Andreas Dombret: Facing up to the original sin - experiences of establishing a local currency bond market

Opening remarks by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the "Local Currency Bond Markets" Conference, Pretoria, 8 March 2018.

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1. Introduction

Dear Governor Lesetja Kganyago

Dear Deputy Governor Daniel Mminele

Ladies and gentlemen

I am very honoured to be here today at the Conference Centre of the South African Reserve Bank (SARB) in Pretoria. This conference is another symbol for the close partnership between the SARB and the Bundesbank. This partnership, together with our joint chairmanship of the G20 Africa Advisory Group, gave the impetus for this event. The Africa Advisory Group coordinates the G20"Compact with Africa" initiative that aims at promoting inclusive growth and investment in Africa. I am convinced that this conference on local currency bond markets will provide valuable insights on how the initiative's goals can be reached.

Let me start with a reminder of why we are all here today. True, we have come to talk about local currency bond markets. But why are they important for a country's financial system?

Time and again, throughout the history of economic development, emerging economies have given in to the temptation to over-borrow abroad, which often gives rise to a significant currency mismatch on their aggregate balance sheets. Risky borrowing in foreign currencies can be tempting because it is often cheaper than raising funds at home – last but not least as foreign creditors accept lower interest rates when the exchange rate risk is born by the debtor. In blunt terms, over-borrowing abroad is called the "original sin" of an emerging currency because – although it comes at low cost in good times – it may cause serious damage to the economy when there is an abrupt currency shift.

In contrast, the existence of a functioning local currency bond market can lower financing costs at home and thereby provide the incentive to reduce foreign currency exposure. In the face of volatile global capital flows, it can therefore help making emerging economies crisis-proof. What is more, sound local currency bond markets support the development of a country's financial sector and can channel foreign capital into an emerging economy, a valuable source of long-term financing for both the government and the private sector.

Now, some of you may be thinking: Why is a German discussing these issues – given that German sovereign bonds count internationally as "safe haven" investments and are traded on a very deep and liquid market by international standards? To give you my short answer right away: This hasn't been the case from the outset. In my speech, I would therefore like to draw upon the German story 70 years ago in order to illustrate the lessons we have learned and to outline why this conference may become a catalyst for local bond market development in developing and emerging economies.

2. The German bond market – where it started in 1948

Let us travel roughly 70 years back in time.

At the end of World War II, Germany and its economy were devastated. Large parts of its industrial plants and of its infrastructure lay in ruins – and so did its financial system. War expenses had been financed via the printing press, and the German currency had lost its value.

It was only in 1948, when the Allied powers governing the country at that time initiated a fundamental reform of the German currency, marking a turning point. The introduction of the D-Mark and the foundation of a new central bank went hand in hand with the transformation of the German economy from a centrally planned to a market-based system. This laid the foundation for what is known as the "German economic miracle" of the 1950s and 60s.

And this is where local currency bond markets come into play. Their development in Germany was already envisaged at the outset of economic policy reforms. But as you might suspect, the German bond market, too, got off to a very bumpy start in 1948. The country and its currency faced a lack of trust –and so did its bond market. People were very hesitant about saving long-term, and many initial public offerings of bonds were disappointing. Just to give you an idea: during the first 18 months of the D-Mark, only about half of all bond IPOs received funding on the infant German capital market.

So we, too, have experienced that political will is one thing and implementation is another, and that establishing a functioning bond market denominated in the local currency hinges on a number of factors.

Let me now single out the aspects of bond market policies in Germany that I believe are still instructive for today's policymakers.

3. The institutional framework

Again, let's zoom back to 1948. It quickly became clear that the undeveloped German bond market needed two things: sound regulation and an independent central bank.

There is no question that regulation can be very useful in establishing certain financial instruments and certain financial markets. For instance, when the German bond market was still in its infancy, there was a law in place that required debt to be denominated in local currency unless the central bank gave its special approval for foreign denomination. Undoubtedly, such preferential legal treatment of bonds denominated in local currency was conducive to bond market development and to the D-Mark becoming its nominal anchor. But, if not applied prudently, regulation can also be a hindrance. Especially when it becomes too intrusive and when it suspends the market mechanism. That is exactly what happened in Germany after the 1948 currency reform. Heavy price and interest rate controls were imposed on market forces and put a serious drag on the emerging bond market.

Back then we also had to learn our lesson about implementing a sound regulatory regime; that it needs to be a catalyst, not an impediment to the infant capital market.

But it turned out that regulation was not the only key to a successful currency and functioning bond market in the emerging post-war economy in Germany. At least equally important was the existence of an independent central bank that could credibly commit to its single mandate of ensuring price stability. During the 1950s, such credible commitment to stable prices, combined with sound fiscal policies, was instrumental in anchoring inflation expectations and in achieving the kind of macroeconomic stabilisation that formed the foundation of the "economic miracle" I just mentioned. And this also had a significant impact on investors' confidence in local currency bond markets. In short: without a credible central bank, there is no stable currency. And without a stable currency, there can be no thriving bond markets.

4. The central bank as a facilitator

Leaving institutional arrangements aside, which concrete positions can and should a central bank take when it comes to shaping local currency bond markets? In other words, how should a central bank act operationally? Well, during the second half of the last century, we at the German central bank interpreted our role as that of a facilitator to the market.

There were three key aspects to this role. First, providing support to market participants. When capital markets were liberalised in the mid-1950s, interest rate volatility surged. Consequently, the German central bank promoted the foundation of a capital market commission, a discussion platform, that consisted of the most important market participants. Its primary task was to align the timing and volume of upcoming bond issuances with prevailing market conditions. In this way, liquidity shortages and excessive price hikes on the market were to be prevented. As time went by and bond markets got more mature, the cooperative work of the capital market commission was replaced by yearly and quarterly issuance calendars for sovereign bonds.

A second aspect of the operational role of central banks concerns engaging in market management. In terms of market management, the Bundesbank's strategy has always been clear-cut. In 1957, the Bundesbank Law stipulated that the issuer of a bond is responsible for market management and market smoothing operations. Indeed, the Bundesbank has since conducted market management for federal government bonds; but we have done so on behalf of the government, not on our own behalf. Let me stress here that the Bundesbank's approach is just one of many, and that there is no right or wrong approach. This is only one way in which a central bank is able to maintain independence and avoid fiscal dominance.

This brings me to the third aspect of the facilitation role that the German central bank opted for. In the early stages of capital market development, market management of sovereign bonds can be crucial for many reasons. One main reason is that financing conditions in most credit markets critically depend – usually via price quotations – on the price that the sovereign has to pay for its debt. In other words, a central bank's market management for government bonds can facilitate the establishment of a benchmark debt yield curve. And a sound benchmark is key to a functioning overall bond market.

That is how we did it. And there might be a lot of other ways of doing it. I want to emphasise again, however, that when embarking on the development of domestic bond markets, every central bank should be wary of trading its institutional independence for market involvement. Because providing the sovereign with market management services always entails the potential of exposing the central bank to unwanted fiscal pressures.

5. Conclusion

Ladies and gentlemen, what can the German experience teach us? First, it can teach us that the political will to enhance local currency bond markets needs to be accompanied by a number of supporting factors. A well-balanced regulatory regime and a stable currency – defended by an independent central bank – certainly are among these factors.

Second, while I am convinced that regulation and central bank independence are universally valid, the concrete strategy a country's central bank may follow in promoting local currency bond markets is not. As every country finds itself confronted with unique challenges, the ways to tackle them are unique as well. And though I hope you regard my anecdotes and remarks based on the example of Germany as inspirational, every central bank has to find its own strategy.

In my speech, I have touched upon some of the topics of tomorrow's panel discussions, such as market management, the benchmark yield curve and, in particular, the role of the central bank. I am convinced that tomorrow's discussions will shed light on these and many other aspects of bond market development.

I wish you all fruitful discussions and an inspiring conference.

Thank you to the South African Reserve Bank for hosting us and to you all for your attention.