A Virtuous Cycle in Local Currency Bond Markets?

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Executive Summary

There is a growing consensus among policymakers, academics, and market participants regarding the importance of local currency bond markets for financial stability. Global institutions, including the IMF, BIS, World Bank, and OECD, have highlighted the importance of local bond market development, and regional organizations such as the Asian Development Bank have championed the strategy. Attention focused on local bond market development following a series of currency crises in emerging economies that revealed the financial fragility associated with a currency mismatch (Goldstein and Turner 2004) and opened the debate regarding the ability of emerging economies to overcome the problem (Eichengreen and Hausmann 2005; Burger and Warnock 2006).

Recent years have seen rapid growth in local currency bond markets worldwide and a substantially reduced reliance on foreign currency issuance in many emerging economies. Particularly impressive is the evolution of Latin America's bond markets, where in 2001 only half of the bonds were issued in local currency but by the end of 2006 over two-thirds were local-currency-denominated. These developments raise an important question: How have cross-border investors responded to the surge in local currency bond issuance by emerging economies?

Ideally, we would study all foreign investors' positions in local currency bonds, but we demonstrate why such a study is not possible. Although one broad multilateral database does exist—namely the IMF's Coordinated Portfolio Investment Survey (CPIS) data—it is particularly ill-suited to address participation in local currency bond markets. We warn our readers about studies based on the CPIS that claim to analyze local currency bond markets, as this is impossible to do so; the CPIS data does not include information on bonds' currency denomination and so cannot speak to foreign participation in local currency markets. What we can do is provide a formal analysis of the recently released 2006 benchmark survey of one large set of international investors—U.S. cross-border investors—for whom data on the currency denomination of bond holdings is available.

The survey provides reliable evidence on the change in U.S. positions in local currency bonds since the last benchmark in 2001. The surveys reveal increased participation in emerging local currency bond markets. Participation is still very limited in Emerging Asia, at 0.21 percent (on average) of local currency bonds outstanding, but is up from near zero in 2001 and is reasonably large in some countries such as Indonesia and Malaysia. U.S. participation in local-currency Latin American bonds has increased dramatically to a level of 2.03 percent by end-2006, double the share U.S. investors held of developed markets. In fact, for developed markets as a whole U.S. investors *decreased* their holdings as percentage of outstanding bonds. The survey indeed reveals a shift in U.S. investor portfolio weights away from developed countries toward emerging economies.

We next analyze the country-level factors that are associated with greater U.S. investment in local currency bond markets. We use the Gemloc investability index created by CRISIL (2008) and its six subcomponents: capital controls; market liquidity and efficiency; regulatory quality and creditor rights; market infrastructure; taxation on bonds; and the size of the local institutional investor base. The CRISIL investability data are available for the 20 Gemloc countries. In addition, we added roughly 20 developed countries by creating, where possible, similar indices. Our empirical results indicate that countries with higher scores on the aggregate investability index are able to attract significantly more U.S. investment into local currency bond markets. Furthermore, each of the individual components of investability has a statistically significant impact on U.S. participation.

Having established that U.S. investors' cross-border bond positions were influenced by the institutional factors and policies embodied in the investability index, we next evaluate whether country specific returns characteristics can further explain investor behavior. Returns characteristics were very attractive to foreign investors during the 2001-2006 period, in part because volatility (the bane of local currency bonds from a foreigners' perspective) was greatly reduced relative to prior periods. The favorable returns clearly contributed to the broad increase in participation by U.S. investors but our empirical analysis suggests that U.S. investors did not discriminate *among* local currency bond markets based on the performance of past returns. Returns in local currency bond markets were generally favorable, prompting more U.S. investment (especially in emerging markets), but past returns characteristics did not appear to influence allocations among local bond markets.

To summarize, our empirical results indicate that cross-border participation in local currency bonds is highest in countries where investor-friendly institutions and policies have been established. For emerging economies seeking to broaden their investor base by appealing to international investors, our results are potentially good news. Many of the factors that appeal to cross-border investors are within the control of the host country. It is not surprising that capital controls represent an impediment to cross-border investors, but potential host countries should also take note of the importance of tax policy, regulatory quality and creditor rights.

The empirical results also point to the possibility of a virtuous cycle developing in local currency bond markets. Over the 2001-2006 period we have witnessed a surge in local currency issuance in emerging economies *and* increased participation from cross-border investors in these bond markets. These two developments should be mutually reinforcing. The same creditor-friendly policies and institutions that enabled the development of these markets are also factors we have demonstrated to be attractive to cross-border investors. Furthermore, the newfound ability of emerging markets to borrow internationally in their own currency should help stabilize their domestic macroeconomic performance and reduce the likelihood of future crises.

We end, though, on a cautionary note. Inflation is creeping up in many emerging market economies. If this trend continues, one could imagine the gains emerging markets have made in developing local currency bond markets and attracting investors—both domestic and international—might evaporate.