

Long Term Finance Highlights

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Local Bond Market Development and Missing Markets

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Reducing global real imbalances and a reform of the international financial system are still top of the international political agenda. But while a co-ordinated approach and a more market-led exchange rate system are often publicly discussed, the problem of “missing financial markets” is less prominent.

The development of local currency bond markets in emerging markets got the highest political support in 2007, when Germany had the G7/G8 Presidency, and again in 2011 in Cannes under the French G20 Presidency. More developed domestic bond markets enhance national and global financial stability. Therefore, it is not surprising that this is a topic which generates an exceptional high international consensus and interest even beyond the G20 – and yet is widely unperceived by the international media.

Developing domestic bond markets can help alleviate the problem of “missing markets” in emerging market economies, which is a cause of real global imbalances. As the Bank of England rightly underlined, “missing markets act primarily to push capital uphill from EMs to advanced economies by incentivising reserve accumulation as a form of (self) insurance.” Moreover, underdeveloped national financial markets increase the risk of herding behaviour. Therefore, deeper local currency bond markets will help to reduce or avoid external imbalances.

More diversified domestic financial systems strengthen the ability of countries to absorb an increasing volatility of international capital flows and therefore dampen the need or incentive to reintroduce capital controls. Increasing capital flows to emerging markets not primarily reflect an accommodative stance of monetary policy in advanced economies. This is not a short-term and cyclical crisis-related phenomenon, but more a structural and long-term problem which needs a structural and long-term response.

Global institutional investors are playing a story of the “new normal”, the expectation of increasing weight in EMs over the next few decades. This process is accompanied by deeper integration of the EMs into the world economy. According to estimates of William Speller, Gregory Thwaites and Michelle Wright, by 2050, more than 40 per cent of all external assets will be held by the BRICs, up from 10 per cent now.

But even for countries which are undertaking capital account liberalisation, developed local currency bond markets are a very important strategic option to facilitate the process.

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.

Long Term Finance Highlights

These proved a key driver of the financial crisis in the real economy during the Asian crisis in the late 1990s. It is fair to say that more diversified financial systems and more effective regulation helped EMs have a fast economic recovery after the first wave of the current financial crisis, and this helped significantly to stabilise the world economy.

In other words, developed domestic bond markets have helped to contain contagion and spillover effects. The current financial crisis was the first serious test for the efficiency and stability of local currency bond markets and they fared quite well. The outstanding volume of domestic debt in EMs has reached around \$9.5tn, more than four times as high than at end of 2002. This dynamic trend has not been significantly impaired by the crisis. But beyond the aggregate level there is what we might call a "triple concentration": Asian EMs clearly dominate these markets with a share of about two-thirds. On the securities side, government securities dominate with two-thirds, while corporate securities amounts to about an eighth and on country level only five countries issued three-quarters of all outstanding domestic debt securities. Despite this dynamic development, there is a significant potential for further development: while outstanding domestic securities in advanced economies amount to around 140 per cent of GDP, this comparable weight for EMs is 40 per cent. The pre-crisis ratio provides a more reliable indication than crisis-induced figures.

Given all this, perhaps the issue of developing local currency bond markets will be discussed in forums beyond the G20 International Monetary Systems Working Group (chaired by Germany and Mexico in 2011). The Bundesbank has significantly supported this initiative inter alia with international workshops in close cooperation with The World Bank Group, the IMF and the German Federal Ministry of Finance. This initiative deserves further political support.

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