Discussion of “Emerging Local Currency Bond Markets” by J. D. Burger, F. E. Warnock and V.C. Warnock

Rajeswari Sengupta (IFMR, India)

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- Balance sheet weaknesses due to currency mismatches have been crucial in every major crisis affecting EMEs since 1980s.
- Global finance is made more fragile by inability of most nations to borrow in their own currencies.
- This means currency depreciations often lead to debt and/or banking crises.
- Also encourages global imbalances–lack of reliable financial instruments in EMEs channelled global savings toward industrial countries.
  - Encouraging development of local currency bond markets (LCBMs) is one way of reducing global financial instability.
  - Imp. to assess how much of this has been done in EMEs and what factors help explain foreign investment.

- Study the evolution of LCBMs in EMEs & AEs from 2001 to 2008 (size, returns, outstanding amounts, maturities etc).
- Why are some EME LCBMs more attractive to US investors than others?
  - Simple model of portfolio allocation using cross-sectional data on EME share of US bond holdings for 2006 and 2008.
  - Include investability, correlation, expected mean-variance-skewness.
    - GMM Estimation in a dynamic panel setting to estimate expected mean-variance-skewness.
    - Include past values of inflation, CAB, GDP growth rate and bond yields.

- EME LCBMs have grown sharply over past decade; reliance on foreign currency debt has gone down.
- Unhedged EME bonds provide higher returns & diversification benefits to US investors.
- During crisis (2007-early 2011) EME bond returns comparable to non-US AE bonds but greater diversification benefits.
- Effect on expected mean returns: CAB(+), yield(+), past yield(-), GDP growth(-).
- Effect on US holdings of EME bonds: Investability(+), Correlation(-).
- Countries with investor-friendly institutions & policies attract more US investment in LCBMs.
- By strengthening institutions, EMEs could develop LCBMs, reduce currency mismatch, lessen likelihood of crises.

- Why not look at only EMEs since question of LCBM is particularly crucial for them?
  - US participation has gone up slightly (2001-2008) in Asia but markedly in LATAM.
- No/borderline significant effect of expected mean (calculated using macro indicators).
- Inflation not significant—one major factor behind development of LCBMs was strong performance on inflation.
- Also movement towards greater exchange rate flexibility makes EMEs attractive destination.
- Maybe *also* look at effect of inflation volatility, exchange rate volatility, depth of financial system (M2/GDP), fiscal deficits, public debt, & country size.
- Difference in factors contributing to increased investor participation for hedged vs unhedged bonds.

- Low-yield/low-volatility global environment in recent years has provided arbitrage opportunities.
- Decline of dollar since 2002 have also helped spur interest in return-enhancing properties of local currency investment.
- EMEs from early 2000s began accumulating substantial reserves–improved macro environment.
- Development of derivatives and swaps markets in EMEs may have helped foreign investors.

- How has foreign currency bond share declined for EMEs between 2001 and 2008?
- How has rise of LCBMs changed exchange rate & interest rate exposures of major EME borrowers?
- Still host of regulatory restrictions in major EMEs (e.g. India)–skepticism about outflows.
    - India has put QR on foreigners buying rupee-denominated bonds.
    - \$5 billion for FII investments in government bonds, and \$3 billion in corporate bonds.
- How much of investment in LCBMs comes from foreigners vis-a-vis domestic investors?

- Excellent presentation of data, insightful analysis, useful policy implications.
- While EMEs have a share of around 34% of world GDP, share of debt securities is only 9.5%.
- The question isn‘t whether we will see more LCBMs going forward. The main question is, how and where will local markets develop?
- Need more data–longer time series, diversification of foreign investor base in EMEs etc.
- New financial risks? Rapid rise in foreign investment may create risks in investor countries (and EMEs too?)
- One area of related research: Impact of foreign participation in determining long-term local currency govt. bond yields and volatility in EMEs.

Thank You