INVESTING IN LOCAL CURRENCY BONDS MARKETS

Comments by Romain Ranciere (PSE and IMF)

Disclaime: Not the views of IMF or IMF Board.

Local Bond Markets

- Underdevelopment of Local Bond Markets.
- Market Incompletness.
  - If lack of foreign Currency instruments to perfectly hedge foreign currency risk for issuers and creditors.
- Consequences:
  - Risk-Taking by Domestic Issuers with no foreign currency income: currency mismatch and balance sheets effects
  - Foregone Returns and Diversification Opportunities for investors.

Origins of Local Market Underdevelopment

- Original Sin (Eichengreen, Hausman)
- Macroeconomic Policies
  - Exchange Rate Regime (Kamil, 2006)
  - Inflation and Exchange Rate Depreciation (Jeanne, 2005)
- THIS PAPER: Institutional Features and Investability
  - Financial Openness
  - Institutions: Creditor Rights
  - Investors-friendly Policies (Taxation)
  - Market Infrastructure
- Risk-Taking and Systemic Bailout Policies (Ranciere and Tornell)
  - Foreign Liabilities and Bailouts

This paper

- Document the rapid development of local bond markets in emerging market countries in recent years.
- Document the potential of local bond markets for portfolio diversification and returns.
  - Evidence based on 2002-2006.
- Explore the causes of local bond market developments.
  - Predictable Risk-Returns Characteristics.
  - Investability is the main feature.
- Discuss Global Asset Shortages and Local Bond Markets.
  - Crisis questions the role US provider of good quality risk-free assets.

Questions on Investability Index

- Which features are specific to local bonds vs. international bonds.
- Simultaneity with other reforms and policy changes.
- What is the interpretation of lack of impact of predictable risk-returns features.
  - Are they endogenous to the change of the policy/institutional environment.

Foreign Currency Risk and Crisis Risk

- Development of instruments to hedge foreign currency risks.
- Foreign Currency Swaps.
- Foreign Currency Options to Hedge Disaster Risk.
- Large Exchange Rate Reserves Holdings
  - Reduce the risk of currency crises (Jeanne, 2007)
  - Mitigate the consequences of sudden stops. (Jeanne-Ranciere, 2009)

Implication for currency mismatch

- Currency Mismatch Definition: Foreign Liabilities that are not backed by foreign currency assets or income.
  - Ex: A non-tradable firm with foreign currency borrowing.
- Bond Issuances are restricted to sovereign, sub-sovereign and large firms mostly in the tradable sector and few in utilities and telecoms.
- Assessing Currency Mismatch imposes to look at the banking sector balance sheet

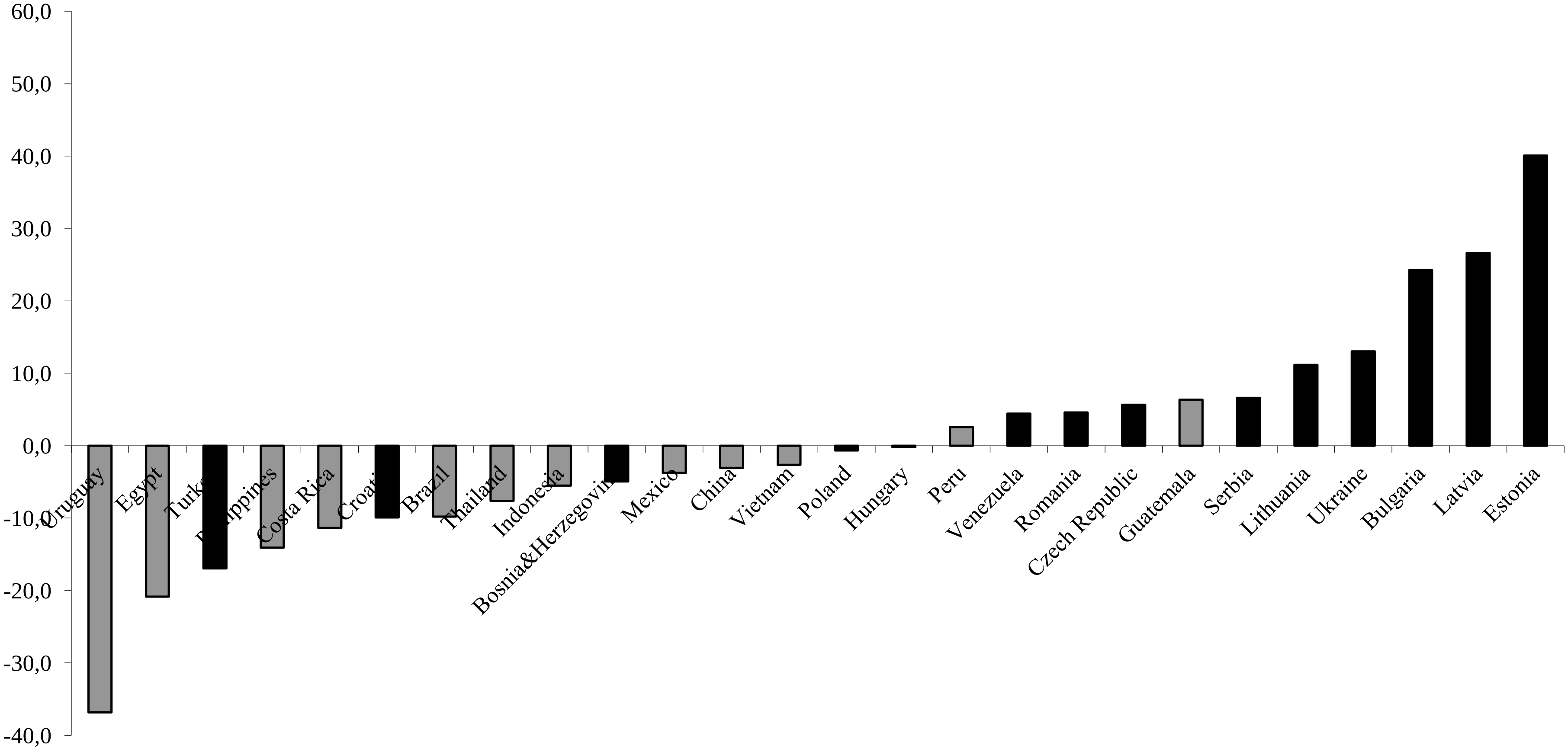
The misfortune of local debt market development: Commercial Mexicana

- Comercial Mexicana: Supermarkets chain.
- Local Currency Debt + Foreign Currency Puts
- 2 Billions of losses on derivatives and
- Structured Products in Local Governments in Europe

Currency Mismatch: Eastern Europe vs. Rest of Emerging Market World

- Ranciere, Tornell, Vamvakidis (2010)
- Currency Mismatch in Banking Sector.
  - Foreign Currency Liabilities – Foreign Currency Assets
- Need to correct for the unhedged part of foreign currency assets.
  - Lending in foreign currency to agents with no foreign currency income
  - Nominal to “True” Currency Mismatch makes HUGE difference.
- Adding direct lending (bonds issuance) do not change the picture.

Increase in currency mismatch in emerging economies before the crisis (2004-2007)



Conclusion

- Very interesting paper.
- Investigate more
  - issue of hedging exchange rate risk.
  - Simulteneity in reforms.
- More nuance implications for currency mismatch.

Thank you

Il est possible de présenter les images de façon plus spectaculaire sur les écrans larges.