Sovereign Debt Management Forum 2014

Summary Note for Plenary Session 2

Changes in the investor base for emerging market public debt: What has happened in the last decade and what do we see going forward?

I. Summary of session

Daniela Klingebiel of the World Bank Treasury introduced the topic by giving an overview of recent trends and developments in the supply of and demand for emerging market (EM) local currency sovereign debt. Ms. Klingebiel emphasized the significant increase in the size of EM local currency tradable debt and the concentration of the market in the ten largest issuers. In the introduction, she also draw out the substantial interest in EM local currency debt by foreign investors in recent years and posed the question to panelists if they see strong foreign demand, especially by institutional investors, as a result of global liquidity conditions and monetary policy in advanced economies or whether that trend was a structural shift in investor preferences. The panelists, David Lubin of Citi, Alberto Fassinotti of Rock Creek Group, and Luc Everart of the International Monetary Fund (IMF), engaged in a dynamic discussion on Ms. Klingebiel's question on cyclicality vs. structural changes, the preferences and investment strategies of various institutional investors, including private and public pension funds, mutual funds, as well as central banks and sovereign wealth funds (SWFs).

II. Key insights from presentations and discussion

Daniela Klingebiel's presentation framed the issue under discussion by first sharing trends in the supply of EM local currency sovereign debt. Her presentation underlined strong growth in the asset class in the last decade, also relative to EM equity, and the concentration of the market among key issuers, led by China, Brazil, India, and Mexico. The top 10 issuers represent more than three quarters of the asset class. Following the analysis of supply, Ms. Klingebiel focused on the demand for EM local currency debt, showing how foreign ownership has increased in most EM countries from 2006 to 2013, and that in 10 out of 21 EM countries foreign ownership already represented more than 20% of outstanding local currency debt. Ms. Klingebiel argued how the development of local currency debt indices was a response to increased investor appetite as well as how inclusion in an index increases liquidity in local markets. Lastly, she focused on the example of US public pension funds that increasingly have allocations to EM local currency debt to illustrate how non-traditional investors have move into that asset class.

David Lubin spun a story centered on developments in China. He argued that the speed of growth in China as well as the structural evolution of the economy where major drivers for the economic prospects in EM economies, and hence critical in understanding the prospects for EM local currency debt by international investors. Mr. Lubin argued that a slowdown of growth in China as well as a rebalancing of the economy to reduce the propensity to import would slow growth in EM economies, especially commodity-driven ones, and hence may lead to an outflow of capital. Mr. Lubin also suggested that the evolution of China's economy may be a more prominent driver in capital flows to EM economies than monetary policy in advanced economies. In addition to reflecting on cyclical drivers such as growth in China and global liquidity conditions, Mr. Lubin observed a decline in home bias in G-20 members and attempted to disentangle cyclical from structural characteristics of this development.

Following the two presentations, Ms. Klingebiel moderated a dynamic discussion between panelists. One common theme Ms. Klingebiel discussed with all panelists was the differentiation between emerging markets, including how investors differentiate among different markets and how countries themselves can differentiate themselves to attract stable investors with long term investment horizons. Panelists acknowledged significant herding behavior among investors, especially in times of distress where portfolio decisions (e.g. the need to liquidate assets) might drive relatively broad brush investment decisions. However, panelists pointed to factors such as external balance (current account), the structure of exports (e.g. commodities vs. manufacturing), overall macroeconomic stability, and the strength of political institutions that investors analyze and use to differentiate among markets. Additionally, factors such as the development of capital markets, including the ability to hedge currency exposure, and liquidity conditions (including the ability to sell with imposed restrictions in times of market distress) were important in investors' investment decisions.

Alberto Fassinotti shared his insights in how investors make investment decisions and how different types of institutional investors (e.g. US state pension funds vs. corporate pension funds) differ in the extent to which allocations to EM local currency markets are part of a strategic asset allocation or rather opportunistic investments given current yield prospects. Mr. Fassinotti also outlined how investors typically manage their exposure against indices and what factors (as discussed above) are driving limited off-benchmark exposure.

Luc Everaert pointed towards the risks related to sudden swings in investor preferences due to changing global liquidity conditions that countries with significant participation of foreign investors in local currency sovereign bond markets are exposed to. Mr. Everaert also elaborated on other effects of foreign ownership on local bond markets, sharing insights from an IMF study showing how increased foreign ownership drives down yields and increases liquidity.

III. Conclusion and issues for further discussion

Contributions from panelists highlighted how a combination of cyclical and structural elements resulted in the change in the investor base for EM local currency sovereign debt that can be observed in recent years. Underlining how important global liquidity conditions driven by monetary policy in advanced economies was in increasing investor appetite for higher yielding assets, panelists shared concerns that

tightening of monetary policy by the Federal Reserve in the US would lead to a reduction in investor demand for EM local currency debt and potentially difficult environments for EM economies. Panelists, however, also highlighted structural changes in investor preferences and increasing differentiation among EM economies by international investors. As a result, panelists saw opportunities for EM countries to further diversify the investor base through macroeconomic stabilization and continued development of capital markets to increase 'investability' of their respective markets. Plenary session 3 subsequently discussed in detail how EM governments can increase the attractiveness of local currency debt markets to non-resident investors.