be more complex than it did two days ago. Perhaps some of you may share this impression. Nonetheless, let me try to draw up some general conclusions and recommendations.

Experience shows that a *credible anti-inflation policy* is a crucial prerequisite for developing efficient and liquid bond markets. Indeed, those EMEs which were able to achieve and maintain a stable macroeconomic framework with well-anchored inflation expectations have also made considerable progress in the development of liquid local currency bond markets. In countries where such conditions have been lacking, borrowing has tended to be predominantly at the short end of the market.

Moreover, a stable macroeconomic framework also has a positive impact on the structure of the markets and on the financial instruments. Recent empirical studies on the investment behaviour of institutional investors tend to confirm that macroeconomic stability improves the return characteristics of the EME bond markets and makes them more attractive for institutional investors.

III.

However, while a stable macroeconomic framework is a necessary condition for developing and strengthening local currency bond markets, it is not sufficient. In deciding which other specific reforms are needed for market development, in particular, two broad principles seem to me to be of particular importance.

First, reform measures should be geared to strengthening market forces. Market intervention should occur only where markets are unable to develop spontaneously owing, for example, to insufficient critical mass or institutional deficits.

A direct consequence of this principle relates to sequencing within financial markets. The development of financial systems is, above all, a market-led process. Empirical studies show that financial systems follow some typical patterns, but these patterns should not be seen as a “benchmark” for country-specific measures directed at strengthening domestic bond markets.

- Second, and simply stated, “one size cannot fit all”: in other words, when providing recommendations, we have to take into account the different stages of development, the reforms already taken and the different financing and economic structures of specific countries.

As regards the different stages of development, I believe our workshop has made a valuable contribution to improving our knowledge. Indeed, there are substantial differences in the structure of financial markets and instruments within EMEs.

- In Latin American countries the share of domestic debt outstanding that is foreign currency-denominated or exchange rate-linked has been substantially reduced, but a large share of the debt is still floating-rate. In the larger Asian countries, by contrast, the vast majority of domestic debt is straight fixed-rate.
- There are also marked differences with regard to market liquidity. Measured by turnover or bid-ask spreads, some EMEs already have relatively liquid markets. But, in many EMEs, liquidity remains low.

- As regards the issuer base, it is also worth noting that in Asia financial institutions together with the corporate sector have a much larger share in the issuance of domestic debt securities than in other EME regions.
- It is also worth emphasising that in the past few years some EMEs have been raising funds through issuing local currency bonds on international financial markets. The largest issuers in 2006 were South Africa, Brazil, Mexico and Colombia.

IV.

Let me now turn to the reform measures that should to be taken. I believe two areas stand out where further reforms are needed: namely, *promoting liquidity and developing corporate bond markets*.

There are several measures that EMEs need take to promote liquidity and to develop corporate bond markets:

- First, they need to broaden and diversify the investor base;
- Second, they need to develop domestic derivatives markets; and
- Third, they need to strengthen the legal framework and the market infrastructure.

These areas are, of course, closely interrelated, and I would like to discuss them in turn.

1. *Broadening and diversification of the investor base*

In order to promote market liquidity, broadening and diversifying the investor base is essential. Institutional investors having a stronger presence can also contribute to reducing maturity mismatches and may be a major driving force for the development of new financial instruments and the transfer of expertise to strengthen market infrastructure.

Many local currency bond markets still have a rather narrow investor base. In most EMEs, investment is still concentrated on domestic banks. Their share of outstanding domestic debt is much larger than the corresponding ratio in industrial countries. It is, however, positive that the domestic institutional investor base has been growing on average recently.

In addition, foreign investors play a much smaller role in EMEs than in advanced countries. The share of outstanding domestic debt securities held by foreign investors is on average several times higher as in EMEs. Here again, of course, there are large differences between EMEs; and, on average, foreign participation is growing.

One major element in broadening and diversifying the investor base is the establishment of large benchmark issues at key maturities.

On the domestic investor side, pension funds are an increasingly important investor class in the EMEs, and *pension reforms* in EMEs have certainly played a role in that development. Improving financial literacy may be an essential component of a successful pension

reform, especially when these reforms involve setting up Defined Contributions schemes, as has often been the case in emerging markets.

Most EME pension funds are still highly invested in local government bonds. To increase liquidity and to stimulate the issuance of non-government securities, EMEs should consider reviewing and eliminating *investment restrictions* which hinder a broader diversification of funds.

The official international financial institutions (IFIs), including the IMF, the World Bank and the BIS, are well placed to analyse which investment regulations discourage the development of local currency bond markets.

Since domestic institutional investors often pursue a buy-and-hold strategy, which contributes less to improving liquidity, measures to promote liquidity also need to be geared towards attracting *foreign investors*. They tend to restructure their portfolios more frequently.

It is also necessary to support local bond markets on the supply side. This would include opening markets to *foreign issuers*, including or starting with IFIs, which would improve the range of high-rated instruments in local currency.

From the viewpoint of IFIs achieving this objective would be helped by adopting standardised bond documentation and international accounting rules, by lowering transaction costs (not least through interlinked clearing and settlement systems) and by developing domestic derivatives markets.

2. *Promoting domestic derivatives markets*

Developing domestic derivatives markets is a crucial measure to promote liquidity both directly and indirectly through helping to diversify the investor base. Derivative markets provide cost-effective ways for institutional investors to structure their portfolios more efficiently and improve their risk management.

Despite their dynamic growth over recent years, the EMEs' derivatives markets account for no more than 10% of the total outstanding notional values in global derivatives markets. Furthermore, the development of derivatives markets differs remarkably across regions.

The trading volumes of exchange-traded and over-the-counter contracts are largest for foreign exchange forwards and swaps and for equity options and futures. Trading of these instruments is particularly important in emerging Asia, while exchange-based trading of interest derivatives on the whole is lagging somewhat behind and is more important in Latin America.

To promote the development of derivatives markets, the EMEs should examine the extent to which *regulatory deficits* and *shortcomings in the market infrastructure* may be impeding the evolution of such markets. The G7 countries could assist this process by providing their expertise and supporting technical assistance in this area in close cooperation with the IFIs.

3. *Strengthening the market infrastructure and the legal framework*

A strong legal and regulatory framework, international competitive clearing and settlement systems, effective credit ratings, and good corporate governance are also key ingredients for the development and efficient functioning of capital markets. Despite the remarkable progress that EMEs have made so far, further reform steps are needed in these areas.

Let me address these aspects in more detail.

First, *clearing and settlement systems*: capital movements are global but the clearing and settlement of securities is very often country-based. The current setup in many EMEs in terms of mitigating risks in the settlement process and cost effectiveness is often less than optimal. In addition, clearing and settlement systems are still highly fragmented.

However, *best practices* in this area are well developed in the form of recommendations by the Committee on Payment and Settlement Systems (CPSS), the International Organisation of Securities Commission (IOSCO) and the G 30 Action Plan towards enhancing the interoperability of settlement systems.

Thus, the challenge does not lie in determining what goals to set but rather in bringing existing rules and regulations into line with best practices, while giving due regard to a country's specific circumstances.

Regional cooperation in building market infrastructure can also be an effective way of strengthening clearing and settlement systems. A regional central security depository that acts as a central access point to various domestic markets, providing multi-currency as well as delivery versus payment settlement, would be a possible alternative to a gradual expansion of cross-border links based on existing national systems.

Finally, in many EMEs, the securities clearing system is not keeping pace with the payments system in terms of its technological and legal development. *Improving the link between the payments system and the securities clearing system* would be a major step in minimising transaction risks that occur when the buyer of a bond makes his payment days before the delivery of the bond takes place. The ultimate objective must be to accelerate settlement and to develop true delivery-versus-payment systems.

It should also be mentioned that many of the existing barriers to an efficient clearing and settlement infrastructure relate to legal and regulatory issues. This underlines the need for close interaction between the private and public sectors.

Second, the *legal framework: property rights* and a *tax system* that is not overly complex or discriminatory are key factors in ensuring that markets are fair, efficient and transparent. A governance structure that enforces contracts and resolves disputes in a credible, speedy and predictable manner is vital for the development of sophisticated financial markets.

Given the problems of asymmetric information that are inherent in the financial sector, the regulatory framework should also set ambitious standards for *auditing and accounting*. Disclosure rules that ensure the generation and dissemination of reliable information on a timely basis are particularly important. The OECD principles of good governance give appropriate guidance in this regard.

Let me emphasise that full implementation and enforcement of the corporate governance framework, information disclosure regulations and accounting and auditing standards and practices are as important as the laws and regulations themselves.

Third, the *credit ratings*: credit rating agencies play a major role in improving the price discovery process in bond markets, thereby furthering the growth of the corporate bond market. These agencies must be able to compile the necessary information to help investors assess credit risk and pricing spreads of corporate bonds.

The rating standards of global agencies currently focus primarily on country risk. But they are less appropriate for evaluating the specific creditworthiness of particular firms in EMEs, which is a key ingredient for the development of corporate bond markets. There is an ongoing debate, especially in Asia, on whether a *regional credit rating agency* is superior to *local credit rating agencies*, even if the latter used regional standards for their ratings.

In my view, *further standardisation of the rating systems* of local credit rating agencies at the regional level would be a crucial step in facilitating cross-border comparisons and using the advantages that

local credit rating agencies have in terms of reducing the problem of asymmetric information.

V.

I would now like to turn to two special aspects of developing local currency bond markets which are closely related to IFIs, namely the database on local currency bond markets and technical assistance.

As regards the *database*, formulating recommendations for further reforms to develop local currency bond markets in EME depends on the availability of appropriate macroeconomic and financial data. So far the amount of internationally comparable data on domestic bond markets is limited.

In particular, there has so far been little internationally comparable data on the maturity and on the instrument structure, and thus on the currency and maturity composition of domestic debt securities in EMEs. The information on sectoral mismatches is even more limited. There is also little information on derivatives markets in EMEs.

However, more data on these aspects of domestic debt would be a vital factor in making a better assessment of the risk characteristics of domestic debt. In view of the increasing importance of global portfolio flows for real economic development, a more comprehensive and timely coverage of cross-boarder activities – especially of non-bank private activities – is also necessary.

Improving transparency of local currency bonds is not only a matter of macro and microeconomic data. It is also a matter of qualitative data, namely regarding the regulatory and legal framework or the market infrastructure.

These qualitative factors can have a significant impact on transaction costs for issuance and investment. Empirical studies by the Asian Development Bank have shown that legal protection and standards for governance and transparency are major determinants for deepening bond markets.

In my view, improving transparency is not only important for central banks or supervisory authorities but also for competition between financial markets, and thus also for market participants. Therefore, we should encourage the BIS, the IMF and the World Bank as well as the national statistical agencies to improve the data basis for local bond markets.

But let me add a word of caution. I am also responsible for statistics at the Bundesbank, and complaints about the statistical burden are frequently brought to my attention. It is therefore important to balance the need for more and better data with the additional workload placed on those who are required to provide the figures.

As regards *technical assistance (TA)*, most IFIs and many advanced countries have been providing technical assistance to develop domestic bond markets for years. However, I believe most observers would agree that such technical assistance could and should be more selective and better coordinated among the main providers of TA.

I think the workshop has revealed some consensus that a collaborative approach is needed with increased cooperation between the IMF and the World Bank and with other IFIs. And while I am sure that in the follow-up to our workshop, there will be more discussion on the extent to which the collaboration between the main providers of TA could be stepped up, I believe three aspects of technical assistance may be worth mentioning.

- First, as mentioned earlier, market-oriented debt management strategies that also establish large benchmark issues at key maturities are crucial for the development of domestic bond markets.
- Second, there may also be a need to for closer cooperation on technical assistance to strengthen trading, clearing and settlement systems.
- Third, what is also important is an in-depth exchange of information as well as cooperation among debt managers, institutional investors, market associations, on the one hand, and the IMF, the World Bank and multilateral development banks, on the other. One option could be to join forces with forums that already exist, such as the IMF's Debt Management Forum, or that of the OECD or the Group of Trustees.

VI.

Let me finally add a few remarks on *sub-Saharan African countries*. Local currency bond markets in these countries are at a very early stage of development. In 2006, market capitalisation in sub-Saharan

Seite 16 von 18

African countries was US\$ 87 billion, with South Africa accounting for 62% of this amount.

Local bond markets in this region also vary widely in size and structure. Foreign debt in relation to total debt is still high, the investor base quite narrow, and the maturity structure of government debt very short-term. Corporate bond markets are lacking.

As bond markets in this region are small and will probably remain so, *closer regional cooperation* could pave the way to creating critical masses for bond markets, with low transaction costs and well-functioning clearing and settlement systems. Strengthening regional cooperation is one possible way of increasing the size of the markets. In this context, African countries could use the experience of closer regional cooperation which has been gained by Asian countries.

VII.

Before closing, I would like to make three final and very quick points.

First, I hope that this workshop will be a catalyst for further international dialogue on developing bond markets in EMEs. It would be a major achievement in itself if this two-day event here in Frankfurt were to provide an opportunity to establish a network of experts.

Second, as I mentioned at the beginning of my speech, the results of our workshop will be incorporated into an Action Plan which G8 Finance Ministers will discuss at their forthcoming meeting in Potsdam.

Third, I would like to take this opportunity to express my sincere gratitude to all of you for your outstanding contributions to this workshop.