Government Bond Market Advisory Services Peer Group Dialogue

Meeting #15: Minutes

Local Currency Bond Markets: the Challenge of Deteriorating Liquidity?

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<tr><td>Date:</td><td>November 4, 2014</td></tr>
<tr><td>Place:</td><td>Conference call led by the Government Bond Market Advisory Services team of the World Bank in DC via WebEx online conferencing tool</td></tr>
<tr><td>Time:</td><td>8 am- 9:30 am (EST time)</td></tr>
<tr><td>Attendees:</td><td><u>Country Participants</u>:
Brazil: Jose Franco Medeiros de Morais, Fernando Eurico de Paiva Garrido, Leandro Puccini Secunho, Roger Araujo Castro, Otavio Ladeira de Medeiros, Paulo Fontoura Valle (Brazilian Treasury)
Colombia: Camilo Andres Meza Campuzano, Ana Carolina Diaz Zuleta, Luis Alexander Lopez Ruiz (Ministry of Finance and Public Credit)
Hungary: Laszlo Buzas, Andras Rez, Zsolt Bango (Government Debt Management Agency - AKK)
Poland: Michał Wisniewski (Ministry of Finance)
South Africa: Phumzile Maseko (National Treasury)
Turkey: Fatih Bozkurt, Emrah Pilavoglu (Undersecretariat of Treasury), Gürsu Keleş (Central Bank)
<u>World Bank Group Participants (staff and consultants)</u>:
Mike Williams, Anderson Silva, Indhu Raghavan, Olga Akcadag, Eva Hansen, Zauresh Kezheneva (World Bank); Oualid Ammar (IFC)</td></tr>
<tr><td>Topic:</td><td>Local Currency Bond Markets: the Challenge of Deteriorating Liquidity?</td></tr>
<tr><td>Objectives:</td><td>Introduction of the topic by the World Bank
Roundtable on recent developments in other Peer Group Countries
Discussion and Q&A</td></tr>
<tr><td>Issues discussed:</td><td><u>Deteriorating liquidity in local currency bond markets</u>
Background: In emerging market economies (EMEs), local currency bond markets (LCBMs) have grown substantially, although the pace has slowed in recent years. LCBMs continue to dominate foreign currency bond markets in terms of both outstanding stock and new issuance. In 2013, the issuance in LCBMs slowed down for corporates, with a slight increase on the governments' side. Despite recent slow growth, foreign investor participation remains at a historically high level, with non-</td></tr>
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resident holdings of approximately 30% in the outstanding LCBM stock.

- **Liquidity concerns in the EME LCBMs:** (i) The turnover ratio (proportion of trades to the total outstanding stock) has remained relatively stable and at a low level compared with the advanced economies despite growth in outstanding stock; (ii) Liquidity has worsened when measured by widening of bid-ask spreads in several EMEs since 2010. Liquidity trends vary with country, and the data are dominated by relatively few markets: 10 countries account for 78% of total traded volumes in EMEs.

- **Concern for low turnover:** Liquidity remains concentrated in government debt instruments, but foreign investor holdings of these instruments significantly exceed the average daily trading volumes. In the event of a significant divestiture/outflow of foreign capital, is there sufficient liquidity to accommodate the outflow or will it significantly move the yields on government bonds?

- **Concern for widening spreads:** In the last 3-4 years, bid-ask spreads have widened for 10-year local currency government bonds. However, the focus solely on a 10-year point may be misleading, as it is not clear what the trend is in the other parts of the yield curve, particularly for short or medium-term benchmarks. Experience may be different in other parts of the maturity spectrum – there may also be much better liquidity in benchmark bonds, even if it has declined for others. Additionally, sharp widening in spreads may reflect the opportunistic behavior of some intermediaries in volatile or uncompetitive environments.

<u>Main determinants of deteriorating liquidity</u>

- **On the supply side:** Whether substantial or marginal, the contributors to the deteriorating liquidity in EMEs may include (i) the rise in foreign currency-denominated issuances given the favorable low-interest environment and investor demand (e.g., Sub-Saharan Africa); (ii) the greater fragmentation of financing sources (*sukuk*, public-private partnerships); and (iii) the recent interest in sub-national bond issuance, which tends to be less liquid and may be disrupting the scheduled government issuance.

- **On the demand side:** Contributors to the deteriorating liquidity are likely to include: (i) the reluctance and withdrawal of some banks from market making due to deleveraging; (ii) the growth of buy-and-hold domestic investors that contribute little to trading activity - reflecting a general lengthening of maturities of government debt portfolios in EMEs; (iii) the change in the nature of foreign investors, with hedge funds often being replaced by longer-term funds, such as pension funds – reflecting consolidation of EME bonds as an asset class and their inclusion in relevant global indices.

	Other trends and observations pertaining to market liquidity • Despite the setbacks in market making, EMEs have advanced in terms of price transparency and market information flow, resulting from developments in primary market practices, primary dealership/market making programs, etc. • Trade sizes have risen in some EMEs, particularly in the Asian markets. It may be indicative of increasing market sophistication. • A growing use of government bonds as collateral may contribute to improving liquidity. • New risk factors for liquidity stem from market expectations of rising US interest rates. This increases the risk of currency mismatches in liabilities, sudden flight of foreign investors and oligopolistic behavior by intermediaries. Country-specific issues can intensify such risks. **Country experiences** **Brazil:** • Certain strategies in the Brazilian primary market help to overcome constraints in the secondary market. In the last 10 years, Brazil has had an ongoing regular program of switch auctions. Switch auctions are run once a month, where a floating rate debt, particularly linkers, with shorter maturity is exchanged for benchmarks with longer maturities. A rising concern is a possible impeding effect of this policy on the development of the secondary market in the long term. **Colombia:** • **Foreign investor participation:** Colombia has experienced a significant increase in foreign investor participation from 3% in 2012 to 15% in 2014 mainly due to a decrease in foreign investor taxation, but also due to more weight assigned to Colombia in EME bond indices. With 500 foreign funds entering the market, the inflow has had a positive effect benefiting competition and limiting the price movement potential of large local investors (pension funds). Foreign investors have tended to invest in long-term bonds and have not been active traders on the secondary market. In the future, such buy-and-hold behavior may affect liquidity in benchmarks held. • **Primary dealers (PDs):** Current PD program aims to stimulate secondary market liquidity. The performance scoring system assigns 20% for primary market activity and 80% for secondary market activity (with particular weights for volumes, quoting and repo operations). **Hungary** • Hungary witnessed some decrease in secondary market liquidity; although in 2014, secondary market liquidity significantly improved.

	The number of bonds outstanding was decreased and more PDs were assigned to quote the benchmarks. In the secondary market, over-the-counter (OTC) trades significantly dominate trading on the MTS platform and on the organized stock exchange. • **Liquidity deterioration factors:** (i) the auction system redesign – frequent auctions since 2008, taking away some secondary market trading; and (ii) the initiative to increase participation of retail investors, who are not active in the secondary market. Since 2012, the government issued a number of retail securities and improved sales/distribution channels to retail. As a consequence, the share of retail holders of government debt increased from 3.5% in 2011 to about 14% in 2014. • **Liquidity enhancement factors:** (i) a large proportion of foreign investors, who trade in large sizes; (ii) changes in monetary policy requirements, encouraging banks to take a more active share in the government bond market. The debt management office (DMO) facilitates such demand from the banks by issuing floating-rate bonds meeting their specific requirements. **South Africa:** • On the primary market, PD system works effectively to improve the liquidity (PDs can make markets in 14 benchmarks). Non-resident investor participation has been at 36-37% in the past 3 years, with a positive contribution to liquidity, particularly in newly introduced bonds. The sell-off intensity from foreign investors was not at the level that the local investors could not absorb. The rich local investor base and PDs were able to accommodate all sell-offs and helped to keep the market stable. The DMO is also looking at further incentives for PDs in an effort to increase liquidity in the new low-volume bonds. Additionally, the DMO is reconsidering its approach to conducting irregular, refinancing need-driven switch auctions to avoid distortions in the short end of the yield curve. **Turkey:** • Turkey has observed decreased liquidity in the secondary markets at the times of recent market turbulence. Liquidity squeeze in the longer end of the yield curve was bigger than in the shorter end of the curve. • **Role of primary dealers:** PDs/market makers are very important for increasing market liquidity in Turkey, as realized during the 2013 turbulence. PDs and other banks absorbed the withdrawal of foreign investors, increasing their securities portfolio. To assist with liquidity in the crisis situation, the Turkish DMO widened the choice of benchmarks to be quoted by PDs (from 6 to 9). In general, the performance of PDs was quite effective, although the performance measurement system could be based on absolute rather than relative metrics as is the case now.

	• **Role of foreign investors:** Foreign investors are a very important source of secondary market liquidity in Turkey. Local investors prefer purchasing directly from the government in the primary market and dealing with foreign investors in the secondary market. Foreign investors prefer entering into swaps or entering through the OTC market to avoid moving the market. • **Fragmentation of instruments:** To diversify the investor base the country began issuing fixed-coupon 2-, 5- and 10-year bonds, 5- and 10-year inflation-indexed bonds and sukuk, while increasing the nominal amount of the issuances at specific maturities. Such fragmentation contributed to lower liquidity on the organized market. • **Trade venues:** After the recession, with more foreign investor participation, the share of OTC transactions increased. Volume in the OTC market is twice that on the organized exchange. Currently, no shift in trading activity from OTC to electronic trading platforms is expected.
Documents discussed:	• Presentation on the topic by Mike Williams
Next steps:	• Solicit other topics for discussion in future PGD meetings