

2ND PUBLIC DEBT MANAGEMENT CONFERENCE

How to Attract Non-Resident Investors to Local Currency Bonds

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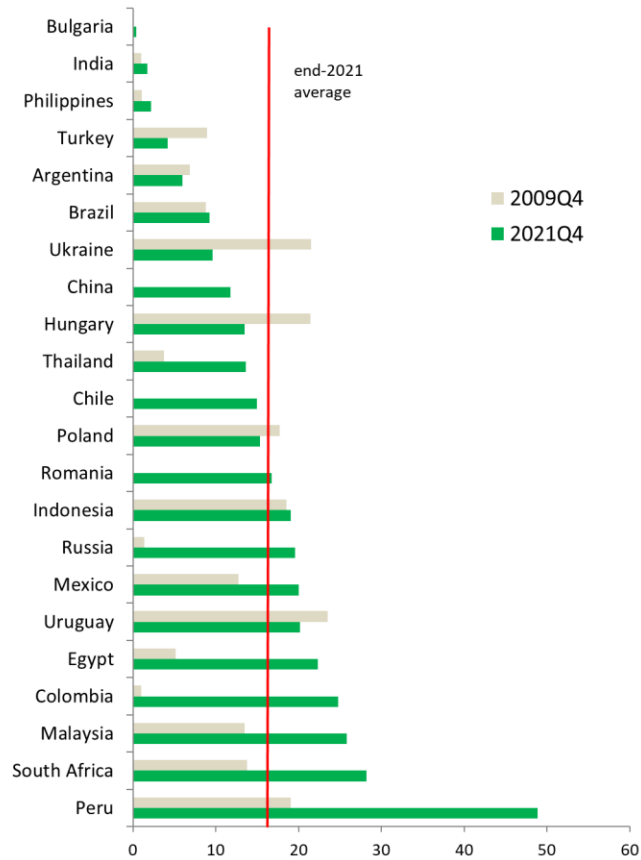
AGENDA

- Trends on Non-Resident Investment in EMs
- The Good and the Bad in the Participation of Non-Residents
- Debt instruments for Non-Resident Investors
- The cases of Ukraine, Panama and Brazil
- Final Remarks

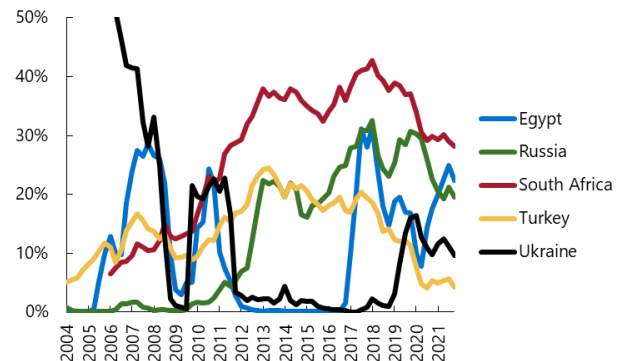
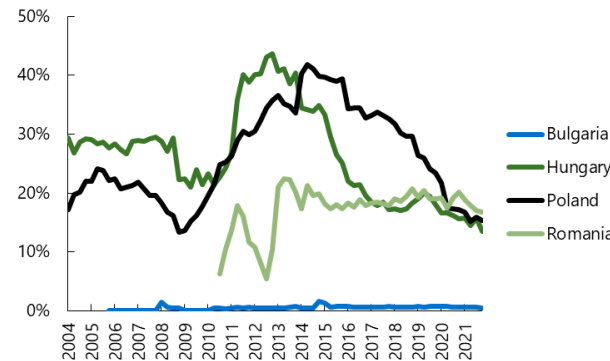
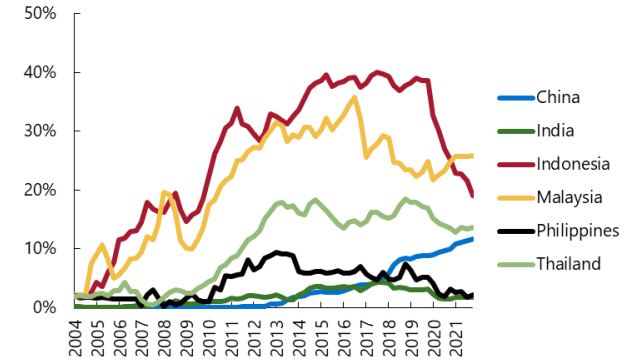
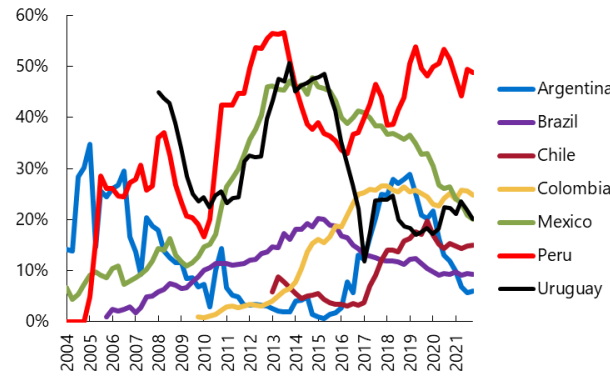
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NON-RESIDENT PARTICIPATION IN EMERGING MARKETS HAS INCREASED IN THE LAST DECADE



Source: Arslanalp and Tsuda (2014, updated)



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PROS OF NON-RESIDENT PARTICIPATION IN LX MARKET

Mitigate vulnerability to exchange rate shocks

- Help filling EMs investment-saving gap borrowing in local currency rather than FX or short-term financing
- Avoiding crowding out of financing to the private sector

Catalyze upgrade of the domestic debt market

- Market infrastructure satisfies minimum standards on transaction, settlement and safeguard of assets
- Primary and secondary markets benefit from the boost in demand

Appetite for medium and long-term securities

- Mexico and Brazil, developed their nominal fixed-rate medium and long-term curve partly thanks to the demand from non-residents

... BUT THERE IS NO FREE LUNCH

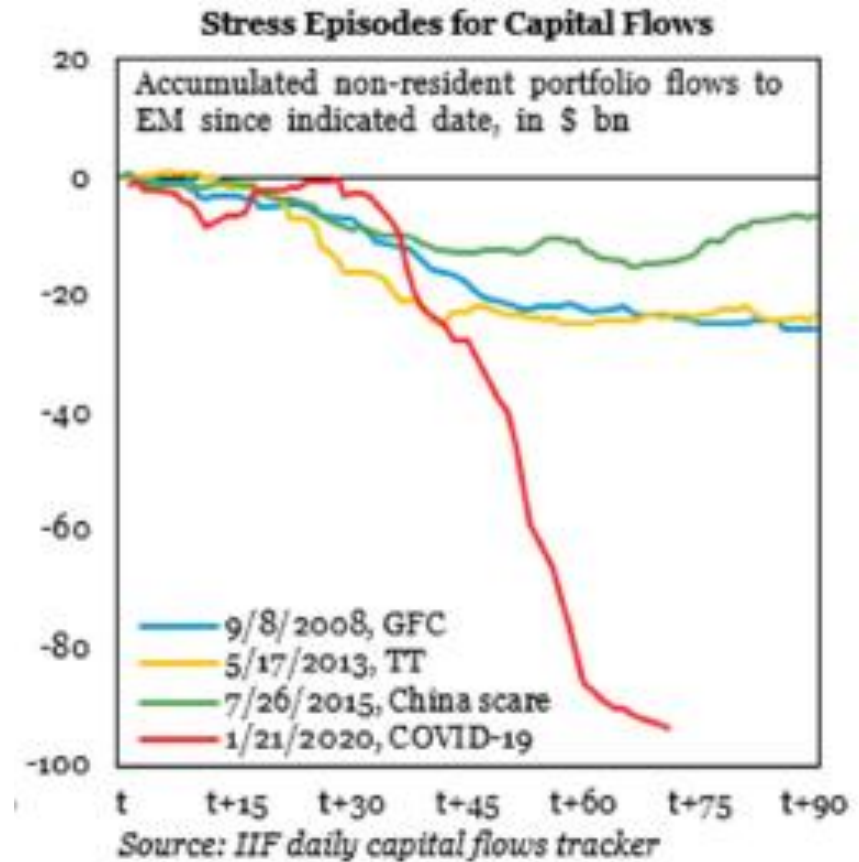
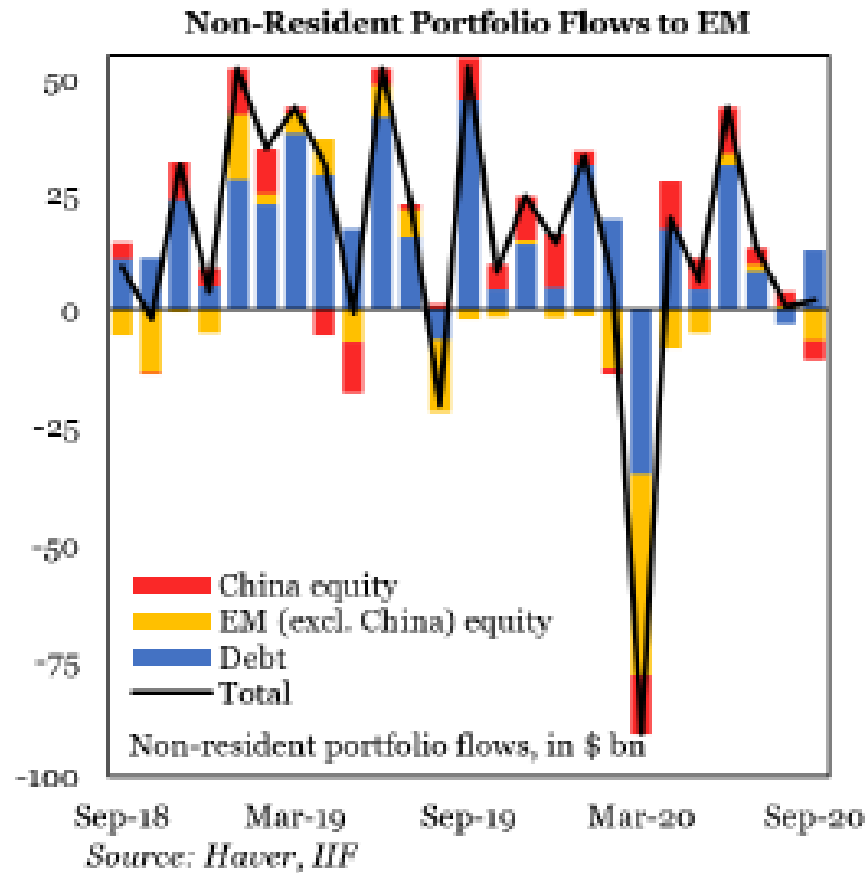
Benefits come at the expense of the risk of reversal of capital flows

- Borrowing in your own currency does not make you immune to turbulent global financial condition
- New version of the *Original Sin*: not because of the mismatch in the borrower balance sheet but because investors returns are highly elastic to the exchange rate

A severe reminder of the potential consequences of the materialization of this risk was given by the initial phase of the COVID-19 crisis.

- EM DMOs suspended their regular auctions of LX government securities, reduced the offered amounts, and shortened the offered maturities amid rising uncertainty.
- Fortunately, the impact of the virus outbreak on the capital flows was relatively short lived thanks to the decisive action taken by CBs in advanced economies.

COVID HAS POSED ENORMOUS CHALLENGES TO THE DMOS



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CONSIDERATIONS AND INSTRUMENTS FOR NON-RESIDENTS

Factors

- Currency of denomination of the security
- Jurisdiction of issuance
- Currency of settlement of the purchase/sale of the security
- Entities charged with clearing, settlement and safeguard of the security

Debt instruments

- Credit Linked Notes
- Global LX Bonds
- LX local bonds held with an international CSD
- LX local bonds held with a local CSD

If the investor is comfortable with the risk/return profile of the LX security s/he explores the other three factors to decide on the instrument to get in

RISK ABSORPTION BY THE NONRESIDENT

Increasing investor risk absorption ↓

Instrument	Currency risk	FX credit risk	LC credit risk	Convertibility	Clearing & settlement
Global bonds in USD (for reference)		Dark Blue			
Credit link notes	Dark Blue	Light Blue	Dark Blue	Light Blue	Light Blue
Global LX bonds	Dark Blue	Light Blue	Dark Blue	Light Blue	Light Blue
LX-local bonds with ICSD	Dark Blue	Light Blue	Dark Blue	Dark Blue	Light Blue
LX-local bonds	Dark Blue	Light Blue	Dark Blue	Dark Blue	Dark Blue

COMPARISON OF DEBT INSTRUMENTS

	Credit Linked Notes	Global LX bonds	LX local bonds with ICSD	LX local bonds
Deal with local market infrastructure	No	No	No	Yes
Price transparency	Low	High	High	High
Issue/deal size	Small	High	Regular auction size	Regular auction size
Frequency of access	Low	Low	High	High
Risk of market fragmentation	High	High	Medium	None
Impact on the domestic debt market	Low	Low/medium	High	High

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UKRAINE: STARTING FROM SCRATCH

2014-15 the perfect storm

- Invasion/annexation of Crimea breaks the fiscal accounts
- GDP falls cumulative 16% , inflation: 43%, UAH falls 70%
- Stabilization package included external debt restructuring

2016 auction of government securities resume

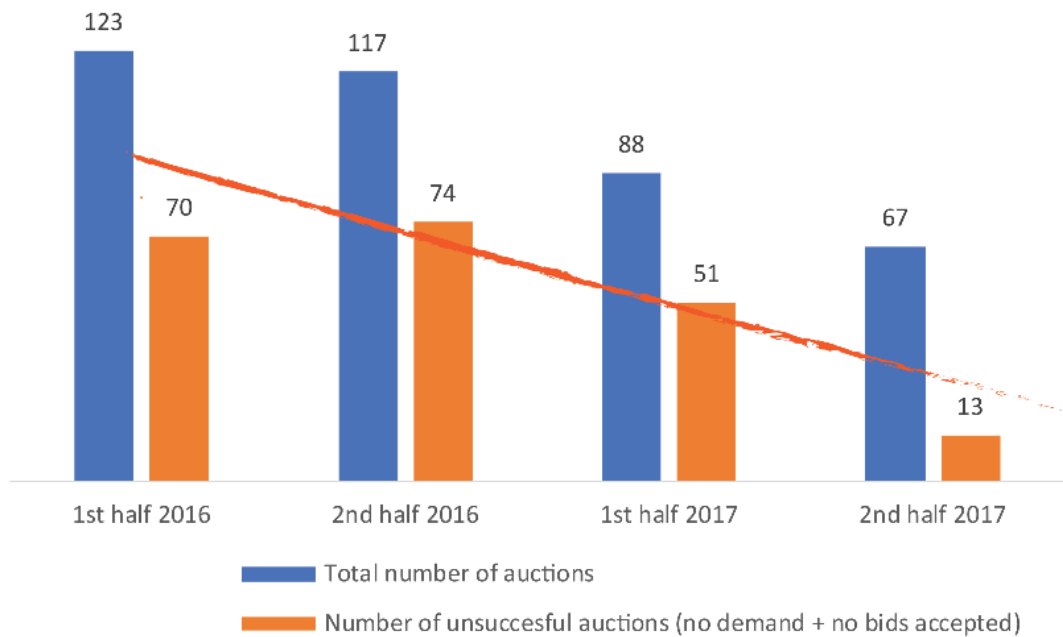
- 240 auctions, but 60% failed
- Administered prices, no communication with investors, poor organization of maturities and homogeneous investor base

2017 start fixing the supply

- Improve communication with the market
- Organization of the maturities to avoid the risk of cannibalization
- Better auction calendar and reduction of number of lines

AUCTIONS GRADUALLY PICKED UP AND SUPPLY IMPROVED

Decrease in Unsuccessful UAH Auctions 2016-17*



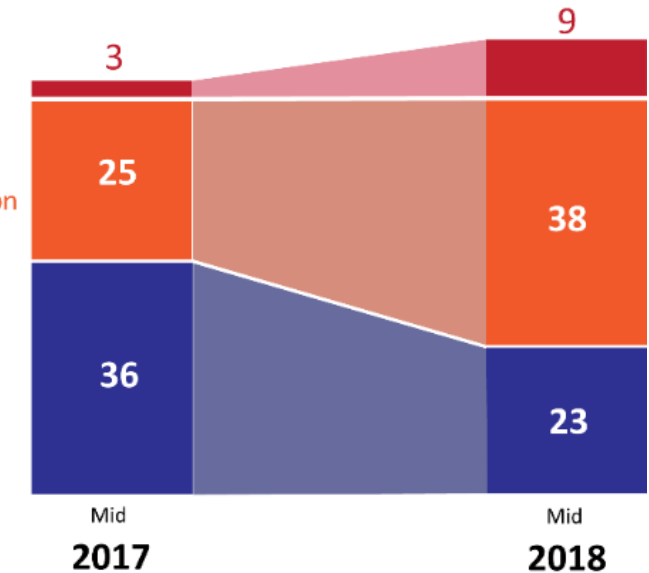
* Source Ministry of Finance - Ukraine

Ukrainian Debt Office gradually pushed the market towards securities with bigger volumes

Number of lines with volumes \geq UAH3 bn

Number of lines with volumes between UAH500 mn and \leq 3 bn

Number of lines with volumes \leq UAH500 mn



Source: Ministry of Finance, Ukraine

THE SCENE WAS SET FOR ATTRACTING FOREIGN INVESTORS

First steps beginning of 2018

- Allow foreign banks to issue Credit Linked Notes
- Started discussions with Clearstream to make UAH bonds eligible
- Explored issuing a local currency Global bond

Critical actions second semester of 2018 and beginning of 2019

- Currency liberalization (June 2018),
- Adoption of the concept of the Nominee Holder (November 2018)
- Link with Clearstream (May 2019), elimination of requirement for foreign institutions to use a local custodian.

... FINALLY FOREIGN INVESTOR PARTICIPATION INCREASED

- Non-resident participation in the local currency bond market increased from almost zero in July 2017 to 12 percent as of June 2019 and 30 percent by the end of that year.
- In 2018 mainly in short-term securities in 2018 but investors' appetite gradually moved to medium-term in 2019 (US\$2.8bn out of US\$3.5bn).
- The presence of non-resident investors has increased competition, strengthened the price discovery process and improved the functioning of the domestic debt market.

PANAMA: THE CHALLENGE POSED BY THE SOCIAL SECURITY FUND (SSF)

Panama: dollarized economy with low debt levels

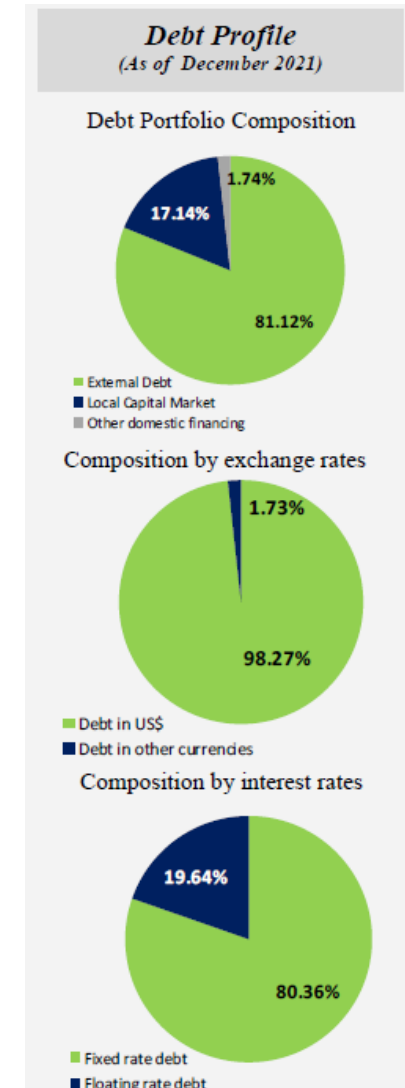
Heavy reliance on Global Bonds, 60% of total debt versus 20% of Local Bonds

Domestic illiquid market dominated by the SSF

- SSF held more than 50% of Local Bonds stock in 2019
- Local Bonds trade below yields of Globals driven by SSF demand
- Private banks (assets >USD100 billion) stay away of Local Bonds because of yield and illiquidity

How to connect the two markets and reduce dependence on the Globals?

- Can Panama use the nonresident investor base to help develop a more active market for Local Bonds?



DIVERSIFYING THE INVESTOR BASE THROUGH NON-RESIDENTS PARTICIPATION

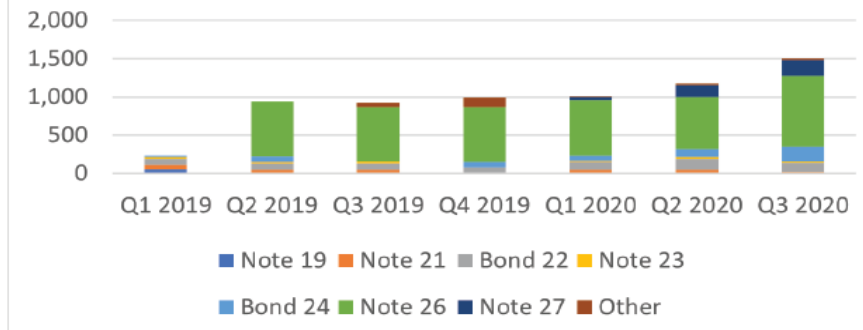
Two-folded solution: International CSD and syndicated transaction

- Euroclear: enable foreigners to access and trade local bonds without holding an account in the local CSD
 - Use of the securities in repo transactions
- Syndication: larger than auctions - benchmark size, better price discovery

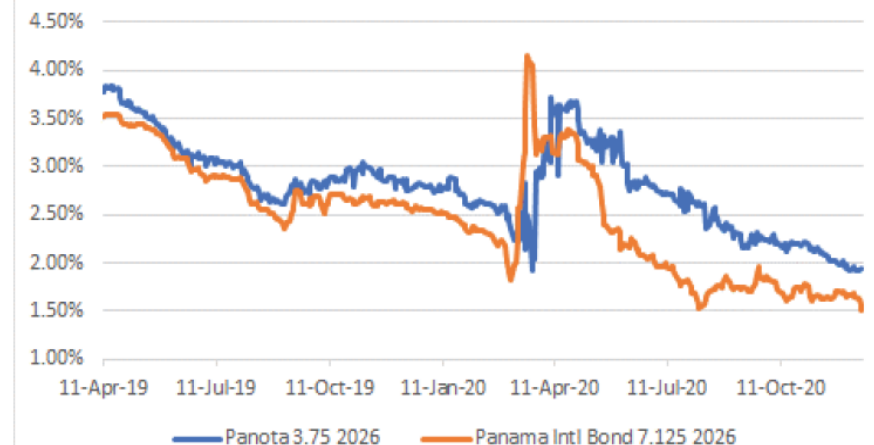
Panota 2026 inaugural issuance (April 2019)

- USD 1 billion, against USD 30 – 150 million on infrequent auctions (3-6 a year)
- Large participation of non-resident investors (75%)
 - Mitigation of prevailing price distortions
 - Greater liquidity in the secondary market

Figure 12 Transactions of government securities in Euroclear (USD mn)



Panama Global and Local Bonds (Yield-to-maturity)



BRAZIL: A LONG-TERM PLAN PUT IN PRACTICE

Building-up prior conditions (2001-2006)

- DMO reorganization
- Domestic bond indices
- Development of a Primary Dealers system
- Benchmark size bond issuances and maturities organization
- Strengthened communication with investors

Intermediary steps and progressive maturities lengthening

- LX Global bond issuances (2005-2012) - 10-, 15- and 20-year instruments
 - Initial step to investors get acquainted to LX and country credit risk
- Creation of new benchmarks in the local market (5-, 7- and 10-year bonds)
- Instruments gained traction with the increased participation of non-resident investors (peaked 20.8% in May 2015, 9.4% in March 2022)

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ATTRACTING NONRESIDENT INVESTORS: A COUNTRY SPECIFIC PROBLEM WITH COUNTRY SPECIFIC SOLUTIONS

- Increasing the participation of non-resident investors in local currency debt markets presents benefits and risks that each country must weigh.
- CLNs and LX Global bonds are used at early stages of the process, while ICSD and direct access to local markets suits better countries in more advanced stages.
- CLNs are easier to implement but may be more costly and less transparent to investors while LX Global bonds have been used as a temporary channel.
- There is no evidence that clearing and settling bonds at ICSDs is better or worse than doing so at local CSDs.
- Attracting non-residents through direct access to local markets is more demanding but may help capital market development and avoid market fragmentation.