



## *Progress Report*

### **IMPLEMENTATION OF THE G-8 ACTION PLAN ON DEVELOPING LOCAL BOND MARKETS IN EMERGING MARKET ECONOMIES AND DEVELOPING COUNTRIES**

#### **I. OVERVIEW**

The Action Plan of the G8 Finance Ministers on “Developing Local Bond Markets in Emerging Market Economies and Developing Countries” identified seven key policy issues at furthering the development of local currency bond markets in emerging market (EM) economies to enhance financial stability and economic growth. These key recommendations aim at improvements in several areas including: strengthening market infrastructure and debt management strategies; broadening and diversifying the investor base; developing derivatives and swap markets; broadening the database; strengthening regional cooperation; developing domestic bond markets in less developed countries, in particular in Sub-Saharan African countries and Technical Assistance. The main objective of the initiative is to further the broadening and deepening of local currency bond markets in these country groups. Indeed, the current tensions on international financial markets underline the importance of stable, well developed and diversified financial systems.

The G8 Finance Ministers requested the International Monetary Fund (IMF) and the World Bank for a joint progress report on their implementation of the G8 Action Plan on local bond market development.

The progress made so far reflects a broad consensus among industrial countries, emerging markets and less developed countries on developing domestic bond markets, in particular to promote growth, and to enhance national and global financial stability. There has been significant progress made since the G8 Finance Ministers endorsed the Action Plan in May 2007, which was initiated during the German presidency. The discussion with relevant institutions and countries shows that the G8 Action Plan has proven to be an anchor for different international initiatives, which are focused on these issues.

This report is based mainly on the work programs of the IMF, the World Bank Group, BIS, ECB, OECD, other multilateral development banks, central banks and relevant country groups.

The outcome of two conferences - *inter alia* - on Implementing the G8 Action Plan contributed to this progress report: (i) The Deutsche Bundesbank and the German Federal Ministry of Finance co-hosted a conference on “Financial Globalisation, Vulnerabilities and Data Needs” in Frankfurt am Main in January/February 2008. The outcome of this conference contributed in particular to the future work program of the reconvened Working Group on Securities Databases (WGSD). (ii) A workshop co-hosted by the Deutsche Bundesbank, the IMF, and the World Bank Group on “Implementing the G8 Action Plan – Global support to develop domestic bond markets in emerging markets and developing countries” in Frankfurt am Main in September 2008. This workshop, attended by the key donors, IFIs and development institutions, undertook a comprehensive stock taking of the related efforts of various agencies involved in local bond market development. A survey was also undertaken to map the recently completed work and ongoing efforts by various participants (see Annex).

## II. KEY AREAS OF PROGRESS

Emerging capital markets have been major beneficiaries of the impressive gains in EM macroeconomic performances, rising globalization of financial markets, and improvements in capital markets law, regulation, and infrastructure over the past decade. EM asset class was transformed with the broadening and deepening of local debt markets, supported by the expansion of the investor base. Although EM assets have suffered significantly from rising risk aversion in the wake of the current global financial turmoil, they now appear to be a well-established international asset class, which should continue to attract a growing foreign and local institutional investor base. That said, there remain a number of challenges to further developing local capital markets.

Many EM economies are taking a holistic approach to foster the development of local capital markets by crafting comprehensive capital market strategies. This effort is supported by the IMF and the World Bank Group as well as the BIS, ECB, the OECD, multilateral development banks, and other relevant institutions and industrial countries. The pace of local bond market development, however, has varied across various regions with Asian markets having seen the most significant growth, followed by Latin America. EM Europe is much smaller than Asia and Latin America, while Africa is the least developed after the Middle East.

### **Public Debt Management and Market Infrastructure**

Significant progress has been achieved on the sovereign debt markets, notably in debt issuance and management as well as in trading infrastructure and other market operations. The work on issuance and debt management has involved providing guidance on coordination of cash, debt, and monetary management that support government operations. The role of market makers in the primary market has also increased somewhat in certain EMs.

The core work on implementing sovereign debt management and debt market development builds on the joint IMF-World Bank Public Debt Management Guidelines, “Developing government bond markets: a handbook (2001).” More recently, lessons learnt from the twelve pilot needs assessment was consolidated in the World Bank publications “Managing Public Debt (2007)” and “Developing the Domestic Government Debt Market (2007).” Debt management assistance through the joint IMF-World Bank Medium-Term Debt Management Strategy toolkit (MTDS) and Risk Measures for Public Debt Portfolio have also been implemented. The World Bank’s Debt Management Performance Assessment (DeMPA) tool also assesses debt management operations and identifies strengths and weaknesses in debt management operations through a comprehensive set of indicators. MTDS and DeMPA specifically target low income countries: MTDS has recently performed assessments in Bangladesh, Ghana, Cameroon, Nicaragua, and Moldova; and DeMPA in 15 countries in Sub-Saharan Africa (SSA), Albania, Moldova, Guyana, Honduras, Nicaragua, Bangladesh, and Mongolia.

A full range of debt management TA missions and advisory work have taken place. The IMF and the World Bank Group worked in Latin America and Asia, including Brazil, Colombia, Chile, Indonesia, Peru, Philippines, Central America, Costa Rica and Dominican Republic. The IMF also had other debt management missions to countries covered by the IMF’s Regional Technical Assistance Centers in Central and West Africa. Missions. For the first time, international bond issuance have taken place in member countries such as Kenya and Mongolia. The IDB, jointly with the IMF has also provided the financing for the creation and implementation of a debt management office in Uruguay. The US Treasury’s Government Debt Issuance and Management (GDIM) also has a sustained field-based program with resident advisors that has served 60 countries, such as EM Asia including Indonesia and Vietnam as well as South and Central America.

In terms of advisory work on debt market development, the World Bank has multiple work agendas that are ongoing in all regions. Relevant work includes the advisory work in Colombia, India, Nigeria, Egypt, Vietnam, UAE, and Oman. For example, the India TA is under a large TA loan to support capital market and pension reforms, including setting up of an autonomous Debt Management Office and improving the institutional investor participation in the primary market through regulatory adjustments. In SSA, there is a World Bank Group program funded by SIDA called ESMID-Africa, which is identified under the SSA topic.

The World Bank is also working on the Global Emerging Markets Local Currency Bond Program (Gemloc), another vehicle to support the development of local currency bond market that also contains a debt management component. The Gemloc program combines the comparative advantage of the World Bank Group and the private sector to help develop local currency bond markets and to increase their investability. It has three separate but complementary parts: (1) a private investment manager that develops and manages investment strategies to promote institutional investment in EM local currency bonds; (2) a new private sector-led global index (GEMX) that tracks EM local currency bonds that meet minimum market size and investability criteria; and (3) advisory services provided by the World Bank to strengthen local bond markets in emerging economies to help enhance their

investability and attract new investments. The overall program was initiated as of February 2008, while the TA program was started in May 2008 with a conference held in Washington. The Gemloc team has collected a needs-assessment survey from authorities from 24 countries to identify the priority areas of work.

The FSAPs/IOSCO assessments continue to be the main instruments for identifying reform priorities in the regulatory and supervisory framework for securities including debt markets. In addition, TA work including assessment whether the legal and regulatory framework for securities regulation allow for effective enforcement as well as reforms needed to enhance capacity, have been undertaken in several countries.

There are several global forums and networks on debt management to address key issues. First, the Annual IMF Public Debt Managers' Forum has become a well-established forum where country officials can exchange views between themselves and with private sector representatives on debt management policy issues, global market conditions, and discuss current country experiences with regards to the key aspects of sovereign liability management.

Second, the World Bank Group hosted the 2008 Sovereign Debt Management Forum in October end and have hosted the 2008 International Retail Debt Management Symposium, training courses on "Developing Debt Management Strategies" and "Implementing Debt Management Strategies," and a workshop on "Cost-risk modeling."

Third, the OECD Global Forum on Public Debt Management addresses debt management policy issues and techniques, including their interface with the functioning of government bond markets. The 2008 Forum meeting included three principal discussions: (i) the impact of the global financial crisis on borrowing strategies, (ii) sovereign asset and liability Management (SALM) and (iii) changes in the use of short-term securities by debt managers.

Fourth, the Italian-OECD Public debt management (PDM) network is progressing. This is a virtual platform for debt managers, to promote international dialogue and knowledge sharing. Active users from EMs include Czech Republic, Hungary, Mexico, Poland, and Turkey. The next step is to broaden the participation in the PDM program among EMEs.

In terms of market infrastructure, the depository, clearing and payments systems have become more efficient as local custody, settlement and depository systems (CSDs) are increasingly linked to the international CSDs. A number of FSAPs have looked at the issues relating to payment systems. In addition, two IMF projects in Central America have looked at the regulatory framework and institutional arrangements relating to CSDs. IMF projects in Peru and Brazil are also assessing the framework for determining market prices, availability of price vendors, and cooperative public-private solutions to determining reliable prices of illiquid securities and applying them uniformly across the entire financial sector. The World Bank has ongoing work in restructuring and reinforcing payment, settlement and depository systems, including in LAC and the Middle East.

In many EMs, working groups have been set up to develop a comprehensive capital market strategy. This includes strategic plan for strengthening the market infrastructure, such as in Serbia. Infrastructure work on establishing a primary dealer system has been undertaken in Ukraine by the KfW. Similarly, plans and their implementation have entailed reforms of the pension fund, rationalization of taxation, improvement of debt management, and in the analysis of regulatory issues for derivatives and valuation of assets across the financial sector (Peru and Paraguay).

### **Diversifying and Broadening the Investor Base**

The growth of the local investor base in the past decade (e.g. pension, mutual funds, and life insurers) and the entry of foreign institutional investors into EM local debt markets have underscored the broadening of the investor base. In this regard, reforms of the regulation governing investments of pension plans and mutual funds to ensure that such regulation would not hamper proper asset allocation or market development, are the focus of the implementation work. Other efforts have focused on improving the investability of local currency assets by removing inefficiencies and hurdles created by taxation and regulation of local currency investment, adopting CSD arrangements, or improving access to local currency hedging.

The IMF, under the auspices of the IMF's Capital Markets Consultative Group (CMCG) and in collaboration with the private sector, has prepared a draft report on, "Globalization of Emerging Capital Markets: Opportunities Challenges and Responses". This report aims to provide a private sector perspective on major impediments to capital market development in EM countries; how market participants are gaining exposure to these markets via various access instruments; and on related policy perspectives. The study finds that the high costs of access to some of these markets stem from the diversity of tax treatments, investment restrictions, capital controls, inefficiencies in market infrastructure, and inadequate access to local repo and derivative markets. The report stresses the importance of easing access to local markets, lowering transaction costs and broadening the local institutional investor base.<sup>1</sup>

The World Bank's Gemloc program aims to broaden and deepen the investor base through several channels. First, Gemloc's advisory service identifies and addresses obstacles to investing in local bond markets, so as to strengthen the market environment and attract more domestic and foreign investment. Second, the advisory service also aims to strengthen the investor base through such support as regulatory adjustments and capacity building. Additionally, Gemloc's investability indicator measures investor impediments to access EM local bond markets and further informs countries about their reform needs. The indicators evaluate market aspects such as taxation, accessibility, liquidity and infrastructure. Based on these indicators, Markit, a commercial index provider, in cooperation with IFC, developed the GEMX index to provide a new emerging market bond index that further supports investment in emerging bond markets.

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<sup>1</sup> This report has not been published. Some of the content in the report may be subject to revisions following the current turmoil.

Separately, the World Bank Group undertakes various advisory work in reforming the pension system, such as in Chile and Colombia. The TA work in India also involves reforms of the institutional investor base. The World Bank is also working with the private sector in identifying the linkages between the development of institutional investors and capital markets.

The IMF has also provided advisory and TA on the liberalization of investment regimes of local institutional investors. For instance, the IMF has advised the authorities in Peru to significantly relax the investment regime of the private pension funds. This advice is also being communicated to other countries with a similar framework of pension funds through outreach activity as well as further research. The advisory work on Brazil has focused on the regulatory and supervisory framework for developing an efficient mutual fund industry.

Other institutions like the EBRD have also worked with local banks and authorities in EM Europe (e.g. Kazakhstan, Romania, Russia and Ukraine) to help improve the transparency and credibility of local money market indices that can enhance the investability in these markets and help attract a broader investor base.

A growing number of market initiatives by the IFIs to foster debt capital market development have taken place over the last decade. The Executives' Meeting of East Asia-Pacific Central Banks (EMEAP) created the Asia Bond Fund 2 (ABF2), a local currency bond fund in EAP to expand opportunities for local institutional investors to invest within their own region. AfDB is currently looking into a similar program. FMO has also founded and prepared with KfW a Currency Exchange Fund (TCX), which in particular, aims to create a new partner that offers local currency swaps, enhances public and private partnership, helps the mobilization of additional funds and facilitates the generation of additional diversification effects by pooling demand.

Similarly, many of the IFIs have funded themselves by issuing local currency bonds in EM economies with a view to offer high quality local currency instruments to help develop the domestic yield curve, to jump start the local swap markets, to improve documentation standards as well as to attract new investors to the local currency market. IFC, the World Bank, EBRD, IDB, ADB, AfDB and KfW are among the IFIs and development banks who have issued local currency bonds across various regions which have predominantly attracted foreign investors.

### **Developing emerging repo and derivatives markets**

The challenges facing the development of local repo and derivatives markets are primarily in the following areas: (i) relatively underdeveloped markets for the underlying assets; (ii) lack of adequate regulatory, legal and market infrastructure; and (iii) restrictions on the use of derivatives by local and foreign entities. With significant limitations on foreign investors' ability to obtain local funding for local investments or to hedge their on-shore positions, they have resorted to offshore OTC derivatives, structured notes, and non-deliverable forwards which in turn inhibits local derivatives and repo market development.

A major part of the World Bank's debt market development work has centered around the repo market. For example, the World Bank group has implemented a money market program in Colombia funded by FIRST, which provided assistance towards developing a regulatory framework for repo and sell-buybacks, including changes in the legislation for accounting and prudential regulations, and the building of an automatic facility for securities trading. The IFIs, such as EBRD in Kazakhstan, Romania, and Russia are working on EMs to clarify derivatives' environment with ISDA (e.g. recognition of swaps and netting opinions). Technical cooperation mission on enhancing the prudential regulatory framework for derivatives in EM countries has been undertaken in countries like Colombia. The mission identified restrictions to growth and development of derivatives markets, and recommended specific areas of improvements for the current prudential regulatory and supervisory framework for derivatives.

The involvement of the IFIs in developing the derivatives market has been relatively sparse with a few exceptions. The World Bank Group's IFC has been using derivatives to provide local currency products, and has been in the forefront of opening markets as the first entity to engage regulators on swaps in many countries. IFC offers derivatives to clients as part of its risk management services and uses local currency derivatives when available to structure local currency financing to clients. IFC is outlining a strategy for assisting countries in strengthening domestic derivatives markets, particularly tied to government bond market operations. Derivative market development will also be supported under the Gemloc advisory services program.

The IMF is currently working on a research project entitled "Derivatives in Emerging Markets: Recent Trends and Policy Implications for Capital Markets" which is expected to be an Occasional Paper by the first half of 2009. The project identifies key policy considerations for developing and regulating safe, sound and efficient derivatives markets in EM countries. In particular, it reviews the current state of derivatives markets in EMs including Brazil, Chile, Hungary, India, Israel, Korea, Mexico and Poland.

As part of the outreach activity related to this research effort, the IMF organized four regional workshops in Austria, Brazil, India and Malaysia during 2008. The workshops brought together experts from academia, regulatory authorities and private sector institutions to share their experience with EM policymakers and regulators embarking on promoting the development of derivatives markets.

### **Broadening the Database**

Considerable progress has been achieved in broadening the database in addition to the regular statistics provided by the BIS. The Asian Development Bank (ADB) under the ASEAN+3 initiative, which is funded by the Japanese government, has enhanced its work on the AsianBondsOnline and Asian Bond Monitor, that provide valuable data with coverage of 13 countries and the Asian regional markets. This effort has centralized local bond data on market activities, legal and regulatory frameworks, and government policies and initiatives.

Other important efforts are also underway to help fill the gaps in bond market data. The Working Group on Securities Databases (WGSD), originally established in 1999, was reconvened (July 2007) with the objective of assessing data issues and implementing actions to encourage the availability of internationally comparable data on domestic bond markets. The group is chaired by the IMF and includes the ECB, BIS, and the World Bank as members. Selected experts from national central banks have also been invited to contribute to the deliberations of the WGSD.

The WGSD is working on a *Handbook on Securities Statistics*, which will initially focus on debt securities and will be based on existing international statistical standards. The main objectives of the Handbook are to provide guidelines for the presentation of aggregate debt securities statistics that are relevant, coherent, and – in particular – internationally comparable; and encourage the production of securities statistics to assist in monetary policy and in financial stability analyses. The *Handbook* is anticipated to be completed around April 2009. The pros and cons of developing a security-by-security database will be discussed in an annex to the *Handbook*. An annotated outline and timetable for completion have been posted on the WGSD's website (<http://www.imf.org/external/ks5101/wgsd/index.htm>).

To date, a preliminary first draft of the *Handbook* is being commented on by selected experts from national central banks. A revised draft incorporating comments from the experts was further discussed by a bigger group of reviewers —the Review Group— in Basel during October 28-29, 2008. The Review Group was established from an invitation to national central banks and relevant statistical agencies, as well as international and regional organizations that have an active interest and expertise in securities statistics. Thus far, 53 institutions have indicated their interest in participating in the Review Group. The first draft of the handbook will be published on the WGSD's website in February 2009. International experts are invited to provide comments and recommendations on this handbook. The handbook provides valuable information also for those countries which are at an early stage of developing securities statistics and databases.

A Working Group of the Committee on the Global Financial System (CGFS) delivered a report on “Financial stability and local currency bond markets”. A subgroup discussed related data gaps and recommended broadening the database. The recommendations of the CGFS subgroup were integrated into the work program of the WGSD.

The ECB, in cooperation with some national central banks, will continue its work on developing a Centralised Securities Database (CSDB) for the European System of Central Banks (ESCB). The CSDB will provide a comprehensive security-by-security database with a single, complete and reliable representation for each security with low reporting burden for issuers and holders.

The World Bank Group is developing a local bond market database as part of the Gemloc and ESMID programs, notably to facilitate its benchmarking work. Under the Gemloc program, Crisil has also provided assessments of the investment climate of the initial list of 20 EMs, which are made available on the website ([www.indexco.com](http://www.indexco.com)). This is to be updated on a quarterly basis.

The OECD has also launched a database project for the collection of data on African central government debt. This new OECD database will give a comprehensive and detailed view of African public debt based on the methodology of OECD's "Central Government Debt: Statistical Yearbook."

The AfDB is also in the conceptual stage of developing a database for the region. The approach of the African Development Bank is to build up or strengthen a financial database in Africa under the framework of the African Financial Markets Initiative. Broadening the database in Africa is among the most urgently needed steps.

Lastly, the work of the IDB on broadening the data coverage on a micro-structural base is of high relevance to monitor and evaluate current and future potential distortions, in particular for corporate balance sheets.

Two conferences have provided important inputs to the work of the WGSD. The first was organized in January/February 2008 by the Deutsche Bundesbank in close cooperation with the German Federal Ministry of Finance, which dealt with a number of issues, especially broadening the database. The main takeaways of this conference included: (i) compiling international securities statistics; (ii) intensifying the dialogue between users and compilers of financial statistics on future data requirements to explore further opportunities to reduce the time lag of identifying data needs and closing the data gap; (iii) data for analysing international investors behaviour ; (iv) giving greater importance to financial stability issues when identifying data gaps; (v) further extension of balance sheet approaches.

The second workshop was organized by the Irving Fisher Committee on Central Bank Statistics and hosted by the IMF in March 2008 on challenges in improving the global comparison of securities statistics. The conclusions from these international conferences strongly supported the WGSD's work plan and confirmed the need for a handbook on the compilation of securities statistics. Both of the conferences and the Workshop on Implementing G8 Action Plan in Frankfurt am Main in January/February 2008 and September 2008 strengthened international networks in developing the database.

### **Promoting Regional Initiatives**

Regional cooperation has proven to be fruitful in developing best practices for the legal and regulatory framework for securitization, in harmonizing the trading, settlement and custodial infrastructure, and in developing good corporate governance standards. Regional initiatives have exploited the economies of scale for common or harmonized regulation while linking and integrating exchange platforms. However, such initiatives have been largely limited to East Asia and in selected parts of Central America and Africa at a slower pace.

Regional initiatives such as the Asian Bond Market Initiative (ABMI) by the ASEAN+3 have led to a significant growth in terms of size and diversity of issuers in the constituent markets. The Asian Bond Fund (ABF) is a collective investment scheme, jointly developed by the EMEAP for investing in sovereign and quasi-sovereign bonds in eight EMEAP economies (excluding AUS, NZ and Japan). Such initiatives have provided a cost effective mean for

issuers and created low entry threshold for investors and alternatives to low-yielding bank deposits in the region. It has also facilitated market development through the removal of cross-border regulatory impediments (e.g. China, Malaysia, and Thailand), removal of tax barriers (e.g. Malaysia, Thailand) and has facilitated the introduction of bond ETF regulatory framework (e.g. Thailand, Malaysia, Hong Kong and Singapore).

The ADB is working with ASEAN+3 to develop a medium-term roadmap to accelerate the development of the respective bond markets. The Finance Ministers of ASEAN+3 agreed in Madrid 2008 on four key areas, where progress is needed most urgently: promoting the issuance of local currency-denominated bonds; facilitating the demand for local currency-denominated bonds; improving the regulatory framework; and improving the related infrastructure of the bond markets. To implement the new ABMI roadmap, a steering group and four task forces have been established.

Africa has also started to see coordination efforts that conceptualize regionalization. AfDB and the World Bank Group's ESMID program both entail regional integration, with ESMID focusing specifically on regional securities market integration. The development of domestic bond markets is a new focus of the Franc Zone countries, assisted by France. Franc Zone Ministries of Finance endorsed a strategy as well as a list of recommendations in April 2008. A first report on these recommendations will be delivered in October 2008.

### **Developing Bond Markets in Less developed Economies – Sub-Saharan Africa**

Local bond markets in the African region (excluding South Africa) are nascent but their prospects look encouraging. Donors have underscored the increasing importance of developing financial systems in Africa for enhancing growth and ensuring financial stability. They also continue to support ongoing and new programs. Currently operational programs are the World Bank Group's ESMID program, programs led by various donors including the U.S.'s GDIM, and OECD's programs. A new partnership is also being coordinated around the AfDB.

The G8 initiative on "Good Financial Governance in Africa" - *inter alia* - supports the harmonization of technical assistance and developing local currency bond markets. Sub-Saharan African domestic bond markets are coming more and more into focus of foreign institutional investors. Indeed, private capital flows to SSA have grown five-fold since 2000, while there is an acute need for infrastructure and housing development, which can be implemented through capital market financing.

ESMID-Africa, a partnership between the World Bank, IFC, and SIDA is a program for non-government bond market development in Sub-Saharan Africa to improve long-term financing for housing and infrastructure and increase availability of long-term investment instruments for institutional investors. It provides technical assistance for strengthening the regulatory framework, market infrastructure, and market participant capacity, while providing support to bring transactions to the market. In addition, it provides advisory services on regional capital market integration, as appropriate. ESMID-Africa has projects underway in East Africa (Kenya, Tanzania, Uganda, and Rwanda) and will soon be launching operations in

Nigeria. The program plans to expand to other African countries/regions, which may include West Africa, Southern Africa, and Ghana.

Various donors have also supported TA work in SSA. The US Treasury, under GDIM has bilateral TAs in Ghana and Kenya, covering also Rwanda, Tanzania, and Uganda; as well as intermittent work in other SSA countries. DFID has provided Nigeria's debt management office with capacity building support. SIDA is involved with multiple programs, including ESMID. KfW is considering supporting Ghana and Nigeria for their local currency bond market development; and GTZ also continues to assist efforts in SSA. Finally, France has been supporting West Africa through a comprehensive debt market development advice.

The OECD is developing its work on Africa under three pillars: (i) OECD Fora on African Public Debt Management; (ii) regional workshops dealing with operational and technical aspects of market infrastructure; and (iii) the database projects that also facilitate cross-country studies on public debt management and bond markets in and outside Africa. The third OECD Forum on African Debt Management in 2008 was focused on three issues: (i) changes in the use of short-term securities by debt managers, (ii) issuance procedures and primary dealers and (iii) co-operation and information sharing.

The IMF is actively engaged in strengthening the debt management systems through the resident debt management advisors posted at Central and West AFRITACs, including providing support to the BEAC's initiative to develop a regional debt market. The IMF has been assisting SSA countries in developing broader financial sector strategies including road maps for implementation in countries like Madagascar.

AfDB's partnership is mainly led by two efforts: Making Finance Work for Africa (MFW4A) and the African Financial Market Initiative (AFMI). MFW4A is a joint capital market strategy which - *inter alia* - aims to generate a framework for coordinating donor activities and transparency on African Capital Markets Development. The two main building blocks for AFMI are: (i) the African Financial Markets Database (AFMD) and (ii) the African Domestic Bond Fund (ADBF). The AFMD is in the data gathering stage and at the preliminary stage of the web portal that will contain up to date information on the African fixed income markets. The ADBF is currently in the mapping stage of the ongoing initiatives on bond market development in Africa in order to identify interlinkages, overlaps and gaps. The initial findings will feed into the Joint Capital Markets Strategy under the MFW4A with a consultative process between the donors, governments and the private sector.

### **III. THE CHALLENGES AHEAD**

#### **1. Principle challenges and the financial crisis**

There are many remaining challenges in developing local debt markets to improve their efficiency, stability, transparency and liquidity. Some principal challenges cut across all regions in different development stages, while others are more country specific.

First and foremost, there needs to be a strong commitment to pursue prudent macroeconomic management, implement a coherent capital market reform agenda, and create an effective regulatory and supervisory framework. The current financial turmoil also underscores that EMs and developing countries should foster a strong institutional structure for local currency bond markets as part of a well diversified financial system. Countries that continue to develop deep and liquid local bond markets have reduced currency mismatches and are likely better placed to sustain shocks from the risks of a protracted global credit crisis. Additionally, countries need to also adjust the shorter maturity structure of local bond markets that generate rollover risks.

Many of the policy lessons from the current crisis in mature markets are also similarly applicable to emerging bond markets. In particular, the regulatory frameworks may need to be reevaluated, the appropriate securitization model will have to be contemplated, and the adequacy of the ratings process will have to be studied. Among many other issues, the importance of transparency and disclosure in ensuring investor confidence will also likely be highlighted. It should also be noted that all emerging markets, even those with sound and stable macroeconomic management, have been significantly impacted from the liquidity crisis, added by EM currency depreciations and large-scale deleveraging by investors. Further research is needed to draw lessons from this crisis and to calibrate the future agenda.

## **2. Challenges ahead in the field of G8 recommendations**

### **2.1 Strengthening market infrastructure**

At the market infrastructure level, secondary market liquidity in the sovereign debt markets continues to be an issue. Enhancements are needed in price transparency through exchanges and trading platforms. The role of market makers and price vendors needs to be further developed for sound and uniform valuation, so as to also create more confidence.

Securities regulation overhaul has largely focused on public issuance and transparency while additional challenges remain including weak enforcement and reforms in supervisory practices. More effort is needed in strengthening valuation methodologies of investment funds and in forging a better understanding by regulators of risk management and internal controls of market intermediaries. Developing regulations for private placement is also needed to broaden issuance methods and OTC markets to facilitate bond trading.

A sound MBS/ABS market requires establishing capital, liquidity, ratings, underwriting standards and valuation rights, while keeping the structures simple. Major problems in developing the asset-backed securities markets have been incomplete regulation and legal uncertainties concerning true sale, insufficient clarification of tax treatments, multiple taxations, and poor developments in primary markets for commercial term mortgages.

Bond issuance by IFIs in local EM to develop the markets is welcome, but the benefits are at times limited as the investor base is predominantly foreign and issuances are one-off, that

may not help create a liquid benchmark yield curve. Such shortcomings could be remedied if the IFIs had the option to manage their open currency risk position through hedging in the onshore derivatives markets, which still remain underdeveloped in most EM countries.

## **2.2 Broadening the investor base**

The regulatory framework of EM institutional investors needs to be addressed urgently. The investment regime of pension and mutual funds, insurance companies, and banks that in one way or other favors investment in public bonds have created a strong buy and hold attitude, impeding liquidity in such markets. In several countries, this often created asset bubbles in local markets, and deterred foreign investment. Therefore, second generation reforms are needed to substantially modify regulations on minimum return guarantees, ease restrictions on domestic or foreign investments, change commission structures, and enhance competition.

Foreign investors seeking access to EM frequently encounter impediments related to capital controls, taxation, and limited market transparency. There are obstacles to accessing the local funding and derivative markets even in countries with no formal capital or exchange controls. To this end, actively managed investment strategy, benchmarked against indices such as the GEMX, could induce positive reaction from foreign investors and, perhaps lead to increased participation by a more diverse array of investors, including “real money” accounts.

## **2.3 Developing repo and derivatives markets**

The lack of repo and derivatives markets has inhibited liquidity in the cash market in many EMs. Diagnostic work on repo and derivatives markets should receive greater emphasis in the capital market segment of FSAPs and their updates. Furthering the development in repo market require easing restriction on securities lending, and improving foreign investor access to domestic financing. The development of derivatives markets have been stymied by transaction taxes, restrictions on certain derivative instruments, the lack of liquid underlying cash markets, deficiencies in prudential regulation and supervisory oversight, and restrictions on market participation by domestic and foreign institutional investors and banks.

## **2.4 Broadening the database**

A number of initiatives by the IFIs have identified a broad spectrum of data needs. With regard to securities statistics, a comprehensive database will entail further breakdown by currency, maturity, sector of issuers and holders of securities. The compiled statistics will also have to be internationally comparable. The WGSD is the core group tasked with closing data gaps in the field of securities statistics.

However, a broader statistical work program will likely be needed for a deeper analysis of international investor behaviour. In particular, a more comprehensive coverage of cross-border portfolio flows of non-bank financial institutions that build upon the CPIS data could

be a top priority in broadening the database. In addition, the coverage could be extended to new financial instruments to discern the changes in their risk exposures in cross-border flows.

While significant progress have been achieved in gathering balance sheet data in the EM countries, the sectoral coverage on households and the corporate sector remains weak, especially with respect to their assets and liabilities in the capital markets. Progress in this area could significantly broaden the scope of analysis of the overall financial sector.

## **2.5 Promoting regional initiatives**

Regional initiatives can help in integrating smaller markets and forging a common platform to overcome the issue of critical mass. Such initiatives can provide support for non-sovereign local debt markets, including local corporate, ABS, infrastructure financing, and sub-sovereigns. The respective countries, may want to recognize cross-border products and instruments, while trying to achieve greater commonality for investor protection through the adoption of international standards and best practices.

## **2.6 Developing domestic bond markets in less developed countries, in particular Sub-Saharan African Countries**

Many African bond markets suffer from a comparatively weak regulatory environment, inadequate market infrastructure and lack of capacity. The level of development in local markets is dispersed with little or no cross-border trading due to capital controls, underdeveloped market culture to attract private investors, the lack of harmonized tax treatment. While there are pockets of collaboration on developing capital markets in Africa, international support is largely fragmented. Indeed, a more inclusive partnership consisting of multidisciplinary working groups is called for. This effort has to be complemented by developing platforms for information sharing and knowledge exchange.

The task ahead for SSA will be dictated by the priority areas as identified at the Accra Forum in 2008, notably in the areas of: i) legal, regulatory and judicial environment; ii) long-term finance; iii) new financial products and innovation; iv) financial infrastructure; v) diagnostics and surveys; vi) role of government; vii) comprehensive financial sector policies; viii) agricultural finance products; and ix) financial literacy.

## **3. Conclusion**

Accordingly with the stage of local bond market development, different approaches of technical assistance may be required. Large EM countries like Colombia, Brazil, Korea, Malaysia, and Mexico may need to continue receiving targeted and focused interventions, while small countries may need a more comprehensive approach (e.g. ESMID). Tackling these challenges will require enhancing coordination among the donors and the development

institutions to effectively capitalize on the synergies, particularly in the areas of advisory service work and possibly with regards to transactions.

The IMF and the World Bank Group will continue to collect information from participating and other related parties to keep an updated view of the development of local bond markets in emerging and developing countries. The IMF and the World Bank Group will continue to support international forums for policy discourse and contribute to the exchange of knowledge in this field with the involvement of EM authorities, regulators, academics and market practitioners.