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Background Note for Plenary Session 3[1]

How have debt managers increased the attractiveness of local currency debt?

Government debt portfolios in many emerging markets underwent significant transformation due to growth of domestic borrowing in local currency. Backed by healthier macroeconomic fundamentals, such switch to domestic currency financing was facilitated by active debt management strategies to increase the appeal of local currency debt markets. Some strategies encouraged investments by non-resident investors while others improved the functioning of markets, by implementing sound primary market practices and promoting liquidity. The creation of benchmarks, publishing of regular borrowing plans, promotion of electronic trading platforms, and adequate primary dealer arrangements were some of the actions undertaken. This note will discuss particular strategies debt managers have used to increase the attractiveness of local bond markets.

I. Introduction

Many emerging markets (EMs) underwent a significant shift in the composition of their government debt portfolios since the 2000s. The larger role of local currency bond markets (LCBMs) in government financing of EMs was particularly pronounced in the early 2000s. The proportion of external to domestic debt for selected EMs dropped from 65% in 2000 to 11% in 2009 (Figure 1). In the same period, the quality of the domestic debt structure significantly improved through an extension of the portfolio's average life and a growing issuance of long-term fixed-rate instruments (Figures 2 and 3). The essential role of domestic government debt in government financing was reaffirmed in the aftermath of the 2007-2008 global crisis, helping maintain the ratio of external to domestic debt at historically low levels (9% by the first half of 2014).

The expansion of LCBMs in the last decade came on the back of improved macroeconomic fundamentals and structural changes in investor base. In the years preceding the crisis, EMs achieved healthier macroeconomic environments reflected in buoyant growth rates, stronger fiscal and external balances, and lower inflation. The local institutional investor base continued to grow, stimulating demand for longer-term and local currency denominated debt. Non-resident exposure to local currency-

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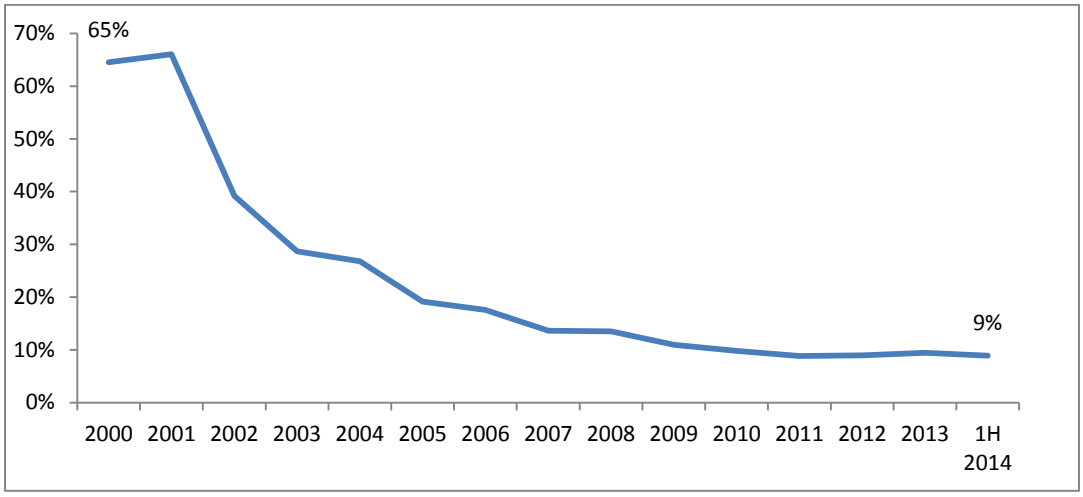
denominated government bonds increased as well, reaching 25.4% across EM issuers in the beginning of 2014, and remained broadly stable, reflecting the consolidation of EM LCBMs as an asset class.

Figure 1: Ratio of external to domestic government debt in selected emerging markets:



Note: Figure 1 is based on a sample of 20 EMs (Argentina, Brazil, Chile, China, Colombia, Croatia, Hungary, Indonesia, India, Lebanon, Malaysia, Mexico, Pakistan, Peru, Philippines, Russia, Saudi Arabia, South Africa, Thailand, and Turkey).

Source: BIS (Debt Securities Statistics)

Changes in domestic government debt portfolio:

Figure 2: Increase in fixed-rate debt

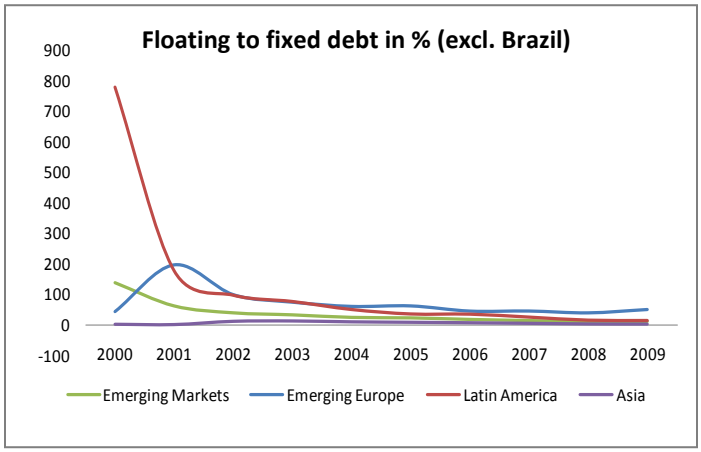
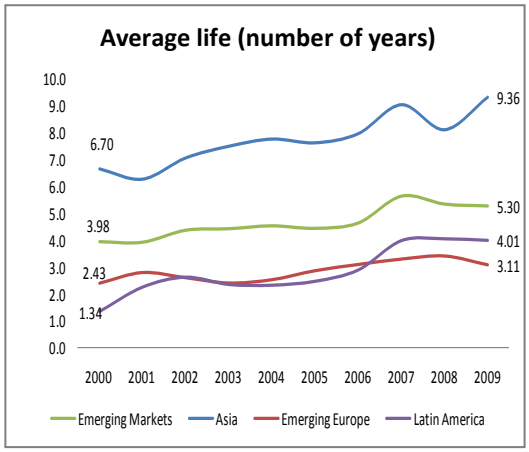


Figure 3: Lengthening of maturities



Source: Public Debt Management In Emerging Market Economies: Has This Time Been Different? The World Bank

Government debt managers engineered the change in government debt portfolios by adopting policies that enhanced the attractiveness of local currency debt. This process was anchored by carefully designed public debt management strategies that helped policy makers set the pace of shift to domestic debt. Accordingly, most countries formalized the intent of developing their domestic debt market as an explicit debt management objective. This brief background note focuses on certain measures available to debt managers within a more extensive government LCBMs development agenda.

II. The Building Blocks and Policy Agenda for the Domestic Debt Market

A full-fledged government bond market requires several building blocks: (i) well-functioning money markets; (ii) efficient primary markets; (iii) a robust and diversified investor base; (iv) a secondary market architecture that facilitates trading and price transparency; (v) a credible legal and regulatory framework, and (vi) a sound clearing and settlement infrastructure. In addition, as the market develops, the presence of a derivatives market and hedging tools to support risk management by investors also become increasingly important.

Building Blocks	Rationale and Contribution to Government Bond Market Development
Money Market	• Essential for liquidity management • Anchors prices for government bond yield curve and derivatives markets
Primary Market	• First source of price formation, usually through auctions or syndications. Provides pricing references for different maturities supporting yield curve development • Good practices contribute to competition, facilitate liquidity and portfolio management.
Investor Base	• Supports demand and liquidity in primary/secondary markets
Secondary Market	• Improves price discovery and transparency (pre-trade and post-trade procedures) and stimulates liquidity (e.g. trading venues, market making)
Clearing and Settlement	• It is the foundation for safe and efficient settlement of transactions, reducing risks and costs that investors would otherwise be exposed to.
Legal and Regulatory Framework	• Provides the foundations to enable issuance, and supports market integrity and investors' confidence
Derivatives Market	• Provides risk management tools to investors and market makers/primary dealers of government bonds • Supports price formation across cash and derivatives markets

Strategies to enhance the attractiveness of local currency markets include a wide variety of measures and involve several of the building blocks. In the money markets block, for example, key issues are (i) the development of the repo markets; and (ii) the policy coordination between the Central Bank and the Debt Management Office (DMO) in the selection of instruments and procedures to implement monetary policy, conduct government's cash management and execute the funding program. In the clearing and settlement block, actions could ensure delivery-versus-payment, upgrading systems to automate processes, thus reducing costs and the risk of manually processed transactions, and in some cases, linking a domestic central securities depository (CSDs) to an international central securities depository, facilitating access of non-resident investors.

We focus below on a subset of measures in the overall agenda for the development of domestic government debt markets, emphasizing those perceived to be more widely spread across EMs, involving: (i) primary markets; (ii) secondary markets; and (iii) other selected areas.

Improving the functioning of primary markets: implementation of sound market practices

The policy agenda in primary markets usually involves: (i) selection of an issuance mechanism and procedures (e.g. auctions vs. syndications); (ii) a choice of instruments (e.g. fixed, floating, inflation-linked instruments; bullet or amortizing bonds); (iii) implementation of a benchmark building strategy to consolidate reference points in the yield curve and stimulate liquidity; and (iv) measures to enhance transparency and predictability in primary markets such as the publication of annual borrowing plans and auction calendars, among other measures to enhance communication with investors (e.g. the development of an investor relations group or strategy).

Establishing credible and efficient issuance mechanisms and procedures is critical to enhance competition in primary markets and to improve price discovery. A first step is the selection of the issuance mechanism - most commonly auctions, even though some EMs may find advantageous to also consider the use of syndications in combination with auctions, particularly for launching new benchmarks as is commonly done in mature markets (e.g. France and Belgium). A second and arguably more difficult step is the determination of rules for auction participation (exclusive to primary dealers or open to a large pool of investors), and cut-off rules (multiple or uniform price auction). Numerous practices are adopted worldwide reflecting that the adequate format and policies in primary markets are not only country-specific, but also instrument-specific. The lesson is that the agenda to make particular bonds attractive starts from the instrument's origin – the form of placement, which affects its original price formation and distribution across investors.

The choice of instruments is the next critical consideration. Most countries favor issuing mainly plain bullet bonds with a fixed-rate coupon that are easier to price and limit instrument fragmentation. Others combine fixed-rate with variable-rate bonds such as inflation-linked and other floating-rate debt instruments. The instrument choice may reflect restrictions in the demand for long-term fixed-rate instruments or preferences of an investor class (e.g., pension funds and insurance companies demanding inflation-linked instruments). Often debt managers would need to evaluate the trade-off as a more diverse pool of instruments could reduce the liquidity and depth of the market. This trade-off is country-specific, as it depends on the structure of existing domestic investor base, the macroeconomic preconditions, and the size of debt, among other factors.

Benchmark building strategies involve consolidation of debt issuance in a few standardized securities, reaching concentration that stimulates liquidity, deepens the market and provides better pricing references across different segments of the yield curve. A benchmark building strategy helps to reduce debt fragmentation in small-size instruments that affect liquidity and pricing. Besides improving issuance programs and reopenings of benchmarks, several countries also find it useful to conduct liability management transactions, such as buybacks and exchanges, to accelerate the buildup of benchmark securities. Syndications to introduce a new benchmark may facilitate a greater size and good price

formation in the first launch of the benchmark. The use of a benchmark strategy usually requires a concomitant strategy to mitigate refinancing risks due to large concentration of redemptions that it creates. For that, several DMOs have found it useful to maintain cash buffers and implement active liability management operations, such as buybacks and switches of short-term debt.

To enhance transparency and predictability, debt managers have focused on a series of complementary policy documents, starting with (i) a medium-term debt strategy that provides guidelines on the funding program and the composition of debt; and (ii) annual borrowing plans that offer greater detail of the funding strategy for a particular year; and finally including (iii) issuance calendars that cover information on instruments, auction dates and other details. Many countries have found it useful to strengthen the investor relations functions.[2]

Promoting secondary market liquidity via primary dealer systems and improved secondary market architecture

A deep and liquid secondary market depends on the well-functioning of all building blocks listed above. Accordingly, it is usually inaccurate attributing credit to any single specific policy for achieving a liquid market. Nonetheless**,** to support their secondary markets, debt managers often focus on : (i) primary dealer/market making arrangements; and (ii) a design of secondary market architecture (e.g. OTC markets, electronic trading systems).

Primary Dealer (PDs) systems may play a critical role in supporting both primary and secondary markets. The decision process to appoint PDs and the mix of obligations and privileges that strikes an adequate balance to stimulate PDs' performance are common challenges faced by DMOs. Not surprisingly, the design of PD systems is among the areas with the highest demand for advisory services and for peer-to-peer collaboration among EMs.

- **In primary markets, PDs are usually obliged to submit bids in most auctions and to subscribe minimum amounts or a share of the total volume of securities being auctioned**. Also common are commitments to support distribution of government debt to final investors (either by bidding on behalf of clients or by selling securities in the secondary market).
- **PD's support in secondary markets is more directly fostered through market making arrangements that vary from country to country**. A usual approach is for PDs to provide firm bid and ask prices among PDs and to commit to provide prices to clients on request. Numerous restrictions usually interfere in reaching a full-fledged market making arrangement, especially due to the cost and risk of holding an inventory of securities for market making purposes. The policy agenda to create enabling conditions for market making includes, among others, the primary market development measures discussed above (e.g. benchmark building strategy),

[2] For a comparative evaluation of the efforts by selected EM issuers to strengthen their communication and data dissemination practices relevant to sovereign risk analysis, see the report by the Institute of International Finance "Sovereign Investor Relations: 2014 Evaluation on Investor Relations and Dissemination Practices by Key Emerging Market Borrowing Countries".

provision of a set of incentives for PDs[3], creation of dedicated securities lending facilities for PDs and introduction of electronic trading platforms (more below).

The secondary market architecture enables market access to different segments of the investor base; contributes to price discovery and dissemination; influences the venue where trades are conducted (e.g. OTC vs. on a stock exchange); and ultimately, contributes to determine the degree of liquidity. A key topic on the secondary market architecture development agenda is the use of electronic trading platforms (ETPs)[4].

- **ETPs efficiently contribute to price transparency and market liquidity.** ETPs role since early 2000s has expanded thanks to the PDs' use of ETPs to comply with their market making obligations by quoting two-way prices. This is because ETPs are the only way for DMOs to monitor efficiently the compliance by PDs with their market making commitment.
- **Given that success of an ETP largely rests on the compliance by PDs with their quoting obligations, launching an ETP is the last step in a comprehensive government bond market development strategy**. Strategic prerequisites preceding such launch include benchmark issuance policy, authorization of short sales, availability of securities lending facility, and the ability of a DMO to reward top performers.
- **Debt managers face a number of strategic decisions in the design and launch of an ETP.** The strategic choices include a decision to lease or to build an ETP, a limitation on the number of ETPs, a limitation on access to an ETP (B2B: business to business model, or B2C: business to client model, etc.), a determination on continuous or periodic nature of quoting obligations, a selection of an ETP provider and a specification of PDs' performance evaluation on an ETP. Although there is no standard most efficient type of market configuration, it is practical to keep the number of ETPs limited in order not to fragment the market.

Other selected areas to enhance the attractiveness of local currency debt:

Besides PD systems and the architecture of the secondary market, taxation and links to the International Central Securities Depositories could also play a role in promoting market liquidity by attracting or complicating access to foreign investors. Different taxation regimes have been adopted and streamlined across EMs; for instance, while some EMs have lifted taxes on capital gains, others have used taxes as a mechanism to attract or control capital flows. On the clearing and settlement

[3] A popular incentive is granting PDs the status of a privileged counterpart of the DMO for certain debt management operations (e.g., granting a mandate of lead manager in a syndication, or participation in a liability management transaction – buybacks or switches). Other common incentives include post-auction non-competitive subscriptions, exclusive direct access to auctions and the publication of league tables with the best performing Primary Dealers (a tool that PDs value for marketing purposes with their clients).

[4] See for example a survey of eight EM DMOs (Colombia, Hungary, Korea, Malaysia, Mexico, Poland, South Africa and Turkey) on the use of Electronic Trading Platforms, undertaken as part of the Government Bond Markets Peer Group Dialogue initiative organized by the World Bank (http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTFINANCIALSECTOR/0,,contentMDK:22213130~menuPK:6213500~pagePK:210058~piPK:210062~theSitePK:282885~isCURL:Y,00.html)

infrastructure, some countries have found it helpful to establish links between their local CSDs and ICSDs such as Euroclear, to facilitate access to non-resident investors.

Finally, appropriate crisis response interventions have reinforced the investors' confidence on the market resilience in turbulent times. EM LCBMs have been through periods of high volatility and market turmoil due to global events and expectations regarding the end of Quantitative Easing (QE). Debt managers have adopted active strategies to deal with funding pressures and market disruptions during crisis periods, including the use of cash buffers, debt exchanges to alleviate liquidity constraints and reduce volatility in specific segments of the yield curve, etc.

III. Issues for Discussion

- What have been the changes in primary market policies that had the greatest impact on enhancing the attractiveness of local currency debt?
- In secondary markets, how relevant has been the role of primary dealers in stimulating liquidity? Are there positive trends regarding liquidity and depth of local currency instruments?
- How relevant have been other reforms such as on tax regime, links to ICSDs, money markets, etc. in the overall agenda to develop the local market? How have debt managers coordinated reform implementation with a broader set of stakeholders (e.g. Central Banks, regulators, etc.)?
- What are the aspects and reforms that matter the most to attract non-resident investors? What are the areas/minimum conditions that are considered "deal breakers" in attracting non-resident investors? How do they differ according to level of development of domestic debt markets and global economic relevance of particular EMs?
- What level of involvement and what specific actions should be taken by debt managers in times of crisis to support the local market?

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