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## Successful Emerging Domestic Bond Markets in the Global Financial Landscape

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- ◆ Risk-based public debt management and liquid domestic bond markets are important mutually reinforcing strategies for emerging financial markets and developing countries in general.
- ◆ They can help to attain 1) enhanced financial stability, and 2) a more successful participation in the global financial landscape.
- ◆ This twin-strategies approach requires however taking a policy-coherent macroeconomic perspective.

A remarkable feature of the fast-moving new financial landscape has been the astonishing rate of internationalisation of the financial system in the last two decades. In particular, emerging markets became increasingly important participants.

At times this participation led to an excessive reliance on foreign financing, making the participation of these countries in the global financial system more vulnerable to shifts in expectations and perceptions. The sovereign debt management strategy suffered from many structural weaknesses, failing to take into account OECD's leading practices in financing budget deficits, managing public debt and developing domestic government securities markets. Consequently, emerging markets experienced serious financial crises episodes. Against this background, a recent OECD study outlines new and more sophisticated strategies to develop domestic bond markets, taking into account the risk profile, complexities and other constraints of emerging markets<sup>1</sup>.

The central thesis of this study is that risk-based public debt management and liquid domestic bond markets are important mutually reinforcing strategies for emerging financial markets to attain 1) enhanced financial stability, and 2) a more successful participation in the global financial landscape. It is also shown that this twin-strategies approach requires taking a policy-coherent macroeconomic perspective.

1. See Hans J. Blommestein and Javier Santiso (2007), "New Strategies for Emerging Domestic Bond Markets in the Global Financial Landscape", *Working Paper* No. 260, OECD Development Centre, April.

### Policy Implications

Policy discussions at the OECD<sup>2</sup> and elsewhere increasingly emphasised the notion that successful participation by emerging markets in this uncertain and more complex global financial landscape requires a well-functioning domestic, local currency bond market.

Until the late 1990s, domestic fixed-income securities markets were relatively underdeveloped in many countries in Latin America, Asia, emerging Europe and Africa. This situation had led to an excessive reliance on foreign financing, making the participation of these countries in the global financial system more vulnerable to shifts in expectations and perceptions. At the same time, sovereign debt management suffered from many structural weaknesses, failing to take into account international best practices. Consequently, until quite recently, emerging markets experienced serious financial crises episodes.

But during the last couple of years, emerging markets have become more stable due to the implementation of long overdue structural changes. Ten years ago, emerging markets were registering current accounts deficits of 2 per cent on average, while they exhibited a 2 per cent surplus in 2005. Fiscal deficits that averaged more than 3 per cent

2. The OECD Global Forum on Public Debt Management and the OECD/World Bank/IMF Global Bond Forum hold annual discussions, both under the aegis of the OECD Working Party on Debt Management.

of GDP ten years ago have been reduced to 1 per cent of GDP. The anchoring process of lower inflation has been even more impressive, averaging 15 per cent ten years ago and now standing below 4 per cent. This reduction is particularly impressive for Latin American countries that had experienced hyperinflation. Buoyant global commodity prices and healthy trade exports, combined floating currencies, have given them trade surpluses and paved the way for fiscal surpluses or equilibriums.

In parallel, governments reduced their debts. Above all, they tried to buy back nearly all of their external debt. Stocks of external debt experienced impressive contractions. They also tried to reduce the exposure to foreign exchange shocks and their subsequent debt impacts, moving away from dollar denominated bonds. Dollar bonds, now account for just 28 per cent of the outstanding debt of emerging markets economies, tracked by the JP Morgan Emerging Bond Markets Index. They also increased debt issued in local currencies, helping that way local capital markets to become deeper and more sophisticated. Even some emerging countries running large budget surpluses and healthy finances have been issuing new securities in an effort to provide a benchmark for corporate bonds, extend the borrowing for longer periods and add liquidity to their financial systems.

Moreover, and quite crucially, public debt management in emerging markets has become much more sophisticated by adopting leading practices from OECD countries, including a market-based issuance process, an integrated

and risk management approach to public debt, the use of benchmarks, and an emphasis on the importance of establishing liquid secondary government bond markets<sup>3</sup>.

Public debt management and government securities market operations have a direct effect on the securities markets as a whole because governments play a key role in supporting the development of fixed-income securities markets. Well-functioning government securities markets give public support to private fixed-income market (both cash and derivatives) in the form of a pricing benchmark, while they also provide a tool for interest rate risk management.

For these reasons, the development of a well-functioning government bond market will often precede, and very much facilitate, the development of a private-sector corporate bond market. The focus on a risk-based approach to debt management, with the establishment of interest rate-, liquidity- and currency benchmarks, has contributed to a more prudent risk profile of the government balance sheet while it also has helped to improve the transparency, predictability, and liquidity of domestic fixed income debt markets more in general. As a result, an increasing number of emerging markets countries are creating the conditions for a more successful participation in the global financial system.

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3. Hans J. Blommestein (2005) (ed.), *Advances in Risk Management of Government Debt*, OECD, Paris.



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