

## **High Level Workshop on Developing Bond Markets in Emerging Market Economies**

### **Session III: Local bond markets and capital account liberalisation**

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#### **Review of the key issues**

As we are well aware, capital account opening can have a powerful impact in stimulating growth and investment through relaxing the constraint of domestic savings and reducing the cost of capital.

Moreover, what the recent debate has called ‘collateral benefits’ of an open capital account can be equally important in stimulating the development of financial markets. However, such benefits only accrue where domestic institutional arrangements have reached a certain standard to support cross border flows in financial instruments. What lies at the heart of this is a strong and internationally connected banking system that can act as an intermediary of capital flows in deposit, loan, securities and derivative instruments. Only then will an economy be able to cope with the inevitable cyclicity of investor sentiment. Clearly across the region and in particular Russia and the CIS, a lot still remain to be done in this regard. Although the banking system has significantly strengthened the ability for it to provide the transparency and liquidity in the various instruments still remains limited.

Domestic capital markets may sustain access to finance in times of banking system stress. Yet their development will require the presence of institutional investors that are often sparse at home, and restricted in their access from abroad. Premature capital account opening may be a bridge too far in the pursuit of capital market development. Hence, throughout the emerging markets we continue to find a wide variety of capital controls, including quantitative limits, price-based distortions or minimum holding periods. Administrative barriers regarding access to local banking and settlement services present additional obstacles. This has discouraged and prevented investors from entering such markets through transparent and liquid financial instruments.

At the same time the global capital markets across all risk categories from FX, rates, credit and equity, continue to integrate and dominate capital allocation and flows. This has exacerbated the isolation of those markets that are by nature of their size, stage of economic development and credit rating restricted by capital accounts.

Let me shed some light on this conundrum from the transition economies.

#### **Prospects for bond markets in the transition region**

The EBRD works predominantly within the private sector in 29 countries across Eastern Europe and the former Soviet Union. Among these countries there is a wide range of prospects for bond market development. Obviously the role of the EBRD as a direct lender is greatest in the sub-investment grade countries with limited access to local and international financing and can therefore play a key role in the development of domestic capital markets.

- There is of course the unique pull of monetary and capital market integration within the EU, and from the EU vis-à-vis the candidates and would-be candidates in south Eastern Europe. Some of our countries of operation are already within EMU (Slovenia), or likely to enter very soon (Slovak Republic) and have effectively become part of the integrated European bond market. Although there are strong international financial institutions present in these countries, there is no need for a domestic capital market as such. What is important is the establishment of a reliable domestic institutional investor base. At the same time the EU single market legislation has provided an effective framework under which domestic market participants, both investors and issuers can utilise the broader international markets.
- Several other EU accession states that ultimately intend to accede to EMU at their current exchange rate parities are seeing the date for € adoption continually recede. In the meantime, euro substitution in the financial system by banks, corporates and consumers has significantly increased and with it un-hedged currency exposures. Similar trends can be observed in countries in the Balkans. This substitution has resulted in most financial market participants using the € bond markets and we have consequently seen very little development in the domestic bond markets across the EU accession states. The overwhelming presence of international banks in these countries has further contributed to this trend, due to their focus on € and \$ lending. These substitution risks coupled with strong credit growth and resulting current account deficits have been identified potential sources of financial instability.
- We view the CIS countries as a group of separate, yet interdependent monetary systems, with every need to build domestic capital markets as foreign currency substitution in these countries is highly risky in the medium term. These efforts are progressing in Russia and Kazakhstan, promising in Ukraine, and in their infancy in the smaller economies. There is potential for a certain degree of regional integration of bond markets through common legal and settlement infrastructure, but these countries still face a large agenda in domestic capital market reform, especially as the evolution of these markets will be very different from those in Western Europe. With the introduction of an effective legal and financial market infrastructure, new financial instruments such as securitisation, loan trading and credit derivatives will in many cases develop ahead of traditional corporate bond markets.

### **Implications of capital account opening in our region**

The transition region has of course gone through a period of extremely rapid financial liberalisation. This is true not just for foreign direct investment which is traditionally encouraged, but also for bank lending and portfolio debt. Last year, Russia and Kazakhstan alone accounted for USD 38 billion of the total USD 88 billion of foreign currency bonds issued by the EMEA group of countries (this includes Turkey). Interestingly, in the same year private institutions in these two countries also issued USD 27 billion in local currencies, rivalling what was issued in foreign markets.

Yet, many restrictions on capital account transactions remain in place. It seems that even within these constraints a significant amount of bond market financing can be achieved. In reality, however, domestic markets are still dominated by domestic bank investors whilst the international institutional investors play a major role in the issuance in the international markets and increasingly in the domestic markets

## **The EBRD's work in capital market development:**

The work the EBRD does in several countries across the region, illustrates the role the bank plays in local capital market development.

**Russia** took a major step forward last summer with the abolition of the remaining capital controls – essentially unremunerated reserve requirements on non-resident holdings. This was the culmination of a longer process, rather than an abrupt shock to Russia's financial markets, though significant nevertheless. An active off-shore market has emerged, as the ICSD's Euroclear and Clearstream can now settle bonds in Rouble. This now enables the EBRD to fund itself in the Rouble market from resident as well as non-resident investors although there is still no link between the domestic settlement system (National Depository Center) and the ICSD's cross border flow in Rouble bonds is still not possible.

But it is important to remember that the growth of Russia's private bond market preceded this step. Capitalisation on MICEX, one of the two principal exchanges, more than doubled in each 2005 and 2006. Indirect participation by foreign investors (participating through subsidiaries and custodians) in the private bond markets has risen, to an estimated 15-25 per cent last year. This is still small, but even Hungary, as the most open local currency sovereign bond market in our region, only has 27 per cent non-resident participation.

Beginning in 2005, the EBRD supported the development of the Russian bond markets through the issuance of rouble denominated floating rate notes. On the back of these FRN's, a new benchmark money market interest rate developed, Mosprime, which has by now established itself as a transparent, credible and accurate money market benchmark. This has been a critically important factor and we now see Mosprime increasingly used in the pricing of loan, mortgage and derivative products, especially interest rate swaps. This experience underlines our strong belief that the development of bond markets – private or sovereign – should be preceded by the development of efficient money markets and derivative instruments. The Rouble bond market development will always be held back without efficient funding and hedging instruments. Although we have seen the increasing use of Rouble swaps, due to uncertain domestic legislation, the actual derivative market has increasingly moved offshore in spite of the currency liberalisation.

**Ukraine** still has a large number of capital controls in place; and given the political and macroeconomic risks, the evolving exchange rate regime and the ongoing reform of the banking sector, this seems prudent. Yet, our efforts to follow similar steps as those we have made in Russia flounder on more fundamental obstacles. The EBRD is still unable to borrow and lend in Hryvnia which contributes to the ongoing IFI practice of only providing hard currency funding and risks to local projects. Given the limited funding needs of the government, the EBRD should also be able to borrow and issue in our own name and lend in local currency. This is a country in which relatively young institutions and recurring confidence crises have entrenched a high and persistent substitution of foreign currency in the financial system. With the increasing role of foreign owned banks in Ukraine the country needs to urgently embrace reforms in its domestic market.

Establishing efficient local currency money, derivative and bond markets should be a key element of strengthening financial stability and the institutional and legal frameworks that have been introduced in the accession states and increasingly in Russia could be easily adopted.

**Romania** had to abolish the remaining capital controls as part of adopting the EU body of regulations. The very strong liquidity inflows and the attendant overheating problems are certainly one symptom of this, though of course EU membership brings with it a number of other advantages. Over half of private sector credit is in foreign currency, and in an economy with persistent external imbalances this is clearly a source of potential financial instability. Romania needs to reap the benefits of its EU membership, adopt the EU financial market regulatory framework and accept the efficiency of the EU financial market infrastructure. Unlike Russia and Ukraine, Romania needs to institutionalise the use of Lei instruments within the context of an efficient EU wide capital market and remove all barriers and inefficiencies that still exist.

In the money market, the building block of the credit, derivative and bond markets – a lei money market interest rate similar to Euribor – already exists: the Bubor. Yet, to date the banking system has been unable to establish this rate as a transparent money market benchmark; too many banks of differing credit quality are participating in the rate setting process at far too wide bid-offer spreads. This is in spite of the top 8 banks in the country being owned by strong international banks. At the same time the government is still attempting to create a bond market that does not utilise the efficiency and liquidity of the EU wide market. Clearing and settlement is not yet connected with the ICSD's, and local listing requirements, and market practices are costly and cumbersome in comparison with the international markets.

Finally, we are looking at opportunities to fund in local currency in some **early transition countries**. In these countries the banking sector is too small and the foreign banking presence very limited and this consequently constrains our ability to establish similar money market instruments as those in the more advanced transition countries such as Russia and Kazakhstan. It is nevertheless equally important that we support the development of local currency lending and money markets. We are therefore exploring the possibility of raising local currency, through transactions with the governments, and expect that this should stimulate a more effective local currency money market. The development of local bond markets is more distant and will require the formation of a liquid money market and corresponding market infrastructure. Demand for local currency funding and the pervasive currency mismatches in these economies certainly would warrant such developments.

I think as these cases make amply clear, capital account liberalisation is neither a sufficient nor a necessary condition for the development of private bond markets. Compare the early successes in Russia to the slow growth to date in Romania.

## **Conclusions and recommendations for future work**

In conclusion, capital market development efforts will obviously need to cohere with broader macroeconomic policy objectives, and specifically the pace and sequencing of capital market opening that is deemed prudent given the state of the banking system and exchange regime that the country has adopted. However, our experience has demonstrated that within these constraints a lot can be accomplished. Specifically:

- Well established and tested financial instruments, trading and settlement infrastructure, market regulations and practices apply to both the economies with open and restricted capital accounts. Although a lot depends on the size and diversity of the economy and strength of the banking system, countries should nevertheless seek to adopt where possible best practices that prevail in the international markets.
- Even with limited involvement by foreign investors in a country with capital account restrictions a lot can be done to stimulate domestic institutional investors, such as the state pension fund or insurance sectors. There is little risk to allowing the state pension fund to invest in highly rated domestic currency assets such as those issued by IFIs and strongly rated domestic and international banks.
- There is still an important agenda for sovereign debt management which in many of our countries can play a strategic role in supporting private bond market development. Establishing a liquid yield curve may not always be optimal for fiscal or liability management reasons, though generally fiscal positions are secure enough that market development objectives should be given a higher priority.
- Finally, let me again emphasize the key and central role of money and derivative markets. Time and again we have learned that efforts to build liquid bond markets and effective derivative instruments start with the creation of a transparent and reliable money market. As derivative markets increasingly becoming more important in interest rate and credit risk transfer, it is key that we see the development of domestic money and derivative markets to enable an efficiently functioning cash bond market. Given the growth, internationalisation and strengthening of the banking sectors across eastern Europe over recent years it important that we direct our efforts to these very basic building blocks of the financial markets.