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THE WORLD BANK GROUP

STAFF NOTE FOR THE G20 IFAWG

RECENT DEVELOPMENTS ON LOCAL CURRENCY BOND MARKETS IN EMERGING ECONOMIES

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EXECUTIVE SUMMARY

At the Cannes Summit in 2011, the G20 launched an initiative to prepare an action plan for the development of local currency bond markets (LCBMs). During the meeting of the International Financial Architecture Working Group (IFAWG) in Washington D.C. in April, 2017, the G20 requested a short note from the IMF and the World Bank to take stock of recent developments related to the G20 LCBM Action Plan.

Globally, emerging market (EM) securities outstanding have risen, and issues in LCBMs continue to dominate. 88 percent of outstanding emerging market debt was issued in LCBMs as of 2016, up from 84.5 percent in 2015. The stock of emerging market debt securities grew by 9.9 percent to $20 trillion in 2016, and is up more than 50 percent since 2011. Foreign investor holdings of local currency debt have seen a significant increase since 2011, although this percentage is unchanged at 24.8 percent over the past year. A recent survey of government debt management offices shows mixed trends in EM secondary market trading volumes. Several EM countries are considering enhancing their market-making frameworks for government securities to ensure an adequate provision of liquidity.

LCBM development initiatives are on the work agenda of international organizations (IOs). The Compact with Africa and the World Bank Joint Capital Markets Development initiative both include components of LCBM development. IOs have also contributed to the development of an LCBM framework through analytical work on state-contingent debt instruments. These are intended to offer additional opportunities of risk-sharing among sovereigns and private investors, and have the potential to contribute to debt sustainability, thus reducing possible local market disruptions.

In addition to conventional financing, analytical and advisory support for developing private capital markets and mobilizing institutional investors is being provided. MDBs are expanding the range of EM currencies in their bond issuances to support LCBM development. For example, the World Bank Group raised funds in 32 emerging markets and frontier currencies covering all regions and the IFC is moving forward with issuance in new currencies in several jurisdictions.

CONTENTS

Abbreviations and Acronyms

ADB	Asian Development Bank
AE	Advanced Economy
AUM	Assets under Management
BIS	Bank for International Settlements
CFO	Chief Financial Officer
EM	Emerging Market
EME	Emerging Market Economy
EMTA	Trade Association for the Emerging Markets
EU	European Union
EUR	Euro
F&M	World Bank Group Finance and Markets Practice
FIG	Financial Infrastructure Group
FSB	Financial Services Board
FX	Foreign Exchange
GDP	Gross Domestic Product
GMTN	Global Medium-term Note
IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
IOSCO	The International Organization of Securities Commissions
IFAWG	International Financial Architecture Working Group
IFC	International Finance Corporation
IMF	International Monetary Fund
IO	International Organization
LMO	Liability Management Operation
MDB	Multilateral Development Bank
MIGA	Multilateral Investment Guarantee Agency
PD	Primary Dealer
PPP	Public–Private Partnership
SECO	Swiss Economic Cooperation and Development
TA	Technical Assistance
TF	Trust Fund
USD	United States Dollar
WBG	World Bank Group

INTRODUCTION[1]

At the Cannes Summit in 2011, the G20 launched an initiative to prepare an action plan for the development of local currency bond markets (LCBMs). The action plan targeted three key areas for progress: (1) scaling up technical assistance, (2) developing a shared database to track such assistance, and (3) monitoring the progress made on an annual basis.

Deepening the LCBM in a given country provides several financial stability benefits, which are particularly relevant in the current macroeconomic and financial context. In particular, it: (1) increases a country's ability to withstand volatile capital flows; (2) reduces the reliance on foreign borrowing and the risks linked to currency mismatch; (3) contributes to the reduction of current account imbalances; (4) mitigates the need for large precautionary reserve holdings; and (5) allows balance sheets to adjust more smoothly, therefore improving the capacity of macroeconomic policies to respond to shocks.

This report is organized as follows: Section I examines trends in government and nongovernment LCBMs, including size, the investor base, secondary market liquidity, and key drivers. Section II provides an update on recent work of International Organizations (IOs) in the area of LCBM development.

OVERVIEW OF CURRENT DEVELOPMENTS IN LCBMS IN EMERGING MARKETS

A. LCBM Trends and Developments

1. LCBMs increased their significant role in EME debt securities issuance in 2016. EM total debt grew by 9.9 percent year-over-year, to an estimated $20 trillion in 2016 (Table 1, Figure 1).[2] [3] The increase was driven by growth in local currency debt, with its share rising from 84.5 percent in 2015 to 88 percent in 2016. As a share of GDP, local currency debt increased by 7.5 percentage points.

[1] This note was prepared by Anderson Caputo Silva, Zsolt Bango and Loic Chiquier from the World Bank Group (WBG) and Thordur Jonasson and Michael Papaioannou from the IMF, under the overall guidance of Alfonso Garcia Mora and Ceyla Pazarbasioglu from the World Bank and Daniel Hardy and Peter Dattels from the International Monetary Fund (IMF) respectively. The authors would like to thank Sayyora Krulikowski (WBG); Tadeusz Galeza (IMF) and peer reviewers from the WB, IFC TRE, and the IMF for their input and comments to this note. The views expressed herein are solely the authors' and should not be attributed to the World Bank Group, IMF, their Executive Boards, or their management.

[2] The analysis of size focuses on absolute levels of outstanding debt rather than as a percentage of GDP. This allows for direct comparison with other indicators presented in absolute levels, such as new issuances, trading volumes, size of institutional investors, and investor flow data. The BIS debt securities statistics – data source for this note - are harmonized with the recommendations in the Handbook on Securities Statistics (BIS-ECB-IMF, 2015), which sets out an internationally agreed framework for classifying securities issues and holdings.

[3] For the purposes of this note, the term "total debt" refers to the total of debt securities issued by government and non-government entities in local and international markets. "Local currency debt" refers to debt issued in local markets with its currency denomination being predominantly in local currency (the share of local currency debt denominated in foreign currency may not be negligible in all country cases).

Over the past year, EMs' general government debt increased from $8 trillion to estimated $9.5 trillion, or by 4.8 percentage points of GDP. The increase in local currency market borrowing (relative to total debt) lowered foreign currency risk in EMs. EM total non-government debt increased more slowly from $10.2 trillion in 2015 to an estimated $10.6 trillion in 2016.

Table 1. Emerging Markets Debt Overview 2011–16 (USD trillion)

	2011	2012	2013	2014	2015	2016e
Total Debt	12.7	14.0	14.5	16.2	18.2	20.0
Local Currency	11.2	12.3	12.5	14.0	15.4	17.6
International Market	1.5	1.8	2.0	2.2	2.8	2.4
Local as Share of Total (%)	88.3	87.5	86.0	86.5	84.5	88.0
Local as Share of GDP (%)	42.0	43.8	42.1	45.6	51.5	59.0
General Government	6.5	7.2	7.3	7.5	8.0	9.5
Non-government	6.1	6.8	7.2	8.7	10.2	10.6
Government as Share of Total (%)	51.6	51.3	50.6	46.3	44.1	47.3
Government as Share of GDP (%)	24.6	25.7	24.7	24.4	26.9	31.7
Non-government as Share of GDP (%)	23.0	24.4	24.2	28.3	34.1	35.4
Local Currency Debt by Type of Issuer	11.2	12.3	12.5	14.0	15.4	17.6
General Government	5.9	6.5	6.6	6.7	7.2	8.6
Non-government	5.3	5.8	5.9	7.3	8.2	9.0
Government as Share of Total (%)	52.7	52.6	52.5	47.9	46.7	48.8
International Debt by Type of Issuer	1.5	1.8	2.0	2.2	2.8	2.4
General Government	0.6	0.7	0.8	0.8	0.8	0.9
Non-government	0.8	1.0	1.2	1.4	2.0	1.5
Government as Share of Total (%)	43.7	41.8	38.8	35.8	30.0	36.3
Local Non-Government Debt by Region (%)	100	100	100	100	100	100
Asia Pacific	73	73	74	80	84	84
Latin America and Caribbean	20	19	19	15	12	12
Emerging Europe	4	4	5	3	3	3
Africa and Middle East	3	3	3	2	2	2
Local General Government Debt by Region (%)	100	100	100	100	100	100
Asia Pacific	50	51	54	58	63	65
Latin America and Caribbean	33	32	30	28	24	22
Emerging Europe	11	10	10	8	7	7
Africa and Middle East	7	7	7	6	6	6

Sources: BAML, BIS, IMF and WB staff calculations.

NB: As defined in the Handbook on Securities Statistics, the general government sector can be divided into central government, state government, local government, and social security funds (2008 SNA, paragraph 4.129). Non-government sector debt includes debt of financial corporations (including banks) and non-financial corporations.

2. Some emerging and low income countries are now benefitting from pursuing the development of their LCBMs by attracting non-resident investors and extending maturities

(Figure 2). In Africa, for example, countries such as Cote d'Ivoire, Namibia, Senegal and Uganda more than doubled the issuance of local currency government bonds between 2009 and 2014, with the stock of local currency bonds in these countries now on average equivalent to 8.5 percent of GDP. The maturity of bonds issued between 2009 and 2014 rose on average from 1.5 years to 6.4 years, with some counties such as Ghana, Kenya, Namibia, Nigeria, and Tanzania issuing local currency bonds in maturities over 15 years.

3. In addition to non-concessional domestic sources of financing a number of emerging and low income countries are accessing international capital markets. Eurobond issuance (Figure 1) has surged during a period of prolonged low global interest rates (Figure 2) but experience has shown that the Eurobond market can be volatile and access conditions can be highly uncertain. Global interest rates are expected to move higher and capital flow reversals could coincide with the initial wave of Eurobonds reaching maturity. Refinancing risk could become acute, particularly for countries with macroeconomic imbalances.

4. Foreign investor positions remain large and are concentrated in local currency government debt instruments (Figure 3). For example, foreign participation in local currency government bonds was above 30 percent for Indonesia, Malaysia, Mexico, Peru, Poland and South Africa compared to the average for EM countries of about 25 percent during 2015 and 2016. While the foreign investor participation rate went down in 2016 in some EMs, including Brazil, Hungary, Mexico, Peru, Philippines, Poland, and Thailand (Figure 3), China and India, two of the largest issuers of local currency bonds, continued to experience limited foreign participation.

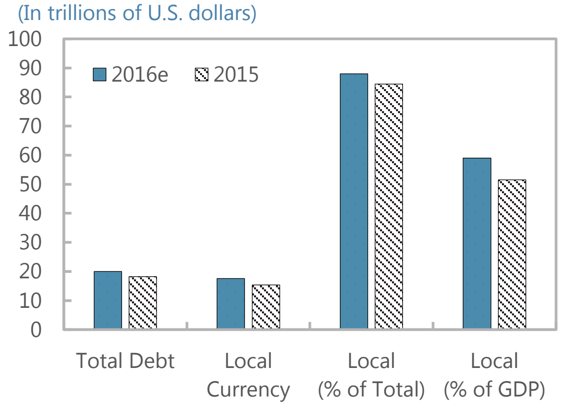
5. Outflow of foreign investors is a key risk should global financial conditions change (Figure 4). Flows into EM portfolio debt turned positive in 2017, after having remained negative in 2016. It is worth keeping in mind that economic exposure of foreign investors to EMs is a relatively recent phenomenon that intensified during the quantitative easing of central banks in major advanced economies during the past few years. This has significantly affected interest rates on EM local currency bonds.[4]

[4] *Global Financial Stability Report*, April 2016, IMF. https://www.imf.org/external/pubs/ft/gfsr/2016/01/pdf/c2_v3.pdf

Figure 1. Recent Developments in EM Debt

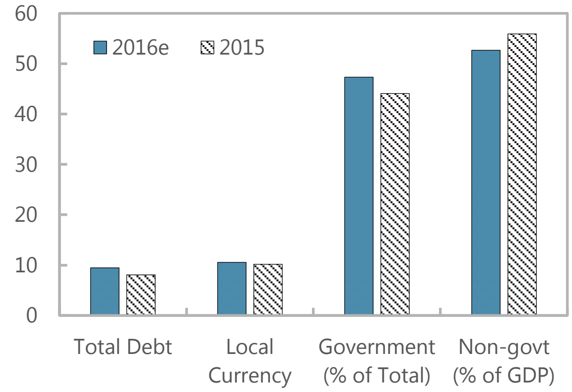
Total debt increased by $1.8 trillion between 2015 and 2016…

Total debt
(In trillions of U.S. dollars)



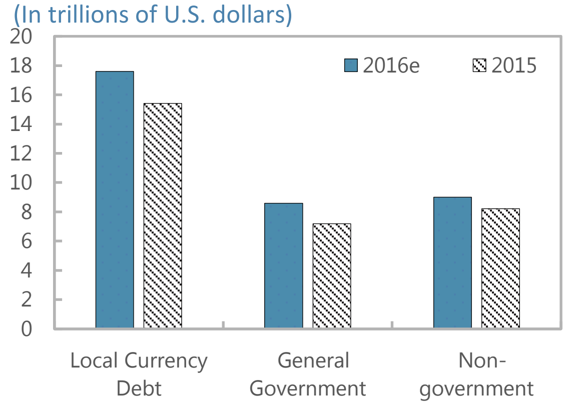
…with general government debt growing more than non-government debt.

General Government debt
(In trillions of U.S. dollars)



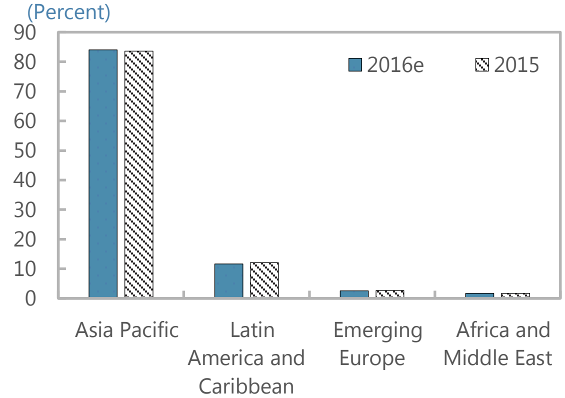
Local currency government debt grew by 2.2 trillion U.S. dollars…

Local currency debt
(In trillions of U.S. dollars)



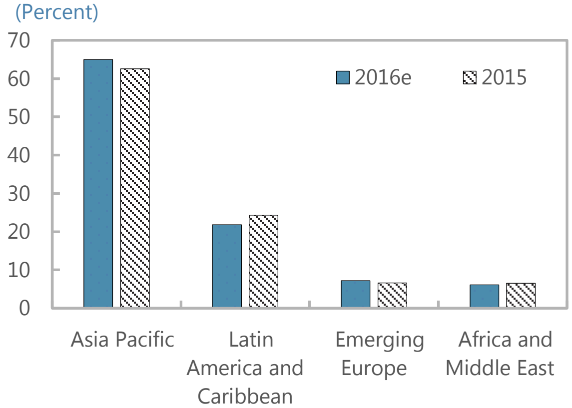
…while the distribution of non-government debt across regions remained unchanged…

Local currency non-government debt
(Percent)



… and government debt grew fastest in Asia and Pacific.

Government debt issued
(Percent)



Overall, local currency debt outstanding has remained high and growing as a share of GDP.

Local currency debt securities outstanding

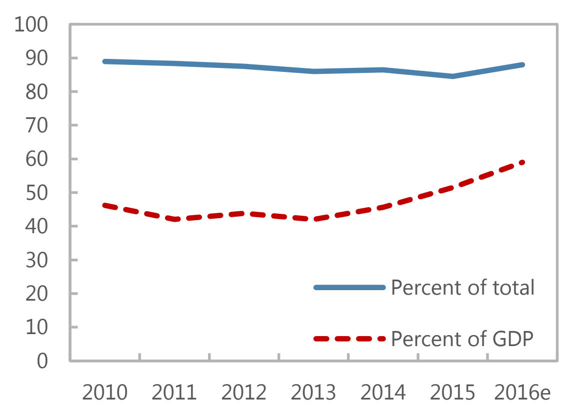


Figure 2: Evolution of Public Debt, 2007 - 2020

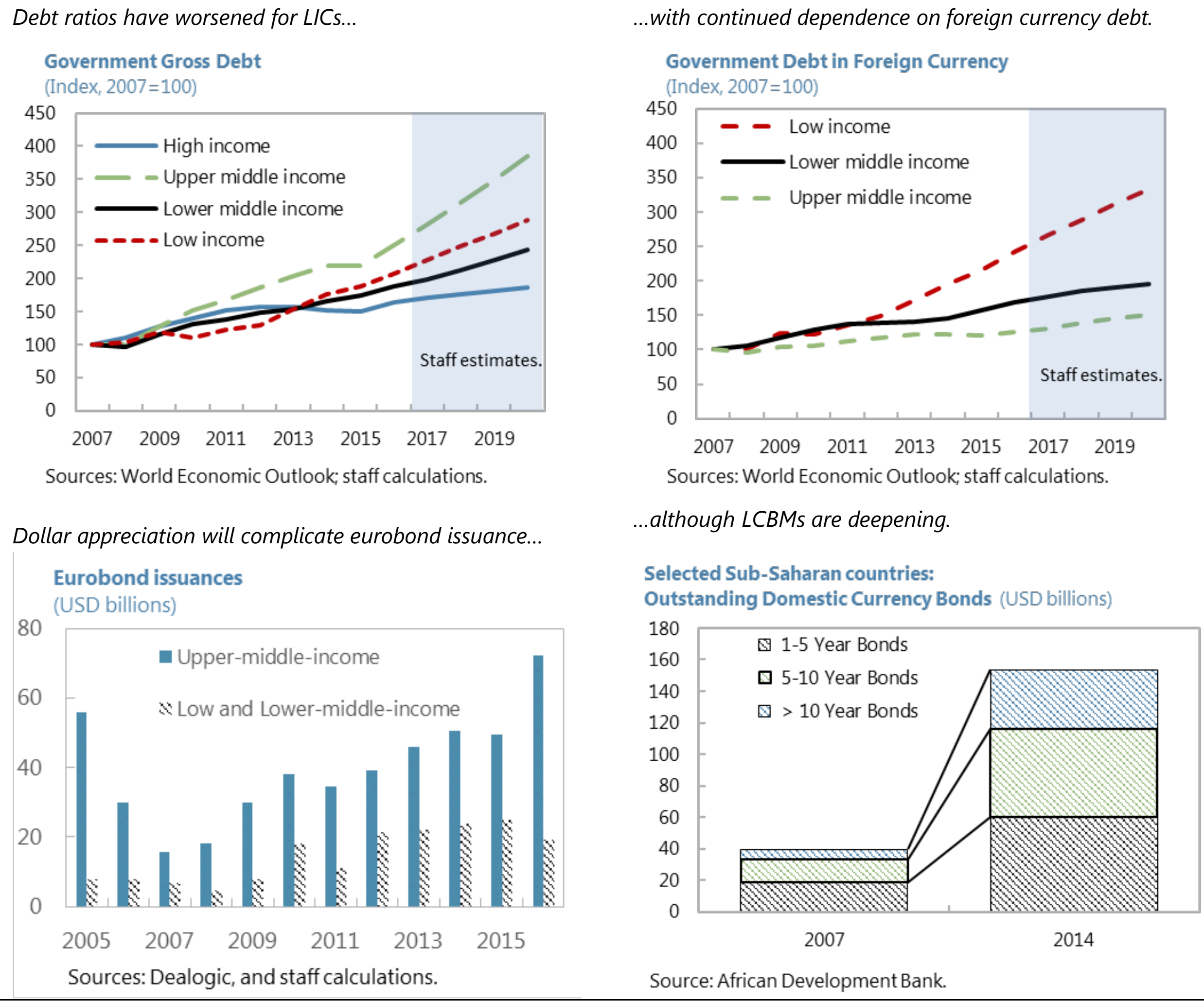
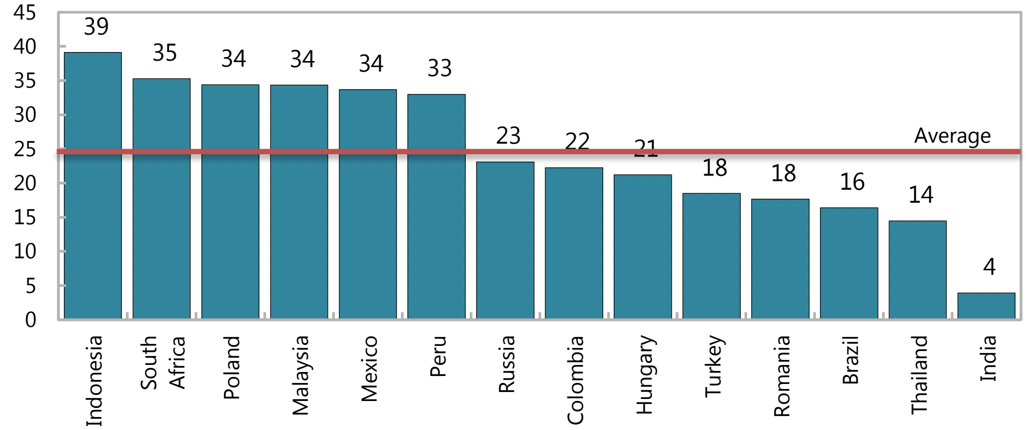
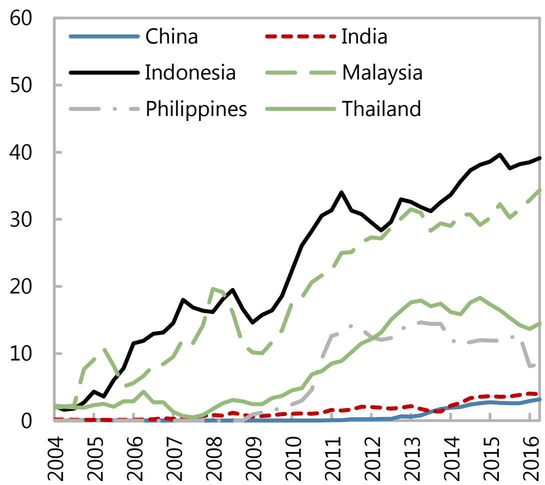


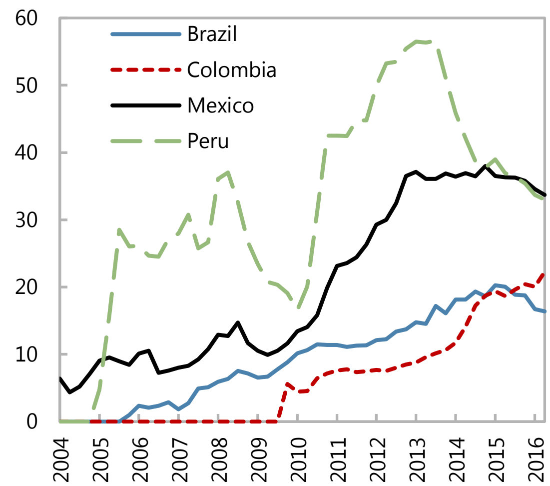
Figure 3. Recent Developments of Foreign Holdings of EM Government Debt Securities in Local Currency Bonds (percent of total)

The average share of foreign holding of total government debt was unchanged between 2015 and 2016 at 24.8 percent

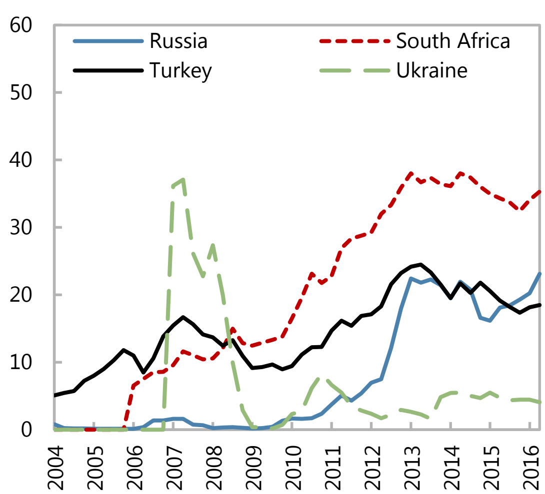


with mixed developments across countries in 2015-2016, where Indonesia, Malaysia, and Colombia observed an increase…

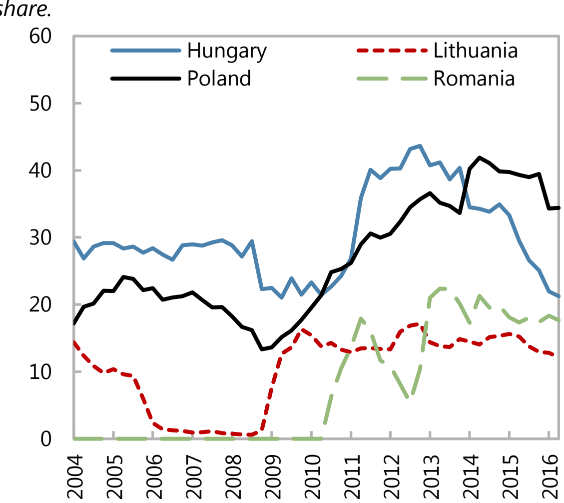




… along with Russia and South Africa…



…while other EM countries saw either a stable or declining share.



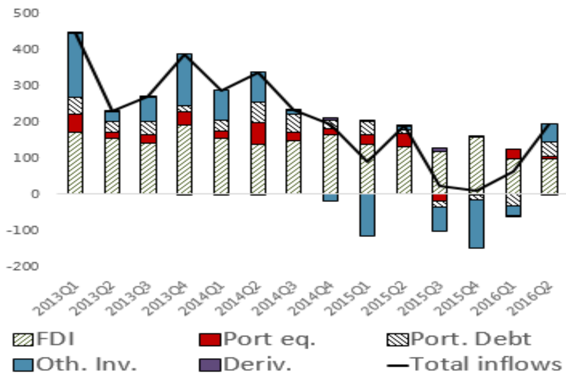
Source: IMF - Sovereign Investor Base Dataset for Advanced Economies (Arslanalp & Tsuda).

Figure 4. Developments in Capital Flows and Interest Rates

EM capital inflows have recovered on aggregate

Emerging markets: Capital inflows, 2012-16

(2013Q1-2016Q3, billions of U.S. dollars)

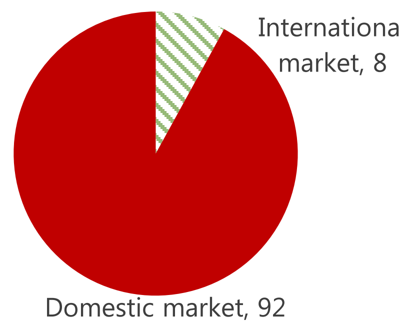


Source: IMF World Economic Outlook.

International bond issuance is a small share of EM Total Debt

AE Government outstanding bonds

(As of 2013Q3, percent)

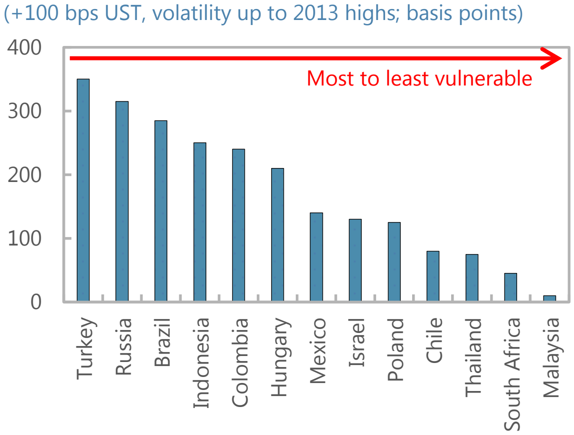


Source: Bank for International Settlements.

The impact of higher global interest rates would be non-uniformly observed in EM local interest rates…

Impact of higher U.S. rates and volatility on EM local rates

(+100 bps UST, volatility up to 2013 highs; basis points)

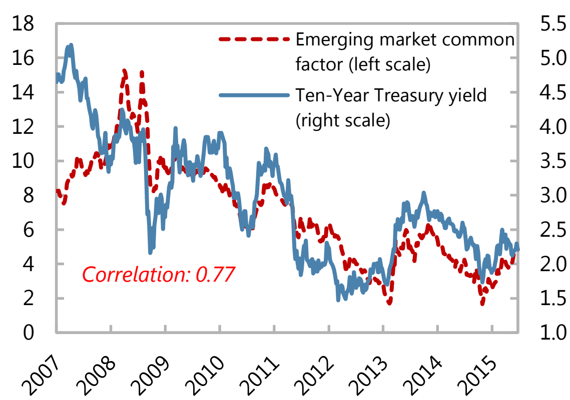


Source: IMF World Economic Outlook.

…despite a significant exposure to the U.S. Treasury rate.

Emerging Market Common Factor and 10-year Treasury yield

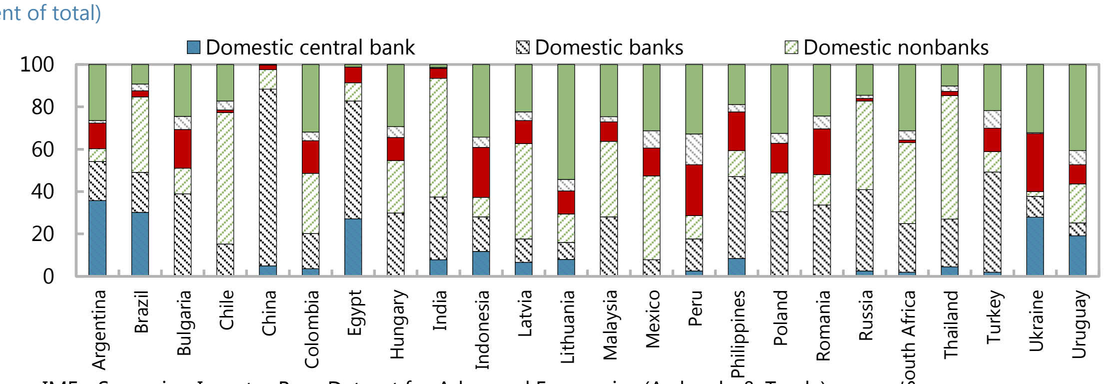
(Percent)



Sources: Bloomberg, L.P.; and IMF staff estimates.

Investorbase of EM General Government Debt at end-2016Q2

(percent of total)



Source: IMF - Sovereign Investor Base Dataset for Advanced Economies (Arslanalp & Tsuda).

B. Secondary Market Liquidity

6. **Emerging markets are grappling with the evolving landscape of secondary market liquidity provision in global and local government securities.** A recent survey of government debt management offices, conducted by the World Bank during the first quarter of 2017, covering 25 AE and EM countries, illustrated a number of challenges. [5] Some EMs reported declining secondary market trading volumes, attributing this to reduced market making capacity by broker-dealers and compressed yields. Lower participation of foreign investors, who tend to trade more frequently, was also cited.[6]

7. **In response to these challenges, a number of emerging markets are looking to strengthen market structure, including introducing market innovations,** such as enhanced electronic trading platforms. In addition, some are experimenting with different trading methods, such as call markets, which only trade during limited hours. Further monitoring of the development of secondary market liquidity in EM is a critical issue going forward.

WORK OF INTERNATIONAL ORGANIZATIONS ON DEVELOPING LCBMS

A. Development Framework and Technical Assistance

8. **International Organizations continue to support the development of LCBMs as it enhances growth and reduces vulnerabilities.** The WB/IMF/EBRD/OECD Diagnostic Framework for LCBM development and deepening has been broadly disseminated and is being used as a reference by IOs, bilateral TA providers, and policymakers in EMEs. IOs will sustain their enhanced collaboration and information sharing to improve resource allocation and the effectiveness of TA, including through using the TA project database. There have been increasing efforts to address challenges related to the domestic resource mobilization for LCBM development in low-income countries, either stand-alone or as part of larger programs, such as the Debt Management Facility-II Multi-donor Trust Fund and the recent Compact with Africa (CwA) Initiative.

9. **The African Development Bank (AfDB) and the Asian Development Bank (ADB) have supported the development of local bond markets through specific initiatives to improve data**

[5] The World Bank conducted the survey in the context of the "2017 WB Government Bond Market Conference: The Changing Landscape of Secondary Markets" on April 26-27, 2017. The countries that responded are geographically diverse and at different stages of government bond market development, including Albania, Austria, Brazil, Bulgaria, Cameroon, Denmark, Fiji, Finland, France, Germany, Hungary, Italy, Latvia, Mexico, Philippines, Poland, Portugal, Romania, Serbia, Slovenia, South Africa, Sweden, Tunisia, Turkey, and the United Kingdom.

[6] A number of EM countries expressed that the minimum size of the mandatory quotes as well as the number of assigned government securities lines have increased, while the maximum bid-ask spreads have tightened. Some countries have adapted the reference spread from an absolute number down to the level of the average spread quoted by PDs to incentivize their market makers to quote even more tightly. The improving market making performance of EM primary dealers could create more activity and increasing volumes in these markets.

transparency. The AfDB in conjunction with the African Financial Markets Initiative (AFMI) launched its AfDB/AFMISM Bloomberg African Bond Index (ABABI) in February 2015. The composite index currently comprises Bloomberg local currency sovereign indices for South Africa, Egypt, Nigeria, Kenya, Botswana and Namibia and as of April this year also Ghana and Zambia. The ASEAN+3 Asian Bond Markets Initiative (ABMI) promotes bond market development in the region, supported by the ADB.

10. In October 2014, the IMF Executive Board supported the inclusion of enhanced contractual provisions in sovereign bond contracts. This would improve the efficiency of sovereign debt crisis resolution and reduce possible LCBM disruptions.[7]

11. Recent IMF work related to State-Contingent Debt Instruments (SCDI) has focused on enhancing the management of sovereign risk.[8] Debt-to-GDP ratios have risen in many advanced and emerging economies, as have other risks, such as natural disasters associated with climate change. This highlights the need for developing and/or enhancing existing markets of financial instruments that address these risks, such as SCDIs and contractual clauses, e.g. disaster contingent clauses in loan agreements. Next steps in this work stream may include further discussions with financial regulators, debt managers and market participants with a view to developing practical guidance for potential issuers, more careful consideration of first-mover options and developing underlying markets.

B. Local Currency Debt Issuance by IFIs

12. The WBG takes on a catalytic role as issuer of bonds in EM local currencies along with several MDBs, both in domestic and in international capital markets. These risk-free instruments can play a catalytic role in the development of LCBMs by establishing a benchmark for lower-rated issuers.[9] Taking the World Bank and IFC as examples, the World Bank has executed funding transactions in 32 emerging markets and frontier currencies so far, while the IFC has issued local currency bonds in onshore or offshore bond markets of more than 20 countries in FY16 and FY17.

13. The World Bank has raised funds in 32 emerging markets and frontier currencies covering all regions. The biggest local currency transactions have been executed in Brazil, China, India, Mexico, Russia, South Africa, Turkey:

[7] Chung, K. and M. Papaioannou, Do Collective Action Clauses reduce sovereign borrowing costs? IMF Working paper (forthcoming), 2017.Work on State-Contingent Debt Instruments, Green Finance.

[8] See http://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Featured/G20/2017-04-05-g20-staff-note-for-the-g20-imf.pdf?__blob=publicationFile&v=4

[9] The objectives, challenges, and limitations of MDB issuances in EM currencies will vary depending on country-specific characteristics and on whether these securities are placed in domestic or international capital markets. Issuances in domestic markets tend to have a greater benchmarking role and impact for the development of the market. However, specific features such as (potentially different) tax treatment or reporting requirements compared to other local instruments may reduce the referencing role of these MDB instruments.

- In EMEA, the World Bank has had 903 fund raising transactions in 16 currencies amounting to more than US$ 35 billion. South Africa accounts for more than half of these transactions, with others including Poland, Russia and Turkey. Other markets in the region, where the World Bank issued local currency bonds are Botswana, Ghana, Kuwait, Nigeria, Uganda, Zambia in the Middle East and Africa, and Czech Republic, Hungary, Romania in Europe.

- In Asia, the World Bank has had 297 transactions amounting to US$ 11 billion. The Indian rupee accounts for the highest share, and other significant issues include China, Malaysia and South Korea. There have also been issuances in Kazakhstan and Thailand.

- In Latin America, the World Bank has tapped 7 local currency markets in 452 transactions. The total amount raised was US$ 16 billion. The largest deals have been executed in Brazil and Mexico, but there have been transactions in Chile, Colombia, Peru and Uruguay as well.

14. The IFC has issued local currency bonds in several emerging market currencies in onshore and offshore markets in the last two fiscal years, 2016 and 2017. During this time the biggest issuances in local currency bonds have been in Brazil, Turkey, Russia, offshore China, India, Mexico and South Africa. Other markets where IFC issued local currency bonds in onshore or offshore bond markets are Nigeria, Ghana, Namibia, Uruguay, Colombia, Kazakhstan, Chile, Peru, Costa Rica, Dominican Republic, Armenia and Georgia.

- In EMEA, the IFC will continue to expand its issuance program in onshore and offshore markets in line with its pipeline and is working closely with governments and regulators to obtain necessary regulatory approvals. Currencies include Botswanan Pula, Ghana Cedis, Kenyan Shilling, Nigerian Naira, South African Rand, Georgian Lari and Armenian Dram.

- In Asia, the IFC has received regulatory approval in various countries like Philippines, Bangladesh and Papua New Guinea to issue local currency bonds onshore or offshore and will issue local currency bonds as the pipeline materializes. Other countries in the region where IFC is looking forward to issue local currency in offshore or onshore markets are China, Sri Lanka and Nepal.

- In Latin America, the IFC expects to tap into the Colombian domestic debt capital market under its GMTN Program within this calendar year subject to market conditions and IFC's local currency needs. IFC also continues to source local currency by tapping into Costa Rican and Dominican markets subject to business needs.

15. In April 2017 the World Bank Group has launched a new Joint Capital Markets Initiative (J-CAP) to promote capital market development in emerging market and developing countries. This joint initiative of the World Bank and the International Finance Corporation (IFC) will support the development of liquid, diverse, long-tenor financing and well-regulated local capital markets. With a more transparent, accessible and larger pool of local currency funding, capital markets will be better positioned to contribute more sustainable economic growth. The J-CAP approach will ensure that countries receive end-to-end analytical, advisory and financing support for developing their markets.

It will help diagnose, design and implement relevant capital market interventions tailored to each country. Policy and regulatory interventions will be complemented by demonstration transactions (such as project bonds, infrastructure funds, covered bonds, securitization, corporate bonds, etc.) to crowd in the private sector and further support governments' capital market development efforts.

16. At the global level, the World Bank is investing in the development of innovative financial products to deepen the liquidity of local capital markets. For example, in Brazil the World Bank is piloting the Issuer-Driven Exchange-Traded Fund (ETF) initiative with the Brazilian Treasury. The Issuer-Driven ETF initiative supports the development of local currency bond markets via an innovative Government Bond ETF structure designed in consultation with industry leaders to enhance the viability of ETFs in emerging markets. As such, the World Bank partners with government debt issuers to create ETFs. The World Bank is helping to structure the product, observing minimum standards and the government will hire a private investment manager to manage the ETF. The Request for Proposals to hire the fund manager in Brazil is expected to be launched by calendar year 2017, paving the way for a replication of this initiative in other countries and potentially expand the product to other asset classes such as corporate and infrastructure bonds.

17. The International Organization of Securities Commissions (IOSCO) constituted a Task Force (TF) on Infrastructure Financing. It aims at identifying whether actions are needed at the level of securities markets regulation to unlock capital markets potential to bridge infrastructure funding needs. The WBG has identified three areas that might require attention by securities regulators (the choice of public versus private offering, the level of disclosure provided to investors and control issues) and is currently preparing a policy note drawing lessons from cross country experience. The IOSCO TF will use such note as input for the development of a self-diagnostic toolkit to assist emerging markets in identifying whether improvements are needed in their regulatory frameworks.

C. MDBs' Work on Mitigating Liquidity risks, and Providing Hedging and Credit Enhancements

22. Presently, MDBs alleviate liquidity risks and provide hedging tools to mitigate the impact of shocks and support the sustainable development of LCBMs. One of the most traditional types of MDB support is their lending operations, which usually grow in moments of stress or hard funding conditions in domestic and international capital markets. Several countries have been proactive in establishing contingent lines of credit with MDBs and in building cash buffers to weather stressful times. These buffers act as a market stabilizer, mitigating refinancing risk concerns and reducing funding cost and pressures during market difficulty. MDBs also provide an increasing menu of hedging tools, including cross-currency and interest rate swaps that help countries reduce exposures to FX and interest rate shocks.

23. MDBs also help reduce the cost and facilitate access to LCBMs for a broader set of issuers via the provision of credit enhancements and direct investments. One of the clear themes that affect especially non-government LCBMs is to expand market access to a larger number of issuers and products (for example, infrastructure bonds and covered bonds). This often requires credit enhancements to access the market or attract greater demand. Countries and MDBs could also, more formally, integrate and coordinate on policies to foster the use of credit enhancements as part of an overall action plan to develop LCBMs, according to country-specific circumstances. MDBs have also acted as investors in some selected products, guaranteeing, for example, partial demand and underwriting securities in primary markets or providing seed capital to products such as investment funds.