The Need for Domestic Currency Denominated Debt (Bond) Markets in Developing Countries

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First draft, August, 1998
Revised March 2000

I. Introduction

1. Developing Countries are distinguishable by their tendency to experience periodic inflation and/or instabilities in exchange and interest rates, both accompanied by low or sudden drops in investment and related declines in GDP and employment. In addition, countries with developing status can experience poor or unstable governance. An important ingredient in removing these problems and achieving developed status is to initiate and nurture competition in domestic currency denominated debt markets, which will be called bond markets. Three separate but complementary markets are possible; for treasury (deficit) financing, for infrastructure and for private (corporate) bonds. Below I examine how competitive domestic bond markets can help alleviate the problems of underdevelopment. I consider four development problems separately, although they are interrelated. I conclude with the observation regarding a moral hazard problem; Unless very carefully orchestrated, reliance on borrowing from the IMF and World Bank can slow or prevent the introduction of domestic currency bond markets and/or markedly reduce their competitiveness and developmental usefulness.

II. Solving Development Problems: The Role of Bond Markets.

I begin by considering the use of domestic bond markets to increase and stabilize savings and investment and through this, expand and stabilize the rates of growth of GDP and employment. Because of assumptions I make about what constrains investment, these paragraphs focus on the role of bond markets in providing longer-term debt and financial assets (term financing) and on reducing investment risks. Following this, a few paragraphs examine the role that bond markets can play in stabilizing exchange and interest rates and in mitigating inflation. Finally, I take the Hamiltonian view that bond markets can lead to improvements in governance by giving people a stake in their governments and vice versa.

A. Increasing and Stabilizing Saving and Investment.

I adopt the notion that saving and investment involves the purchase of assets[1] in order to earn varying rates of return (depending on risks) and to insure for disasters and retirement or old age. Savings and investment increase along with a broadening of the array of assets or investment opportunities, as well as with the increased trading or marketing of these assets. Although much investment in developing countries is self-financed with own or family savings, it is becoming increasingly the case that investors must borrow credit from savers to finance at least a portion of their asset purchases. In developing countries this

[1] Assets are also liabilities or debt and net worth. Rates of return can be in the from of interest payments, in which case the assets are debt or bonds, or rent and profits, in which case the assets are real estate or equity ownership.

financial intermediation is mainly performed, not very well or efficiently, by a few, monopolistic commercial banks. In more-developed countries bond and stock markets improve the financial intermediation process by enabling the matching of risk and term maturities, by making commercial banks become more efficient and by stimulating the development of better asset markets.

1. Improving Risk and Term-Maturity Matching.

Savers and investors have different risk preferences that require matching to different asset risk characteristics if saving/investing is to be maximized. Bond markets are a very important component of this risk matching process. It is generally presumed that shorter-term maturities are less risky and lower yielding than longer-term maturities and equities. However, establishing, broadening and improving bond (asset) markets will both improve the risk characteristics of all marketed assets and enable savers/investors to match their risk preferences to the risk characteristics of marketed assets. In particular, more developed asset markets will allow investors to match the term-structure of their debt with the term-structure of their likely revenue flows.

Examples relating to project financing and life insurance will enlighten.
Borrowing short-term money to undertake a project which begins earning revenue three years down the road is fraught with risk. Even a good project may not be financed or undertaken. Commercial bank (i.e., short-term) lending will not be forthcoming unless the loan is heavily collateralized, which in turn may appear so onerous that the entrepreneur refuses to undertake the project. With bond markets, medium-term bonds can provide a more appropriate alternative to too risky and/or too onerous commercial bank lending. Without bond markets, either the project will not be undertaken or banks will under-collateralize the loan, thus exposing themselves to excessive risks. Another poor alternative is to enhance commercial bank collaterization with government guarantees either on the banks' deposits, or loans, or both.

2. Making Commercial Banks Become More Efficient

Efficiency in private commercial banking is evidenced, to some extent, by relatively high interest rates paid on deposits, relatively low interest charged on loans and low spreads between deposit and lending interest rates. Appropriate real domestic rates and spreads are those which are similar too foreign ones. Such efficiency is a direct result of unfettered competition amongst banks and across financial intermediaries within the financial system. In a few instances competition from foreign banks will insure domestic bank efficiency, but in most cases, domestic banks are provided some sorts of protection which enable them to avoid price competition amongst themselves. In these, rather numerous situations, competitive alternatives to banks, particularly bond markets are needed to ensure efficiency-increasing competition. Bond markets are an alternative and/or companion source of credit; one in which the quality of the bond is tailored to the pattern and probability of revenue receipts, rather than to the value and liquidity of posted collateral. In addition, bond markets provide savers and investors with alternatives to bank deposit and savings accounts, thus forcing banks to compete for saver/investor funds.

<u>3. Stimulating the Development of Better Domestic Asset Markets</u>

Saving and investing will increase as competitive, domestic currency asset markets are formed and expanded. This occurs importantly because smoothly functioning asset markets increase the liquidity of all assets, thus generally reducing domestic investment risk. Establishing bond markets is a crucial element in this process. Asset markets, open to the public, have historically been initiated through the placement to and subsequent secondary sales of bonds held by the non-bank public. In many present circumstances, non-bank holding and trading of domestic currency bonds is virtually nil. This is the result of the easy availability of foreign currency bonds, the tendency of governments to borrow at concessional rates from international organizations and the lack of facilities for the placement of domestic currency bonds. The advent of these placement facilities can be the initial step in forming domestic asset markets.

B. Stabilizing Exchange and Interest Rates

Poorly developed domestic asset markets can cause developing country exchange rates to be highly unstable, particularly in a downward direction. In many developing countries, foreign exchange transactions are the only, or the dominant form of asset exchange. Without bond markets, exchange rate instability problems worsen as the saving/investment propensities of the public increase. In the absence of domestic bond markets, the non-bank public can save and invest only by building up domestic currency balances or, in some cases, buying highly volatile equities. These limited alternatives heighten the attractiveness of and demand for foreign currency denominated assets. This in turn puts pressure on the exchange rate or, if attempts are made to support it, on domestic interest rates. However, since these interest rates are inaccessible to the general saving/investing public, (open, domestic asset markets are scarce and thin) higher and higher interest rates do not effectively stabilize the exchange rate. Instead, the major saving/investing alternatives for the public are increased holdings of foreign exchange and/or stocks of easily tradable imports. For both of these, speculative profits depend on increased frequency of devaluation and domestic inflation. The alternative is to establish domestic bond markets that will give the saving/investing public a choice of interest-bearing domestic currency assets to purchase. If these are traded in open, competitive markets, including secondary markets, bonds will provide the best determination of the economy's interest rates. If an important element of the bond market is trade in government Treasury bonds, which are by their very nature "guaranteed," then the interest rates on these bonds will establish reference prices for riskless domestic debt.

C. Mitigating Inflation

Without bond markets, implementing anti-inflation policies is quite difficult and contrived. The absence of bond markets also means that countries must become more dependent on foreign borrowing, particularly from international institutions and on larger BOP deficits to implement anti-inflation policies. Inflation is mainly a monetary phenomenon involving the creation of too much domestic currency. The usual and easiest way for the Central Bank to reduce the rate of money creation and inflation is to sell some of its stockpile of longer-term Treasury bonds to the non-bank public. This will directly reduce the availability of money and also raise market-determined domestic interest rates

(if competitive asset markets exist). Higher interest rates can cut spending, unless offset by increases in domestic expenditures and/or deficits that are not sensitive to higher interest rates (these are mainly public sector expenditures and deficits). In the absence of bond markets, as is the case in much of the world, anti-inflation measures involve implementing a series of administrative interventions. These include arranging official borrowing to finance relatively larger amounts of imports and BOP deficits and artificially raising interest rates to levels that may or may not reduce aggregate spending. Even in the event that the relatively larger amounts of imports and higher interest rates suppress inflation in the short term, the country ends up with markedly expanded international, official indebtedness and the prospect of larger future budget and BOP deficits as the foreign debt is serviced.

D. Improving Governance

Alexander Hamilton advocated starting a US Treasury bond market because it gives citizens a stake in the Federal Government while at the same time requiring national politicians to pander to their citizens' interests. Hamilton presented a defense of a strong central government against Jeffersonians who advocated a weaker central government (and Central Bank) and stronger local government (state's rights) as a way of enhancing the nobility and pastoral simplicity of the peasantry. Political scientists would generally argue (as Michael Lind does in Hamilton's Republic, Free Press, 1997) that Hamilton was essentially correct; that US economic development proceeded rapidly, importantly because the US Government made heavy use of domestic bond markets. Hamilton's views conform to the common sense notion that governments are beholden to their taxpayers and creditors and that it is best if these two are the same. The present international situation in which governments do not borrow from their citizens but rather arrange borrowing from the IMF and World Bank leaves room for suspicion that governments, or significant personnel in them are beholden to foreign interests.

III. Conclusions

In my view, the above arguments definitively demonstrate the desirability of developing countries having competitive, domestic currency-denominated bond markets. Furthermore, awareness of the benefits of domestic bond markets has been around for decades, if not longer. This leads me to wonder why domestic bond markets have not sprung up long before now? The least conspiratorial reason I can think of is that such bond markets only develop along with growth in domestic savings and real economic growth, which have been relatively slow, outside of East Asia. This view is logical, but I don't believe it has empirical merit. If anything, I would argue that there is a greater (but still not too large) probability that the reverse is true. That better developed bond markets would lead to more real growth and domestic savings. This leaves me with the speculation that the lack of development of domestic bond markets is somehow related to the way the Official international financial system operates, particularly the IMF and World Bank. It has certainly been the case in my work with the World Bank that governments in Africa and Eastern Europe seem mainly focused on the IMF and World Bank as the means of obtaining "non-inflationary" budgetary finance, even during the late 1980s, when inflation was romping out of sight.