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Reasons behind those shifts of market sentiment regarding emerging markets’ assets have been two-fold. First, there is the fact that the broad-based growth slowdown in emerging economies since 2013 has apparently reflected underlying fragilities. The previous enthusiasm with those economies’ growth prospects derived from the perception that they had before them some avenues of opportunity regardless of the post-crisis feeble recovery in advanced economies (Canuto et al, 2010): healthy public and private balance sheets in the aftermath of the crisis and existing infrastructure bottlenecks would provide room for increased investment and higher total factor productivity in many developing countries; technological convergence and the transfer of surplus labour to more productive tradable activities could continue, despite the advanced economies anemic growth; rapidly growing middle classes across the developing world would constitute a new source of demand; and, with their share of global GDP increasing, developing countries would sustain relative demand for commodities, thereby preventing prices from reverting to the low levels that prevailed in the 1980s and nineties.

Nevertheless, emerging economies’ motivation to transform their growth models in order to explore those avenues was weaker than expected. The global economic environment – characterised by massive amounts of liquidity and low interest rates stemming from unconventional monetary policy in advanced economies – led most emerging economies to use their policy space to build up existing drivers of growth, rather than develop new ones. After a post-shock fast recovery, growth returns have dwindled, while imbalances have worsened in several EMEs (Canuto, 2013a).

Secondly, there has been a change of perspectives with respect to the recovery in advanced economies, particularly the US, which is now deemed to be steadier than in any time since 2008. While such a scenario change entails rising prospects for exports from emerging market countries, it...
also points to normalisation of the US monetary policy and therefore to tighter external financial conditions for those economies that do not address rising imbalances in due time. While growth prospects are still dim in the eurozone and the European Central Bank has announced a round of unconventional policies, there has been a steady flow of resources into its sovereign debt market.

In fact, two bouts of volatility and downward adjustment of exposure to emerging markets since 2013 can be traced back to those factors (Canuto, 2013b, 2014). First, a global portfolio rebalancing was put in motion along the summer of 2013, following the talk of the US Federal Reserve shrinking – and eventually reversing – its asset purchase programme (QE or quantitative easing), a policy change that started effectively to be implemented in December. Second, news in January 2014 about a heightened possibility of a disorderly unwinding of China’s shadow banking over-leverage of latter years, associated with a burst in domestic property markets, led to a further worsening of risk-return prospects for assets in other emerging market economies vulnerable to a significant growth deceleration in that country. Policy responses – higher interest rates, exchange rate devaluations – on the side of those countries most affected in both stressful moments have been followed by relative stability of capital flows since then.

Emerging and developing economies as a group remain showing strong growth, lower than before the crisis, but high nevertheless. The World Bank forecasts their growth to remain below 5% in 2014, but reaching 5.4% and 5.5% in 2015 and 2016 — broadly in line with potential. These economies will have to cope, however, with a changing world environment. With tighter financial conditions and a tougher financial environment, foreign investors will become more attentive to country-specific vulnerabilities and macroeconomic weaknesses will become more costly. Financial bumps, such as those two bouts of volatility since 2013, may certainly take place again. Furthermore, unless the exhaustion of old growth patterns is recognised and the needed structural reforms to explore new avenues of opportunity are pursued, emerging economies will fall short from fulfilling their potential as global economy’s main engines.

**Prospects for long-term financing via capital markets**

Greater susceptibility to shifts in market sentiment brings a heavy toll to EMEs in the process of developing long-term financing via capital markets. EM local currency bonds, in special, have been one of the fastest growing assets classes in the world, with average annual growth close to

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**EM1 domestic debt securities outstanding by type of issuer**

**Exhibit 1**

<table>
<thead>
<tr>
<th>Non-financials</th>
<th>Financials</th>
<th>Governments</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>6,000</td>
<td>4,000</td>
<td>2,000</td>
<td>10%</td>
</tr>
<tr>
<td>5,000</td>
<td>3,000</td>
<td>1,000</td>
<td>5%</td>
</tr>
<tr>
<td>4,000</td>
<td>2,000</td>
<td>500</td>
<td>2.5%</td>
</tr>
<tr>
<td>3,000</td>
<td>1,000</td>
<td>100</td>
<td>0.5%</td>
</tr>
<tr>
<td>2,000</td>
<td>600</td>
<td>20</td>
<td>0.1%</td>
</tr>
</tbody>
</table>

1 EM country included: East Asia: China, Indonesia, Malaysia, Philippines, Thailand; Europe/Central Asia: Croatia, Hungary, Poland, Russian Federation, Turkey; Latin America: Argentina, Brazil, Chile, Columbia, Mexico, Peru; and South Asia: India, Pakistan; Middle East/Africa, Saudi Arabia, South Africa.
2 GDP is from IMF WEO Oct, 2013
3 September 2013

Source: BIS table 16.
24% in the last 13 years (Exhibit 1). More than 80% of emerging market government debt is currently financed in local currency and maturities are being extended up to or beyond 10 years in countries such as Brazil, Turkey, Mexico and Poland, providing 'risk-free' price references that facilitate issuances by corporate sector institutions. Nevertheless, the gap in the development of bond markets between advanced and emerging economies remains wide. The risk is that changing conditions may stall progress of EM bond markets.

Large and frequent swings in investor sentiment are an important but not the only concern in EM bond markets. Investors are facing larger spreads to trade and market turnover is far below the peak reached in 2010 (IIF, 2014). Some of the causes may be structural: (i) stricter regulatory constraints – leading market-makers to reduce their inventories; and (ii) growing participation of buy-and-hold domestic institutional investors. Larger insurance and pension fund industries in some EMEs are enhancing opportunities for long-term financing, as discussed later, but the overall drop in liquidity brings to the forefront the need of a policy agenda to keep EM bond market development on track and to mitigate risks of ‘disorderly adjustments’ in EM bond markets.

On the side of government bond markets, countries should focus on crisis response preparedness and on measures to support liquidity. A rich set of measures were adopted by EM governments to contain funding pressures and volatile secondary markets during the market turbulence of 2008-09 (Anderson et al, 2013). Policy-makers could draw from these experiences and build contingent plans to withstand similar shocks in the future. Secondary market liquidity could be fostered by:

i. implementing issuance programmes that reduce debt fragmentation and concentrate debt in larger size benchmark instruments;

ii. aligning incentives of primary dealers to quote firm and competitive bid and ask prices;

iii. developing repo markets and securities lending facilities to help market-makers finance and cover their positions; and

iv. improving secondary market architecture, including the effective design of electronic trading systems that could lead to enhanced liquidity and price discovery.

On the non-government bond market agenda, main observed challenges are to broaden access to a wider variety of issuers and attract a diversified investor base. Significant effort is under progress to simplify securities offering procedures, minimising time and financial costs for issuers while providing sufficient level of disclosure to investors in countries like India, Malaysia and Thailand. But more needs to be done: (i) greater availability and use of credit enhancement tools and securitisation could amplify the breadth products and issuers; and

(ii) (innovative) solutions for liquidity support, such as more effective market-making schemes, could help bonds attract a diversified group of investors.

The good news is that these agendas are in progress in several countries. Approximately 80% to 90% of the demand for World Bank advisory services in government bond markets involves at least one of the items discussed. Countries such as Morocco and South Africa are making substantial progress in their secondary market architecture. Similarly, countries are studying liquidity support mechanisms (Brazil) and improving regulations for securitisation (e.g., Turkey), whereas multilaterals and governments are providing a wider set of guarantees and credit enhancements.

Financing infrastructure

EMEs potential to change their growth models relies heavily on their capacity to close their growing infrastructure gap. Globally it is estimated that infrastructure investment needs to range between US$57 trillion and US$67 trillion (Exhibit 2), of which around 37% account for EMEs. Most of these investments are required for energy generation, roads and telecommunications, all of which would be essential to support growth, competitiveness and job creation.

EMEs are facing a twin challenge: how to arrange these
projects into bankable structures, and how to access long-term funding in the post-crisis era. Traditional funding sources from governments and commercial banks, while still relevant, are retrenching after post-crisis tighter fiscal constraints and more conservative prudential regulations for banks (shorter maturities and lower risk tolerance), following Basel III. Additionally, lending from foreign banks significantly declined since 2007 and the expectation is that the trend will not reverse (Canuto, 2013c).

In this context, EMEs need to tap new sources of long-term funds. Foreign capital is still flowing into EMEs debt (see Exhibit 3), but it is doubtful that it will be the dominant player in infrastructure finance, given perceived risks and competition for infrastructure investments in their home advanced economies (AEs).

Nevertheless, EMEs have been gradually building their own pool of sizeable long-term assets managed by institutional investors, mainly pension funds and insurance companies, accounting to around US$5.5 trillion as of end 2012 (see Exhibit 4). Infrastructure assets are ideal investments for pension funds and insurance companies as they tend to match their long-term liabilities, provide inflation protected yields and have lower correlation to other financial assets. An additional benefit is that a large base of domestic institutional investors could also make infrastructure investments more attractive to foreign investors, as they will be perceived as a potential liquidity buffer in times of capital outflows.

The task ahead is to develop the financial vehicles that can channel EMEs long-term institutional savings into financially viable infrastructure projects. The growing share of public private partnerships (PPP) for infrastructure projects is facilitating the development of innovative financial structures to fund these projects.

Local fixed income markets, through infrastructure project bonds, could fill in a large share of the remaining funding gap, complemented by more traditional unlisted products, provided policy-makers develop the appropriate framework for issuers, investors and intermediaries. Infrastructure project bonds are also an innovation in AEs but are showing growing relevance, with several types of bonds and credit enhancement schemes being tested depending on the project (e.g., greenfield and brownfield*).

The challenge for EMEs to develop these bonds is two-fold. The first one is building a minimum fixed income market regulatory and institutional framework so that structuring, issuance and placement of infrastructure project bonds is cost-efficient. Most large EMEs have already that

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**Estimates of needed infrastructure investments, 2013-30**

*US$ trillion, constant 2010 dollars

**Source:** McKinsey Global Infrastructure, Jan 2013
framework in place and are in a position to support such bonds. The second challenge is to develop the appropriate credit risk enhancement instruments so that project bonds have credit ratings acceptable for institutional investors, generally domestic investment grade or above (BBB-).

Governments, multilateral organisations, development banks and commercial banks are to play a key role in either supporting or providing these risk mitigating instruments.

As infrastructure financing options are developing, it is becoming clearer that public policies and the direct engagement of government and multilaterals in making these long-term vehicles financially viable would be critical for their success. Furthermore, the development of an active infrastructure project bond market could have a number of positive externalities in reinforcing a long-term fixed income market for a broader range of issuers. This could compensate for the higher volatility in foreign capital flows and support local fixed income markets in EMEs that are less dependent on foreign investors.

Bibliography

Volume of long-term assets managed by institutional investors

**Exhibit 4**

**EM pension assets at US$2.1 trillion at the end of 2012**
- EM Asia
- EMEA
- Latin America

**EM insurance company assets approaching US$3.4 trillion**
- Latin America
- EMEA
- EM Asia

Source: Official sources and J. P. Morgan

Notes:
- The authors would like to thank Carlos Senón Benito for his excellent research support. The views expressed in this chapter are those of the authors and do not necessarily represent those of the World Bank or World Bank policy, nor do they commit the World Bank in any way.
- EM economies accounted for around 43% of global GDP as 2007, but their share on world's bond market capitalisation represented only 11% (Ruivivar, 2010). EMs started breaching the gap by gaining approximately 8% from 2007 to 2013, based on BIS data and WB staff estimates.
- The risk of 'disorderly adjustments' and the challenging liquidity conditions in EM bond markets are covered in Plender (2014), Wheatley (2014 and 2014b).
- Greenfield makes reference to projects in the construction phase where no cash flow is generated yet, whereas brownfield refers to projects in a generating cash flow phase where additional capacity or operations and maintenance needs to be financed.