

„LONG-TERM FINANCE, LOCAL CURRENCY BOND MARKETS AND GLOBAL CAPITAL FLOWS“

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The views expressed are those of the author and shouldn't
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OVERVIEW

- High political support
- The problem of missing markets -> objectives of the LCBM initiative
- Current stage of development
- Interrelations between political initiatives on
- Local bond markets and long-term finance
- Future challenges

MACROECONOMIC PRE-CONDITIONS

Stability

- Macroeconomic stability is the first priority for developing local currency bond markets and for creating an investor friendly climate
- Price stability - main pre-condition to overcome „original sin“ and to reduce currency and maturity mismatches
- To develop a yield curve over the whole spectrum of maturities
- To reduce dependency on short term foreign borrowing
- Promotes issuance of longer term bonds with fixed nominal interest rates
- To reduce volatility of interest rates etc.

Credibility

- History matters, anchoring of inflation expectations
- Constrain volatility of interest rates, influence the level and volatility of the yield curve
- Enhance intermediation and marketisation of finance
- Credibility by strong laws, investor protection and efficient regulation
- Promote development of pension funds; enable pension funds to diversify investments
- Safety of investment environment
- Long-termism needs constancy in the regulatory framework to anchor expectations

MACROECONOMIC PRE-CONDITIONS

Transparency

- Empirical studies show that transparency enhance the broadening of the investor base, in particular promotes the entry of foreign investors
- Transparency with regard to macropolicy actions, transparency of market developments, issuance and market structures
- Ratings: according to empirical studies, surprisingly, around 90% of rating changes in EMEs are determined by three global factors; nor more influence of country-specific developments? Ratings: local, regional or global?
- Price and cost transparency, also with regard to payment and settlement

Openness

- Sustained deepening of local currency bond markets (LCBM) needs a solid foreign investor base
- Capital controls are significant determinant for underdeveloped LCBM
- A well balanced sequencing of capital account liberalisation and developing LCBM is a key challenge
- But more influence of global factors on interest rate and spread variance; 50% of the variance of the spreads in selected EMEs are determined by global factors
- More dependent on international investor sentiment

I. HIGH POLITICAL SUPPORT

G8 COMMUNIQUÉ HEADS OF STATE AND GOVERNMENT, HEILIGENDAMM,
MAY 2007

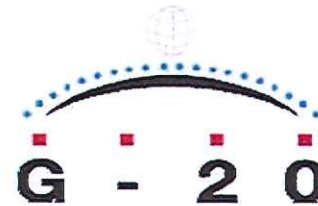
G8 Summit 2007
Heiligendamm



G8 Initiative under the German G8 presidency in
2007

18. We support the initiative of G8 Finance Ministers to foster the development of deeper, more liquid local bond markets in emerging economies. This can make an important contribution to reducing the vulnerability of individual countries to crises and to enhancing the financial stability of emerging countries as a whole.

G 20 COMMUNIQUÉ HEADS OF STATE AND GOVERNMENTS CANNES, 2011



Communiqué

G20 Leaders Summit – Cannes – 3-4 November 2011

Towards a more stable and resilient International Monetary System

8. We have made progress in reforming the international monetary system to make it more representative, stable and resilient. We have agreed on actions and principles that will help reap the benefits from financial integration and increase the resilience against volatile capital flows. This includes coherent conclusions to guide us in the management of capital flows, common principles for cooperation between the IMF and Regional Financial Arrangements, and an action plan for local currency bond markets. We agree that the SDR basket

G20 COMMUNIQUÉ MEXICO , 4-5 NOVEMBER 2012



Final Communiqué

Meeting of Finance Ministers and Central Bank Governors Mexico City,
4-5 November 2012

13. We note the World Bank and other International Organizations' (IOs) progress report on implementation of the G20 action plan to support the development of local currency bond markets. We look forward to full implementation of the action plan in 2013 to ensure a broad ownership of the diagnostic tool among potential users, and further reporting on progress by the World Bank. We welcome ongoing regional initiatives to promote local currency bond markets. We will deepen work on these issues under Russia's Presidency.

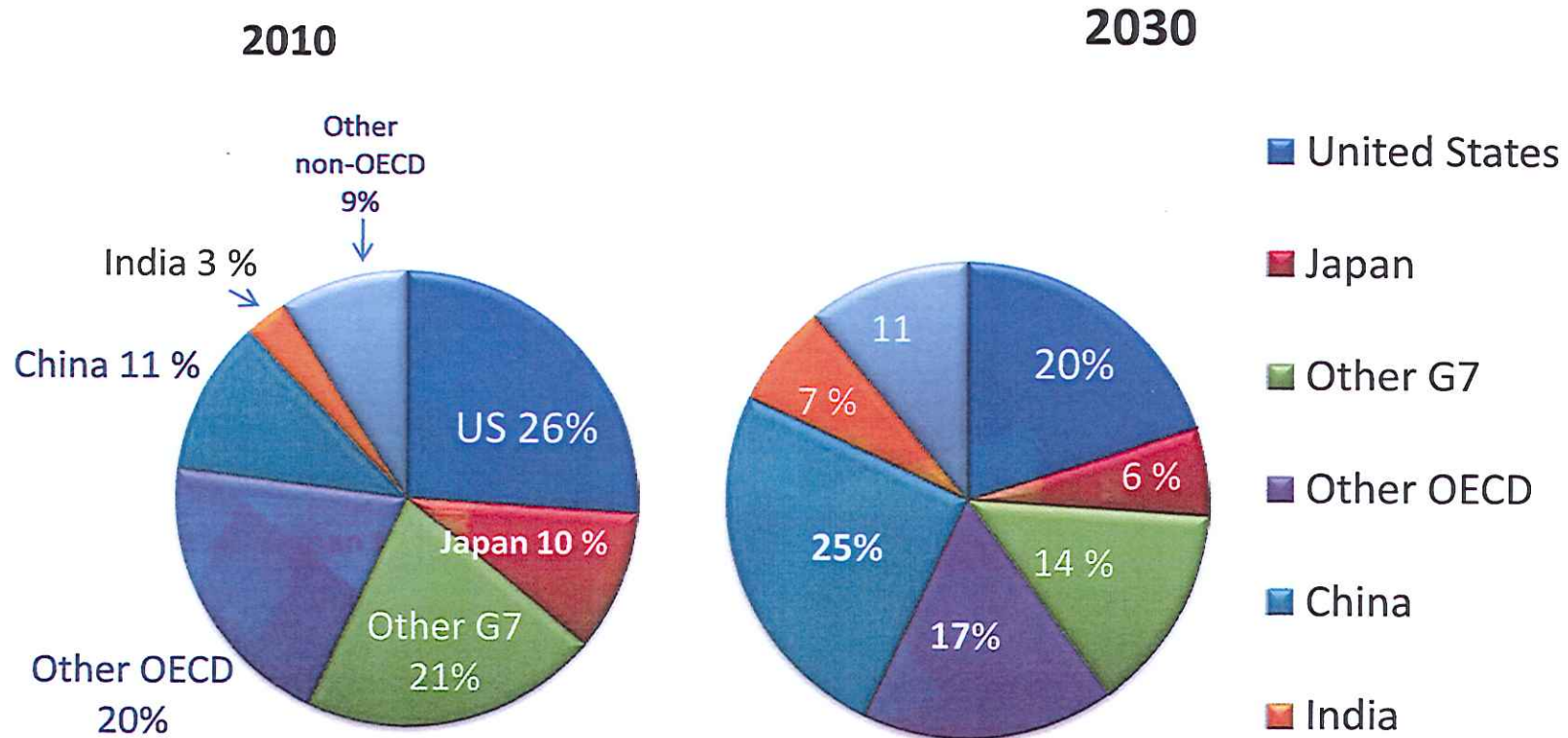
14. We acknowledge the importance of long term financing, particularly for infrastructure investment, recognizing that work on this subject will foster an environment more conducive to long-term investment, effectively helping to boost jobs and growth. We ask that the World Bank, IMF, OECD, FSB, UN and relevant IOs undertake further diagnostic work to assess factors affecting long-term investment financing including its availability. We look forward to receiving this work in early 2013 to provide a sound basis for any future G20 work.

**II. WHY SO MUCH AND SUSTAINED
POLITICAL SUPPORT? –
THE PROBLEM OF MISSING MARKETS**

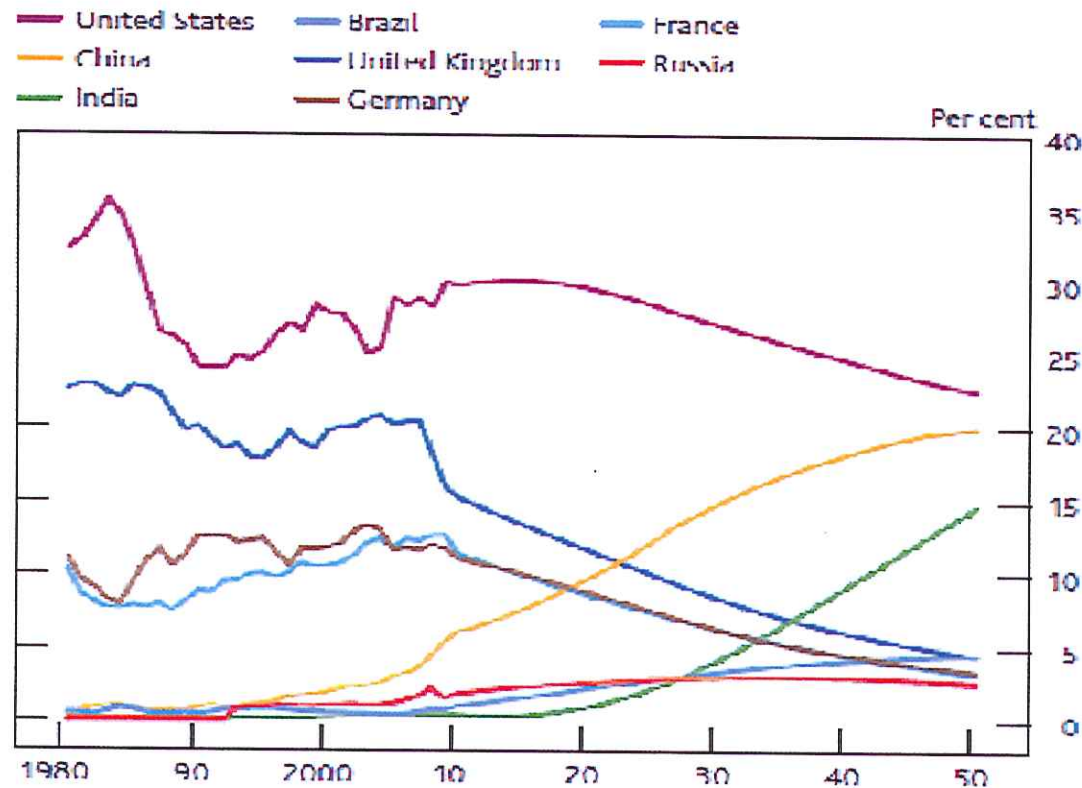
INCREASING REAL WEIGHT OF EMES BUT STILL „MISSING FINANCIAL MARKETS“

In % of World	GDP	Stock Markets	Debt Securities	Bank Assets	Capital Markets
Euro Area	19,3	10,4	26,2	28,6	23,9
United States	23,0	31,7	34,2	13,3	24,9
Japan	8,7	7,5	15,0	10,4	11,5
Emerging Markets	34,3	23,0	9,3	21,2	17,2
Africa	1,7	1,3	0,3	0,6	0,6

Nominal \$ GDP at market exchange rates



SHARE OF G20 TOTAL GROSS EXTERNAL ASSETS, BY COUNTRY



Further integration of EMEs into world economy will be further driven by high global capital flows

Sources: Updated and extended version of the External Wealth of Nations Mark II database developed by Lane and Milesi-Ferretti (2007), IMF, Penn World Table, US Census Bureau and Bank calculations.

„MISSING MARKETS“

- High and dynamically increasing weight of Emerging market economies in the world economy
- Long-term projections also signal increasing share of EMEs in the financial sphere
- But this development is anticipated or forestalled by globally acting institutional investors playing the „Story of New Normal“, therefore „blaming accommodative monetary policy is an oversimplification“
- EMEs face increasing international capital flows although financial markets are still underdeveloped in many EMEs and developing countries
- Risks for financial stability.

„MISSING MARKETS“ – WHAT ARE THE MAIN CONSEQUENCES?

- Missing financial markets weakens global (real) adjustment mechanisms
- Currency and maturity mismatches
- Developed and deep LCBM constrain „contagions“ in the financial sphere...
- ... and the strength and manifestation of spillover effects into the real economy –
 - *„This section examines whether indicators of currency mismatches can help to explain differences in economic growth following the global financial crisis of 2008-09.“ (J. Gagnon, p 8)*
 - *„The first three columns of Table 3 show that all three measures of mismatch have a strong predictive effect on economic growth after the crisis.“ (J. Gagnon, p 10)*
- Developed domestic capital markets prove a „Spare tyre“ in times of tensions on bank credit markets
- Enhance the diversification of the financial system and its ability to absorb external shocks
- Developed LCBM facilitate the liberalisation of capital accounts (Roadmap PBoC))
- LCBMs facilitate the capital flow management
- Contributes to greater stability of International Monetary System

MAIN OBJECTIVES

- While it is clear that developing local bond markets can enhance growth ...
- ... the main objective of the G8 and G20 initiative is enhancing global and national financial stability

G8 ACTION PLAN UNDER GERMAN G8 PRESIDENCY 2007



G8 Action Plan for Developing Local Bond Markets in Emerging Market Economies and Developing Countries

Seven key recommendations

- Strengthening market infrastructure and debt management
- Broadening and diversifying the investor base
- Developing derivative and swap markets
- Broadening the data base
- Promoting regional cooperation
- Developing local currency bond markets in less developed countries, in particular in Sub-Saharan African countries
- Technical Assistance

G20 ACTION PLAN UNDER FRENCH G20 PRESIDENCY 2011

G20 Action Plan to Support the Development of Local Currency Bond Markets

as endorsed by G20 Heads of State and Government

November 3-4, 2011

5. We have discussed these issues within the G20 and with relevant international financial institutions and agreed to further strengthen efforts in this area, building on existing initiatives. Besides the role of LCBMs in financing growth and development, the financial crisis also emphasized the need to do more on the financial stability side. Future activities should therefore bolster the role that LCBMs can play in improving domestic and global financial stability and strengthening the ability of economies to manage capital flows, thereby contributing to international monetary stability more generally.

Key recommendations

- Scaling up Technical Assistance,
- Diagnostic framework
- Improving the Database
- Joint Annual progress reports to the G20

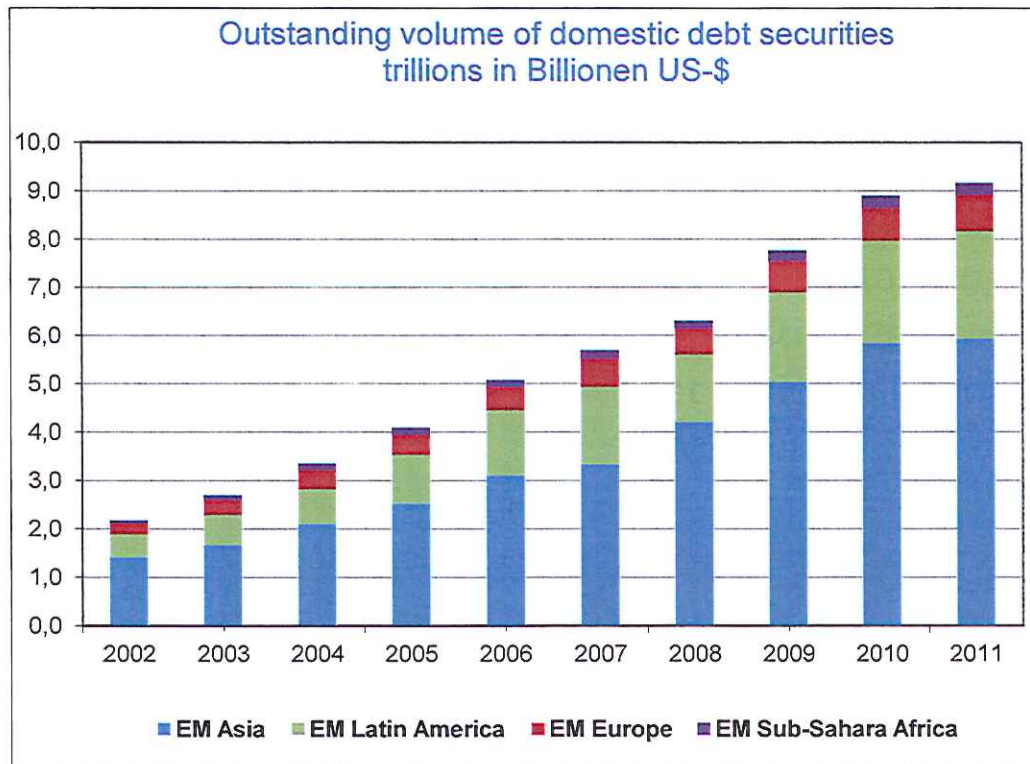
Coherent conclusions
for capital flow
management drawing
on country experiences

Russian G20 presidency

- Local currency bond markets and Long-term finance
- What will be the outcome?

III. LCBM - CURRENT STAGE OF DEVELOPMENT

DYNAMIC DEVELOPMENT - BUT WITH REMAINING WEAKNESSES



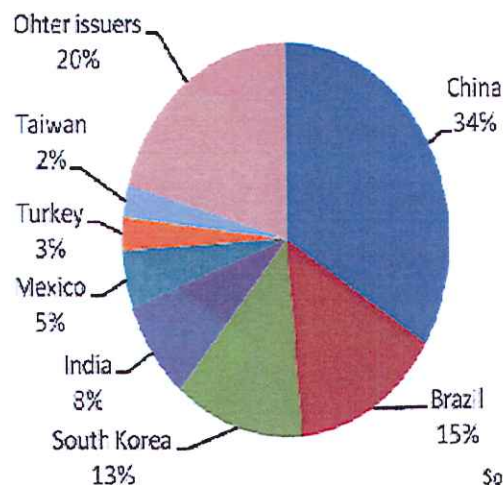
High
concentration
across EM regions:

2/3 of outstanding
domestic debt
securities fall upon
EM Asia

REMAINING WEAKNESSES

Concentration of the volume of domestic debt securities outstanding in emerging market economies

End-September 2010



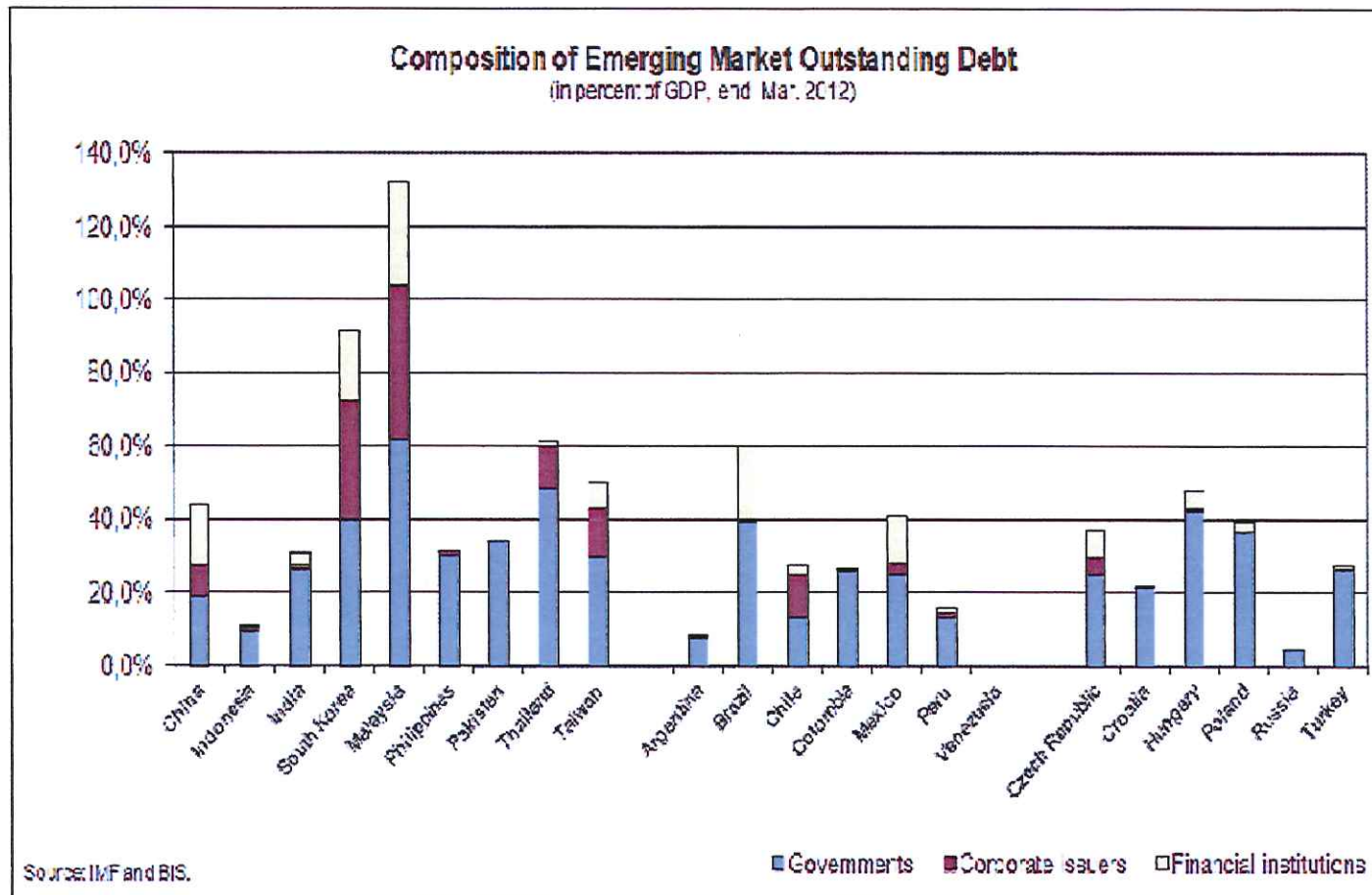
Source: BIS and own calculations.

High concentration on country level

$\frac{3}{4}$ of all outstanding domestic debt securities of EM countries fall upon only 5 countries ...

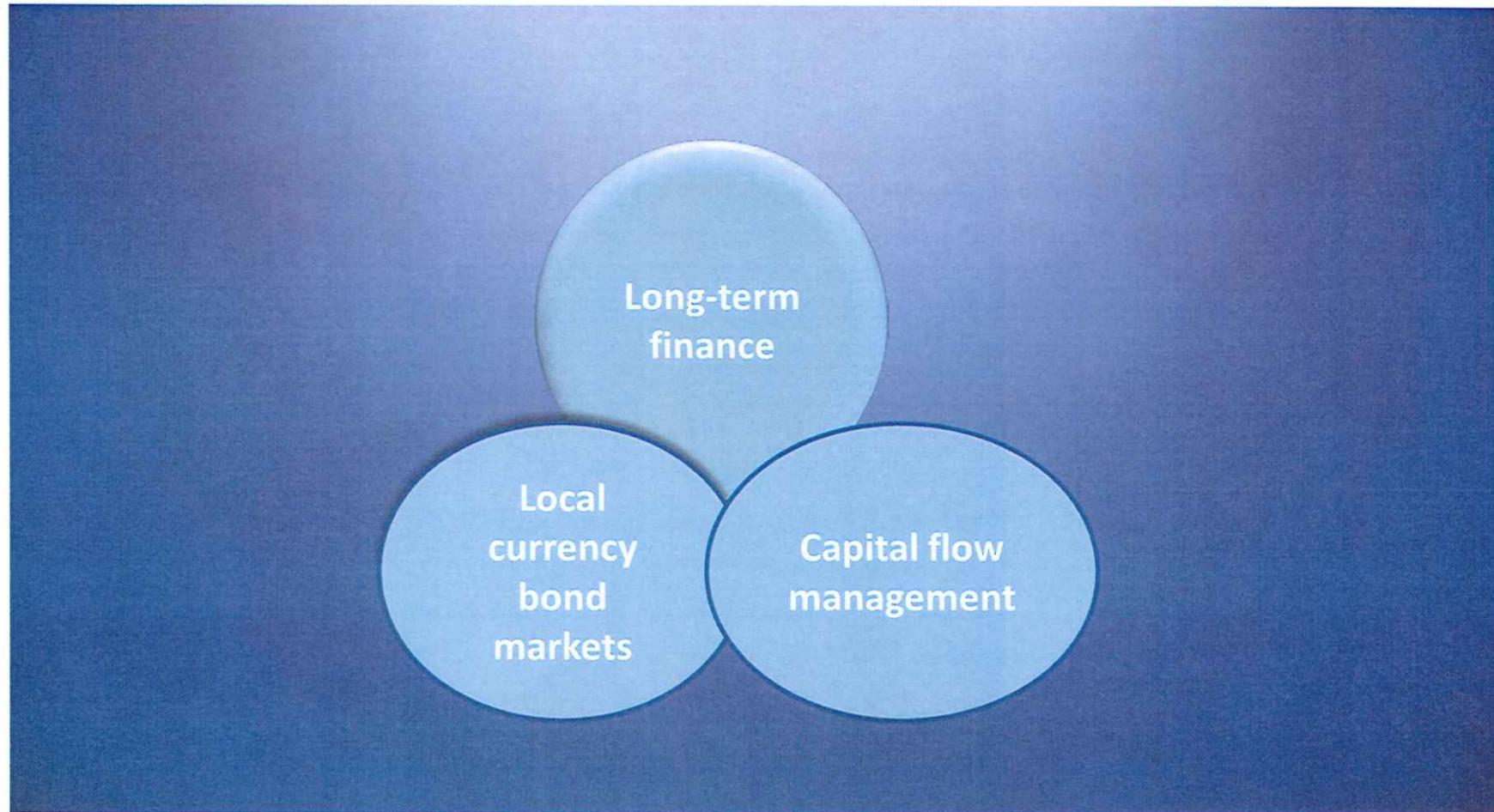
... and the development is not always driven by market forces

„Missing markets“ - in particular true for corporate markets



IV. INTERRELATIONS AND FUTURE CHALLENGES

THREE STRONG POLES FOR A NEW FINANCIAL ARCHITECTURE - WHICH DESERVES CONTINUED HIGH LEVEL POLITICAL SUPPORT



CAPITAL FLOW MANAGEMENT

- French G20 presidency – discussion in a subgroup co-chaired by Germany and Brazil
- *„Coherent conclusions for capital flow management drawing on country experiences“*
- Capital flow management
 - Coherent conclusions
 - Some kind of hierarchy of measures
 - Macrostability
 - Macroprudential approach
 - **Developing local currency bond markets**
 - Capital controls

CAPITAL FLOW MANAGEMENT

- Country specific circumstances are important
- ...but more and more common global factors relevant as determinants of capital flow volatility
- ... which are beyond the control of individual countries
- Strengthening surveillance of the IMF
- ... and in particular monitoring of international capital flows
- IMF New institutional view – based on the coherent conclusions
- OECD Code of Liberalisation
 - Open for Non-OECD countries
 - Proved rules for liberalisation of capital flows – may be a model for EMEs
 - OECD Task force for drawing lessons from the financial crisis for restructuring the code

LONG-TERM FINANCE

Main objective: mobilizing private long-term capital

Main challenges:

- Overcoming mainly three mismatches
 - Supply demand worldwide, what are the projections
 - Geographical mismatch
 - Mismatch regarding regulation – are there obstacles?
- Instruments for mobilising long-term capital
- Overlaps between the initiatives on Local bonds and Long-term finance

INTERRELATIONS

- All three initiatives reinforce each other
- All three need fulfillment of same macroeconomic pre-conditions:
 - Macro stability, in particular price stability
 - Strong regulatory framework
 - Credibility
 - Transparency
- Developing LCBM over the whole maturity – that means long-term
- LCBM – facilitate the sequencing of capital account liberalisation as well as long-term and less volatile capital flows
- Platform for innovative instruments
 - Infrastructure bonds
 - Regional bond fund solutions
- Re-adjusting existing programs for strengthening long-term finance (ESMID; ADB programs)