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Emerging bond markets: No longer the next frontier

by Doris Herrera-Pol¹, World Bank

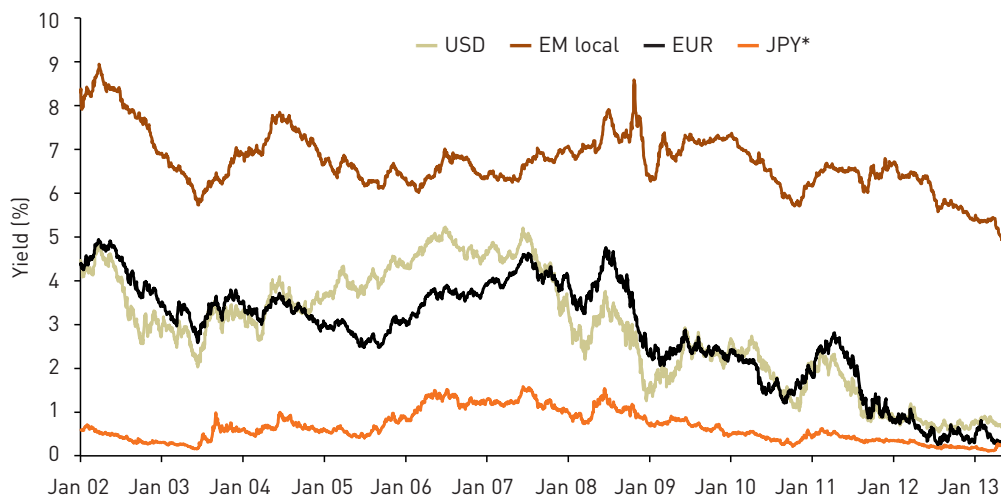
TODAY, INVESTORS CAN EASILY BUY BONDS ISSUED IN A VARIETY OF EMERGING MARKET (EM) CURRENCIES AND CHOOSE FROM A BROAD SELECTION OF ISSUERS. OVER THE LAST THREE YEARS, FOR EXAMPLE, INVESTORS COULD BUY WORLD BANK BONDS DENOMINATED IN SOME 20 DIFFERENT EM CURRENCIES. MORE INVESTORS ARE BUYING LOCAL CURRENCY GOVERNMENT BONDS AS WELL. EVEN RETAIL INVESTORS IN SOME COUNTRIES HAVE EMBRACED THE VARIETY OF EM CURRENCIES OFFERED – ALTHOUGH THE ‘FLAVOUR OF THE MONTH’ HAS CHANGED ALONG THE WAY. THIS WAS NOT ALWAYS THE CASE AND, ALTHOUGH IT IS A FAIRLY NEW PHENOMENON, IT IS HERE TO STAY. EMERGING BOND MARKETS ARE NO LONGER THE NEXT FRONTIER.

In the nineties, many emerging markets initiated sweeping changes to their economies and adopted sound fiscal and monetary policy frameworks.² In parallel, these countries embarked on a process of gradual and sequential modernisation and liberalisation of their financial markets. International investors then started trickling into fixed income investments in these newly liberalised emerging markets. During the pre-crisis years of the decade, EM local currency assets started to get traction among international investors, stimulated by the launch of offshore local currency instruments and new instruments, and maturities in domestic markets. During this period, governments undertook massive regulatory changes, developed their domestic markets, and enhanced investor confidence. Local currency bond markets grew from US\$1.4 trillion at the end of 1997 to US\$6.5 trillion at the end of 2007.³ But EM local currency exposure had a narrow following among international investors – mostly dedicated EM funds. Lack of familiarity with local credits, local standards and local documentation made mainstream international investors uncomfortable. This explains why

supranational borrowers like the World Bank often played an ‘introductory’ role in these markets, enabling international investors to gain experience – through a well-known AAA-rated credit – with local currency denominated bonds, often in the euromarket format familiar to those investors.⁴



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* Japanese yen

Source: Bloomberg (5-year US, German and Japanese government bonds, and government bond index (GBI) EM local yield to maturity)

Low yield differentials relative to developed markets was another factor prevailing before the 2008 crisis (see Exhibit 1), and investors did not find the then prevailing yield differentials compelling enough to reward them for the EM markets' real or perceived higher volatility and illiquidity.

At the time, EM yields were not compellingly high because of improved economic fundamentals. Many governments curbed inflation, stuck to fiscal discipline, lowered currency risk in their debt portfolios, developed their domestic bond markets, and accumulated foreign exchange reserves to cut their vulnerability to external shocks. EM economies were growing quickly, and strengthening their external and fiscal balance sheets.⁵ This, in our view, was a compelling enough reason for investors to do more than dip their toes in EM waters.

The crisis that turned the world upside down

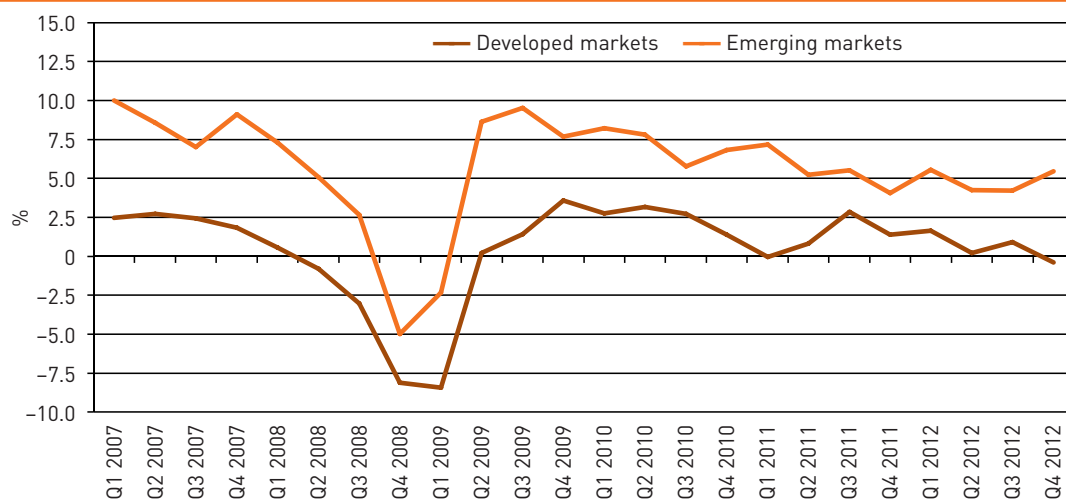
The 2008 global financial crisis dispelled most reservations

international investors had about investing in EM bond markets. The crisis that started in the housing and banking sectors in the US and Europe evolved into a developed-countries' sovereign debt crisis, eroding investors' confidence in the outlook of the major developed economies and their currencies. To lessen the effects of a global recession and avert a deflationary spiral, governments enacted stimulus packages and eased monetary policy, bringing down interest rates to near zero levels, with modest success thus far.

Against this background, most EM economies exceeded growth in developed markets by an ample margin, and while not totally immune to the general economic slowdown (see Exhibit 2), showed resilience. It is telling, for instance, that the top 10 borrowers of the World Bank are now investment grade (at least by one rating agency), up from only three countries in 2000.⁶ Over the last five years, emerging markets have moved to the forefront as an important destination of capital for many fixed income investors around the world.

Developed vs. emerging markets: Real GDP growth q/q* [%]**

Exhibit 2



* quarter over quarter

** period: Q1 2007-Q4 2012

Source: JP Morgan database

Creating resilient emerging capital markets

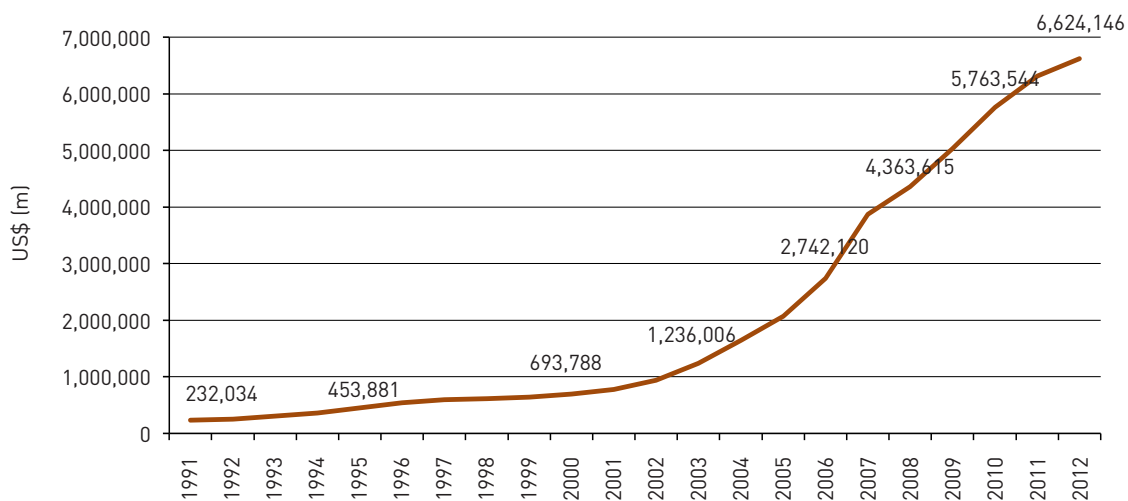
Emerging markets have come a long way, after having been the main protagonists of several crises and casualties of financial contagion over the previous two decades: the Latin American debt crisis of the 1980s, the Tequila crisis in 1994, the Asian crisis in 1997 and the Russian crisis in 1998. The Asian crisis especially, highlighted the vulnerability of EM debtors' over-reliance on foreign-currency denominated debt – public and private – and the need to focus on debt and risk management. As a result, many EM governments developed local currency funding capabilities, extended the duration of local and foreign currency debt, adopted self-insurance mechanisms such as international reserves, and reduced contingent liabilities.

EM governments relied less on foreign currency-funding and more on domestic bond markets.⁷ While the developed market economies wrestled with the 2008 crisis, international investors that started investing in EM

currencies through bonds issued by international financial institutions (IFIs) in the early part of the new millennium went on to buy EM sovereign local currency bonds, through domestic bond markets and international local currency bond deals (see Excerpt 1). The international investor base expanded to include 'cross-over investors' such as hedge funds and 'real money accounts' such as pension funds. Improvements in the clearing system infrastructure such as linking the local system to the international clearing systems have also supported more international demand for domestic local currency bonds.

Pioneering demand

The search for diversification and yield has driven international investors to discover small and nascent emerging bond markets. Since 2008, besides issuing its first bonds in Chinese renminbi and Thai baht, the World Bank issued offshore bonds in five African currencies (Botswana pula, Ghanaian cedi, Nigerian naira, Zambian kwacha and Ugandan shilling) for global asset managers



Source: IMF-IFS Database

and other international investors. All in all, since the start of the 2008 financial crisis the World Bank has raised around US\$25bn equivalent in bonds denominated in African, Asian and Latin American currencies. Many of these EM currency bonds are key assets of diversified investment trust/mutual funds focused on EM markets for retail and institutional investors in Asia and Europe.⁸

The other side of the coin: Developments on the domestic buy-side

As mentioned in Excerpt 1, developing a domestic securities market went hand in hand with reforms supporting local savings, including pension system reforms. The switch from defined benefits to defined contributions and privatising pension systems is one area in which EM markets have had a strong lead over developed markets, and the enhanced depth and duration of domestic EM markets are to a large extent due to the growing base of domestic pension funds. More importantly, as they

experience further growth, these pools of domestic savings can play an increasingly important anchoring role at times of market turbulence.

According to a Morgan Stanley report, EM pension fund assets grew nearly 70% in five years, to US\$1.5 trillion in 2011.⁹ In a few cases, IFIs can provide assets to local pension funds, such as in Colombia, Uruguay and Malaysia. Bonds issued by the World Bank, the International Finance Corporation (IFC) and other IFIs have provided an opportunity for local pension funds to diversify and enhance portfolios with low, uncorrelated credit risk in the local currency.

Where to from here?

Emerging bond markets have grown by leaps and bounds over the past decade, especially the government bond sector, anchored by strong demand from domestic and international investors looking for higher yields and diversification. So is the term 'emerging markets' a misnomer already? Some market participants already

Excerpt 1

International sovereign issuance in local currencies

When governments embark on developing a market for local currency sovereign bonds, they ground their activities in the domestic market. As part of the efforts to deepen the financial sector, the authorities enable the creation and growth of local buy-side institutions such as mutual funds, pension funds and insurance companies. The public debt manager focuses on building and lengthening a yield curve of government securities and enhancing secondary market liquidity by regularly auctioning a range of set bond maturities and instruments. Different segments of the yield curve cater to different investor segments, from the short-end (the maturities usually preferred by bank treasuries and mutual funds), to the long-end (the maturities typically preferred by pension funds and insurance companies). Foreign investors interested in acquiring sovereign debt local currency exposure would do so by investing in domestic government securities. The establishment of a broad, deep and liquid local currency sovereign debt market also provides a solid foundation upon which to build other market segments such as the interest rate swap market, the futures market, and the corporate bond and infrastructure finance markets.

Alongside these domestic development efforts, a few sovereign borrowers have also opted to develop a local currency issuance presence offshore. Brazil, Chile, Colombia, Egypt, Peru, Philippines, Russia, and Uruguay have raised nearly US\$30bn of international bonds in 40 bond issues in their local currencies since Uruguay and Colombia pioneered the format in 2004. These offerings aim to cater to international investors who: (i) may be deterred from buying domestic government securities by the imposition of capital controls such as withholding taxes; (ii) may feel more comfortable with international law, disclosure, documentation standards and clearing mechanisms than with the respective domestic options; and/or (iii) may want to purchase maturities not offered in the local market because they are not of wide-spread interest to domestic investors. Sovereign borrowers have issued these transactions opportunistically and achieved quite attractive funding cost, with placement in the US, Europe and Asia among fund managers, pension funds, hedge funds, insurance companies and banks. There has also been some participation by local investors.

Issuers have used these transactions to also achieve important policy objectives. In Brazil's case, they have focused on issuing fixed rate instruments in the 10 to 20-year maturity range, extending the local currency nominal yield curve beyond those maturities of interest to most local market investors.

substitute the term 'growth markets' for 'emerging markets'. Demand and supply for many EM domestic government bonds have 'emerged'. Going forward, there is clearly room for further expansion of international demand considering that international investors' portfolios are still underinvested in EM, relative to the share of emerging markets in global GDP.

Many countries have made significant progress with products, liquidity, tenors and bond market infrastructure, while others still have a way to go. Several countries, large and small, need to do away with financial sector distortions such as, for example, directed lending at subsidised interest rates that have led to bank debt

financing going to unproductive purposes. It will also be important to foster the development and growth of ancillary capital market segments such as the corporate and municipal bond markets, and the repo, interest rate and currency swap markets, as sources of financing and risk management tools for the private sector. Bond market regulation and infrastructure, such as trading, clearing and settlement processes and systems also need upgrading.

Going forward, it is also likely that international investors' interest in EM exposure will be less fickle but also more discerning. Although there will always be pockets of investors willing to take excessive risks for potential quick profits, a large share of EM demand is now more about

fundamentals and growth prospects than about speculation. As long as this remains the case, EM debt will play a lasting role in fixed income investment portfolios. Instances of quick changes in sentiment and wide-spread contagion among emerging markets will become rare, but especially small markets will need to keep an eye on capital inflows, since a reversal of inflows can have destabilising economic consequences.

Global financial markets are just now adjusting to forecasts of higher interest rates in the US and other developed countries and lower EM growth. But the view among market participants is that emerging markets have come a long way compared to previous economic cycles and, although a few countries will experience vulnerability, slower growth will not undermine the overall strong fundamentals.

As new market segments develop and grow, the next emerging bond market frontier is likely to be the infrastructure or project finance market, which faces a huge financing gap. Until recently, the infrastructure finance market was the purview of bank lenders. But the appetite of banks to provide long-term funding for projects has declined dramatically because of stricter regulatory capital requirements. Meanwhile, local and international institutional investors such as pension funds, insurance companies and sovereign wealth funds have large pools of liquidity and need long-duration, high-yielding fixed income assets. They could play a big role in EM infrastructure finance. The challenge is to structure financings to match project requirements, like gradual draw-down, amortising repayments, and often local currency and investor needs, like investment grade ratings, due diligence and secondary market liquidity. Several multilateral lending institutions and private sector financial intermediaries are exploring ideas to expand the availability of bond financing for infrastructure projects in emerging markets.

Emerging markets as a whole are no longer the next frontier, and international investors are no longer pioneers in these markets. Nevertheless, there are EM segments yet

to be explored and chartered that bear the promise of further diversification, and less correlated – and possibly excess – investment returns, especially for the first movers.

Notes:

- 1 Doris Herrera-Pol wishes to thank Qiming Chen, Bozena Giza Krupa, Huy-Long Le and Fei Wang, who collaborated with information and data for this chapter, as well as other World Bank Group colleagues who acted as peer reviewers and provided valuable feedback: Phillip Anderson, Michael Bennett, Anderson Caputo Silva, Christine Davies, Vanita Dewan, Andrea Dore, Catiana Garcia-Kilroy, Dolores Lopez-Larroy, Heike Reichelt and George Richardson.
- 2 For an overview of the areas and extent of the macro improvements in EM economies, see World Bank Policy Research Working Paper 5399. Anderson, P., Silva, A.C. and Velandia-Rubiano, A., 2010. *Public Debt Management in Emerging Market Economies: Has This Time Been Different?* Washington DC: World Bank.
- 3 Bank for International Settlements, 2007. *Financial Stability and Local Currency Bond Markets*. CGFS Paper #28.
- 4 Herrera-Pol, D., 2005. *The Opening of New Markets to Foreign Issuers: What Has Changed in the New Millennium?* In: The Euromoney International Debt Capital Markets Handbook 2005. West Sussex: Wyndeham Grange Ltd, pp.125-131
- 5 Ibid.
- 6 The countries are: Brazil, China, Colombia, India, Indonesia, Mexico, the Philippines, Poland, Romania and Turkey. Of these, the only three with at least one investment grade rating as of December 2000 were China, Mexico and Poland.
- 7 De la Torre, A. and Schmukler, S., 2006. *Capital Market Development: Taking Stock*. World Bank paper.
- 8 Separately, pioneering international investors have also ventured into first-time EM sovereign bonds in USD from countries like Albania, Angola, Belarus, Bolivia, Honduras, Jordan, Mongolia, Nigeria, Paraguay, Tanzania, and Zambia. These deals have been met with exceptionally strong demand from international EM investors.
- 9 Morgan Stanley Research, 2013. *EM Rates – (R)evolution, Part II: The Ascent of Local Pension Funds*. Morgan Stanley.

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