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

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Motivation: Currency Mismatch in EME Bond Markets

- 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?

- 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.


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.
Major Comments

• 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?
Interesting research area

- 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.
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Interesting research area

Thank You