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Developing bond markets in Latin America and the Caribbean

Pietro Masci and Benjamin M Rowland

I. Introduction

The development of financial markets is a critical challenge for emerging-market countries. As with so many other facets of the globalising economy, there are positive as well as defensive reasons for rising to this challenge. The positive reasons include the following:

- When conditions are right, financial and capital market development allow countries to allocate their economic resources more efficiently, both in time and in space.
- The financial system provides price information that helps the coordination of decisions; aligns market and financial incentives; provides clearing and settlement mechanisms; allows the pooling of resources to permit diversification; and in general offers new ways of managing, mitigating, and transforming risk.
- The process of market development places greater amounts of timely, accurate, and transparent information into the public domain – the oxygen that the private sector needs to make informed decisions and to grow.
- Countries that master the skills and disciplines associated with capital market development tend to have higher levels of capital formation, grow more quickly, provide better financial services to all segments of their populations, and enjoy greater prospects for long-term financial and economic stability.

Yet a strong defensive element – a foundation of cautious, prudent policies and practices – also needs to be an integral part of the development of financial and capital markets. The first line of defence is a sustained commitment to appropriate macroeconomic policies. This is an essential commitment, but as recent experience has shown, it may not be sufficient. Most commentators now agree, for example, that the critical failures giving rise to the Asian currency crises of 1997–98 were not failures of macroeconomic policy but instead mainly failures at the level of institutions, supervision, regulation, and the rule of law.

For many emerging-market countries, financial-sector and capital market development starts with the development of a government bond market. This is a logical path, not only because governments are usually the largest domestic borrowers and have the best credit in the nation, but also because governments, by their actions or inaction, affect the scope and potential for market development throughout the economy.

The purpose of this article is to provide a review of the progress of and prospects for the development of government bond markets in the Latin American and Caribbean region. Section II briefly reviews the literature on capital and bond market development in the region. Section III considers some of the main trends and forces that have influenced bond market development in other parts of the world. Section IV seeks to apply these lessons to the region, with reference to the experience of selected countries in the region. Section V concludes with recommendations for the development of government bond markets in the region and a programme of supporting activities for multilateral organisations.

II. Brief literature review of capital and bond market development in the region

This section reviews the literature on financial and capital market development and emphasises the development of bond markets as a step toward a more efficient capital market.

A solid financial system has five components: (1) sound fiscal and macroeconomic policies, i.e., public finance discipline; stable monetary, interest, and exchange rate policies; (2) qualified and competitive financial institutions; (3) effective prudential supervision; (4) an adequate legal system; and (5) a stable and predictable political system (Cole 1997). From a functional point of view, financial systems have the primary function of facilitating the allocation of economic resources across time and space. In this context, a financial system provides price information that helps the coordination of decisions; sets up incentives that make financial transactions possible; offers clearing and settlement mechanisms; allows the pooling of resources, which eases diversification; and supplies ways of managing, mitigating, and transforming risk (Crane et al. 1995).

In the past decade, many countries have adopted policies aimed at creating or improving domestic capital markets to realise economic growth. The development of financial markets is widely acknowledged to be one of the crucial issues facing emerging markets that have a noticeable impact on economic growth; i.e., research on financial market development shows that there is a strong correlation, and possibly causality, with economic growth. Levine and Zervos (1996) show that stock market development is positively associated with economic growth. Demirgüç-Kunt and Levine (1996) show also that the level of stock market development is a good predictor of economic growth. Boyd and Smith (1996) illustrate that the endogenous evolution of debt and equity markets in the development process provides an economy with a more efficient set of financial opportunities and encourages the development of capital markets. Levine (1997) and Beck and Levine (2001) find a positive causal impact of financial development on productivity and economic growth. Caprio and Demirgüç-Kunt (1998) confirm that long-term credit is scarce in emerging-market countries and more so for small firms that could otherwise obtain long-term finance if located in industrial countries. Also, long-term credit is associated with higher productivity.

In addition, Wurgler (2000) finds that financially developed countries boost investment more in their growing industries and cut it more in their declining industries, implying that efficient financial markets allow a better allocation of capital and determine economic growth. Rousseau and Sylla (2001) take a long-term perspective of two centuries to demonstrate the leading role of financial-sector development on growth. In that direction, Al-Yousif (2002) studies time-series and panel data for 30 developing countries for the period 1970–99 and supports the view that financial development and economic growth are mutually causal, but that the relationship cannot be generalised

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across countries because economic policies are country-specific and depend on the efficiency of the implementing institutions.

Research on the dynamic of financial and capital market development has mostly focused on the factors that influence financial markets. Various studies examine the relationship of liberalisation and openness of economies in relation to financial market development and growth. Rodrick (1999) examines the relation between openness to trade and economic growth, and he introduces the role of the financial sector in a standard cross-country analysis. He finds that the relationship among openness to trade, financial markets, and economic growth is weak. In contrast, Bekaert, Harvey, and Lundblad (2001) find that financial liberalisation is associated with higher real growth. Rajan and Zingales (2001) illustrate the role of openness and 'interest group' politics in financial market development. Bekaert, Harvey, and Lumsdaine (2002) show that integration is accompanied by a significantly larger and more liquid equity market, with stock returns that are more volatile and more correlated with world market returns. Integration (and consequently liberalisation) is associated with a lower cost of capital, improved credit ratings, real exchange rate appreciation, and increased economic growth.

With regard to the specific policy choices that spur financial market development, the existing research has emphasised the relevance of legal regulatory reform, property rights, the role of institutional investors, and the importance of effective corporate governance. La Porta and others (1997, 1998) confirm that the legal environment and enforcement matter for the size and depth of the financial sector. They study the quality of laws governing investors' protection and enforcement and confirm that a weak legal system has a negative impact on financial development and economic growth. Demirgüç-Kunt and Maksimovic (1998) illustrate that in countries with an efficient legal system, a greater proportion of firms use long-term external financing. On the relevance of corporate governance reform for fostering financial market development, La Porta and others (2000) look into the protection for investors to be expropriated by managers as a factor for capital market development. Lopez-de-Silanes (2001) indicates that the legal system (i.e., rules and enforcement) matters for the size and the extent of a country's financial market. He develops indicators of investor protection and of the quality of the legal system that are based on a cross-sectional review of countries for 1999. Various researchers have explored the impact of institutional inheritance on financial development (Coffee, 2000; Rajan and Zingales, 2001; Stulz and Williamson, 2001).

In the context of domestic capital market development, the establishment of a bond market is considered a crucial step. In its study on corporate debt markets, IOSCO (2002) points out the role that government securities play as a benchmark. Various studies provide a historical perspective on bond market development: Sylla (1998) for the United States; Emery (1998), Kim (1999), Batten and Kim (2001), Batten, and Fetherston (2003) for Asian countries; and Schinasi and Smith (1998) for United States, Europe, and Japan. BIS (2002) reviews the experience of several emerging countries – mostly in Asia and Latin America – in the development of debt markets. The research indicates that to different degrees in European and Asia countries, three main factors drove the 'delay' of bond market development: overvaluation of domestic currencies and borrowing in low-interest-rate currencies; a bank-centered financial system that limits the role of capital markets; and opaque corporate governance, mostly linked to families that would not permit a level of transparency and disclosure that would have allowed access to capital market.

De Broeck, Guillaume, and Van der Stichele (1998) present the institutional reforms of the debt markets during the past 20 years, underlining the shift of government financing from 'relationship' to market-based funding and the informational improvement that the market-based funding introduces. Johnston (1998) regards the opening of the capital account making financial-sector reform even more urgent. Del Valle (2003) provides the policy framework of and the building blocks for the establishment of a successful government bond market. Musalem and Tressel (2003) indicate that the development of securities markets is stimulated if the demand of contractual savings is matched by government debt. Contractual savings stimulate the public bond debt market that substitutes short-term government securities and provides a benchmark for setting interest rates and building the yield curve. However, this 'virtuous' circle is threatened by the crowding out of incipient corporate debt and equity markets.

Karacadag, Sundararajan, and Elliot (2003) emphasise that the government bond market is the pillar of domestic capital markets because it provides the market-based term structure of interest rates, which is the foundation for developing derivative markets that allow market players to manage their risks. Government bond markets create a range of positive externalities and prompt innovations, including repurchase agreements, money market instruments, asset-backed securities, and bonds of other public-sector entities (e.g., municipal bonds). Turner (2003) articulates the policy issues and trade-offs that are related to bond market development in general and the government bond market in particular. On specific aspects related to bond market development, Mohanty (2002) tackles the fundamental problem of liquidity of the bond market and suggests some of the actions that monetary authorities can undertake to enhance liquidity. Hawkins (2002) looks at the impact of bond market development on the banking systems; he argues that despite the worries of competition between bond market and banking system, banks play a crucial role for a healthy bond market.

In the context of APEC (Asia-Pacific Economic Cooperation), Asian countries have recognised the role of the bond market and its regional dimension, and they have asked the Asian Development Bank to produce rules and regulations to harmonise the regional Asian bond markets (APEC 2003).

III. Experiences in other parts of the world

Domestic bond markets are growing and offering new kinds of instruments in many parts of the world. This section reviews recent developments in Asia, Europe, and the United States.

Asia: The risks of unbalanced development

Perhaps the major financial difference between pre- and post-crisis Asia has been the development and deepening of the domestic government and, more selectively, corporate bond markets. The crucial lesson policymakers took from the Asian crisis is the danger of the absence of diversification, manifested in an overreliance on banks, short maturities, and foreign currencies. The four economies most affected by the crisis – Indonesia, the Republic of Korea, Malaysia, and Thailand – historically relied on short-term borrowing from domestic and foreign banks to fund their long-term needs. These countries were characterised by the success of their real economies, e.g., strong exports, low inflation, high growth, and low public-sector deficits. In tandem with these accomplishments, however, significant levels of government and political intervention stunted the development of capital markets in general and domestic bond markets in particular. Rather than tapping incipient domestic bond markets, companies gambled on the ability of their interventionist governments to maintain fixed nominal exchange rates and borrow in lower-coupon currencies (i.e., the yen and dollar).

The corporate governance structure, characterised by disclosure-shy, family-held firms, favored a bank-centered system over a capital markets solution. Other obstacles to a bond market alternative for private borrowers included the lack of a strong government securities market to provide a benchmark for private issuers, an underdeveloped role for institutional investors, and inadequate market infrastructure. All these elements reflected the absence of a government strategy to develop bond and capital markets.

Since the crisis, financial-sector reform has become a priority for the countries hit by the crisis, such as Korea and Thailand. The domestic bond markets have assumed much more importance, and in fact they are now the fastest growing asset class in Asian emerging markets. The administrative determination of interest rates has been abandoned, and financial reform has led to the opening of the bond market to foreign investors and to greater transparency and efficiency. The fiscal deficits that resulted from the crisis turned many Asian governments from modest net borrowers into large net borrowers. This, in turn, is helping to establish a government yield curve and benchmark instruments to assist banks and corporations in pricing their issues. Modest inflation and large domestic liquidity are keeping interest rates low and are expected to boost bond issuance. Although the region's bond markets remain national, a consistent approach to macroeconomic and institutional reforms – as well as coordination in countries such as Korea, Malaysia, and Thailand – could provide the conditions for markets that are more regional in scope and that have benefits for all.

At the end of 2002, the value of bond markets in emerging-market Asian countries exceeded USD1.2tr, more than half the total for emerging markets. In the early 1990s, commercial banks dominated the financial scene, and the region's policymakers, issuers, and investors did not consider bond markets as a viable financing alternative. However, despite a series of difficulties during the past decade, domestic bond markets have grown rapidly to become an important feature of financial markets across Asia. However, governments, regulators, and multilateral institutions still see the need for more robust domestic bond markets to finance the massive infrastructure investment that is needed to sustain the region's continued high levels of growth.

Despite these real advances in the financial sector, the lure of old habits remains strong, particularly in the area of governance. According to many observers, government commitments to deep reforms affecting the regulation and conduct of business have weakened with the passing of the acute phase of the crisis. Table 1 presents interesting comparisons of the evolution of the banking sector and the bond market over the period 1992-2002. In 2002, bond markets in Asian countries were still smaller than the banking sector. However, in Korea -the largest Asian bond market- and in Malaysia, in 2002, the share of the corporate bond market is beyond 50% (almost 60% in Malaysia) of gross domestic product (GDP). On average for Asian economies (i.e., including also China RP, Hong Kong, Indonesia, Philippines, Singapore, Taipei) the share is above 40%. In 2002, the bond market in the United States was 113% of GDP and over the period 1992-2002 the role of the banking sector with respect to GDP has declined. In European countries such as Italy and Spain, the increase of the corporate bond market is coupled with extremely high levels of domestic government bond outstanding as a percent of GDP (particularly in Italy). The figures of Table 1 show that Asian bond markets are still considerably smaller than those in advanced industrialised economies such as the US, suggesting the potential for the further development of these markets. It also illustrates, i.e., the case of Italy, that the growth of the government bond market reduces the credit available to the private sector, which still relies on the banking sector and possibly on financing from the extended regional market.

Table 1: Size of banking sector and bond market – Percentage of GDP

	BANKING SECTOR				BOND MARKET			
	Deposit money bank assets to GDP (%)		Private credit by deposit money banks to GDP (%)		Domestic corporate bond outstanding to GDP (%)		Domestic government bond outstanding to GDP (%)	
Country	**1992**	**2002**	**1992**	**2002**	**1992**	**2002**	**1992**	**2002**
Argentina	17.67	45.15	12.77	15.09	0.30	13.11	5.25	4.60
Brazil	25.68	45.94	18.53	29.28	11.24	9.11	2.81	37.67
Chile	40.91	67.15	39.32	66.04	10.77	24.78	27.02	29.15
Colombia	15.61	28.11	12.88	19.66	–	–	–	–
Mexico	28.61	32.67	22.51	17.22	0.30	1.66	5.25	12.08
Peru	9.89	26.16	6.47	22.60	*0.28*	3.87	*0.57*	2.99
Italy	80.71	101.32	59.28	84.80	27.73	46.33	77.64	94.21
Spain	105.10	138.86	81.55	115.08	16.45	21.55	24.70	50.83
United States	72.42	55.22	62.63	52.08	73.77	113.28	58.30	43.49
Korea	51.98	109.43	49.85	105.34	30.55	59.83	9.20	20.08
Malaysia	82.33	106.39	69.94	99.50	17.95	51.70	45.35	35.73
Thailand	74.78	91.21	66.62	81.11	6.21	17.65	3.06	27.73

Source: World Bank Financial Structure Database (using IFS and BIS)
Values in italic refer to 1993

Table 2: Size and structure of the world bond market - Governments bonds (1998-2003) – USDbn outstanding

	2001			2002			2003-6		
	Internat'l	Domestic	Total	Internat'l	Domestic	Total	Internat'l	Domestic	Total
United States	3.30	4,187.10	4,190.40	3.10	4,530.30	4,533.40	3.00	4,778.60	4,781.60
Europe Union	277.30	3,532.40	3,809.70	397.00	4,377.60	4,774.60	509.10	4,924.00	5,433.10
Japan	4.80	3,904.70	3,909.50	4.40	4,837.50	4,841.90	4.50	5,276.50	5,281.00
United Kingdom	3.40	411.20	414.60	0.40	473.70	474.10	0.40	470.50	470.90
Canada	84.50	401.70	486.20	87.60	412.00	499.60	89.90	482.20	572.10
Switzerland	0.80	55.30	56.10	0.90	79.50	80.40	0.90	81.90	82.80
Australia	12.00	63.20	75.20	13.30	71.40	84.70	12.80	81.20	94.00
Sweden	24.00	81.40	105.40	26.60	104.10	130.70	24.80	121.20	146.00
Developing countries	258.50	1,117.30	1,375.80	289.40	1,178.00	1,467.40	310.20	1,331.50	1,641.70
Africa & Middle East	14.00	30.40	44.40	17.60	40.90	58.50	20.50	47.60	68.10
Asia & Pacific	26.60	532.20	558.80	32.30	645.10	677.40	33.50	675.00	708.50
Europe	57.40	173.20	230.60	68.20	219.50	287.70	75.10	268.40	343.50
Latin America & Caribbean (LAC)	160.60	381.50	542.10	171.30	272.50	443.80	181.10	340.50	521.60

Internat'l = International debt securities (governments)
Domestic = Domestic debt securities (governments)
Total = Total governments debt securities (domestic and international)

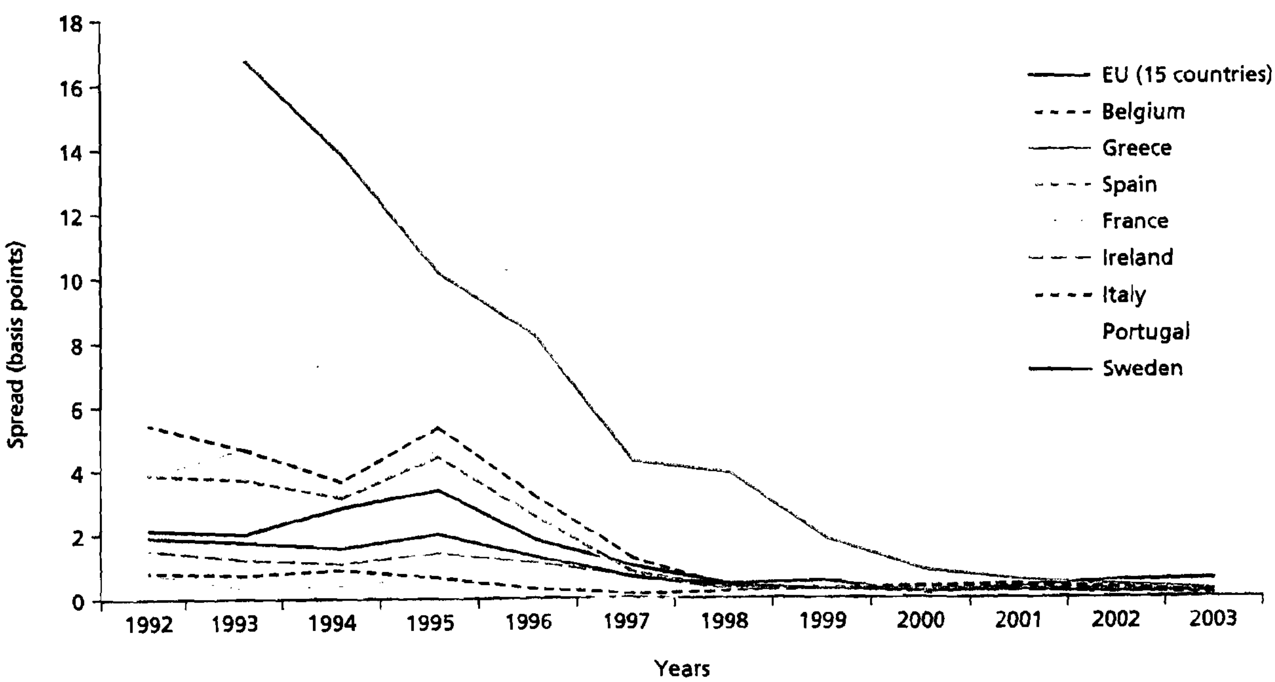
Source: Elaboration on data Bank for International Settlements

Europe: The strengths and limits of integration

Integration, liberalisation, and technology have been the main drivers of the move toward achieving a single financial market in Europe. During the past 10 to 15 years, almost all European countries have put in place policies for bond market development as part of a capital market strategy made possible by the integration process and the adoption of a common currency. Countries such as Italy and Spain, whose public-sector debt in the 1980s was heavily skewed toward short-term funding, now spread their debt over a larger spectrum of maturities. They have created benchmarks for corporate bonds and for other public-sector entities (including local governments) as well as for equity markets, and they have encouraged the creation of derivative markets for government bills and bonds. Innovations such as Italy's electronic trading platform for government securities, the Mercato Telematico, which was started in 1988, have been widely replicated throughout Europe.

In Europe, what used to be several small, segmented, and fragmented debt markets mostly dealing with short-term securities has become, as of 2003, the largest domestic and international market for government securities. Table 2 indicates that in mid-2003 the domestic European government securities market was USD4,924bn, and in the past few years it has been

Figure 1: Spreads of government bonds in selected EU countries 1992-2003



slightly larger than the equivalent US market (i.e., about USD4,800bn).

Since the introduction of the euro, segmentation by national currencies has disappeared. Greater transparency and disclosure of information and a more efficient market infrastructure are facilitating secondary markets, liquidity, and comparisons among issues. With the elimination of exchange rate risk, bond spreads among national issues have narrowed dramatically. Figure 1 shows the sharp decline of the spreads for bonds of selected EU governments over the German Bund over the period 1992-2002. The monetary integration and the creation of the euro have produced the conditions for the very substantial reduction of spreads among the issues of member governments. The benefits are evident: not only a stable benchmark but also considerable savings in borrowing cost for the national treasuries and ultimately for tax-payers. Credit risks have moved toward convergence as a result of the fiscal stability pact that commits governments to limit public-sector deficits to 3 percent of GDP or less. However, factors such as the transparency, speed, and efficiency of issuance and trading systems; clearing and settlement procedures; regulatory frameworks; and specific government initiatives to boost liquidity (e.g., buying back less liquid issues, interest-rate swaps) still are mostly determined at the national level, leaving much to be done. Although market competition is causing many of these factors to converge, after many years of trying, European Union members have yet to agree on a common framework for investment law.

The US experience

The US financial market advantages of possessing both a large unified polity and a unified economy are probably not replicable in other parts of the world. Nonetheless, officials tasked with building more efficient national or regional capital markets can benefit from reviewing the critical turning points, some deliberate and some accidental, that underlie the evolution of government bond markets in the United States. Such a review would start with certain key decisions made two centuries ago, when the United States was an emerging country with an agrarian economy.

Printing money and incurring large amounts of domestic and foreign debt financed the American Revolution. At the end of the war, in 1780, the federal government (which lacked taxing authority) and the states (all of which were in varying degrees of fiscal disarray), struggled to cope with their debts. At the Constitutional Convention in 1786, the federal government gained the power to tax and regulate trade among the states. Given the task of funding the war debt, the first Treasury secretary, Alexander Hamilton, devised a plan in 1789 that has had a lasting impact on the development of the US financial system: it assigned the entire war debt to the federal government. The initial placements in 1789 were, in effect, 'junk bonds' and sold at 25 percent of face value. By 1792, however, the bonds were selling at 120 percent of par and were attracting foreign investors. The US bond market was thus established, and with it the US capital market. History rightly credits Hamilton and the first Congress with putting the new government's finances on a solid footing and establishing its credit. The strengthening of the nation's public finances allowed the expansion of the US financial system (Sylla 1998).

Although the US capital market is often taken as a model of good practice, it also needs to be understood as the product of historical forces. For example, although today central bank independence is treated as a sacred principle, for a large part of the twentieth century, from 1914 to 1934, the Treasury Secretary was ex-officio chair of the Federal Reserve and for several more years, at least until the early 1950s, had a strong informal influence over its policies. A frequently cited example of this influence was the decision to continue the wartime policy of freezing interest rates at a low level until 1951, despite mounting postwar inflation.

There are other examples of the accidental nature of the development of the US financial sector. Treasury markets remained unregulated under the 1933 and 1934 Securities and Securities Exchange Acts because lawmakers at the time were understandably focused on failures in the private rather than the public markets. But this 'quirk of history' helped pave the way for the Treasury market scandals of the 1980s and 1990s. In the 1950s, Federal Reserve open market operations only used Treasury bills. Primary dealers (initially called 'weekly reporters') were not created until the early 1960s. Until the early 1970s, long-term debt was placed by subscription rather than auctions, and regularly announced auctions did not occur until the mid-1970s; nor did the use of accurate, statistically derived yield curves. Treasury benchmark securities eventually arose as a result of the accumulation of these practices and ballooning government deficits. However, their availability was not the result of a deliberate policy but rather the consequence of other policies.

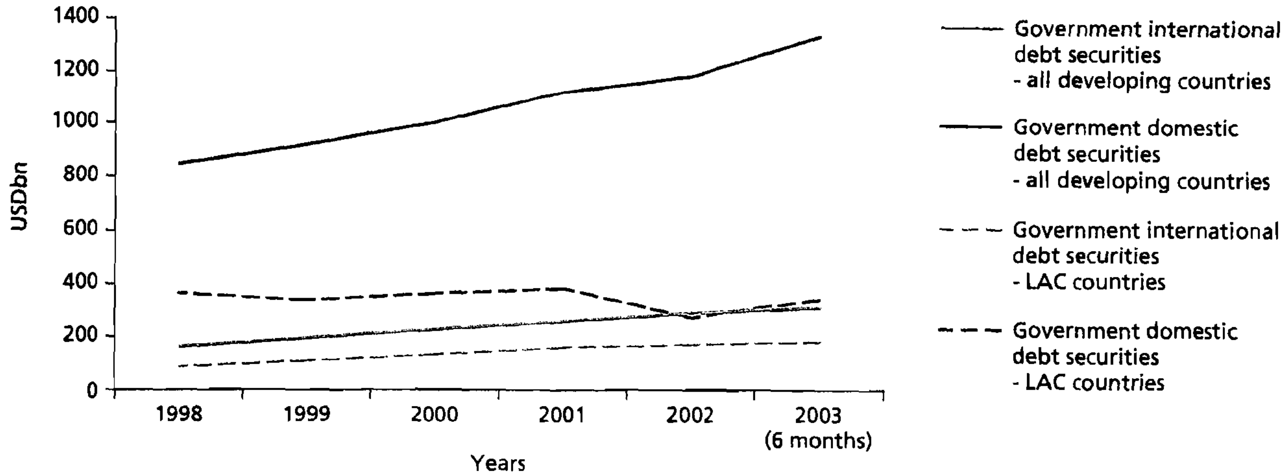
Today, developments in information technology drive debt management in the United States as much as the markets themselves. For example, the US Treasury has reduced the time for releasing auction results from about 20 to 5 minutes, significantly lowering the period during which market participants are 'at risk' for lack of knowledge. At present, the US Treasury's overriding objective is to borrow money on behalf of the government on the best possible terms, which has led it to discontinue its long-term benchmark issue, the 30-year bond, which had been widely used to price and hedge long-term corporate, municipal, and mortgage-related securities. The markets have adapted – but not, according to some traders, without some increase in risks and decrease in liquidity.

IV. Global experience and the development of government bond markets in Latin America and the Caribbean

Structural conditions of the Latin American and Caribbean economies

Although the experiences of Asia, Europe, and the United States are instructive – and in different ways show how weak or small markets can be strengthened through cooperation or convergence – none of them captures what are often seen to be the central problems of market development in Latin America, namely, the low rates of saving and tax compliance that, along with other factors such as commodity-dependent economies, make the region's governments prone to running large deficits. Historically, the financial consequences of this combination of circumstances have frequently produced a vicious circle in which government requirements have crowded out the private sector, often leading to reliance by the government and private sector alike on short-term foreign capital inflows for investment, operating expenditures, and even consumption.

Figure 2: International and domestic government outstanding debt



Excessive *dependence on short-term foreign capital* is dangerous in emerging economies and in particular in those countries whose economies are relatively closed, and where the export sector that would enhance competitiveness and innovation (and earn foreign exchange) is fragile. High debt-service payments to foreign lenders also add risk by removing valuable reinvestment resources from circulation. The international community, after suffering numerous losses, today demands high levels of disclosure from emerging-market borrowers. Opportunistic investors may continue to lend in hard currencies at higher rates and for shorter terms, but prudent investors will simply disappear.

When short-term foreign borrowing increases, it is often a signal for savvy domestic investors to make 'safe haven' investments abroad, even at the cost of drastically lower interest rates. The investors who stay shift to very short-term financial assets or abandon financial assets altogether and shift into nonproductive real assets such as real estate. Left with volatile short-term deposits, domestic financial institutions lose the ability to leverage their resources or lend long term, and they also shift their focus from the productive economy to short-term financial arbitrage. The vicious cycle culminates in the erosion of savings, financial institution disintermediation, slower growth, and a loss of investor confidence.

Vicious cycles are not inevitable. Governments can reap substantial benefits for their economies if they use capital markets with care and foresight. Governments that keep borrowing to prudent levels gain a useful instrument of fiscal policy and set the stage for creating financial markets that serve private as well as public borrowers. Two of the most important services that governments can provide are building a yield curve, or term structure of interest rates, and creating and maintaining liquidity at critical points along the curve through the development of benchmark instruments. Each of these visible achievements is prima facie evidence of a government's commitment to stable financial policies. The term structure reveals interest-rate and inflation expectations, strengthening the quality and reliability of foreign and domestic private-sector planning and investment decisions. Other instruments and innovations can be designed and priced more easily in the financial marketplace, including but not limited to mortgage-backed securities, equities, and bonds.

The emergence of a yield curve and benchmark instruments creates attractive venues through which large institutional funds can invest for long periods, and enables the government to undertake long-term commitments that are critical for socioeconomic development (e.g., education and infrastructure) with greater safety. Ultimately, the availability of a broader range of instruments (ranging from inflation-indexed government bonds to high-risk venture capital investments) allows investors to diversify their portfolios domestically.

Experience in the region

Certain countries (such as Brazil, Chile, Colombia, and Mexico) have had some success in consolidating and extending the term structure of government borrowing, paving the way for corporate bond issuance and more portfolio diversification opportunities for domestic institutional investors. In 2002, Mexican government debt was awarded an 'investment-grade' rating, with the result that USD30bn of Mexico's sovereign and corporate debt moved from the emerging-market category to high-grade indices. However, corporate issuance is still low by international standards and almost entirely concentrated in the very short term. Although the requirements for developing the corporate bond sector are more difficult than those for government bonds, the weakness of the corporate sector in most countries may still mainly reflect the prevailing state of affairs in government bond markets.

The low savings rate clearly contributes to the malaise of capital markets in Latin America, but it is not the only, or even necessarily the most important, factor. Notably, domestic Latin American investors (Costa Rica is a case in point) frequently purchase a large portion of the internationally offered bonds of Latin American governments. For some, this is evidence that there is considerable potential for the development of long-term domestic bond markets. For others, it simply shows that such markets will not develop without major legal, regulatory, and institutional changes to strengthen investor confidence. In the latter view, domestic investors prefer investing abroad because they feel more comfortable with an instrument underwritten by large international houses that relies on international laws and clearing and settlement procedures. Emerging-market countries are becoming increasingly aware of the need to develop domestic capital markets to provide resources for growth and also to effectively manage their economies.

Table 2 and Figure 2 illustrate the great effort that emerging-market countries are directing to the objective of developing domestic capital markets. A growing gap between domestic and external debt clearly emerges, particularly for the all developing countries. Under these circumstances, trading in domestic debt securities becomes greater than trading in international bonds, even though, for emerging-market countries, the international market still has the advantage over the domestic market of longer maturities and greater liquidity. However, as the experience of European countries shows, the spreads between domestic and international issues have narrowed, and in the case of bonds in euros have been eliminated. Figure 1 also shows that the Latin American and Caribbean countries have not developed their domestic bond markets as extensively as some other emerging-market economies, but it is possible that they may catch up with the return of more stable macroeconomic conditions.

Issues for bond market development: liquidity and the role of banks

Well-developed secondary markets are absent from the region because of a lack of liquidity – a major weakness in the region's bond markets that is most difficult to correct – which in turn thwarts the development of a yield curve. Without liquidity, there is little to distinguish a bond from a fixed-term bank loan, from the investor's point of view. Governments in the region have taken some important steps to address the problem of liquidity through such measures as consolidating their borrowing requirements in a small number of benchmark issues.

Ultimately, however, liquidity depends on the existence of a two-sided market, implying the existence of institutional investors with a range of different motives and interests. Where institutional investors do not exist or are not active, the burden of liquidity provision can fall heavily on the governments themselves, through open market operations. But open market operations cannot prudently be the primary source of liquidity because their fundamental purpose is not to serve the needs of investors but to support monetary policy objectives. Liquidity is particularly important from the vantage point of international institutional investors. In Chile, for example, despite the development of a well-regulated fixed-rate bond market with maturities of up to 20 years, there are essentially no foreign investors because of the lack of liquidity. Mexico is the Latin American country that has made the most progress in developing a liquid government bond market. In fact, bid/ask spreads have significantly narrowed (in the range of 10–15 basis points for 'on the run' bonds), while still remaining larger than typical spreads in industrial countries.

The role of banks in the development of government bond and capital markets is particularly important. Bank-dominated systems pose a challenge for capital market development, mainly because both systems are effectively competing for the same pool of funds. However, as capital market development moves ahead, albeit gradually in certain cases, banks become part of the new 'equilibrium' by becoming issuers and investors themselves. e.g., by subscribing to notes and bonds issued and by selling such capital market products as mutual funds to the public. Governments can facilitate this transition by supporting the development of a repurchase-agreements (repo) market, as well as legal and policy frameworks that allow banks to securitise certain assets, such as those related to housing and consumer credit. By lowering the costs and risks of these basic financial products, banks could then gain a greater incentive to address relatively unserved sectors, such as corporate bonds and finance for small and medium-sized enterprises.

Rating agencies (international and local) and financial analysts are crucial in the functioning of the market and particularly in the composition of the bond debt among the various sub-classes of high grade, high yield and emerging market class. Together with financial analysts that follow issues and recommend buying or selling to investors, rating agencies constitute the 'watchdogs' that could make the market system work.

What can be done to deal with complex issues of bond market development? In the area of liquidity, there seems to be scope for greater government intervention. Policymakers should undertake such measures as reducing obstacles like taxation and others where trade-offs have to be carefully considered, e.g., conflict between controlling trading structures and regulatory and supervisory responsibilities (see Turner 2003). One important factor that could help create a liquid secondary market is to attract investors – both national and international, including banks – to invest in domestic government bond issues. The decision to take the route of expanding the investor base is a 'no turn back' one, for the government would need to be fully committed to fiscal discipline and macroeconomic stability to avoid the consequences of a downgrade.

Strategic view

The development of bond markets is an important step toward capital market development and the more efficient use of financial resources. It necessitates fully disclosing government financial dealings, i.e., ensuring greater accountability not only to international creditors but also to individuals and corporations. This can enable governments to harness domestic savings more effectively in the interest of long-term growth. Improved information dissemination is the best antidote for investor uncertainty and can help stabilise international capital flows.

The development of a deep and liquid bond market would likewise reduce the dependency on short-term capital flows and speed the development of pension funds and insurance companies, whose investment horizons are in line with those of the government. Developing long-term bond markets in Latin America can have effects substantially broader than financial market development; their effects ripple throughout the system and can be an engine for national socioeconomic development. Many emerging-market analysts argue that reduced dependence on foreign capital and debt service is what Latin America needs to promote its economic growth and financial strength. Of course, bond market development should not be seen in isolation, but rather as part of an overall capital market development objective – as well as of the objectives of reducing the government's funding cost and facilitating monetary policy.

These objectives require a commitment to macroeconomic stability and fiscal discipline, which usually means a well-defined and independent role for the central bank. In turn, important reforms need to be made to serve the broader objective of capital market development: effective corporate governance for entities that operate in the market, judicial systems capable of enforcing property rights, and regulatory agencies to oversee financial markets. Some of the requirements for bond market development may lend themselves to regional solutions. Yet, as

Europe's experience shows, this is at best a long-term undertaking and may not be possible without a very high degree of monetary, fiscal, and political integration.

V. Conclusions: Lessons and policy recommendations

The different experiences of industrial and developing countries highlight the fundamental components for a sustainable strategy to promote domestic bond markets. They basically include a consistent macroeconomic programme, a sound financial system, and institutions to enforce regulations.

Policy lessons

Several policy lessons can be drawn from the experiences of the rest of the world, as well as from those of the Latin American and Caribbean countries:

- Bond market development requires addressing both the supply and demand sides of the equation. It requires a degree of active cooperation among diverse parties that is unlikely without a strategic plan and strong leadership.
- A regional dimension with coordinated macroeconomic policies can strengthen national endeavours to develop bond markets. But this is only the first step in developing capital markets that have a truly regional character. If the European experience can be taken as a guide, other steps would probably include compensatory cross-border fiscal policies as well as a highly predictable relationship among the region's exchange rates, if not an actual common currency.
- Macroeconomic stability and fiscal discipline are crucial for establishing a sustainable bond market.
- Timing and conditions (level of interest and exchange rates, status of public-sector finances, financial-sector reform and sound regulation, legal framework, infrastructure) are crucial for promoting the development of domestic bond markets.
- Secondary market liquidity is the ultimate measure of success for government (and corporate) bond market development. Governments are more likely to reach this goal when they make a commitment to a sequence of carefully designed, sustained policies.

Policy implementation

The experience of various countries demonstrates that, generally, a 'trigger event' prompts the conditions for the development of bond and capital markets. For instance, in Europe, the financial crises of the early 1990s and the creation of the common currency have led a number of countries (e.g., Italy and Spain) to move ahead with serious reforms, a commitment to fiscal discipline, and the liberalisation of the capital account and establishment of an effective bond market. Similar experiences can be seen in Asian economies (e.g., South Korea after the Asian crises of 1997 and 1998) and in Mexico following the tequila crisis. These experiences show that, over time, a convergence of rules, regulations, terms, and conditions is expected to emerge, leading also to a substantial reduction of spreads among domestic, regional, and international markets for the same issuer.

In response to the trigger event, the effort to build a bond market requires vision, leadership, and a long-term perspective. Some key measures of a successful strategy include decisions to restrict foreign-currency (or foreign-currency-indexed) borrowing, to develop a domestic yield curve with longer maturities, and to create liquid benchmark instruments. The scale and complexity of bond market development makes it almost by definition a nonpartisan 'project of the state' rather than of a particular administration. This implies that broad public awareness of its advantages is also important. Whether the path chosen is to build up national institutions or to foster international (or regional) integration, there can always be much to learn from the experience of other countries, both in and outside the region.

There is growing empirical and anecdotal evidence suggesting that capital market development works best when policymakers introduce reforms in a certain logical sequence (in which money markets and government bond markets are the first steps). This ideal may not be achievable for a number of reasons, including national differences and entrenched interests. A typical problem, for example, is how to enlist the cooperation of banks that may fear that the development of capital market instruments will lead to an erosion of their deposit bases. On such topics, and others, comparative information and an informed public can be a policymaker's best allies. Trade-offs are unavoidable, and governments need to be mindful of all these factors in developing capital markets and debt-management strategies.

The creation of cross-national networks of policymakers and other interested parties to review and analyse experiences and to seek to identify best practices would help in developing these crucial broader perspectives. These networks could explore important questions, such as the role of a 'debt-management office'. Unlike mature economies, where market forces can work out the inherent conflicts between monetary and fiscal policies, the emerging Latin American economies would probably benefit from taking a more formal approach to these issues. The interaction between bond market development and monetary policy and the exchange rate regime is another area where cross-country discussion would be useful.

Even with cautious policies, the goal of developing a domestic capital market is more appropriate in some countries than others. Economies of scale are inescapable, and even the largest Latin American countries have proven unable to defend important market segments against the pull of powerful international financial centres. Thus, the national goals of building stronger financial systems and capital markets need to be grounded in a realistic assessment of which financial products, services, and institutions truly have to be 'home grown' and which are better obtained internationally.

Whether capital market development is defined in terms of building domestic markets and institutions, or whether it is defined 'functionally' (where the aim is to ensure that domestic users and providers of capital have access to the best rates and terms), the two approaches must eventually converge. Competition is pervasive, and money is ultimately fungible. Thus, if domestic financial institutions are to be successful, they must eventually match international competitiveness standards; otherwise, the competitiveness of their own clients will decline, and those with a choice will move elsewhere.

The role of multilateral institutions

Multilateral institutions such as the Inter-American Development Bank have a role to play in the region's capital market development and also a comparative advantage in fostering cross-country discussion and analysis. Activities in which multilaterals are either actively engaged or might become so include promoting public awareness of the importance of bond markets; supporting technical expertise for debt and bond management; advising on investor-protection measures; proposing a standard model for bond indentures; analysing and recommending best-practice changes related to issuing and transaction taxes; developing databases showing default levels; and providing technical assistance to help create credit derivatives. The publication of the Asian Development Bank aiming at the harmonisation of a regional bond market (APEC 2003) and the periodic meetings – sponsored by the Inter-American Development Bank – of top officials of ministries of finance who are in charge of debt management and government bond markets are two examples, among many, of how multilaterals can support the development of bond and capital markets and also promote the harmonisation and integration agenda.

Multilateral institutions have a strong comparative advantage in exposing this body of work to public debate through forums, seminars, and the creation of networks of experts in Latin America and the Caribbean. To help set the stage for a new and stronger standard of financial market disclosure and information sharing, multilateral institutions, in particular the World Bank and International Monetary Fund, could agree with their central bank clients to release the results of the so-called financial-sector assessment programmes (FSAPs) that have now been completed for most of the countries in the Latin American and Caribbean region. The FSAPs, prompted by the market failures of the Asian currency crisis, are purportedly among the most comprehensive financial-sector studies ever undertaken. Weighed against their objective of fostering stronger and more transparent financial markets, there is a certain irony in the fact that the findings of these studies have not been shared more broadly; they have been circulated among only a very small number of senior national officials. Even if it is true, as some officials associated with the FSAPs have claimed, that little in these documents is sensitive or new, the symbolic value of placing this information in the public domain could be substantial.

Other forms of multilateral support for capital market development could include temporary credit enhancement via guarantees, default insurance, purchasing of junior or subordinated bond tranches; providing working capital finance for market makers; and flotation of their own bonds in local currencies to help create AAA-rated benchmarks. Many of these activities should be treated as elements of a broader strategy, rather than as discrete technical instruments. They should also probably be used sparingly and only in well-defined circumstances. Otherwise, they could end up retarding rather than fostering market-based solutions.

John Pietro Masci is Division Chief of the Infrastructure and Financial Market Division of the Inter-American Development Bank and Benjamin M Rowland, PhD, is an independent consultant based in Washington, DC *The authors thank Monica Almonacid and Rogerio Studdart for providing support and data.*

The IDB is the oldest and largest regional development bank. It is the main source of multilateral financing for economic, social and institutional development projects as well as trade and regional integration programmes in Latin America and the Caribbean.

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