Andreas Dombret: Local currency bond markets and international capital flows

Introductory statement by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the third international workshop on developing local currency bond markets in emerging market economies and developing countries, co-hosted with the World Bank Group and the International Monetary Fund, Frankfurt am Main, 17–18 November 2011.

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Ladies and gentlemen

Although the topic "Developing local currency bond markets in emerging market economies and developing countries" rarely makes the headlines, it has rightly met with growing and broader political support in recent years. This is a reflection of the great significance that domestic bond markets in this region have for national and global financial stability. For this reason, we are very pleased that this topic has been one of the main agenda items during the French G20 presidency in 2011.

What is more, this lends greater continuity to the G20 process and to the discussion of the G20 topics. Besides ensuring that summit decisions are implemented, this also gives these decisions greater public credibility.

This applies, in particular, to the establishment or expansion of financial markets, which will take decades rather than just a few years. Since the Asian crisis, many EMEs – supported by numerous global, regional or national institutions – have been successful in their efforts to deepen their local bond markets. Nonetheless, further challenges lie ahead.

At the global level, the G7 finance ministers and central bank governors agreed in 2007 that developing local currency bond markets (LCBMs) deserved more political support. The Bundesbank backed this process in close cooperation with the Federal Ministry of Finance and played a major part in drawing up the G8 action plan, which was endorsed in May 2007. Since then, the Bundesbank has, with the International Monetary Fund and the World Bank Group, co-hosted three international workshops dealing with ways to implement the G8, and now the G20, recommendations. And in the years ahead we will continue to play an active role in this initiative in very fruitful and constructive cooperation with all of you.

The significance attributed to LCBMs for national and global financial stability is also reflected in the fact that, as part of the G20 process, this topic was – *inter alia* – dealt with by the International Monetary System (IMS) working group. A report on their findings was submitted to the G20 finance ministers and central bank governors; this topic was also on the agenda of the heads of state or government at the Cannes Summit 2011. In this context the main focus has been put on the relationship between developed LCBMs and the volatility of international capital flows, which is also the theme of today's workshop.

Against this background, I would like to focus on the following points:

- Objectives of the initiative and the contribution by the LCBMs to increasing financial stability
- State of development of LCBMs
- Main challenges ahead

Objectives of the initiative

The main objective of the initiative was and is to strengthen national and global financial stability. It is important to stress this. The development of LCBMs enhances the resilience of the national financial systems and, therefore, global financial stability. In addition, a number of developing countries have set themselves the task of attracting long-term global investment capital to finance infrastructure investment and, in this way, to boost growth. But very rightly, the G20 action plan points out that

> *"Future activities should … 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."*

Merely stating that developing these markets can have a stabilising effect does not tell us how to get there, nor what form the relevant process might take. In my view, there is a clear need to step up research and expand the necessary data base. Useful though it may be to acquire data by conducting surveys at intervals of five, seven or ten years, this process is inadequate and hardly acceptable.

Yet we must be just as frank when considering the risks entailed in developing local bond markets. After all, they are an important playing field for short-term portfolio inflows and outflows. Indeed, this is true of the present capital inflows to the EMEs: short-term portfolio investment represents no less than 50% of capital inflows.

As far as potential contributions by LCBMs to financial stability are concerned, I would like to mention just a few which have proven important, not least in the context of the current financial crisis.

- Deeper LCBMs reduce the vulnerability of the relevant EMEs to fluctuating interest rates and exchange rates. The main reason for this is that LCBMs help reduce currency and maturity mismatches, which trigger and amplify crises. Thus, they help check contagion and prevent spillovers to the real economy.
- LCBMs make the financial system more diversified, and make it easier for enterprises to access finance on international credit markets in times of tension. What is more, they play a part in ensuring that savings are not invested solely or primarily in equity markets, which could promote herd behaviour.
- LCBMs facilitate the smooth market-based financing of investment needs.
- First studies, which require substantiation, back up the assumption that developed LCBMs also help dampen the volatility of international capital flows, a finding of major significance in the light, in particular, of this year's G20 discussion.
- They broaden the spectrum of investments for international investors and facilitate their global search for diversification.
- According to some commentators, LCBMs actually contribute to rebalancing by keeping savings at home. These savings not only boost domestic investment and consumption, they also increase the country's propensity to import.

This is only an abbreviated list of the potential advantages identified during the financial crisis, although some of them are as yet no more than a scientific working hypothesis. Analyses of this kind always beg the question of their practical implications for any amendments to concepts for technical assistance that may be necessary or changes to priorities. This workshop can bring us an important step forward by also helping to formulate key questions for further research.

Some key questions concern technical assistance itself, however, and are related more to the structure and state of development of the relevant countries than the question of financial stability itself. The focus of the workshop is quite rightly on discussing and developing a diagnostic framework, the aim being to categorise countries by their state of development and financial structure and to determine what TA measures promise the greatest success in which countries.

Although many institutions are working on these issues, permit me to make particular mention of the European Bank for Reconstruction and Development (EBRD). The EBRD is incorporating into this workshop major elements of its local bond initiative, which has been well received worldwide.

To develop a framework that defines uniform principles for all countries is a real challenge, yet it is crucial as a means of heightening the efficient deployment of TA resources.

The question of what obstacles lie on the path to deeper LCBMs is not just about regulatory roadblocks or market infrastructure – which are among the usual suspects when evaluating such things. No, it is important to see local bond markets not only in isolation but also within the overall context of the financial system. For example, a financial system with a decentralised banking sector might fully meet the financial needs of a decentralised economic structure and do so with minimum transaction and opportunity costs. Given such interdependence, it would make no sense to develop bond markets that go against market economy incentives. A diagnostic framework needs to be placed in this broad context if it is ultimately to produce the desired results.

State of development

LCBMs have developed rapidly in recent years. The domestic debt outstanding in emerging market economies amounts to US$9.2 trillion (end of March 2011). It has more than doubled since March 2006, and this dynamic growth has not been much influenced by the financial crisis. LCBMs have significantly more potential. Just for illustration: while the EMEs have a share of around 34% of world GDP, the weight of debt securities is only 9½%. Moreover, this development must not blind us to the fact that important challenges lie ahead and – to put it in a nutshell – that they lie in the very areas that bring to bear the advantages of LCBMs, which I have just mentioned. I would like to raise just a few here:

- Above all, let me say that in many countries corporate bond markets either do not exist or are under-developed. However, only if there is sufficient liquidity on these markets can they serve as a spare tyre when other sources of funding dry up. Sovereign bonds account for two-thirds of bond markets; corporates for only one-eighth.
- There is also a great deal of concentration in EM regions, with two-thirds accounted for by EM Asia and only around 8% by EM Europe.
- Moreover, outstanding local currency bonds of EMEs are concentrated on just a few countries. Five countries (China, Brazil, South Korea, India and Mexico) account for around three-quarters of overall market volume. Of those, China is the biggest market with more than one-third.
- But – and this is a next point – strong growth momentum is not always predominantly driven by market forces. For instance, in order to sterilise the liquidity effects of its foreign exchange market intervention, the People's Bank of China also issues short-term paper on LCBMs. Statistically, these short-term notes count as local bonds. Nevertheless, these markets offer a platform through which both monetary and fiscal management can be facilitated in times of crisis.

Main challenges ahead

These arguments regarding the state of development lead us to other major challenges.

First, if one main objective of this initiative is to strengthen the liquidity of those markets, the financial crisis in particular has shown that there is a lack of liquidity in times of tensions because withdrawals of liquidity by foreign investors are not sufficiently replaced by domestic investment in this country group.

A second aspect that calls for clarification and is important not only for LCBMs when assessing financial stability is that liquidity was often withdrawn without any great distinctions being made in terms of fundamentals and macroeconomic stability, meaning that open and developed markets can also jeopardise countries that are highly stability-oriented. We therefore also need to be mindful of the extent to which LCBMs not only increase the stability of the international monetary system but also contribute to changing the global financial transmission mechanism.

Broadening the data base remains one of the top priorities. Closing data gaps should be a very targeted and cost-effective process. For example, data that have been available only in the form of irregular surveys should be translated into regular, more timely and internationally consistent statistics. The broader support of the G20 can give these data initiatives a significant impulse, in particular in EMEs. But before raising new statistics, we should first and foremost check whether existing tools can be used to filter out data of relevance to LCBMs. The Bundesbank's flexible multi-dimensional approach for providing user targeted data on German securities holdings statistics, which currently covers comprehensive micro-data for more than a million different securities, is just one example.

Although the budget constraints for EMEs expand as they become more integrated into the global savings markets through more developed domestic bond markets, there is no alternative to a credible fiscal consolidation strategy. Moreover, it is especially important to prevent a high concentration of sovereign bonds from building up at banks, and to examine whether and to what extent a concentration of this kind may even actually be encouraged by regulation in some EMEs.

In sum and without any doubt, LCBMs can significantly help to manage the volatility of international capital flows.