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"Developing Bond Markets in Emerging Market Economies"

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1. Introduction

Thank you for inviting me to speak to you tonight,

Dealing with capital markets brings back fond memories now that I have become a M & A practitioner.

Actually, in some cases memories are not so fond, but only exciting.

Given the excellent program of the conference and the highly qualified speakers let me focus on a few points only.

I remember when I was first confronted with the topic of sytematically developing local securities markets, soon after the Asian crisis and in the middle of a deep crisis in Latin America; my colleagues at the IMF had proposed to write a series of chapters in the newly founded Global Financial Stability Report in late 2001: At that time some of the thoughts on using local markets as an "insurance against the vagaries of international capital markets" sounded like some remote pipe dream to many readers. I remember the resistance from within the IMF to even publish something like that.

2. Given the time that has elapsed since then, so has the focus shifted somewhat

We all know a lot of progress has been made in the meantime, especially in the systemically important countries, original sin has been increasingly eradicated, the JPMorgan EMBI no longer has the relevance it used to have. This development explains in part the resilience of Emerging Markets at present.

Incidentally a spread consistently and way below 200 bps over such a long period of time is unheard of and was beyond most people’s imagination only a few years ago.

We now pay more and more attention to the JPM GBI-EM index as if it had existed forever.

Mexico is not the only example but probably the poster child for the progress we have witnessed: local currency bonds sold to international institutional investors, long duration, strong domestic institutional investors, just to name the most crucial ones.

Other countries have also made spectacular progress, but in the past Mexico had been synonymous for boom and bust cycles in financial markets, today, in contrast, their debt managers go out and provide technical assistance to other Emerging Market countries.

Take another example: the discussion in 2002/2003 about a Sovereign Debt Restructuring Mechanism and about Collective Action Clauses, all targeted at international bonds and international investors, today that sounds like yesterday's news: CACs have become, and without friction, a regular feature under New York law, however, at a time, when international bonds have become less and less relevant.

The Institute for International Finance has recently highlighted some interesting trends and innovative activities:

- Large increase of activities on the part of non-domestic investors, especially in highly liquid markets.
- Very importantly, the participation of international investors has increased the liquidity in secondary domestic markets, which had been a serious shortcoming in 2002 when we wrote the GFSR on domestic fixed income markets. Domestic institutional investors largely employed a buy and hold strategy and probably still do today. Chile has been a very good example as to why an open capital account and

deep and liquid secondary markets go hand in hand, other countries have the same experience.

While original sin may have been very much at the forefront of attention initially, lengthening of duration is at least as important, simply to reduce rollover risk

At the IMF we saw in every crisis how the rollover requirements were driving the daily needs for funds, sometimes in a desperate fashion.

In such cases the debt market is often inextricably linked with the banking sector which often is highly exposed to the government debt market.

One of the often overlooked downside risks of a dominating domestic government bond market is the potential spillover effect of a debt restructuring into the domestic banking sector, examples being Argentina, Uruguay.

3. Interestingly, the time lag in terms of development between some EMCs and some more advanced industrial countries is not as wide as one would imagine,

I remember very well 20 years ago, very early in my career, having been sent to Paris then in order to study the radical French reforms to overhaul the domestic securities market to make it more attractive to international investors. These radical reforms were impressive, by the way inspired by the US model, but also urgently needed to attract international investors to the French market..

Germany, “blessed” with a reserve currency, a mixed blessing I would add, was more complacent, given that capital was coming into government securities every time the DM was under upward pressure and thanks to the build up of foreign exchanges reserves.

Only 15-20 years later a number of EMCs have caught up quickly.

4. Against which risks are efficient local markets expected to shield today? what are they supposed to accomplish in the future?

Is the major driver today still the insurance against "sudden stops" on the part of international capital markets, more of the early Mexican type?

Is the primary rationale still to eliminate “original sin” ?

There is no doubt that these issues are still worthy goals and should be pursued further, but there is increasingly a second objective that also transpired here at the workshop.

The development of local markets for the purpose of offering domestic businesses as well as foreign investors a better chance to tap into domestic savings rather than forcing domestic capital to make a round trip via New York or London.. To make one's financial market more efficient, along the line of European countries' experience in the 1980s and 1990s, seems to dominate increasingly the thinking of the authorities.

5. The first issue of "self-insurance" is still valid; it is all about risk management at the country level

-exchange rate related market risk is the core issue, original sin. Given that domestic interest rates for the same credit quality are usually higher than international yields, we are still talking about an insurance premium**,** is it still worth taking? In my view the answer is a yes in most cases, but not in a simple and binary fashion.

- credit risk: the issues have not changed, except that less fx risk should translate into less credit risk as well

- One of the intriguing macro questions remain: Are international investors better off being pari passu with domestic investors?

Maybe in theory, but in practice some governments might be willing to go a long way to consciously discriminate against international investors, regardless of the currency.

6. Let me therefore conclude by focusing on a few special issues that fall more into the category of efficient markets rather than insuring economies against "original sin".

- hybrid forms of debt issuance, global local bond; they are a short cut to reduce original sin by insourcing " the global financial infrastructure" including clearing and settlement systems,

Such an avenue can be an excellent solution for smaller countries, but possibly too tempting for larger countries which might neglect to develop their own domestic infrastructure.

Colombia, Brazil eg.have to be careful not to become too complacent if they used this easy route and failed to create their own domestic infrastructure

- an alternative to insourcing of a global infrastructure could be a "sharing of infrastructure" such as clearing and settlement as well as stock exchanges, at the IMF we discussed this in the context of Central America and Western Africa

7. Technical Assistance

Focus on experts and eliminate the middle men who make a living on "coordinating" supervising etc

Focus on the blue print, and not on a myriad of details where the consultants etc. will stitch together pieces which do not fit

This is especially relevant in the area of sequencing capital account liberalization.

8. Let me finally drive home one point, one that is not confined to EMCs

Institutional investors are the key to success, not only in EMCs but also in mature markets. Without domestic long term capital, by definition institutional capital, you will never have thriving local markets. Macro-economic stability is a necessary but not sufficient prerequisite:

Yes, there is a global savings pool and home bias has weakened considerably, but it will never quite disappear.

The variety and abundance of institutional investors has made New York and London such thriving financial centers, more than forany other single reason.