REINVENTING BRETTON WOODS COMMITTEE

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Global Finance in Transition: Importance of Local Bond Markets

Foreword

Emerging Local Bond Markets have come to the forefront of global finance in recent years. The development of local bond markets has mirrored the phenomenal rise of emerging economies. Secular trend towards globalization of trade, services, and increase in direct and indirect investments has provided a strong engine for emerging market growth and financing development. The emerging market "asset class" has evolved from being a source of vulnerability to the global financial system to being a pillar of strength. After experiencing periods of macro-economic crises, political instability and volatility, many emerging economies have substantially reformed their economies and laid the foundations for long term growth and prosperity. The development of local bond markets is an integral part of this process as we witnessed at the conference "Global Finance in Transition" held on May 7th-8th in Istanbul alongwith our host The Central Bank of Turkey.

We see that macroeconomic stabilization, economic reforms and robust export performance have enabled emerging market economies (EMEs) to move from a vicious cycle of booms and busts to a virtuous cycle of growth and stability. This trend will continue over the course of this century as EMEs steadily increase their share of global trade, capital flows, reserves, and output as can be attested by the steady improvement in their macroeconomic ratings.

Over the past two decades, the emerging universe has moved from being net debtors to net creditors after having improved their balance sheets with sounder fiscal management. Emerging economies currently have debt burdens at 35% of GDP, while advanced economies (AMEs) have ratios approaching unsustainable levels. With emerging local markets still yielding significantly higher returns than developed markets, the risk-return profile has shifted in favour of the emerging economies.

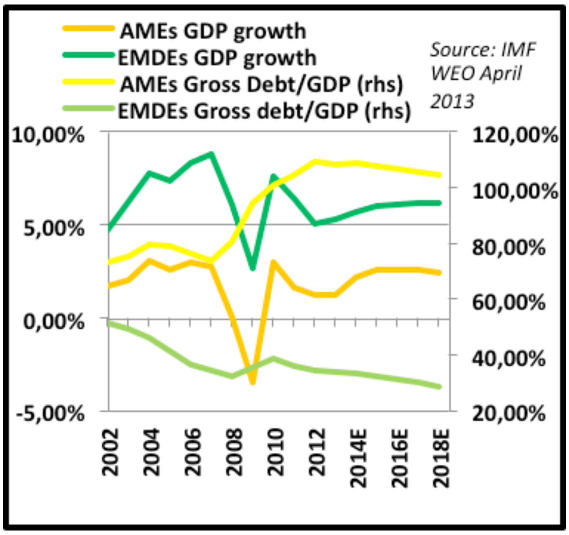
Financial sector liberalization and banking reform has led to the gradually opening and deepening of domestic bond markets. Along with the decline in sovereign risk, many Emerging Treasuries have turned to local market financing to fund deficits and development projects. As many emerging economies, boosted by massive reserve accumulation have become less foreign currency constrained, the focus of bond market development has shifted more towards local markets, debt management and yield curve management. This is in turn has not only led to the development and deepening sovereign local debt markets, it has also enabled emerging corporates to price risky in a more efficient manner.

Despite these developments, many challenges lie ahead. Emerging economies are still vulnerable to sudden liquidity reversals. Over-reliance on short term foreign investors could be dangerous. The global economy is currently moving at different speeds, with advanced economies struggling and emerging markets booming. Large scale inflows into local debt may add to already bloated foreign reserves and may impact on currency competitiveness and reserve management. There are numerous global imbalances and further local debt market deepening may require a change in global reserve currency arrangements and better settlement and clearing infrastructure.

BACKGROUND

Emerging economies account for over 80% of the world's population, 50% of output, 70% of land and 90% of all proven oil and gas reserves. But with only 10% share of global debt, emerging market debt is rapidly changing its label from being classed a "risky" asset class to a "safe haven" status as the capacity to service debt has clearly improved along with economic fundamentals.

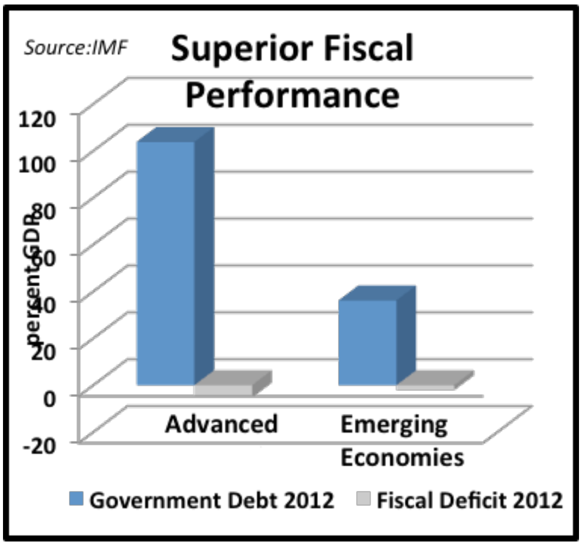
These favourable developments have been a key factor in the development and growing maturity of Emerging Market (EM) Fixed Income markets in recent years. Historically, EMEs were foreign currency constrained, and the main purpose of issuing Euro dollar bonds was to finance this external financing gap. However, as the export and external position of many EMEs improved, this foreign financing constraint became less binding. As foreign currency reserve accumulation by EMEs exploded with lower inflation, macroeconomic ratings improved. Yields paid by EMEs (in local and foreign currency) began to decline substantially.



Many EMEs thus began to shift their sources of funding from external sources to local markets. This also coincided with the increased risk preference of investors for emerging local market risk, in order to take advantage of higher local market yields and potential currency appreciation.

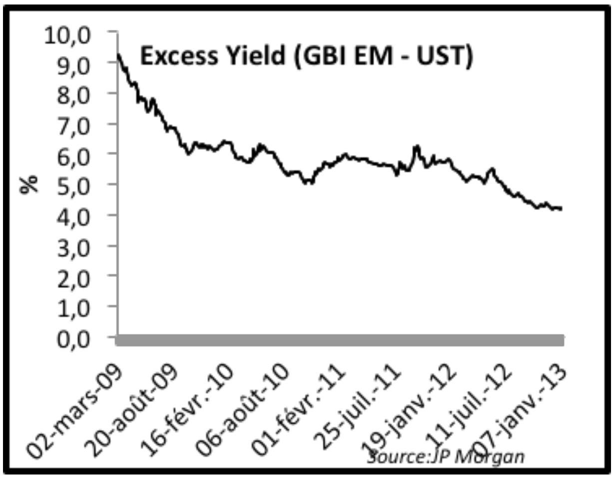
The expansion of sovereign local bond markets have therefore enabled governments to build local yield curves, conduct monetary policy more effectively, enhance liquidity and reduced inter-market spreads.

Local corporates have also benefited from this financial deepening, by better able to price risk and raise funds. While hard currency bonds and syndicated finance remain important sources of funding, local bond markets have become the key mechanism for raising capital. The opening-up of local bond markets have thus completely changed the landscape of emerging market and global financing.

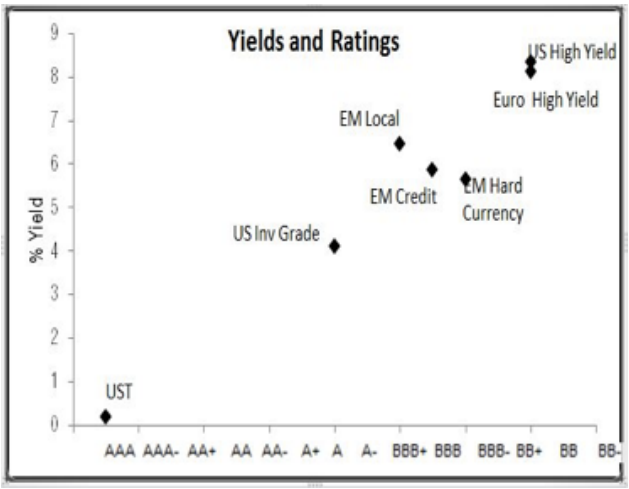


GROWTH OF EMERGING FIXED INCOME MARKETS

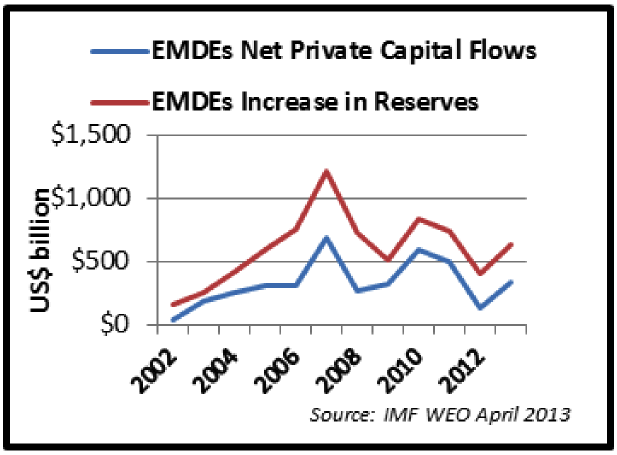
Since 2003 has seen a period of historically low interest rates and high liquidity in AMEs and record size for EME debt markets; local currency sovereign bonds have thus quadrupled in total amount outstanding. The growing popularity of local currency bond markets (LCBM) with global investors is clear, with risk premia diminishing significantly regardless of the on-going global financial crisis. Despite significant spread compression, LCBM still offer the most attractive yields in EM fixed income, with higher ratings-adjusted returns.

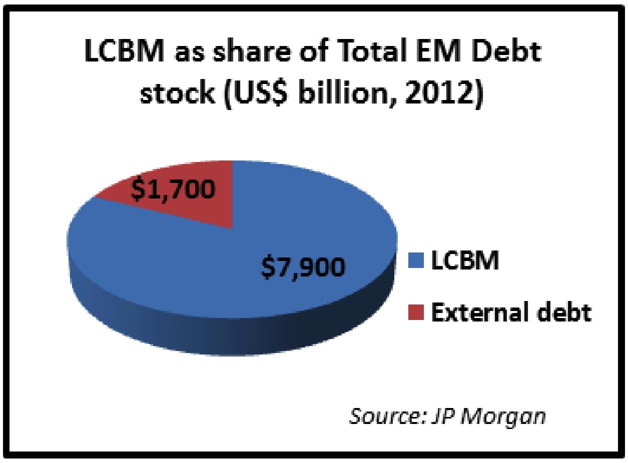


Since 2002, and notably with China's accession to the WTO the previous year, the increasing role of global trade as a share of global GDP exacerbated current account imbalances globally to the benefit of more export-driven economies, particularly those with higher savings rates. However, the ensuing explosion in EMEs' currency reserves, ostensibly denominated in US dollars and invested in US Treasuries, have provided government authorities and officials with tough new challenges for reserve management, including by way of sovereign wealth funds for some, in the post-2008-financial-crisis world.



Sterilized FX interventions by EME central banks, in light of unconventional measures taken by their major AME counterparts such as quantitative easing, while doing little to improve diversification of mounting currency reserve assets, contributed significantly to the growth and depth of LCBM as central governments consequently increased net domestic issuance.

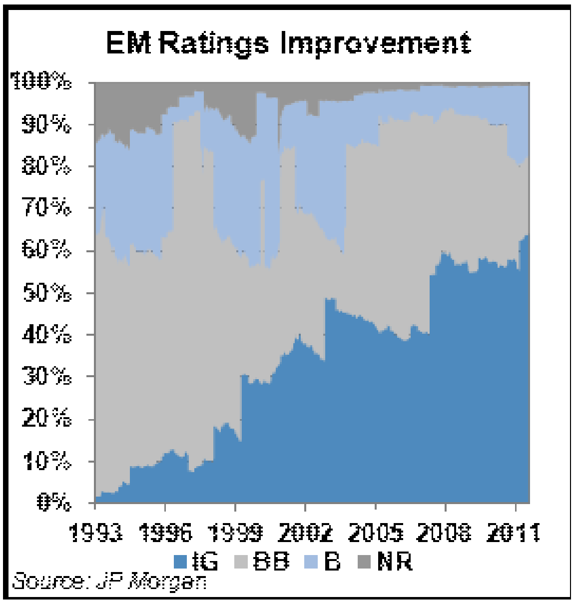


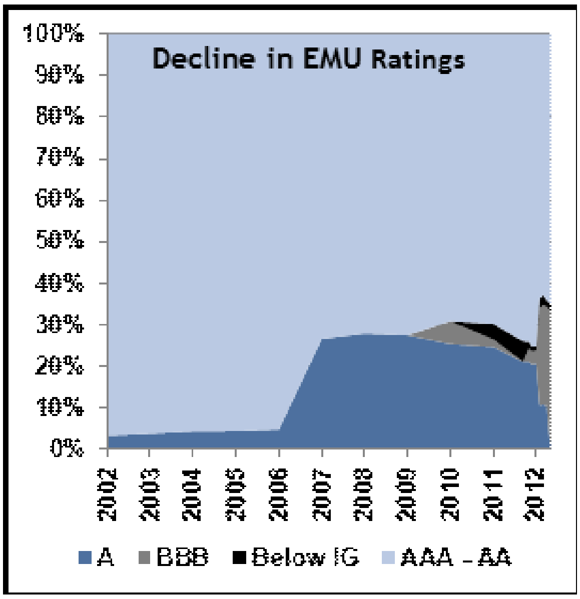


LCBM (both sovereign and corporate) have become an increasingly relevant alternative asset class, with total amount outstanding of US$ 9.6 trillion, comprising full 82% of total outstanding EM debt stock in 2012, up from US$ 1.2 billion and nearly 60% share of the total in 2001.

Although this significant upsurge partially reflects the weaker US dollar and lower US interest rates, yields, and volatility over the period, it also undeniably attests to substantial positive developments in macro balance sheets, political, legal, regulatory, and institutional frameworks, and sounder policy making in general across EME.

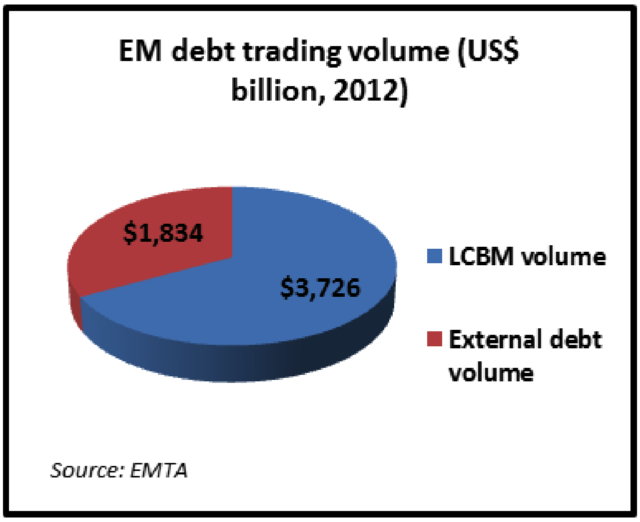
Another key indication of these positive developments is the extensive improvement in EM credit ratings, with the share of investment grade debt almost doubling in the past 10 years to over 65%.



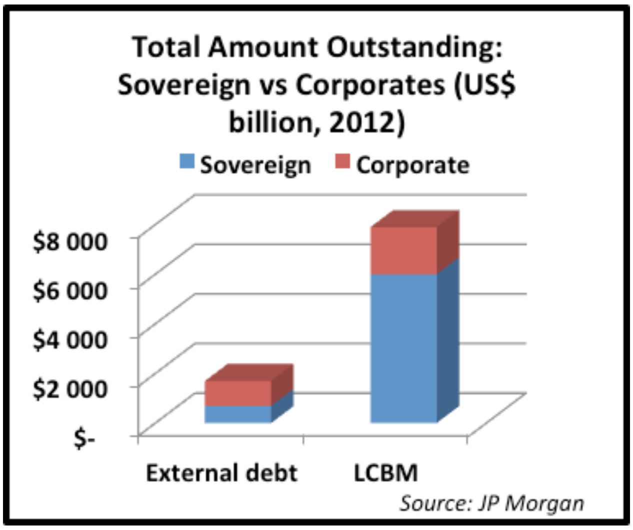


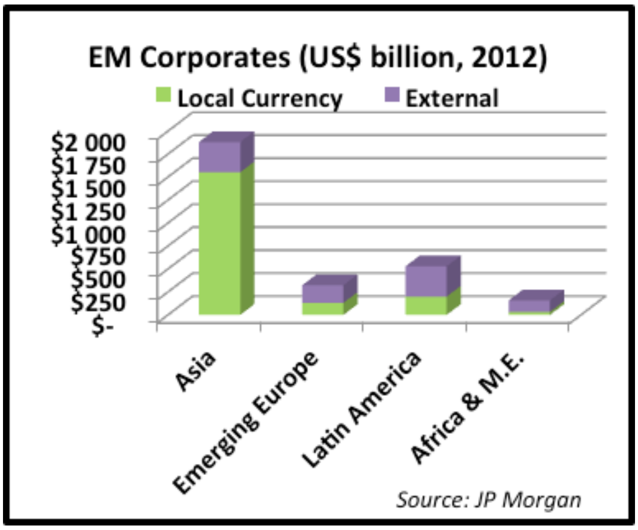
These fundamental improvements enabled EMEs to implement a number of counter-cyclical measures, financed in their own domestic currencies, in the wake of the recent crises in the US and Eurozone, helping to reduce macroeconomic volatility and refinancing risks.

Issuance in local currency debt has accordingly grown substantially, and at a gross estimate of US$ 2.1 trillion in 2012 dwarfed external debt issuance of US$ 71 billion. LCBM also currently accounts for the lion's share of trading activity in emerging market debt, with an estimated turnover of over US$ 3.7 trillion in 2012 according to EMTA, or 67% of aggregate trading volumes, more than twice the amount of foreign-currency debt.

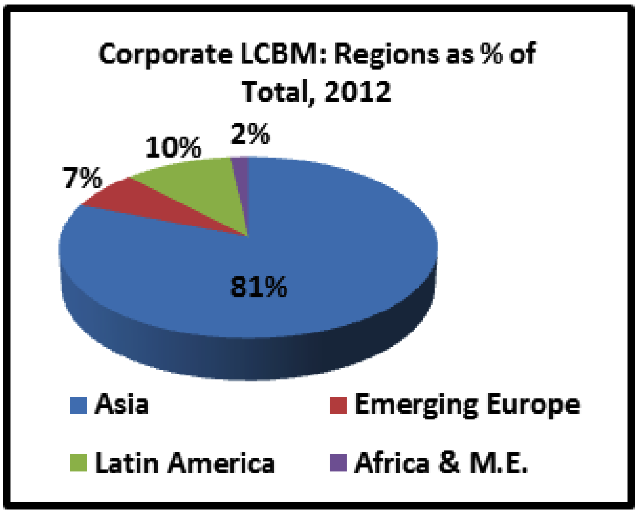


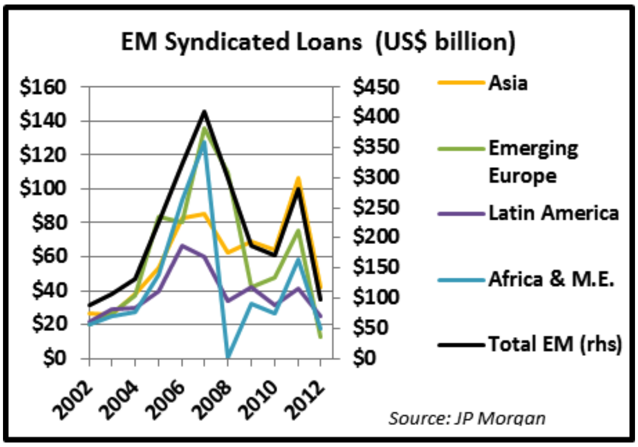
In terms of issuing entities, central governments still largely dominate the EM debt universe and LCBM in particular. Despite very strong growth over the past decade in the major EMEs, corporates still only amount to a fairly modest share of LCBM, with the notable exception of developing Asia. In Asia, China and India, whose bond markets are closed to foreign direct investment constitute a large proportion of local bonds outstanding.





Corporates, with a total amount outstanding in foreign and local currencies of nearly US$ 2.9 trillion, now represent the majority of the external debt stock with a 59% share of the total. While corporate LCBM have overtaken the international EM corporate bond market in size, they still only account for 24% of the total LCBM. The local corporate landscape, comprising a total US$ 1.9 trillion, is still largely dominated by developing Asia, where issuance has exploded since the advent of the Chinese Offshore Yuan (CNH) in 2007 and the related bond market in Hong Kong, colloquially referred to as dim sum.

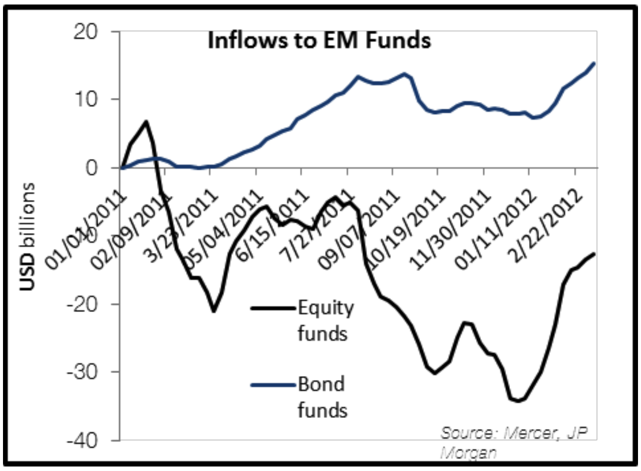




The lower exchange rate volatility and growing internationalization of the renminbi add to the dim sum bond market's appeal and popularity. Developing Asia now accounts for a full 81% of the total corporate LCBM stock, compared to a 34% share in the foreign-currency corporates market. Meanwhile in other EM regions, and despite the growth of LCBM generally, external debt still accounts for an overwhelming majority of corporate bonds outstanding.

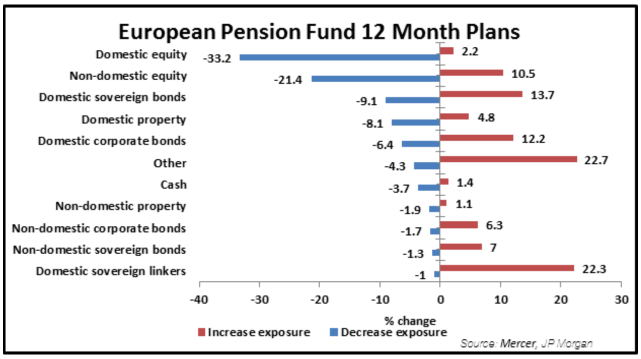
Since the onset of the global financial crisis, and following continued deleveraging by Eurozone banks, activity in the EM syndicated loan market has plummeted, providing further impetus for corporates to issue bonds. Given the current and ongoing challenges faced by major AME-based banks, not least with new regulations such as Basel III and Dodd-Frank encouraging lower leverage, this disintermediation may continue going forward as EME-corporates find more attractive financing conditions in the growing bond market than in the more traditional syndicated loan market.

Overall, as LCBM have developed and gained depth and liquidity in the past few years, so has the eligibility of domestic issues to major institutional benchmarks, such as JP Morgan's GBI-EM for sovereigns and CEMBI Broad for corporates, which are widely followed by international investors.

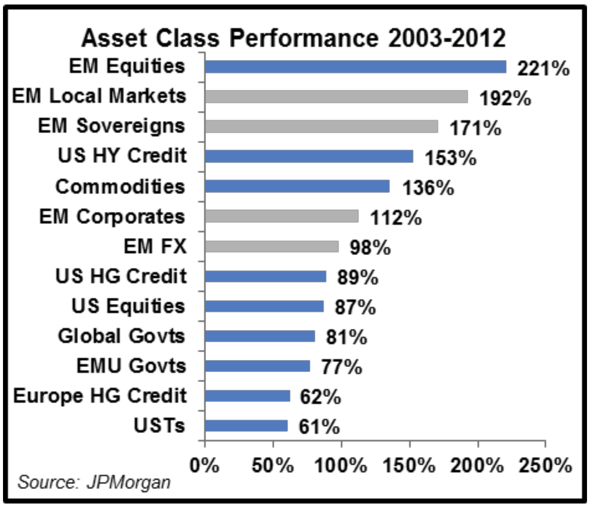


Sound and improving fundamentals of EMEs, as attested by the 182 credit rating upgrades on EME sovereign debt since the onset of the global crisis, compared to downgrades across AMEs, in all likelihood contributed significantly to the rapid growth of inflows into EM bond funds in recent years. This rating convergence is in stark contrast with the past and poses a major structural shift towards higher global asset allocation into EM fixed income and LCBM by extension, particularly given the added potential for future local currency appreciation, including by longer-term institutional investors such as AME-based pension funds.

A distinguishing characteristic of current inflows has been the entry of more long term investors into the asset class. This can be seen by the increased allocations of pension funds and insurance companies in Europe and North America. While the increase has been steady, absolute levels of allocation to emerging local bond markets are still small (>5 %), and well below global bond market shares, hence there is potential for more inflows.



From a global investor's perspective, local-currency bonds are attractive as they have traditionally provided superior risk-adjusted returns to their AME counterparts, notably during 2003-2012, while providing the additional benefit of diversification.



LCBM's strong performance over the last two years, despite tough exogenous challenges such as the US fiscal crisis and ongoing turmoil in the Eurozone, is at least as much an indication of positive EME fundamentals and domestic bond markets' development and maturity as it is a reflection of exceptionally low yields in AMEs; the former provide structural, longer-term tailwinds, whereas the latter may be cyclical in nature, and could provide potential headwinds in the event of "the Fed exit", for instance, causing excessive exchange rate volatility.

The rapid development and growing popularity of LCBM may be partially attributed to the currently positive repercussions for all parties involved, with broad, mutual satisfaction of both supply and demand: domestic issuers enjoy lower financing costs while reducing potential maturity and currency mismatches, and foreign investors earn higher risk-adjusted returns while increasing portfolio diversification. Furthermore, LCBM growth helps improve the monetary transmission mechanism, reducing risk premia and lending spreads, and increase the effectiveness and accountability of local policymaking, as domestic factors appear to be a major component of LCBM performance (Miyajima, Mohanty, and Chan (2012))[1].

For EMEs with lower savings rates and/or current account deficits, and higher financing needs for longer term investments, such as infrastructure spending, LCBM may provide an attractive channel for increased participation of foreign savings, which is consistent with lower domestic yields, towards growth in gross fixed capital formation.

Nevertheless, and despite the rise of LCBM as an alternative asset class, EME policymakers are confronted with a number of challenges in order to ensure favorable, sustainable growth for the market, while limiting local vulnerability to future exogenous shocks.

As LCBM develop and gain depth and breadth, along with longer-term, "real money" investors, "fast money" will also increase activity in the segment. Hedge funds can provide a deep source of liquidity, but have also been ascribed to exacerbate volatility during periods of market turbulence. The development of derivatives markets, allowing investors to hedge interest-rate and currency risks, can be an important contributing factor to volatility.

Furthermore, increased liquidity and easier conditions may lead to higher systemic risk and potential local credit bubbles; hence, as international integration continues, sound market infrastructure will be required, with efficient clearings and settlements systems and appropriate risk monitoring and management tools.

IMPORTANCE FOR LONG TERM FINANCING

While making long term financing and investment a key driver of growth involves many factors, local bond markets have been identified as a major conduit to realise these objectives. Development of local bond markets would not only open up financing for longer term projects such as infrastructure development and capital investment, it would channel the savings and investment needs of economies through the introduction of new of set of institutional investors through currency diversification. Indeed the development and deepening of local bond markets would help alleviate the problem of certain "missing markets," broadening financing intermediation, investment and growth, according to the Bundesbank[1].

While countries with open capital accounts would tend to attract more inflows, there are benefits for countries which are undertaking capital account liberalisation. Local bond markets can facilitate this liberalization process by changing the financing structure of the capital account.

Domestic bond markets enable EMs to reduce the dependency on short-term foreign debt – and issue securities in domestic currency with longer maturity. That means local currency bond markets are an effective instrument to mitigate or reduce currency and maturity mismatches – mismatches which can make countries extremely vulnerable to interest and exchange rate volatility. In other words, domestic bond markets not only attract funds for long term investment, such as for infrastructure, but they also reduce maturity and currency mismatches.

1.*Miyajima, Mohanty, and Chan, Emerging market local currency bonds: diversification and stability, BIS Working Paper No. 391, 2012*

2.Bernd Braasch, Financial Stability Department, Deutsche Bundesbank, 2012