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CEME
CENTER FOR EMERGING
MARKET ENTERPRISES

The Global Financial Crisis: Implications for Emerging Local Capital Markets

Executive Summary Report

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Center for Emerging Market Enterprises
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I. Introduction

- Since the debt crisis days in the 1980s, when every country borrowed internationally, there has been a shift in focus to the development of local capital markets.
- Originally, there were two objectives for this seminar: (1) to examine the uneven development of local capital markets and how to encourage expansion of local capital markets in a way that is beneficial for a wide array of companies; and (2) to compare areas where there is significant development of local capital markets – i.e., Asia vs. Latin America.
- Due to the current financial crisis (fall 2008), the seminar instead concentrates on how this crisis has impacted the development of local capital markets.

II. Evolution of Capital Markets Financing

Dr. Eliot Kalter
Senior Fellow, Center for Emerging Market Enterprises
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- Bank loans and direct investment continue to be the main source of cross border capital financing. Portfolio investment has started to pick up since 2002.
- There is a sizable increase in both debt and equity inflows. It is important to note that the debt is mainly comprised of bank lending, and the equity is primarily foreign direct investment.
- Composition of gross flows by region: emerging Asia is dominant, followed by emerging Europe and then the CIS. During the periods 1997-1999 and 2000-2007, Asia predominated in terms of capital inflows and outflows.
- As there are no significant portfolio flows across borders, it is fair to assume that there is an increase in the growth of the local capital markets that is leading to the increase in debt and equity inflows.
- According to a JP Morgan report, domestic debt is increasing as a share of total debt. Emerging market local debt capitalization is now triple that of emerging market external debt.
- Currently, inflows into both emerging market external and local markets have decreased.
- In terms of vulnerabilities for the future, and because of the current crisis, the next question is: what are the dominating factors in terms of country vulnerability? (e.g., current account surpluses in Asia, where savings has grown more quickly than investment; current account deficits, European investments growing more quickly than savings)
- How will the current global financial crisis impact countries as a source of vulnerability?

III. Evolution of Capital Markets Financing

Anne Milne
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Overview



- Latin American local capital markets (Brazil, Chile, Mexico, Peru, Colombia) have grown rapidly over the past decade. Local issuance has surpassed external issuance.
- However, corporate bond issues are still a small piece of the pie in domestic markets. According to BIS data, 4% of debt issuance in Brazil and 7% in Mexico is corporate.
- A main factor for the development of Latin America's local capital markets has been savings due to the growth of Latin American pensions and insurance companies.
- There is little participation from foreign investors in these local markets—e.g., in Brazil, on the sovereign side, only 5-10% of involvement is foreign. There is no significant yield pick and restrictions are in place in many countries on the corporate side.
- There is still tremendous potential for growth.
- Characteristics of the Latin American capital markets:
 - From 2000-2002, the issuance of debt in Latin American Capital markets was US\$20-30 Bn. This was divided equally between local and international market issuance.
 - Since 2003, the proportion of local debt market issuance has increased rapidly as a share of total debt issuance; in 2008, local debt issuance was just under US\$10 Bn.
 - Brazil and Mexico are the largest local debt issuers. Chile is also significant in issuing local debt.

Chile

- Since 2002, local markets have been the main source of financing for Chilean companies. This is true except for very large companies such as commodity and utilities companies who need dollar denominated paper. These companies resort to foreign capital markets for financing.
- US\$2-3.4 Bn is the average issuance size.
- Most issuances are of very high quality, and the issuers are investment grade companies.
- Non-investment grade issuers do not have access to local Chilean capital markets.
- Chilean pension funds hold over US\$9 Bn.

Mexico

- Mexico experiences a mixed performance in local vs. international issuance.
- Pension funds are the main drivers in the local capital markets.
- The size of issuance is much smaller, but of higher quality.
- The total holdings of local debt issuance is around US\$80 Bn.

Brazil

- The main participants in the local capital markets are asset managers and private wealth managers. Pension funds to a lesser degree are also involved.
- Local issuance is fairly large. In 2006, local issuance exceeded US\$12 Bn.
- Many banks issue local capital market debentures through leasing companies to circumvent reserve requirements. Debentures amounted to US\$40 Bn in 2006.
- Despite the financial crisis, there is still issuance activity in Brazil's local capital markets. In October it saw 5 to 6 issuances.

Colombia

- Almost all debt issuance is domestic. Most Colombian companies are not large enough to access international markets.

Peru

- There is no existent foreign debt market.



Argentina

- The Argentinean debt market started developing 10 to 15 years ago.
- The debt market was dominated by mostly government bonds and international issues until a couple of years ago. There were almost no local issuances until the last few years.
- Most local issues are in the form of trusts, where banks and other companies package receivables and sell these instruments in the local market.
- During the Argentinean debt crisis, when Argentina defaulted on its debt, almost every company also defaulted.
- After the Argentinean debt crisis, a few companies resorted to the international markets to refinance restructured debt.
- Pension fund holdings continue to grow, with current overall size US\$30 Bn in assets.
- In October, President Cristina Fernandez de Kirchner tried to nationalize the pension system. This is viewed as an attempt to get the assets/cash of the pension funds.
- The negative impact of this is that this will eliminate local capital markets in Argentina, as there will be no body to buy Argentinean securities.

Foreign Investors in Latin American Capital Markets

- Foreign investors in Latin America are involved almost exclusively in sovereign instruments.
- This year, due to Latin America's depreciating currencies, many foreign investors have pulled out of Latin America markets. There is currently little foreign interest, though the future of Latin America capital markets still has potential.
- The attractiveness of each Latin America's country's capital markets to foreign investors depends on local market characteristics; e.g., Mexico has no restrictions on foreign investors. Brazil is taking steps to decrease its restrictions while Chile taxes foreign investors. Though Peru has no restrictions on its markets, it is too small for most foreign investors.

Impact of the Current Financial Crisis

- This current financial crisis has been challenging for Latin American first time local issuers due to the shutdown of liquidity. Companies are worried as banks have scarce liquidity and it is difficult to borrow money.
- However, Latin America has learned lessons from previous financial crises that have proved beneficial in this crisis. They have little short-term debt relative to their cash and liquidity balances. Latin American governments knew they had to react quickly to the financial crisis and injected a large amount of liquidity into the system.
- The local capital markets are still open in Latin America. However one huge constraint on closing local deals and bank lending is that – many companies have entered into leveraged derivatives transactions.
- Emerging markets were initially marginally affected by the financial crisis. This changed approximately one month ago in September when companies experienced losses on derivatives. Companies will probably be cutting back on CAPEX and investment plans.
- So far, a few companies in Brazil have announced derivative losses, which are projected to be massive. Though analysts think they have a fair assessment on where Latin American capital markets may experience derivative exposure, they may still be hidden numbers. Central banks are now currently trying to get companies to report more on their derivative exposures.
- Local exchange and interest rates have skyrocketed due to the financial crisis. Sharp FX movements also caught everyone by surprise. The outcome will depend on government policies.
- Brazil: Maintained its government's new issuance schedule. It also injected liquidity and reduced bank reserve requirements. It has also intervened in FX using FX swaps. It has



removed IOF tax on foreign investments and increased the funding capacity of the development bank BNDES.

- Mexico: It has changed its issuance schedule to move to the short end of the curve. It has also done FX intervention using FX swaps. Mexico has three programs: (1) NAFINSA's US\$4 Bn CP Program; (2) Program for Mortgage Banks (for refinancing); (3) Program for SMEs. These programs have US\$8-10 Bn and have the objective of injecting liquidity into the system.
- Argentina: It is nationalizing its pension funds. However, there is widespread concern over the government's long-term ability to sustain the currency and service its debt.
- Chile: It is not experiencing any major problems.

The Derivative Relationship in Latin America and the Current Financial Crisis

- The large derivative losses have been focused on Brazil and Mexico.
- Companies had entered derivative transactions to hedge their profit margins by selling call options to reduce the cost. These options were triggered due to sharp movements in currencies. These losses were multiple of what any foreign exchange loss would have been, ranging from US\$300 MM to US\$2 Bn. As not all positions are unwound yet, the true extent of this derivative exposure is still unknown.
- Countries and companies that have announced losses due to derivatives: (1) Brazil (Aracruz, Sadia, CSN); (2) Mexico (CCM bankruptcy, Gruma, Vitro, Cemex, Alfa)

Conclusions

- Derivatives are the main issue in Latin American markets currently. Once the derivative issue is resolved, local capital markets will continue to grow.
- The investor base will continue to be largely domestic.
- Companies that access the international markets will be larger in size, such as commodities and utilities companies.
- Banks comprise 75% of international issuers.
- There is currently a small market for non-investment grade debt. However, this market is expected to become stronger due to new regulations and more disclosure.

IV. The Crisis: Potential Consequences for Local Currency Bond Markets

Anderson Caputo Silva

Senior Debt Specialist, Global Capital Markets Department

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Overview

- There has been unprecedented growth of local bond markets.
- This growth has been dominated by local government bond markets.
- According to a BIS report, local currency debt is more than 80% of total emerging market government debt.
- Up until the financial crisis, there was an increased participation of foreign investors in a wide variety of emerging market economies. The domestic investor base in these emerging market economies is also growing.
- Despite a higher trading volume, liquidity is low and concentrated in a small number of instruments and countries.
- Deepening these markets will depend on building the necessary infrastructure such as primary and secondary markets, money markets, a regulatory framework etc.

Impact of Current Financial Crisis



- Emerging markets are in crisis and have seen their yield spreads reducing.
- Many emerging economies have experienced a steep depreciation of their currencies – This means that 80% of returns this year up till July 2008 were derived from currency appreciation in Europe and Latin American countries.
- There has been a severe impact on bond returns in Asia and Africa.
- Un-hedged returns were highly negative in October 2008. Brazil's currency appreciated by 9% in October.
- Central question: What will happen to growth in the emerging markets? If there is reduced growth, what will be the variation of growth across the different emerging market countries?
 - Current Account balance: there is a change in dispersion across regions and countries
 - Exchange rates: What will happen to the currency?
 - Inflation: Expectations are being revised down in almost all countries.
- Reflections:
 - Prospects for greater south flows (probably on a selective basis)
 - What could be the macro and micro factors for the growth of local bond markets?
 - Foreign investors are likely to be selective and favor more liquid and accessible markets.
 - What will be the impact of the domestic investment base on the liquidity of local currency bonds?
 - Issuers, especially governments, may need to take more proactive strategies to support benchmarks at different sectors of the yield curve.
 - There will be increased importance, but challenges for both government and corporate markets.

Introduction to the Global Emerging Market Local Currency Bond (GEMLOC) Program

- World Bank views emerging market local currency bond markets as a growing area.
- How can you encourage more markets and smaller countries to start issuing domestically?
- GEMLOC includes:
 - A private investment manager, PIMCO, that develops and manages investment strategies to promote institutional investment in emerging market local currency bonds. PIMCO is a leading global fixed income investment manager.
 - A new private sector-led global index, GEMX, that tracks emerging market local currency bonds that meet market size and investability criteria. The index was developed by Markit, a leading index provider, in cooperation with IFC. The investability indicators were developed by Crisil, the Indian-based affiliate of Standard & Poor's, in cooperation with the World Bank. The investability indicators cover areas such as access to bond markets, taxation, liquidity, investor base, infrastructure, and regulations—aspects that influence the attractiveness of investing in a local bond market. The new index creates significant benefits as a global public good and as a benchmark for this asset class.
 - GEMX has 19 countries in the index, and GEMLOC is looking at adding an additional 14 countries.
 - Advisory Services (AS) provided by the World Bank to strengthen local bond markets in emerging economies to help enhance their investability and attract new investments.
 - AS will be provided through country-specific as well as peer-group programs complemented by cutting edge research on relevant topics.



V. Potential Consequences of the Global Financial Crisis for Local Capital Markets and Priorities for Market Development

Allison Holland

*Technical Assistance Advisor, Public Debt Management
International Monetary Fund*

Overview

- The Emerging Markets local government bond markets have grown substantially.
 - Benchmarks were established.
 - Yield curves were extended. In Hungary, the yield curve was extended out to 15 years and Brazil out to 10 years. Turkey has 5 year fixed rate bonds.
 - There are now more diversified instruments.
 - The investor base has increased as investors get more comfortable with emerging market bond markets (e.g., debt managers have improved the transparency of operations. There are improved investor relations, taxation impediments have been removed and regulatory frameworks strengthened. Pension has led to the significant growth of pensions in many countries. N.B. not the same story in every emerging market).
- The emerging market corporate bond market has also grown.
- Over the past 10 years, many emerging market countries have taken steps to strengthen their macroeconomic fundamentals. They have experienced strong growth, an improved fiscal position, and a build up of reserves.
- Vulnerability to external debt has declined and foreign issuance by emerging market countries has decreased. The depreciation in currencies has not impacted emerging market countries badly.
- At the micro-level, many banks in emerging market countries are well capitalized.

Impact of the Current Financial Crisis

- Prior to May 2008, there was concern that emerging market countries were at risk of inflation. However the commodities markets have since experienced a decline and inflation has improved.
- In September 2008, local market yields really rocketed. However, many local markets felt that with their strong cash reserves and fiscal decisions, they were in a good position
- The current environment for emerging market economies is quite pessimistic. Dealers have weaker balance sheets due to increasing volatility in the markets. Hence, the ability to hold inventory and to meet Primary Dealer obligations is limited.
 - According to MTS, this has led to decrease in liquidity and widening of spreads.
- Foreign investors have started exiting from emerging markets as they experienced a huge spike in volatility in September 2008. Earlier in the year, there was a shift from equity to bonds.
- Depending on the resilience of the local investor base to absorb the exit of foreign investors, many emerging market economies have started experiencing price distortions.
- As every investor is now trying to hoard cash, no investors are coming into these emerging economies and picking up what should now be value investments.
- Though government policy makers have responded in a robust manner, rollover risk still exists and overall economic prospects are negative.
- However many emerging market economies have taken the time before the crisis to establish fiscal and monetary policy credibility. This should help them tide over the crisis.
- Problem: significant quantities of new government guaranteed issuance from advanced economies may “crowd out” emerging market economies.



- There is a strong need for global coordination, especially for new policies to deal with the consequences of interruptions and reversals in capital flows.
- The corporate sector may need liquidity support.

Future Actions

- To maintain the market, there is a need to:
 - Maintain an open and transparent dialogue with investors.
 - Be creative and adaptable in the operational framework.
- To develop the market in the long-term, there is a need to:
 - Continue to develop the local investor base. This will be the key to mitigating future vulnerability.
 - Emerging market economies will need to review their required level of reserves, as there is a need for greater conservation.



VI. Made in the USA: Transmission of a Home-Grown Crisis to Latin America

Lawrence Krohn
Visiting Associate Professor of International Economics
The Fletcher School

Introduction

- Latin American economies do not hold much sub-prime mortgage paper. In this financial crisis, they were innocent bystanders.
- One of the factors that have led to the financial crisis affecting Latin America has been through merchandise trade.
- In Q3, U.S. national accounts showed sharp declines in consumption (cars, durables, food, clothing fuel). Many of these products are sourced from Latin America.
- The U.S. manufacturing slump is also accelerating, hence undermining raw and intermediate goods imports from Latin American countries.
- Declines in generalized commodity prices have hurt most Latin American economies.
- A fall in tourist activity has also hurt the Caribbean economies.
- Multinational companies with bases in emerging market economies are withdrawing funds that could have been re-invested in the region; profit and dividend remittances have been increasing.
- Worker remittances to Latin America are poised to shrink as job losses in the U.S. extend to all sectors and regions.
- Capital account channels: There has been a capital flight (perhaps to quality) in medium to long-term instruments and a reluctance to roll over expiring debt.
- New Latin debt and equity issuance into foreign markets is unfeasible at current yield and equity prices.
- Foreign direct investment has decreased in Latin America. Though this FDI has lagged, it is not likely to totally evaporate.
- There has been a withdrawal of interbank funding by foreign banks and correspondent banks.
- There has been an unwinding of carry trades: LIBOR is increasing and Latin American currencies is depreciating. There is an outflow on these trades.

The Different Impacts of the Financial Crisis on Latin American Economies

- The decline in merchandise trade has impacted Mexico and Central America the hardest.
- South America's exports were more robust as they were also exported to Europe and Asia. However, Europe and Asia are also facing a growing risk of recession, leading to increased vulnerability for South America.
- The Caribbean has been impacted by tourist and remittance deterioration.
- Mexico, Ecuador and Colombia have been impacted negatively by the remittance effect.
- Venezuela, Ecuador and Argentina are heavily dependent on commodities.
- Brazilian markets were punished, but Brazil is well positioned to absorb the shock.
- Chile is best positioned to offer fiscal stimulus. Though it is copper dependent, it has banished pro-cyclicality (when government spending trends follow the country's GDP).

The Degree of Distress Not Yet Evident in the Data

- The recent shocks have not been reflected in the monthly economic indicators of demand and supply except for Mexico.
- Recently a monthly survey was conducted by the ICC index in Brazil. There was a shocking decrease in business confidence.



- Latin American governments and central banks have tried to ameliorate the growing problem by liquidity infusions and loosened reserve requirements.
 - Policy rate hikes have ceased.
 - Fiscal stimulus is being contemplated as a solution; however many countries have pro-cyclical spending and may not have enough on hand to spend on fiscal stimulus.
 - Governments have tried to resist currency depreciation through sales of reserves. This is done in part due to political reasons, and because depreciation would decrease purchasing power.

Near-Term Regional Outlook is Fairly Grim

- The U.S. recession is underway. It is hard to predict how Europe and Asia's recessions will pan out.
- U.S. banks, even those that have been bailed out, seem disinclined to part with any liquidity.
- In this depressed investment climate, it will be tempting for Latin American countries to try to spend their way out of a possible recession.
- However this fiscal stimulus is not free, it would tax future generations.

VII. Crisis and Missing Markets

Patrick Schena

*Adjunct Assistant Professor of International Business
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Overview

- During the Asian financial crisis in 1997, the role of capital markets and bond markets was questioned.
- There was the issue of missing markets—the lack of a developed capital market, especially that of the bond markets, contributed to the crisis.
- Factors that contributed to the 1997 Asian crisis:
 - An absence of alternative sources of long-term credit that accentuated the level of depending on bank lending in Emerging Market Economies.
 - A heavy use of short-term foreign currency borrowings that represented a level of vulnerability that led to maturity and currency mismatches. This increased the credit risks of corporates and the non-banking sector.
- Efficiently scaled well-functioning local bond markets could mitigate these risks by:
 - Increasing the tenor of the debt
 - Reducing mismatches of maturity and currency
 - Promoting transparency and market discipline.
- There is an inability to develop deep local currency derivative markets to conduct risk management operations.
- Concern is raised about a hallowing out effect as the largest and best issuers are all issuing offshore in other international global markets.
- To the extent that structured finance support bank funding is not available, the corporate sector is resorting to non-market sources of financing.
- To the extent that Asia can develop rich local markets, there is the potential for extensive upside.
- A good source of Asian bond data is <http://asianbondsonline.adb.org/regional/regional.php>



Korea

- The dominant bond market in Asia is Korea
- There were significant opportunities for Korean corporations to issue local currency bonds and move away from bank debt.
- Reason for the turnaround in Korean bond markets:
 - The turnaround was driven by investment trust companies aggressively buying large corporate chaebol debt in Korea.
 - These investment trust companies were owned by the chaebol.
 - Hence, the development of Korean bond markets was initially driven by non-financial companies.
 - Korean corporate ownership caused an attenuation, lengthening and delay of restructuring that was required for further development of the bond markets.
 - In two years, 22% of the corporate debt that was issued defaulted.
 - The Korean government decided to step in and started building new regulations to strengthen the bond markets.
- Electronic trading and forced competition for credit rating agencies pushed forward the development of the Korean bond market.

China

- The capital markets are very insular.
- The Chinese is very focused on sequencing the development of the Chinese financial markets and are careful on the institutionalization of reforms.
- China has one of the better functioning local bond markets in Asia.
 - All the key underwriters in Asia are in China.
 - The local markets have attractive spreads.
- Reasons for the attractiveness of Chinese bonds:
 - The global slowdown has had considerable effect.
 - Equity markets that had previously grown over 500% halted and started to decline.
 - Meanwhile, China has developed a significant institutional investor base.
 - Money from this investor base starting flowing out of the Chinese equity markets back to the banks.
 - Local Chinese corporate issuers that have been issuing actively in the local markets found a ready pool of capital amongst institutions that would otherwise place money in banks (spill over) moving to local currency bonds.
- Insularity as a main driver of the Chinese bond market:
 - Closed capital account is combined with an increasingly large investor base with no opportunity for attractive investment alternatives.
 - When the stock market goes down, they resort to the local bond markets.
 - The question is:
 - What happens when the equity markets improve? How would insularity then impact the local bond markets? Is it now an opportunity to start developing the local institutions and bond markets while equity markets are unattractive?
 - Insularity means that foreign investors are kept out of the markets unless they are qualified. There is less opportunity for quality flight.
 - How does the Chinese bond market build and develop in a scalable fashion to account for if foreign investors are allowed to play in the local markets if the markets open up?



VIII. The Latin American and Asian Corporate Bond Markets: Past, Present and Uncertain Future

Lawrence Krohn
Visiting Associate Professor of International Economics
The Fletcher School

Overview

- The development of the Latin American corporate bond market, relative to Asia, has been slow.
- Why has the Latin American corporate bond market lagged?
 - High cost of issuance in Latin America, including the cost of disclosure relative to the size of the issuing firms and issue amounts.
 - Low domestic liquidity (inadequate issue size and domestic market size). This is not only due to the population size, but also saving rates per unit of population.
 - Low turnover rates in many Latin American countries.
 - Lack of transparency and weak corporate governance.
 - A history of policy blunders (populism, adverse outcomes, instability, volatility etc.) Both foreign and domestic investors are aware of this and reluctant to hold long-term fixed rate paper that corporations issue; there is an investor perception that contract obligations will not be fully or expeditiously enforced in the event of default.
 - Weak market infrastructure.
 - Problem with crowding out—it is very difficult to develop a corporate bond market without a sovereign bond market in place with a full yield curve. However, a developed sovereign market also may potentially crowd out corporate issues. The more sovereign issues there are, the more upward pressure on interest rates.

Chile

- Chile has distinguished itself with economic performance and policy stability.
- It permits issue and investor convergence on terms.
- Provide investors with the protections they ask for.
- The issuers in Chile are very highly rated and there are mature credit ratings.
- Chile has a very large, mature institutional investor base (pension funds and insurance companies). Hence there is demand for the long tenors that the corporates want to supply.
- There is a low issuance cost – except for a 1.6% stamp tax, which is amortized over long tenors.

How Will the Corporate Bond Market Fare Given the Troubled Global Environment?

- There are heightened perceptions of corporate vulnerability and potential macro-instability.
- Foreign investors have been exiting from domestic corporate bonds.
- There is likely to be a loss of competitive ground to more mature, liquid, international markets unless globalization is arrested as a function of the crisis. There is a trend towards international issuance instead of local issuance.
- If the crisis reinforces the recent lurch towards populism (e.g. Venezuela, Argentina, Bolivia and Ecuador), domestic investors may start to be repelled.
- Positives:



- There have been enhanced incentives (at the issuer and government levels) to diminish dependence on foreign capital. This has driven local market development in the wake of previous crises.
- There is a general recent trend where countries with checkered histories have started making stabilizing policy choices that enhance credit worthiness (E.g. Brazil, Peru, Colombia joining the already converted Mexico and Chile).
- There is the growing importance of institutional investors (including the huge potential for Brazilian social security).

Patrick Schena

*Adjunct Assistant Professor of International Business
The Fletcher School*

- Two Themes: (1) Sequencing; and (2) Developing the concept of regionalism – a regional approach that may be a solution to developing scale.
- Sequencing: How to develop macro-economic/ tax policies, especially capital controls, in an efficient manner.
- Factor to consider: how do you define scale?
 - What is the trade off to developing a market and investor base capable of supporting the capital market in the emerging market economy?
 - Do you have a sufficiently strong local investor base?
 - How do you make the case for allowing global investors in the local capital markets? What is the trade off?
- China as a case study:
 - If you create an insular environment for your capital markets you can grow smoothly to a launch point to open up your markets. The question is where do you draw the line between the efficiencies the scale and the volatility from opening up your capital markets will bring.
 - What is the launch point? Issue of minimum efficient scale.
 - China enhanced its local institutional base without relieving capital controls through its QFII program. As a foreign investor, if you want access to local capital, you play by a certain set of rules.
 - This process has allowed China to build a local investor base while allowing foreign investors to get involved in the capital markets in a controlled fashion.

The Asian Bond Market

- Emerging bond markets in Asia have grown.
- As of 2007, Asian bond markets comprised 25% of the world's total bond market.
- However, Asia has not done anything remarkably noteworthy. The Asian bond market story has been a Korean story.
- The Chinese bond market has been dominated by the government and the financial sector.
- There have been a few regional schemes aimed at promoting local bond market development. These schemes have been a reflection of the after impacts of the Asian financial crisis.
 - To use reserves in order to create a local bond fund to use for benchmarking and to promote some degree of liquidity.
 - Asian bond market initiative → related to micro, regulatory and informational structures.
 - Development of local or regional rating agencies.
- Challenge for Asian bond markets:



- How to get liquidity to stay within the region, and how to put this liquidity to work?
- Where should the development of the bond markets in Asia be decided?
- Where can you get scale in the building of institutions?
- How do governments collaborate together?

IX. Priorities for Market Development

Anderson Silva

*Senior Debt Specialist, Global Capital Markets Development Department
The World Bank Group*

Survey

- A World Bank Group survey was created with 8 categories and 20 sub-topics.
- 24 countries with surveyed in two phases: 17 countries in Phase I and 7 countries in Phase II.
- We find that there is strong demand for work and assistance in all areas: the highest item was in the secondary markets. The lowest area was in Macro and Micro interactions.
- Analysis was done by market size: Derivatives were examined in the larger markets and the investor base and regulatory frameworks for smaller markets.
- Note that there may be sample bias in this survey
- This survey will be revisited after the aftermath of the financial crisis.

Some Results

- The investor base in Asia has a lot of savings.
- High number of requests in all areas – strong demand for support and cross-sharing of experiences on developing local currency bond markets.
- There was demand for advisory services by product type.
- Advantages of survey included identify aligned interests—now we know that the Central Bank of Mexico has the same interests as the Central Bank of Phoenix.

X. Q&A Session

- **Question:** The G7 had directed the World Bank and the IDC to help deepen local capital markets. A factor that saved China during the Asian Financial crisis was that they had a limited capital market. India is also an example of a country that opened up their capital markets slowly and only instituted structural reforms when they were totally comfortable. From your perspective, during a crisis, will countries with deeper capital markets be less impacted? Are countries with deeper markets more insulated?
 - **Allison Holland:**
 - Deep capital markets help provide a little insulation for external shocks. This is largely due to growth of the country and domestic savings.
 - Countries need to focus on how to develop their domestic savings base as they cannot rely directly on foreign investors.
 - Though foreign investors provide market development, technology transfer and efficiency, people will raise questions as to what is the appropriate speed to liberalize the capital account.



- It is a tricky balance for policy makers that are trying to decide whether to impose market impediments so they can “hold on to the money they make”.
- **Anderson Silva:**
 - Shifting from a short-term perspective to a longer-term perspective: Countries with a larger participation of foreign investors face many inter-related issues.
 - These issues include: Greater difficulty in building a domestic investor base, building the necessary infrastructure in the market for foreign investors, reducing costs as the room for efficiency is diminished.
 - Ultimately, it is very important to build an investor base and the strength of the capital account.
 - Unfortunately, building an investor base takes a very long time.
 - As for the capital base, we face issues such as: (1) what current restrictions are there on investors. (2) The potential for pension funds to distort the market. (3) How can you issue well-priced corporate securities?
- **Question:** With increased regulation of capital markets, how can you maintain a level of capital market efficiency and optimum regulation? This process may be self-iterative. How do you measure this optimum regulation, the trade off between better risk management and controls and maintaining cost efficiencies?
 - **Eliot Kalter:**
 - When facing short term vs. long term gain, short term considerations always win out. Even in Cuba, there was an opinion that regulation was basically bad.
 - **Lawrence Krohn:**
 - The argument that free markets promote efficiency does not hold. The problem is that we do not operate with perfect knowledge, so we do not know what extent of government intervention we need.
 - **Neil Allen:**
 - There needs to be a global regulatory system. However, should not forget that regulatory regimes also had its flaws such as mismanagement and corruption. The challenge will be to how to create a macro regulatory environment that is risk conscious.
 - If this is not handled appropriately, a culture of favoritism, insider knowledge can be cultivated that will lead to much slower growth and greater problems.
 - **Eliot Kalter:**
 - It is very important that studies of the impact of the current financial crisis on different countries and regions come out quickly, and that they get good publicity.
 - e.g., What was the impact on countries with deeper capital markets, savings and fiscal policy?
 - Who has the worst balances right now?
 - Who is getting hit the most?
 - Hopefully it can be seen that the countries with the best policies suffered the least.
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- **Question:** To what extent does Chinese investment in the Latin American bond market have any bearing on Latin America?
 - **Eliot Kalter:**
 - What's driven the investor in Latin America is direct investment. Peru has US\$40 Bn of direct investment. This was coming from Asia as well as the U.S.
 - **Neil Allen:**
 - Two factors that have not been focused on are (1) What are structural changes and (2) the Hedge Fund piece.
 - Structural changes: it is clear that the investment-banking model is dead for all the emerging markets. They have also lost the key element of "oil" in the system that is not coming back anytime soon.
 - Hedge fund piece: Hedge funds loved leverage and investing in the Latin American region. They were a source of liquidity. However now, they are combusting. It will hard to tell how the system will change.

XI. About the Center for Emerging Market Enterprises and The Fletcher School

The Center for Emerging Market Enterprises (CEME) is a research center housed within The Fletcher School of Law and Diplomacy at Tufts University. CEME was established in 2007 to be a leading global hub for research, study, and networking, and to promote understanding and engagement that contribute to global prosperity and stability. CEME's five core research areas reflect a range of key issues in emerging markets: Emerging Market Enterprise Strategy; Emerging Market Local Capital Markets; Energy and Commodity Markets; Inclusive Commerce; and the Sovereign Wealth Fund Initiative.

The Fletcher School, the United States' first professional graduate school of international affairs, has for decades prepared the world's leaders to become innovative problem-solvers in government, the private sector, and non-governmental organizations. Since 1933, Fletcher's multi-disciplinary education in business, law, international relations, and regional studies has offered individuals and organizations a unique global perspective on the day's most pressing issues.

For more information about ongoing CEME research initiatives and events, please visit <http://fletcher.tufts.edu/ceme>.