Recent Developments in Local Currency Bond Markets (LCBMs)[1]

October 2013

Given the importance of local currency bond markets (LCBMs), including in the context of the work now underway on financing for investment, the G20 has a clear interest in closely monitoring trends in the market. International organizations (IOs) continue to support the development of LCBMs through a variety of channels, including the three main pillars of the G20 Action Plan on the Development of LCBMs: (i) improving the coordination of technical assistance (TA) among IOs, (ii) shared Diagnostic Framework to support technical advice by TA providers and EME policy makers, (iii) improving data availability to support LCBMs.

The G20 Finance Ministers and Central Bank Governors, in their July 2013 Communique, indicated that they "…look[ed] forward to annual review by IOs of developments in LCBMs in light of their contribution to financial stability and better capital flow management." As highlighted in the Implementation Report on the G20 Action Plan on the Development of LCBMs, the World Bank Group, in consultation with other international organizations, will be producing a yearly note to the G20 on recent developments in LCBMs. This is the first of these notes and is being provided for their October 2013 meeting.

This note is descriptive and presents key indicators that highlight the evolution of LCBMs in emerging market economies (EMEs) over the last 5 years with particular emphasis on the most recent period. The note is organized as follows: Main Highlights, (1) Market Size, (2) Liquidity, (3) Issuance, (4) Performance, (5) Local Investor Base and Foreign Ownership.

[1] Prepared by staff of the World Bank Group (WBG) in consultation with the staffs of the International Monetary Fund (IMF), Asian Development Bank (ADB), African Development Bank (AfDB), Inter-American Development Bank (IADB), European Bank for Reconstruction and Development (EBRD), Organization for Economic Co-operation and Development (OECD), and the Bank for International Settlements (BIS) for the information of G20 Ministers of Finance and Central Bank Governors for their October 2013 meeting.

Main Highlights

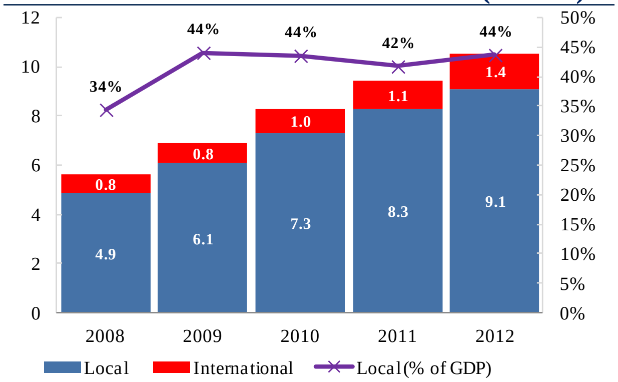
- EM local market debt (LMD) continues to expand, reaching over US$ 9.1 trillion, approximately 87 percent of total EM debt outstanding, as of December 2012.
- Growth over the past years has been largely fueled by a combination of improved fundamentals in EMEs, proactive policies by governments to reduce exposure to foreign exchange debt, and strong flows by global portfolio investors seeking higher returns than available in most leading advanced economies.
- Despite recent volatility related to concerns with tapering of Quantitative Easing by the US Federal Reserve Board, EM LMD is expected to continue to grow backed by an increasing domestic investor base in several EMEs and greater participation, in the medium and long term, by nonresident investors that are still underinvested in this asset class.
- EM LMD remains heavily concentrated in a few countries, highlighting the ongoing challenge to expand the asset class to a broader range of countries. Trading volumes in local markets have recovered from the lows of global cross-market crisis of 2008-2009 and surged to US$1.014 trillion in the second quarter of 2013, a 27 percent increase compared to the same quarter of 2008.
- Liquidity in local market instruments is also concentrated in a handful of markets and in government debt securities. Corporate LMD remains illiquid due both to traditional factors of the asset class (e.g. slow growth due to investor concern about credit risk, lack of credit cultures, limited range of access to the market by issuers, and smaller size of issuances broken down by a number of distinct issuers) and to other country-specific problems (e.g. buy-and-hold behavior, poor price discovery and dissemination mechanisms).
- EM government local currency debt issuance has slowed down since 2010 which has among other factors supported a significant increase in local markets corporate bond issuance over the last three years, peaking in 2012 at US$950 billion.
- In a reversal from the past several years of delivering leading returns across all asset classes, EM LMD has recently come under pressure as investors reacted to concerns over tapering of the Fed's QE program, resulting in a sharp sell-off in EM LMD and significant currency weakness in EMEs, particularly those with large current account deficits.
- Local banks continue to dominate holdings of local market debt. However, total EM insurance and pension fund assets more than doubled over the past five years, contributing significantly to the development of local currency bond markets in EMEs.
- Non-resident holdings of EM local currency bonds have increased to unprecedented levels over the past five years, now standing at 26.6 percent on average across issuers and approaching or exceeding 40 percent in a number of EMEs.
- Despite wide variations in total size and across hard currency and local currency components, nonresident flows into dedicated EM funds shows a persistent trend towards greater investment allocations to EM debt.

1. The Size[2] of LCBMs in EMEs

EM[3] local market debt (LMD)[4] continues to expand, reaching over US$ 9.1 trillion, approximately 87 percent of total EM debt outstanding, as of December 2012 (Exhibit 1). This rapid growth over the past years has been largely fueled by a combination of improved fundamentals in EMEs, proactive policies by governments to reduce exposure to foreign exchange debt, and strong flows by global portfolio investors seeking higher returns than available in most leading advanced economies.

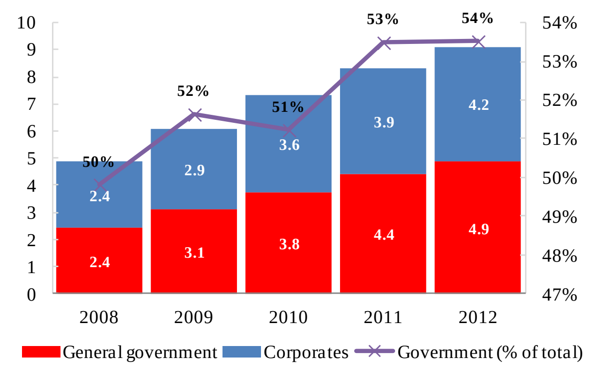
Growth of EM local market debt has been broad based with both the government and corporate bond market segments registering strong growth over the past five years (Exhibit 2). Despite recent volatility related to concerns with tapering of Quantitative Easing by the US Federal Reserve Board, EM LMD is expected to continue to grow, backed by an increasing domestic investor base in several EMEs and greater participation, in the medium and long-term, by non-resident investors that are still underinvested in this asset class.

Exhibit 1: EM LMD vs. International (US$ tn)



Source: BIS, IMF; WBG staff calculations

Exhibit 2: EM LMD by Segment (US$ tn)



Source: BIS; WBG staff calculations

EM LMD remains heavily concentrated in a few countries, highlighting the ongoing challenge to expand the asset class to a broader range of countries. While Asia and Latin America maintain their dominant positions (Exhibits 3 and 4), country level statistics show that a few EMEs account for a very large share, both in government and corporate LCBMs. At the country level China, Brazil and India comprise more than 67 percent of the total EM government local debt market. The share grows to 91 percent if the ten largest markets are considered. Corporate local market debt is even more concentrated, where the top two (China and Brazil) comprise more

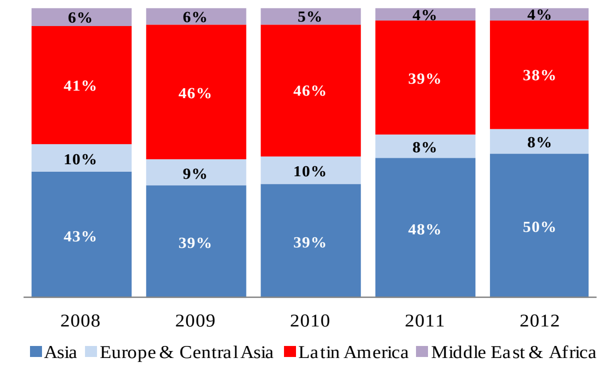
[2] Our analysis of size focuses on absolute levels of outstanding debt rather than as a percentage of GDP. This allows for a more direct comparison with other indicators also presented in absolute levels, such as the size of new issuances, trading volumes, size of institutional investors and investor flow data. Size rankings of LMD would naturally change significantly for both government and corporate bond markets if presented as a percent of GDP.

[3] EM includes Argentina, Brazil, Chile, China, Colombia, Croatia, Hungary, Indonesia, India, Lebanon, Malaysia, Mexico, Pakistan, Peru, Philippines, Russia, Saudi Arabia, South Africa, Thailand, and Turkey.

[4] Local market debt (LMD) comprises government local market debt (GLMD) and corporate (financial and non-financial) local market debt (CLMD). It consists of domestic debt securities defined as issues by residents in the local market in local currency, targeted to resident investors in the BIS securities statistics. Some foreign currency issues are included in these data, but they are small.

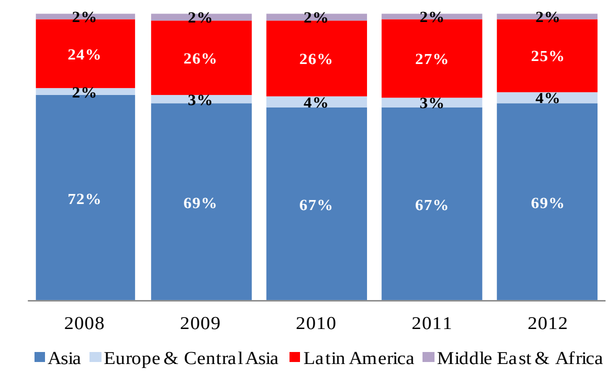
than 77 percent of the total corporate local market debt and ten largest markets represent 99 percent (Exhibit 6).

Exhibit 3: Government LMD by Region (%)



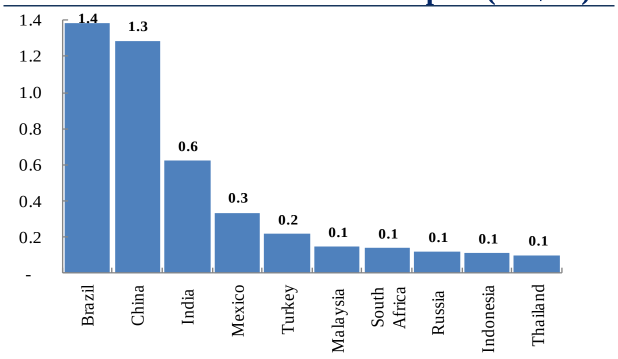
Source: BIS; WBG staff calculations

Exhibit 4: Corporate LMD by Region (%)



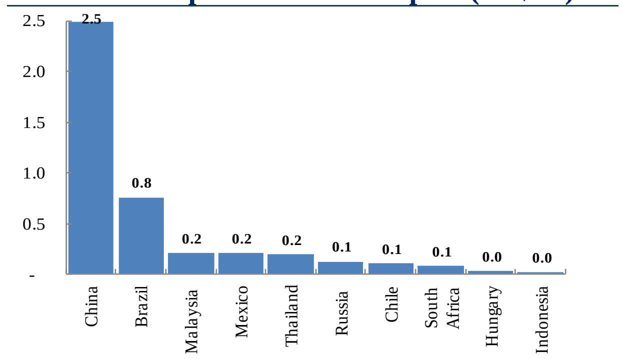
Source: BIS; WBG staff calculations

Exhibit 5: Government LMD –Top 10 (US$ tn)



Source: BIS; WBG staff calculations

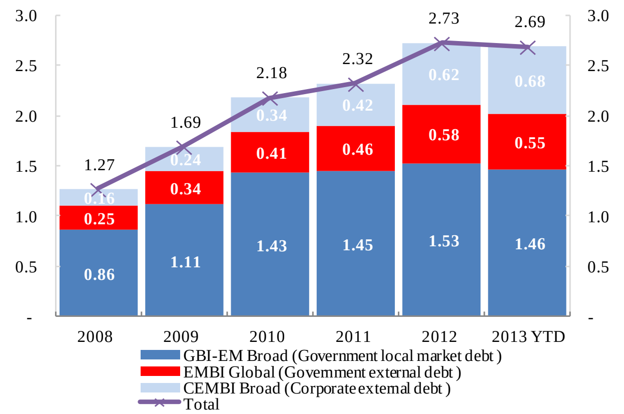
Exhibit 6: Corporate LMD – Top 10 (US$ tn)



Source: BIS; WBG staff calculations

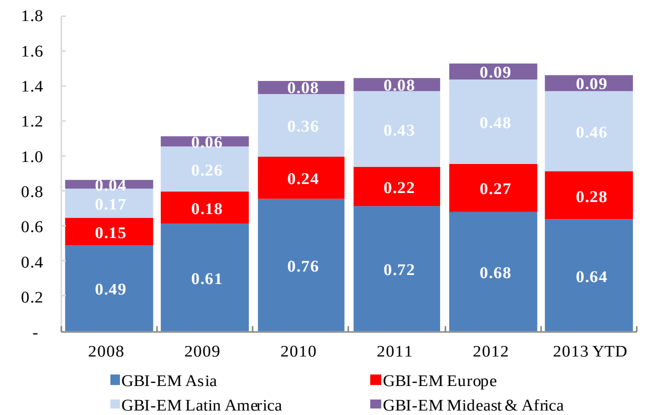
The dominance of government local currency market debt has been increasingly reflected in terms of market capitalization of the EM fixed income indices. As measured by the JPM GBI-EM Broad Index, the index-eligible universe of government local market debt has grown to US$1.46 trillion compared to US$0.86 trillion in 2008 (Exhibit 7). Year-to-date, market capitalization on the government local market debt GBI-EM Broad index has grown to almost three times the size of market capitalization in the JPM EMBI Global index of government external debt and more than double the size of market capitalization in the JPM CEMBI Broad index of corporate external debt. Government local market debt now accounts for more than 54 percent of the total market capitalization of the three indices. Regionally, Asia maintains its dominant share in the GBI-EM (Exhibit 8).

Exhibit 7: Market Cap by Index (US$ tn)



Source: Bloomberg, J.P. Morgan; WBG staff calculations

Exhibit 8: GBI-EM Market Cap by Region (US$ tn)



Source: Bloomberg, J.P. Morgan; WBG staff calculations

2. Liquidity

In line with its dominant share over the total stock of EM debt, EM local market debt accounts for the greatest share (64 percent) of total reported trading volume of EM debt[5] (Exhibit 9). Trading volumes in local markets have recovered from the lows of global cross-market crisis of 2008-2009 and surged to US$1.014 trillion in the second quarter of 2013, a 27 percent increase compared to the same quarter of 2008.

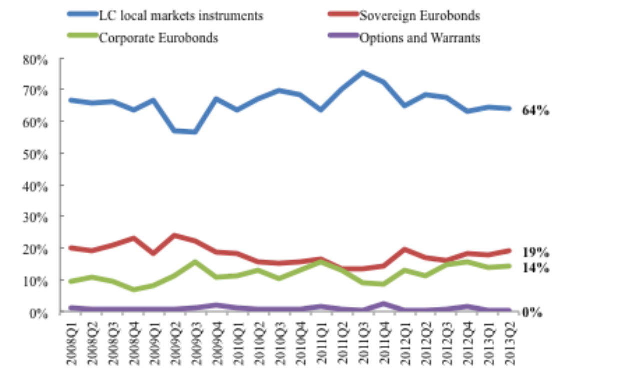
Despite the recovery in overall trading volumes, liquidity in local market instruments[6] is concentrated in a handful of markets. Five countries (Brazil, Russia, Turkey, Mexico and Poland) account for almost 60 percent of total traded volumes in local instruments (Exhibit 10)[7]. Among local market instruments, government debt securities are by far the most liquid, given their usually larger sizes, wide variety of maturities, more frequent issuance and standardization which favors trading. Local market corporate debt remains illiquid due both to traditional factors of the asset class (e.g. slow growth due to investor concern about credit risk, lack of credit cultures, limited range of access to the market by issuers, smaller size of issuances broken down by a number of distinct issuers) and to other country-specific problems such as: (i) the still limited supply in face of large demand by a growing domestic investor base (that tend to buy-and-hold); (ii) poor price discovery and dissemination mechanisms; and (iii) the need of enhanced portfolio management capacity on the part of many EM institutional investors, including many of the largest EM public sector pension funds.

[5] The latest (2Q2013) Emerging Markets Trading Association (EMTA) survey

[6] Local market instruments are generally issued into a domestic market and purchased by local and foreign investors. Local markets instruments are denominated most often in the local currency and include domestic treasuries, bank certificates of deposit and bonds, as well as other forms of indebtedness.

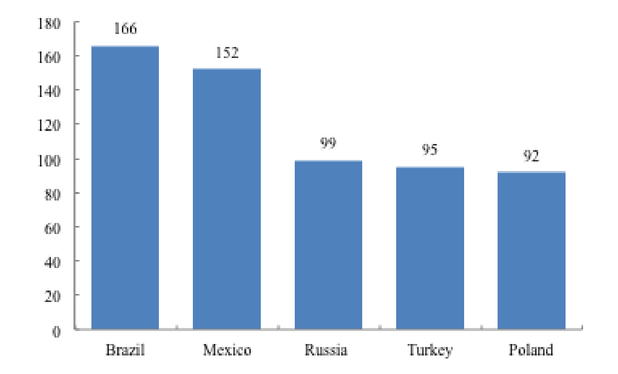
[7] As of second quarter of 2013; data for prior quarters also confirms the concentration in a handful of markets

Exhibit 9: EM Debt Trading Volumes (% of total reported volume)



Source: EMTA; WBG staff calculations

Exhibit 10: The Most Frequently Traded Local Markets Debt (US$ bn, 2013Q2)



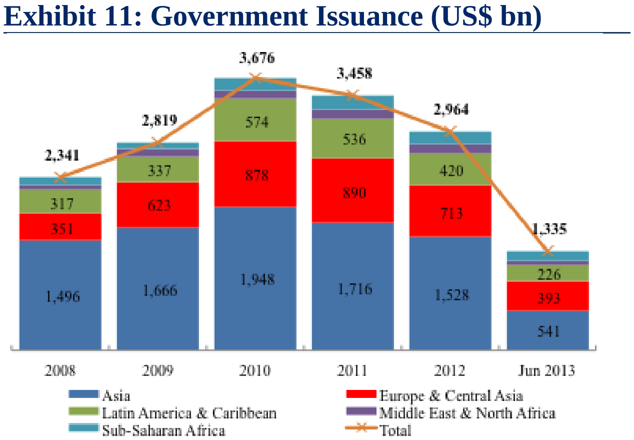
Source: EMTA; WBG staff calculations

3. Issuance[8]

EM government local currency debt issuance has slowed down while corporate issuance has continued to grow since 2010. Year-to-date, local currency debt issuance by governments (US$1,335bn) and corporates (US$675 bn) reached to US$2,010 billion (Exhibits 11 and 12). Government debt borrowing had increased especially in the 2009/10 period as a counter-cyclical measure in some countries (e.g. Brazil) and to withstand sharp declines in tax revenues in others (e.g. Romania).

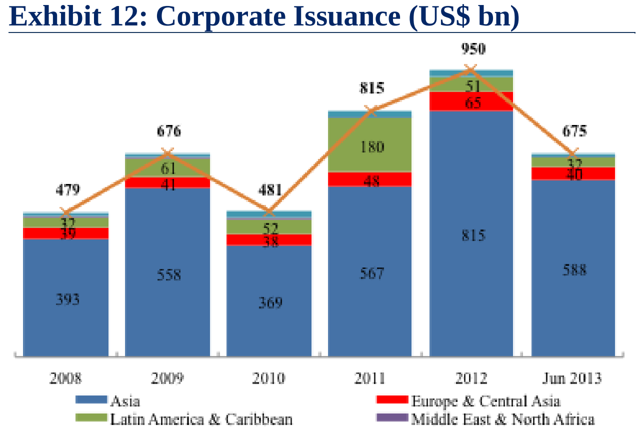
Reduced government debt issuance over the last three years has supported a significant increase in corporate bond issuance, peaking in 2012 at US$950 billion. Banks and quasi-sovereign entities continue to dominate the corporate local currency debt market issuances in most EMEs, but this growth also reflects continuing efforts by leading corporate issuers to diversify funding sources away from the banking sector in response to global commercial bank deleveraging. Issuers were also attracted to lock in long-term, local currency funding at reasonably attractive rates in order to meet EM investment needs in key sectors such as infrastructure and housing.

Exhibit 11: Government Issuance (US$ bn)



Source: Bloomberg; WBG staff calculations

Exhibit 12: Corporate Issuance (US$ bn)



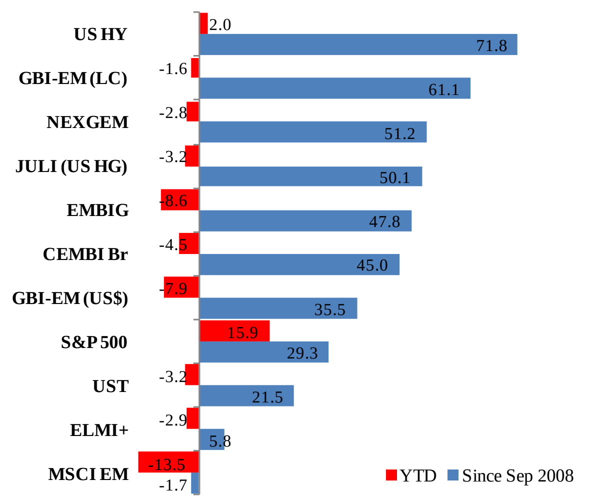
Source: Bloomberg; WBG staff calculations

[8] Gross issuance, includes both short and long-term debt issuances

4. Performance

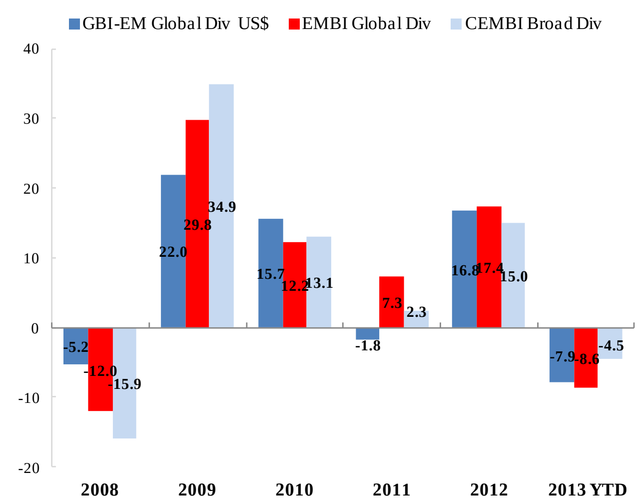
In a reversal from the past several years of delivering leading returns across all asset classes (Exhibits 13 and 14), EM local market debt has recently come under pressure as investors reacted to concerns over the tapering of the Federal Reserve's quantitative easing program, resulting in a sharp sell-off in EM local market debt and significant currency weakness in EMEs, particularly those with large current account deficits. The J.P. Morgan GBI-EM Global Diversified Index posted a negative return of 7.9 percent (unhedged) year-to-date[9], comprised of -3.46 percent (hedged) from interest rates and -4.48 percent from currency depreciation against the U.S. dollar, while EM local yields surged to 6.46 percent, tracking the rise of yields on 10-year Treasuries. From a regional perspective, Europe (-6.7 percent), Latin America (-6.9 percent), Asia (-7.7 percent) outperformed the index and Middle East and Africa (-15.5 percent) underperformed.

Exhibit 13: Performance (Since 2008-YTD, %)



Source: J.P. Morgan

Exhibit 14: Annualized Returns Across EM Assets



Source: Bloomberg, J.P. Morgan

5. Local Investor Base and Foreign Ownership

Local banks continue to dominate holdings of local market debt in many EMEs. However, the local institutional investor base has continued to grow over the past five years, contributing significantly to the development of LCBMs in EMEs. Total insurance and pension assets more than doubled to $4.7 trillion over the past five years. EM insurance companies now have US$2.6 trillion of AUM, while local pension funds hold US$2.1 trillion of AUM[10]. These assets have stimulated demand for longer-term and local currency denominated debt.

Non-resident holdings of EM local currency bonds have doubled in most EMEs since 2008 and reached unprecedented levels, led by a variety of pull and push factors mentioned above. According to the latest available data[11], non-resident holdings stand at 26.6 percent in average

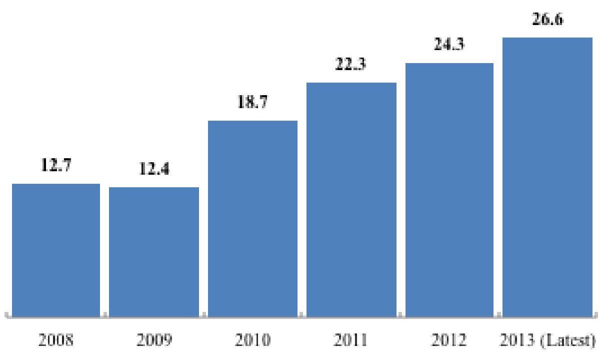
[9] As of July 9, 2013

[10] J.P. Morgan

[11] Availability and update frequency of data vary by country

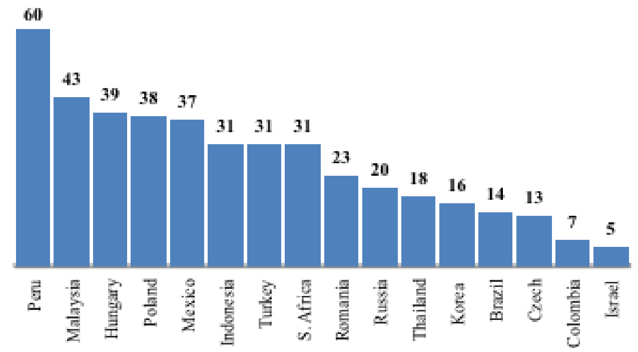
across issuers and approaching or exceeding 40 percent in a number of EMEs (Exhibits 15 and 16).

Exhibit 15: Foreign Ownership by Country (EM Simple Average, %)



Source: J.P. Morgan

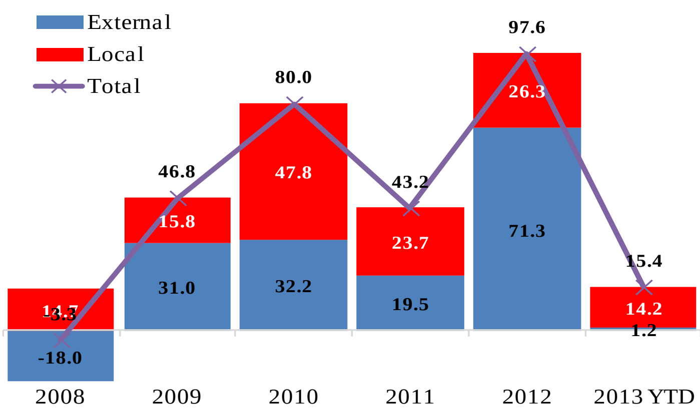
Exhibit 16: Foreign Ownership by Country (2013 Latest, %)



Source: J.P. Morgan

Despite wide variations in total size and across hard currency and local currency components, nonresident flows into dedicated EM funds shows a persistent trend towards greater investment allocations to EM debt (Exhibit 17). Flows attributable to EM local currency bond funds have dropped since the peak reached in 2010 and have been hardly hit in 2013 since May when the Fed’s tapering concerns emerged. However, prospects over the medium and long-term are positive as nonresident investors gradually allocate larger shares of their portfolio to EM local currency debt.

Exhibit 17: Inflows Into Dedicated EM Funds (US$ bn)



Source: Bloomberg, J.P. Morgan