Developing local currency bond markets has become a much-talked about topic, particularly since the recent Asia crisis. A growing number of emerging market countries around the globe are looking into the prospects of building local bond markets to reduce the currency, interest rate, and funding exposures that precipitated the Asia crisis.

This chapter provides a basic framework for evaluating the major impediments to developing local corporate bond markets and some suggestions on how those impediments might be removed. This approach was used to evaluate the situation in the five South Asian countries, and the chapter briefly reviews the main conclusions of those surveys (Chapters 11 through 15).

The paper points out the many benefits of bond markets and the importance of developing them. But it also shows that building bond markets is difficult and takes a lot of time, and not every country will be able to develop active markets. Markets grow from participation by issuers, investors, and intermediaries—not just from building market infrastructure. Participation results when a fairly comprehensive range of economic, technical, as well as political and “behavioral” factors come together. Unfortunately, many of these factors, by definition, are not well developed or are inappropriate in emerging markets and take considerable time to get into place. Many of them are controlled by parts of the government that may care
little about developing bond markets, which further complicates the process.

In addition, as is true when building any financial market, these factors develop at different paces, leaving countries to try to grow their markets in less than ideal conditions. The paper notes that countries likely will have to introduce their market in stages—starting with privately placed transactions and graduating over time to public primary markets and then to secondary markets as conditions improve. Many countries will never be able to develop active secondary corporate bond markets and many may have only limited primary markets as well. But borrowers and investors in these countries still will gain many benefits from access to some form of bond market.

Regulators and market participants need to evaluate this comprehensive set of factors to determine which ones constrain their market’s growth and how to deal with them. Market development will be accelerated if regulators who are interested in the market’s development work closely with market participants to identify problems and solutions, and with other regulators to persuade them to address problems under their control. Although there is no one way to build a market, countries should draw on the experiences of other emerging market countries for guidance on how to progress from “emerging” to “emerged” and on what works best in what types of conditions along the way.

All five South Asia countries could benefit from having long-term, local-currency, fixed-rate financing for their local corporations. As might be expected, they differ in their ability to develop such financing. India is farthest along on the path toward active primary and secondary markets, followed by Sri Lanka. Both countries are actively moving to develop their markets. Pakistan too is now taking steps forward. Bangladesh’s securities markets are still relatively undeveloped, as are those of Nepal.1

1 The surveys are based on information available in mid- to late-1999. Exchange rates on 31 August 1999 against US$1 were: Indian Rupees, 43.5; Pakistani Rupees, 51.8; Sri Lanka Rupees, 71.9; Bangladeshi Takas 49.5; Nepalese Rupees, 68.7.
Developing local corporate bond markets is a relatively new activity for many emerging market countries, and insights from experience are limited. This paper offers some general suggestions on how to deal with key problems. More work is needed to distil specific ideas on how countries with particular circumstances might move through the development process.

**BENEFITS AND GOALS**

The current emphasis on local-currency bond markets stems mainly from their risk-management benefits, as highlighted by the Asia and the Tequila crises. Issuing bonds can reduce the types of interest rate, foreign exchange, and refunding exposures that created those crises and can help ensure that emerging market borrowers have more shock absorbers—more tools—to limit the impact of those exposures.

Foreign investment is clearly a plus for economic development but it does create certain risks. Since financial sector crises will never be eliminated, and, at least for many years to come, flows into emerging markets will be large in relation to the markets in which they are investing, any rapid outflow will create serious problems for the borrowing country. Emerging market countries must find ways to manage the risks, and hence benefit from international capital flows. They need to be able to reduce exposures to foreign-currency borrowing and also absorb the associated shocks and volatility, so that small problems will not escalate into broadly based social catastrophes, harming people who were in no way directly involved in the markets.

As Michael Pettis discusses in chapter 4, local-currency bonds dampen the effect of crises created by international capital flows by locking in interest rates and local-currency funding. This allows borrowers to hold on to their funds and positions and work their way through a crisis. But, as happened in Asia, many borrowers want to rely on short-term, foreign-currency funding because when their economy and local currency is strong, such borrowing creates a double benefit to their net worth: the borrower’s liabilities fall while its assets and revenues rise. The flip side is that when times turn bad, borrowers get a double hit on their net worth: liabilities rise...
and assets fall, causing strains and in some cases defaults. The solution to this problem is to use funding structures that have a neutral effect on net worth, as in the case of bonds. The difficulty lies in convincing borrowers that good times may turn bad, and in getting them to incur the potential opportunity cost from locking in stable funds and rates.

Chapter 6 by Yongbeom Kim and chapter 8 by Ranjit Ajit Singh make clear that the Asia crisis was a major impetus for developing local-currency bond markets in Malaysia and Korea. Korea had a local-currency corporate bond market for years, but it did not play a stabilizing role during the crisis because it was not used extensively enough. Corporations relied mainly on bank loans. When Korean banks were hurt in the crisis, says Kim, the resulting credit crunch precipitated corporate bankruptcies. Korea is now working to develop a larger, more market-oriented, corporate bond market, because the government recognizes how necessary that market is to financial and economic health. It is also aware that the government securities market must be active and market oriented to support the corporate bond market.

Actually, emerging market countries have been developing local bond markets for the past 5 to 10 years, though at a slower, less focused pace. Any country that is liberalizing and growing economically needs diversified financing tools beyond just banks and equity markets. Banks often cannot provide the size or structure of financing needed. In many countries today, banks are increasingly constrained from financing longer-term, large-scale projects because they are trying to improve the quality of their operations. Pressure from international agencies to contain credit extension (for example, via legal lending limits or provisioning for nonperforming assets) is limiting lending as well. Issuing new equity is not always an option, as it is costly and dilutes ownership.

Local bond markets also support major trends that stem from economic and financial sector growth. For issuers, infrastructure development is creating demands throughout Asia and other parts of the world for large-scale, longer-term funds that banks cannot often provide. Privatization, securitization (particularly for housing finance), and decentralization of governments are all creating new financing demands. On the investor side, many countries are now
rich enough for insurance and social security and are creating institutional investors that need long-term assets. They want to keep their interest rate (fixed), reinvestment (long term), and local-currency risks to manageable levels. With macroeconomic stability increasing in many countries, issuers and investors alike are more willing to lock in rates.

Local bond markets also strengthen the financial sector by encouraging greater transparency, pushing companies to disclose in public markets and forcing them to better understand themselves and in turn improve their management (as is the case in equity markets, too). Bond markets create competition with the local banking sector, which can reduce lending rates.

Ideally, countries should try to build both primary and secondary markets for bonds. Primary markets reduce the three risks noted; secondary markets, by adding liquidity and broadening the investor base, help reduce funding costs. As discussed below, many countries will not be able to create secondary markets, and some will find it hard to develop public primary markets. Whatever the situation, reducing one or two of the three financing risks is worthwhile. Getting local-currency, fixed-rate, long-term funds in a private placement may cost more than a publicly traded issue but it might be all that a country can do, and will reduce the issuer’s risk, and allow the investor to lock in an asset.

BUILDING BOND MARKETS

Equity market history offers a few important lessons about how fast a country can build its bond markets. In several cases—despite optimistic expectations, bursts of activity, and establishment of a new equity market infrastructure—little or no issuance or listings followed, or there were listings but no trading.

One reason for this is that many persons involved in building capital markets have operated as if creating markets is a technical, top-down, infrastructure-building exercise. You set up regulations and regulators, incorporate exchanges, introduce trading and clearing systems, and give regulators and market participants some education. Once the systems are plugged in and doors opened for business,
a market will spring to life. But this “build it and they will come” approach often does not work. Doors are opened, systems are turned on, and markets do not operate. Instead, there is often “no product”—no issuers—and no investors or intermediaries to transact. No market participation means no market.

Some General Issues

Generally speaking, issuers, investors, and intermediaries will participate in a market if they see an economic benefit (better costs, better structures), are willing (have the right attitudes) and able (have the skills, regulations), and are structured right as an industry to participate (see table 1). Conversely, there are lots of reasons why they might not participate. Clearly, the three elements of need/benefit, willingness, and ability drive one another. If the benefits are clear and significant, participants will be more willing to do “costly” activities like disclosing information. If better skilled, they will be less fearful and more willing to enter the market.

Market participation cannot be declared or forced, but it can be encouraged by an enabling environment, and it can be discouraged by an “unabling” environment. The environment consists of a range of interactive factors around the market, across other parts of the financial system, and inside the market (see figure 1):

Around the Market. An enabling environment consists in part of macro and political stability, including economic growth that generates a sufficient number of issuers, inflation and interest rate structures that are not too high or volatile, tax policies that do not disadvantage use of bonds, and a broader legal framework (securities laws, bankruptcy codes, and the like) that supports bond markets.

Across Other Parts of the Financial System. Ideally, a government securities market is present or in the making and is helping to build a benchmark yield curve and a dealer community. The equity market is relatively well developed, with a stock exchange and clearing

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2 Building market infrastructure is a foundation for any market, but it is just a foundation.
corporation, and securities firms that are familiar with securities markets. The banking sector can contribute to the market as investors, issuers, and intermediaries.

**Inside the Market.** Regulators support and are committed to developing the market. Trading, clearing, and settlement systems exist for equities and might be modified to support bonds. Issuers form a large enough core, are profitable enough to attract investors, and are willing to disclose information. Intermediaries are present who are capable of dealing in securities. There is a growing institutional investor base that is not captive in other markets (or any captivity that is present can be removed). Privatization programs are in place that create issuers who need bond markets.

### Table 1. Encouraging Market Participation

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<tr>
<td>Instrument Attractiveness</td>
<td>Need: Issuers and investors get new features they cannot get elsewhere such as larger volumes, quicker access, and better maturities. Intermediaries get new business line. Economic benefit: The product provides a financial benefit such as reduced costs for issuers, higher returns for investors, new profit sources for intermediaries.</td>
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<td>Individual Participant Features</td>
<td>Ability: Market Participants can participate in the market (i.e., investors are not unduly constrained by statutory liquidity requirements, investment directives, or an inability to take positions in the market; intermediaries by unnecessarily high capital requirements that reduce profits, inability to finance or hedge their positions, inability to take positions; issuers by too high and costly disclosure requirements). Issuers, investors, intermediaries have the skills needed to perform the business. Willingness: Issuers are willing to disclose because they see an economic benefit to being in the market. Investors are willing to take risks and trade.</td>
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<tr>
<td>Industry</td>
<td>Structure: Economy provides issuers and investors that are diversified, large enough to support the market, not so big that they dwarf the market, in sufficient number to create competition but not so many that they make it impossible for any one firm to make money (i.e., the number of entities in the market fits with the size of the market).</td>
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All these factors influence the market’s attractiveness to an issuer, investor, and intermediary and hence need to be considered from the market participant’s point of view—that is, from the bottom up. In addition, because the factors interact in different ways, they need to be examined simultaneously. Finally, because these are emerging markets, different components will be developing at different rates. They will rarely be in place as an entire set. That means the ultimate evaluation is something of a balancing act. Sometimes one important element is strong and another is weak. Leaders will have to weigh the impact of different factors.

Recognizing that market participants are effected by such a broad range of factors makes it easy to see why developing financial markets is so difficult and time-consuming. Moreover, many of the factors go beyond technicalities and involve attitudes, cultures, and politics\(^5\). Some matters take years to get right, such as corporate

\(^5\) Developing new attitudes and behavior is a main reason why developing markets take so long. People need to learn new ways of thinking about how and with whom they do business. New cultures need to be created—for taking and managing risk, disclosing information, and maintaining quality operations and accounts, among other areas.
governance, which influences an investor’s willingness to invest in a company, particularly its bonds, since they involve credit risk and debt servicing.

Equally important, many of the factors affecting market participation are outside the control of entities that may want to build the market, such as the local Securities and Exchange Commission (SEC). Tax policy may be run by the Ministry of Finance, macro and banking policy by the central bank, insurance and pension rules by their respective regulators. The assumption that building market infrastructure builds markets is appealing because the parties who want to build it can control that process. It is a technical activity, involves a limited number of parties, and so is relatively easy to undertake. By contrast, an SEC that wants to develop the corporate bond market may be faced with a central bank that insists on keeping interest rates high to maintain foreign exchange rates, which prevents bond issuance.

Indeed, market building will take a long time and will be “noisy.” With so much going on and so many entities involved, market activity and capabilities will get out of balance, causing growing pains. Leaders will constantly be challenged to balance activity and capabilities to avoid explosions that destroy market confidence and create “participation scars” that are hard to erase in new markets. This is a reality of the activity.

Remember, too, that developing bond markets can be more complicated than developing equity markets. Bond markets need supporting pricing infrastructure. They operate best when they have money market and longer-term benchmarks. Most emerging markets lack these benchmarks. The issuer’s credit risk is another major concern. The issuer has to service and repay the bonds, whereas with equity the issuer can be “incubated” from payments as it grows. Investors need to make sure issuers have the cash flow to make interest payments and redeem principal. Bond markets simply cannot grow as quickly as equity markets can. Furthermore, bond markets need more sophisticated market participants. Issuers need to be able to manage their cash flow to make repayments. Bond markets typically need dealers and market makers, which means creating a new class of intermediaries who can take positions and manage their risks.
All the pieces of this puzzle are important, but a few are “key factors for success” while others are “second-level” success factors. (Although market infrastructure is critical to the process, it is assumed here that the infrastructure is functioning effectively or can do so.)

**Key Success Factors Around, Across, and Inside the Market**

Whether a market can be built depends on four key factors—two from “inside” the market and two from “around” it. The “inside” factors are suitable and appropriate issuers, investors, and to a lesser extent intermediaries, and a committed government. The “around” factors are macrostability and taxation. For most countries, the lack of appropriate issuers and investors is the main stumbling block to developing the market.

**Market Participants.** Clearly, a market needs issuers and investors. As obvious as this sounds, a surprising number of countries have pushed forward to build markets despite the lack of these players.

An active primary and secondary market needs a diversified issuer base with varied credit risk representing different economic sectors. Potential issuers can include corporations, financial institutions (banks, housing finance), infrastructure projects, and municipalities. Financial institutions (FIs) are often the biggest nongovernment issuers in the early stages. As noted, issuers need to see some economic benefit to the product, must be willing to use it, and must be able to use it.

Investors should be diversified and composed of institutions such as pension funds, insurance companies, mutual funds, and other FIs, interested in different credit risk and economic sectors, and not so large that they dwarf and dominate the market but large enough to take positions and risks. They too need to see economic benefits, such as higher returns to compensate for longer-term investments, and instrument structures or maturities that better match their liabilities than other products. They need to be willing to be in the

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market (take risks) and able (through skills and regulations). How diversified, sizable, and capable the issuers and investors are will determine how fast and large the market can grow.

Intermediaries are also needed to bring issuers and investors together.\(^5\) They need to make money from the business, be willing to take and manage the risks (being profitable will help), and be able, through regulations and skills, to do the business. They need to make enough money in good times to support the ups and downs of the market, which can be accentuated in emerging markets. As for the industry, there should be enough firms to create competition but not so many that no one firm can make enough money. The industry should not be dominated by banks but should include several independent securities firms since banks can constrain the operations and perspectives of their securities affiliates.

**Government Commitment.** “Inside” regulators (such as the SEC) must be committed to building the market. In many cases, the government needs to take the lead in getting the process under way by bringing together key market players to build systems and by lobbying “outside” regulators and leaders. In Korea and Malaysia, the government made bond market development a priority and took steps to make it happen.\(^6\) The level of commitment will determine how fast the market grows. Without “inside” government commitment, the market is not likely to grow.

**Macroeconomic Stability and Credibility.** Bond markets require stable macro and political environments to grow. Economic growth must be strong enough to generate appropriate issuers and investors; in-

\(^5\) Development of local bond markets is causing many emerging market countries to introduce dealers and market makers to their capital markets, because the bond markets need firms that can take positions with their own capital rather than just broker for others. See the discussion on liquidity below.

\(^6\) The Malaysian government gave several tax incentives to encourage market development. It waived the stamp duty and exempted from tax the interest earned by individuals on corporate bonds and then the income earned by unit trusts and closed-end investment funds. These efforts helped the market move forward. Such measures are not always needed (and are often not even suggested since they can create distortionary tax structures that are harder to remove later).
flation and interest rates cannot be too high or volatile. Without sufficient GNP growth, savings and investment rates, and per capita GNP, the economy might not provide the issuers and investors needed (see table 2). Korea, Thailand, and Malaysia, three countries that are promoting their local bond markets, have sizable GNP growth rates and very high savings rates (34%, 36%, and 44%, respectively).

High interest rates can slow issuance by creating high and unaffordable costs. If short-term rates are 25%, what company can pay 40% for 5- or 10-year money? Companies may prefer or be forced to take interest rate and refunding risks. Volatile rates will stop issu-

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a. Real GDP growth for South Asia is for 1998 from the Economist Intelligence Unit. Real GDP growth for the developed countries and for emerging Asia are JPMorgan forecasts for 1999.

b. Gross domestic savings for 1997 (1996 for the six developed countries) from World Development Indicators.

c. Overall budget deficit, including grants, as a percentage of GDP for 1997 (1996 for the United Kingdom; 1993 for Japan) from World Development Indicators (the deficit for Bangladesh is from Bangladesh Bank). Numbers for Bangladesh are not available. The negative figure for Malaysia indicates an overall budget surplus.

d. Inflation for South Asia is consumer price index (CPI) inflation for 1998 from the Economist Intelligence Unit. Inflation for the developed countries and for emerging Asia are JPMorgan forecasts of CPI inflation for 1999.

e. Figures are from international financial statistics, except those for India, which are from the Reserve Bank of India, and for Bangladesh, which are from Bangladesh Bank. They represent short-term treasury bill rates (except in the case of Pakistan, Japan, Korea, and Thailand, where they are the money market rates).
ers and investors from locking in rates. Both will hope that over time rates will move in their direction. At present, short-term rates in the industrialized countries and in Southeast Asia are generally below 5% (see table 2).

Governments also cannot crowd out the private sector from local and foreign investment. Deficits to GNP combined with savings-investment gaps provide some indication of whether this is a problem.

**Taxation.** Taxation is a well-known potential market destroyer, directing financial flows by changing relative costs of different products. Bonds do not need preferential treatment, but they cannot operate at a disadvantage compared with alternative products such as bank loans and equity or they will not be able to compete. Close attention must be given to the effect of stamp duties, transaction taxes, and income taxes on the cost of issuing, investment returns, and intermediation profits.

**Second-Layer Success Factors**

Some countries may have a sufficient issuer and investor base, macroenvironment, and government commitment but are constrained by the lack of development “across” the financial system, in the government securities market, banking sector, and equity markets. These factors will affect how fast and how far the market can grow.

**Government Securities Markets.** The government securities market is an important foundation for the corporate bond market. It provides a benchmark yield curve and helps promote a class of dynamic, profitable fixed-income dealers. A government benchmark is ideal

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7 As noted in several chapters in this volume, to create a benchmark, the government ideally must issue at market-oriented rates, have large issues with representation across the yield curve, maintain current coupons by issuing frequently or through trading, have broad distribution of bonds among investors, and have frequent public announcements about issuance plans so investors stay informed about the supply and demand in the market.
as few alternatives usually are available in emerging markets. Interest rate structures tend to be skeletal, particularly after one-year maturities, and few high-quality credit alternatives exist.

Government markets also provide dealers with experience trading fixed-income securities (as these markets are likely to have some trading), and a chance to earn profits and build credibility as an intermediary, which helps in obtaining better structured and priced financing from banks and financial markets. Brokers in emerging markets can have difficulty getting bank funding for various reasons, which they need since other typical funding tools such as repurchase agreements (repos) are often limited.

**Equity and Money Markets.** The existence of an operating equity market is important for bond market development because it implies that the country has a “capital markets culture” with supporting institutions, issuers with disclosure experience, and investors with some understanding of what it means to invest in securities. Money markets can provide short-term pricing benchmarks and offer dealers less risky trading experience (because potential losses on a money market trade will be smaller than with longer-term paper).

**Banking System.** Banks support bond issuance indirectly, when their lending is constrained (by capital adequacy, legal lending limits, NPAs, and so on), and directly by acting as issuers, investors, and intermediaries. They often dominate bond issuance in a market’s early stages. They are frequent investors, though they can stall market development by buying and holding securities. Because they are the best-capitalized financial institutions in emerging markets, banks tend to

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8 Many emerging market countries—including Malaysia, Korea, Hong Kong, Thailand, India, Sri Lanka, and Egypt— are introducing primary dealers in their government securities markets. These dealers often receive funding benefits which can help support other business lines directly and indirectly.

9 In many countries, the Bank for International Settlements (BIS) capital adequacy requirements, which were not intended for emerging markets and often were implemented rapidly, left banks scrambling to reduce loans and substitute low-risk weighted assets such as government securities to meet the requirements. Corporations needed to find new funding sources.
act as bond market intermediaries. Their ability to deal in the market is important since their affiliates are usually the primary dealers in the government securities markets, which trains them to deal in corporate bonds. Banks can seriously hurt bond market growth if they are given preferential tax or regulatory treatment to protect them from bond market competition.

Credit-Rating Agencies. “Inside” the market, credit-rating agencies (CRAs) face problems that can also have an adverse impact on bond market growth. As is well known, CRAs need to be credible, independent, and able to obtain information if they are to function properly. They also need to be profitable or they will not survive. This means CRAs need enough deal flow to earn profits or they will have to charge high fees, which will deter bond issuers. Because they need deal flow, but also need to encourage new issues, there is often a question of when to introduce a CRA.

Creating Market Liquidity

To this point, the discussion has focused mainly on primary markets. Secondary markets are important for well known reasons, but they do not necessarily emerge from primary markets and in most cases do not. Active trading is difficult to get. Outside the United States, corporate bond trading is not sizable. In many countries, whatever trading exists is usually concentrated among a few larger issues, rather than spread across a range of issues. Yet markets need enough trading for price signaling and to attract a broad investor base. Dealers and market makers can play a critical role in promot-

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10 Some emerging market countries are requiring that the bond business be done in a separately capitalized subsidiary, to ensure business focus and commitment. Banks often own and capitalize those entities.

11 According to Standard & Poor’s, to sustain a credit-rating system, a market needs a critical mass of issuers (for research, default prediction, investor awareness of credit risk differentials, range of investment opportunities), a professional financial intermediary industry, a broad institutional investor base sensitive to credit risk and pricing, and a sound regulatory environment and market infrastructure (that is, accounting, other information, market-based benchmarks). See unpublished report concerning the Egyptian Capital Markets, September 1999.
ing market liquidity, and many emerging markets are introducing these kinds of intermediaries when creating bond markets. But dealers alone cannot create liquidity. They need the right trading tools, an underlying investor base, and the ability to make money, finance, and hedge their positions.

Experience to date has shown that bond markets usually work best with quote-driven trading, particularly when the bonds are not liquid, because bonds are traded on the basis of many variables—interest rate levels and payment structures, maturity dates, and the like. Negotiations often are needed to find the bond with the right characteristics.

In addition, issues should be sizable and issued fairly frequently. Dealers need financing to buy securities, finance securities held in inventory, and help settle brokered transactions—mainly short-term financing, but in sufficient amounts and at reasonable prices. Financing that is too difficult, unreliable, or expensive constrains the dealer’s ability to trade. In more developed markets, dealers typically finance their activities with long-term capital, repurchase agreements, and bank lines.

Dealers also need to be able to hedge their positions, particularly if they are official market makers required to quote “selling” positions to make a market. Liquid treasury bonds, repurchase agreements, short selling, bond-lending facilities, swaps, forwards, futures, and other derivatives are all potential hedging mechanisms.

Problems and Solutions

Some of the problems emerging markets face are technical and can be addressed if the government is willing to tackle them. Others are more structural in nature and often involve elements that are outside the control of the “inside” regulators, such as constraints on the issuer and investor base and macro-instability. These are more difficult to resolve and take more time to fix. Each country will have a different combination of pluses and minuses to address.

**Key Success Factors.** The key to success is to build market participation, secure government commitment, ensure macrostability, and eliminate tax disadvantages.
Building market participation. Issuers can be deterred from participating in the market by a lack of sufficient economic benefits, often due to regulations. The disclosure process may be too costly and onerous, the approval process may take too long (the SEC may ask for too much information and lack the skills to evaluate it), registration may be expensive, and/or listing costs may be high. When economic benefits are limited, issuers may be unwilling to lock in long-term rates. While locking in rates reduces interest rate risk, it has potential interest rate opportunity costs that issuers may be unwilling to “pay.”

Many of these problems can be dealt with by changing regulations in ways that do not sacrifice prudential standards. Regulators can keep regulations simple to make them easier for the regulated entity to comply and reduce approval delays caused by the regulator’s lack of experience. Removing unnecessary information disclosure requirements and consolidating approval processes under one regulator can speed up the issuance process, as can shelf registration by allowing companies to update existing information when making new issues.12

A more difficult issue, though, is the lack of sizable and profitable issuers. Equity markets can also face this problem,13 but it can be worse in bond markets because bonds need to be serviced and repaid, which means issuers have to be of a higher credit quality. Not every firm can meet periodic and ultimate obligations of a bond.

In most countries, issuers will have to come from the top credit category. Dropping below that level to build the issuer base can be a problem if the country does not offer enough diversified instruments and credit risks or some form of credit guarantee for the bonds. Local investors will be assuming risk they cannot diversify because of limited investment opportunities. Some argue that issu-

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12 Singh (chapter 8) notes that approval in Malaysia was taking four to six months because the process was fragmented across a number of entities—the central bank, registrar, and stock exchange if the bonds were listed. That is being rationalized and will likely end up under the SEC.

13 Many equity markets have hundreds of listings (usually from privatizations) and no capital raising or trading because the listed companies are not attractive to investors—because of poor corporate governance, lack of profits, lack of transparency, or other management and economic reasons.
ers should be allowed to issue with ratings that indicate their lower credit quality and let the investor decide/beware. This approach may work in particularly more experienced countries, but often investors buy the higher risk to get the higher return without fully understanding the risk/return trade-offs. Other times, they refuse to buy lower-quality paper, regardless of the return. It may take time to get to the point where lower-quality paper can be sold to knowing investors. In the meantime, countries will have to balance the desire to grow the market with the credit quality constraints of the issuer base.

Issues by foreign firms and supranationals can provide better quality paper to the market and help diversify credit quality. They also can create a demonstration effect (see chapter 5 by Mamta Shah), especially for foreign investors, and help introduce international standards and best practices to the market. They help establish a risk-free benchmark and provide a foundation off which other issuers can extend the yield curve. Shah argues that supranational issues will not necessarily crowd out local issues, but will likely enlarge the pie, allowing investors to diversify their portfolio risk, creating an appetite for local lower-rated bonds, and increasing investor comfort with local-currency investments. However, not all countries will have the option of letting supranationals issue in their local-currency markets, mainly because issuers will not be able to swap out of the currency.

Developing the investor base is one of the biggest impediments to market growth. Many countries do not have institutional investors, particularly pension funds and insurance companies, or are just introducing them. Many countries only have a handful of very large, conservative, and relatively inexperienced state-owned financial institutions, such as employee provident funds and insurance companies, that dwarf the market.

In addition, as seen throughout South and Southeast Asia, often institutional investors do not buy corporate bonds because their money

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14 Malaysia dealt with this problem by requiring issues to be rated (to create a credit-rating culture) and then only allowed investment-grade firms to issue. Now that its market is maturing somewhat, it is considering removing this restriction.
is tied up in government securities, which they buy and hold because of statutory liquidity requirements, or because they are afraid of taking credit risk. They may lack incentives to buy corporate paper because portfolio managers are penalized for incurring losses but are not rewarded for making gains; they are not judged against the market (that is, by whether they provide the “best” return); or there is no marking to market and unrealized gains and losses are not recognized. In other cases, whole ranges of investors are not serviced because distribution channels are weak or intermediaries do not know how to cultivate investors.

Some of these problems can be dealt with by providing investors with incentives to buy and trade securities, such as marking securities to market and evaluating portfolio managers against performance-based measurements. Requiring investors to mark the securities to market reduces incentives to hold paper, but may cause sizable losses for some investors, and so may have to be phased in over time.

Again, many of these problems depend on where a country is in developing its institutional investor base. Unless some move has been or is being made in this direction, market growth will be severely constrained. Retail investors alone usually cannot support the market’s growth. Countries often take a two-pronged attack to building this base. They improve operations at existing (often state-owned) institutions, implementing rules and incentives to encourage more professional management. At the same time, they encourage new private sector, professionally managed mutual funds and pension and insurance firms as this change usually has a quicker and stronger impact then the other.

Of the problems intermediaries face, one of the most difficult is how to make sufficient profits in the market, because capital requirements or financing costs may be high and revenues low (from low fees/spreads or low volume). Too many firms may be competing for too little business, splitting volumes and fees so no one can make money. Intermediaries may lack the skills to attract issuers and investors, and the tools to hedge market-making positions. Some countries allow only separately capitalized subsidiaries to conduct bond market activity. Some can only handle government securities, or corporate and government securities together, but not mixed with equity. This approach is thought to ensure focus, commitment, and
sufficient capital for the fixed-income business. But it can increase costs and make a business unprofitable.

Regulatory changes by “inside” regulators can help overcome such problems. The economic benefits of the business can be improved by having minimum and net capital requirements that meet prudential standards but are not unduly onerous. Many countries use a minimum capital requirement to “select” better capitalized firms for the business, but the amounts are not too high, and then a net capital rule that allows capital to grow with business activity. Sometimes the cost side is fine but the revenue side—underwriting fees, trading spreads, other fees—is too low. (Market makers need to be able to make spreads that compensate them for their risk.) Potential problems can be identified by creating an income statement for a typical securities firm to determine a firm’s ability to profit in the business, and then for the entire industry to determine how many firms can survive given revenue and costs structures and anticipated market-wide volumes for different business lines.

Another issue affecting economic benefits concerns how bond market intermediaries should be structured. A diversified securities firm that can conduct all facets of the securities business—primary and secondary markets for all debt and equity products, is most efficient since it reduces overhead costs and lets firms use their limited skilled personnel across a range of businesses. Most developed countries have diversified securities firms. Moreover, the skills and profits earned in the government securities business helps support the corporate business, and the two should not be separated. Mixing in the equity business can be handled with strong Chinese walls and appropriate supervision. When supervisors are weak, regulators can opt for dedicated capital for the fixed-income business.

As discussed later, these structural problems—which boil down to having enough of the right types of issuers and investors—take time to resolve. Countries may find that they simply have to grow slowly while these areas are being addressed.

*Government commitment.* Often the “inside” government is not convinced that building corporate bond markets is important, or it may want to build the market but cannot persuade the tax authorities or
the central bank to change policies that impede the market’s growth. In some respects, lack of government commitment from “inside” regulators, and perhaps “outside” regulators as well, is less of a problem today because the crises in Asia and Latin America have motivated more countries to develop these markets.

To develop a bond market, market participants (and advisors) will have to convince “inside” officials that the markets are needed. If “outside” regulations create problems, “inside” regulators will need to find ways to get around those regulations or work with “outside” regulators to change them. More and more emerging markets are setting up cross-regulator working groups for this reason (i.e., Malaysia and Korea). Many countries are creating a single regulator, which may eliminate some of these problems by establishing a broader-based regulatory consensus.

**Macrostability.** Though macrostability is increasing in many emerging markets, several still suffer from macro volatility or lack of credible policymaking. Crowding out remains a problem in many countries, as does political instability. A country that has significant political or macro instability and high interest rates may have one option for its bond market: local-currency floating-rate notes of medium maturity. Issuers and investors will be unwilling to lock in fixed rates or to commit to floating rates after a certain time period for fear that rates will move too much against them. Severe crowding out can altogether stop the market’s growth.

**Taxation** Many emerging market countries employ stamp, transaction, and income taxes, usually in ways that are disadvantageous to the bond market. The most striking examples are duties that favor bank products and are set by government bodies whose first priority is tax revenue, not bond market development. These impediments need to be eliminated, or they will prevent the market from ever starting. A neutral tax environment is preferable. This means removing a tax that favors another product rather than introducing a new tax incentive for bonds. It also means convincing the tax authorities to make these changes, perhaps by showing them how the market’s growth can generate other kinds of taxes (such as interest income) that may be less distortionary.
**Second-Layer Solutions.** The main issues “across” the financial system concern building benchmarks and compensating for weak or dominant banks.

**Government securities markets.** Most emerging market countries have little in the way of developed government securities markets. On the whole, these markets lack auction schedules, fungible issues, market pricing, and yield curves—often because governments are reluctant to create a market that will reduce their direct control over their funding costs and volumes. Secondary markets are usually illiquid. Governments often influence interest rates to control debt-financing costs. But if rates are set low, the securities will not trade because the underwriters (the primary dealers) will have to take a loss selling the bonds in the market.15 Dealers are not developed. As a result, the corporate bond market, and the dealer community, lack an important foundation.

It is generally accepted that government securities are the best benchmark for corporate bonds. Developed markets such as those in the United States have other alternatives, like top-quality corporates and swap rates. Some emerging market countries may have a few good-quality local or foreign corporate and supranational issuers. Even if these entities only issue bonds periodically, the issues can still serve that purpose, especially if they are large enough and have enough trading to create a current coupon. Other countries will not have these options. They may be able to use shorter-term treasuries (like three- to six-month paper) and other money market products that may be available to price medium-term, not longer-term, maturities or floating rate notes.

**Banks.** Many banking systems are weak and unable to support the corporate bond market, or they dominate the financial system, as issuers or intermediaries, in ways that hurt bond market develop-

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15 In chapter 6, Yongbeom Kim provides a useful overview of the reasons why the Korean government securities markets did not perform this benchmark role effectively and how nonmarket determined rates seriously hindered the market’s development.
ment. A good number buy and hold securities to meet statutory liquidity requirements. Others do so because net returns on securities are higher than on bank loans. Some use their political might to push for tax policies that protect them against bond markets.

If banks are weak, other firms must be available to issue, invest, or intermediate. If banks dominate the financial sector, their securities activities might be put in a separately capitalized subsidiary, and independent securities firms could be licensed. To get banks to invest in corporate bonds, marking to market and asset-liability management (ALM) requirements can be introduced. Special tax breaks should be avoided along with policies that drive banks from loans to bonds, as banks may see the bonds as loan substitutes to buy and hold, not portfolio products. Banks should be active, not wholly passive, investors.

Credit-rating agencies. In many emerging market countries, new credit-rating agencies have difficulty making profits and becoming economically viable. Some countries (such as China and Pakistan) make ratings mandatory in some form or another to ensure economic sustainability and to build a ratings culture. Having credit-rating agencies do various lines of business, such as rating the issuer as well as the issue and doing broadly based market research on industries and companies, also helps provide a livelihood. The question of how many agencies to have depends on local circumstances. Competition is good, but so is survival. If the volume of business cannot support two agencies, then rely on one. It is important not to overestimate a rating agency’s impact on market growth. A credit-rating agency will not spur market growth significantly. Its absence is an obstacle but its presence will not in and of itself be a spark.

Creating Liquidity. Creating liquidity is a serious problem in emerging markets. Some constraints stem from market infrastructure, particularly the trading system used, but the main ones relate to the size, structure, and capabilities of issuers, investors, and intermediaries.

As for trading systems, many emerging market countries want to use their existing stock exchange to list and trade bonds because they do not want to create redundant infrastructure. But stock exchanges usually have order-driven systems; over-the-counter (OTC)
markets usually rely on quote-driven trading. Countries that do not want to make the stock exchange redundant can combine listing on the exchange with trading OTC. This is often done in developed markets when investors such as pension funds can only invest in listed securities for prudential/disclosure reasons.16 Or the exchange may be allowed to have a separate bond-trading system. If countries are willing to have an OTC market but are concerned about not having enough regulation, they can have a regulated OTC market, with listing, membership, and trading rules. Several countries, Australia is one, are working to develop centralized trading systems for OTC trades to increase market transparency and regulation.

On the issuer side, issuers rarely meet the required criteria for liquidity. Most corporate bonds are not issued frequently or in large sizes, and so have limited trading ability.17 As for investors, dealers need a diversified and sometimes active investor base to buy and sell with. They cannot just trade among themselves. Again, marking to market and judging portfolio managers against the market’s performance can encourage reasonable trading by investors.

Many emerging markets lack financing and hedging tools or discourage their use, sometimes through taxation. According to Singh, trading in Malaysia is constrained by limited RP facilities, many of which are restricted to purely principal dealers. That, in turn, limits wider market participation and increases the cost of risk management and transactions. Kim notes that Korea does not have repurchase agreements (RPs), partly because of tax problems. Dealers rely on high-cost call market funds. There also is no short selling, so

16 A similar issue concerns whether to use existing clearing, settlement, and depositories (CSDs) and add a bond module. The trend worldwide, and in many emerging markets, is to have one CSD that clears and settles for a range of markets, rather than following the U.S. multiple-CSD model, wherein one or two exchanges have their own clearing corporations. Consolidation has important benefits: notably, reduced overhead and better netting. Indeed, the major CSDs for government and equity securities recently merged in the United States. Malaysia is considering consolidating its clearing and settlement systems into one. One problem is that CSDs are often owned by the local exchange, so the questions of where to trade and where to clear and settle become intertwined. Some countries are separating the CSD from the stock exchange so the CSD can serve more markets.

17 Endo.
dealers must own bonds for sale and finance them, which raises financing costs and impedes trading. (Both constraints may be removed in the near future to increase liquidity.) Bank lines are often expensive, partly because brokers are less-known institutions and not so highly regarded.

These problems are common in many emerging markets but can be rectified. RPs are frequently allowed, even in many emerging markets. (Activities such as RPs and short selling are usually not regulated or taxed in ways that distort the market.) They can start with government securities, since these are the most liquid instruments, and need mechanisms such as a central depository to ensure that securities are not double-pledged as collateral, and standardized agreements. Banks will be active in the business, so RPs/Reverse RPs (RRPs) should not be considered a loan or deposit, to avoid expensive capital or reserve requirements. Most emerging market countries worry about introducing short selling because it can promote speculation. To address this concern, some countries—among them, Hong Kong—only allow dealers/market makers to short-sell to make sure they can provide liquidity. Note that derivatives require sufficiently active underlying cash markets and skilled dealers, which will influence when they should be introduced.

As noted earlier, a local government securities market can help develop dynamic and profitable dealers, because primary dealers (PDs) for government securities often get preferential financing, profits, skills, and credibility. These benefits illustrate why it makes sense for the government and corporate bond businesses to be conducted under one roof (see the earlier discussion on intermediaries).

DEVELOPING THE MARKET IN STAGES

Most countries will have numerous pieces missing for building their bond markets and will want to know what steps they should take to

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18 RPs are less common in the corporate market, mainly because corporate bonds are less liquid and not eligible for reserve requirements, which limits their attractiveness to many buyers. But countries rarely have explicit regulatory bans on corporate RPs.
build their market, not just where they need to end up. Steps are hard to map out, since no two countries will have the same combination of pluses and minuses and political and behavioral conditions. Few emerging market countries provide extensive examples yet. Below are some very general guidelines.

To start, each country will have to ask itself: What are my problems and how and when can they be solved? That question should be asked repeatedly over the years as it will help determine what types of activities can be supported at different points in time. The structure, abilities, and attitudes of market participants will influence significantly what can be built and when. If issuers are limited in number, size, and profitability, the chances of building an active secondary market are slim. The same is true for the investor base. The goal then should be to create a well-functioning primary market. It could be a public or a private placement market. In either case, issuers should have to disclose sufficient information for an investor to evaluate the issuer’s credit quality. The macro environment and the state of the government securities market, particularly whether pricing benchmarks exist, might influence the type of products that can be introduced—that is, longer-term, fixed rate securities or medium-term, floating rate paper.

Stages of Change

By and large, countries might move through three general stages. Stage I consists of doing one-off transactions — where an issuer needs local-currency, long-term funding or an investor needs a long-term investor and they get matched up in a limited private placement market. It occurs in a country with limited issuers and investors, relatively unskilled intermediaries, and relatively undeveloped capital markets. Government securities markets are essentially undeveloped. The banking system is likely to be quite weak but dominant. This country cannot support a strong primary, much less a secondary, market in the immediate to medium term. Intermediaries would be needed to broker the deal along with such things as contract law, private placement and basic disclosure regulations, and mechanisms to register ownership and pay for funds. Setting prices would be a problem, as there will be no benchmarks. The issuer and investor
may want to limit the maturity and use floating rates because both parties are afraid to lock in rates without benchmarks. The transaction may be more expensive than a public offering but may be the only way to obtain longer-term local currency for the time being—thereby reducing some refunding and currency risk but retaining interest rate risk.

Stage II involves building a good primary market for public as well as privately placed issues. It takes place in a country that has several attractive issuers, a growing but still limited investor base, developing capital markets, and fairly good macro-political environment. The country would need public company and disclosure regulations, a credit-rating agency, and OTC arrangements to support trading that might be done with the public issues. Having a benchmark, even a limited one, would be useful and important for pricing slightly longer maturities.

Stage III involves adding on secondary markets. The country must have sufficient issuers and investors and skilled intermediaries, along with a supportive macroenvironment. A government securities market is being built that provides a foundation for pricing new issues, as might other elements of the financial system. The credit-rating agency must be able to handle a larger number of issues. Though issuers will still be of higher credit quality, some of slightly lower credit quality will be able to enter the market as well. Efforts should continue to build institutional investors, and to ensure that they are able to invest in bonds by removing unnecessary constraints on investment patterns. Disclosure rules may have to be strengthened as the investor base may broaden beyond the largest institutional investors. Considerable training is needed to educate all persons involved (regulators as well as market participants) about the benefits and risks of the product, and of participating in the market.

**Accelerating the Transition Process**

As noted earlier, some problems are not so difficult to address; they just need to be identified. Three steps can be taken to assist the process. First, regulators can work closely with market participants to understand their perspective on the pluses and minuses of the market. Walking through a transaction with an issuer or an investment
with an investor can help clarify problems—whether they concern fees, capital, the lack of incentives, attitudes, or skills. Prudential goals need not be sacrificed for business attractiveness. In some cases, the government may just need to recognize that its requirements are unnecessarily strenuous and make the business unattractive. Working groups should be set up to facilitate this exchange, and to strategize about how the market should move forward. Second, “demonstration” bond issues by domestic and/or foreign entities should be encouraged, since they powerfully demonstrate how to conduct a transaction and the benefits and difficulties it entails. Third, “inside” regulations should work closely with other regulators to get them to solve problems under their control. Cross-regulator working groups and dialogues can facilitate “outside” government commitment to the process and build support for changing policies and regulations around or across from the bond market. Many emerging market countries are setting up these cross-regulator working groups. Many are also creating a single regulator, which may help eliminate some of these problems and establish more similar goals. Finally, all countries should look at the experience of others with emerging markets for information on how to solve problems and what works best in different types of conditions. This experience is accumulating with time.19

Some countries provide considerable tax incentives to increase the economic benefits. We would suggest identifying the full range of obstructions to market participation before “pushing” on the economic benefits, since they can distort tax and other structures in ways that are difficult to remove later on. These distortions may be avoided, if other problems are addressed.

THE SITUATION IN SOUTH ASIA

This “around, across, and inside” approach was used to identify issues in developing bond markets in South Asia. Not surprisingly,

19 Often changes need to be taken opportunistically, given that so many factors are involved. It is difficult if not impossible to follow a predetermined sequence of steps, and countries that try may miss key opportunities for moving forward.
each country of the region could benefit from bond financing, particularly India, Sri Lanka, and Pakistan, but also Bangladesh and to a small extent Nepal. Also not surprisingly, each country is in a different stage of development with different problems, needs, and mixes of pluses and minuses, as discussed in the South Asia country surveys in Chapters 11 through 15.

India, Sri Lanka, and to a lesser extent Pakistan, are actively working to build these markets. Bangladesh has taken a few steps. Each country has different reasons for wanting a bond market, but in each case some need stems from the banking system’s inability to support funding requirements. Bank lending in Sri Lanka, Pakistan, Bangladesh, and Nepal is constrained, to varying degrees, by portfolio-quality problems. At the same time, demand for funds is rising from the private sector and state-owned enterprises, because the government cannot go on funding the entities out of their budgets.

India has large infrastructure financing needs, and its banks cannot support the structures and volumes required. Sri Lankan banks dominate the financial system and competitive alternatives are needed. Financial sector diversification is a goal (almost all of the country’s investible funds are in bank deposits and government securities), as is corporate risk management though it is a weaker force than in Southeast Asia (but it is indeed a prominent concern in Sri Lanka). More generally and to varying degrees, the countries are shifting to more market-oriented economies and must increase private sector funding sources.

Except for Nepal, each of the five countries has some form of corporate bond market, but only India has one of any size. Trading is virtually nonexistent across the region. Several of the countries, including India, have only private placement markets. Many issuers are state-owned enterprises, even in India. Nonetheless, markets in India, Sri Lanka, and Pakistan are growing.

If we evaluate the countries by their success factors, based on the preliminary surveys included in this book, we can say that they fall into one of the three stages identified earlier.

*India is in Stage III.* It is on the way to developing active primary and secondary markets. The government and private sector are
working to identify and overcome impediments, particularly technical ones that constrain issuance and liquidity. Significant steps have been taken to build the government bond market, and the corporate market as well. Recent removal of the stamp duty on bond issuance and trading is expected to heighten corporate bond market activity.

Sri Lanka and Pakistan may be in Stage II. The development of the bond market, particularly the government securities market, is a priority in Sri Lanka, which is currently focusing on improving rules and regulations, central market infrastructure, and a dealer community. The markets will likely be small, because of the small size of the issuer and investor base and the overall economy, and hence take time to develop. Pakistan’s recently reactivated corporate bond market is tiny, may be constrained by extensive government borrowing and political instability, lacks key market infrastructure, and has a limited issuer and investor base. But the government is taking measures to make the market more attractive. Overall, Pakistan might focus on creating a solid public primary market.

Bangladesh and Nepal are in Stage I. Bangladesh needs new funding sources, as bank financing and foreign aid are declining, but as Kvibäck describes in Chapter 14, market growth will be seriously constrained by a limited issuer and investor base and a weak banking sector. Bangladesh might create a small private placement market. Nepal lacks market participants and has extensive macro and broader financial sector problems. It might be able to create a very limited private placement market over time.

The Status of Key Success Factors

India clearly has the strongest range of key success factors, and supplementing factors as well. Sri Lanka comes second, followed by Pakistan.

Market Participants. Except for India, the countries have very limited sizable issuers and investors; in addition, intermediaries need to develop their skills in bond market transactions. As a result, corporate bond markets in each of those countries are likely to grow slowly.

India does not seem to have a problem with potential issuers (see chapter 10 by Rakesh Mohan). The economy is growing, creat-
ing new and stronger companies. Sri Lanka’s issuer base is small, but Königson (see chapter 13) sees a sufficient range of companies to support a small market. Bangladesh and Nepal as well are constrained because their economies have a lot of very small agricultural and/or garment companies that are not appropriate for bond issuance. All of the countries have slow privatization programs, which limit the supply of new firms to the market.

Most of the countries suffer from regulatory burdens that constrain issuers (issuance costs are high, approval processes are long, and stamp duties remain in effect). India, Sri Lanka, and Pakistan are working to fix these impediments. India and Pakistan are reducing obstacles such as long approval processes. India plans to have a 144A-type private placement market for its corporate bond market, which means less onerous disclosure. The Karachi Stock Exchange (KSE) recently organized a committee of market participants and KSE and SEC officials to identify and address issuance-related problems and plans to reduce costs.

A similar story can be told for the investor side. Market participants buy and hold a lot of government securities because of investment regulations and lack of trading experience and incentives. This is not surprising, since each country is emerging from a situation of high government borrowing financed mainly by pushing paper into state-owned financial institutions. India, Sri Lanka, and Pakistan are taking concrete measures to create more dynamic investors.

India has by far the most diversified and sizable range of institutional investors. It has many large, government-owned financial institutions, but private sector mutual funds, insurance companies, and pension funds are growing, which will generate more funds to be invested and traded actively. Sri Lanka’s investor base is also driven by large buy-and-hold institutional investors who have been captive in government securities. Königson reports that the government is liberalizing investment policies—for instance, for long-term investors such as insurance companies and for unit trusts—and is opening new markets for pension funds.

Pakistan’s institutional investors are limited to mainly banks, and there is modest knowledge of debt markets at both the retail and wholesale levels. Leonardo (chapter 12) notes that several obstacles
remain, most notably, disadvantageous tax policies for provident funds and a history of corporate bond defaults. But, like its neighbors, Pakistan is looking to liberalize investment policies (for provident funds), and mutual funds and portfolio management skills are improving somewhat. Both Bangladesh and Nepal are less developed in this area.

For intermediaries, the government securities market in India and Sri Lanka is helping to create a class of skilled dealers that could help support the corporate bond market.\textsuperscript{20} To varying degrees, they still need to improve their skills in fixed income securities, particularly as markets like India’s become more sophisticated. The ability to make profits may be a problem in Sri Lanka because the government is splitting the government and corporate securities businesses. (Primary dealers cannot engage in the corporate securities business while non-PDs cannot trade government bonds.) Financing and hedging is another problem, as explained in the section on second-layer factors.

\textbf{Government Commitment.} The government’s commitment to change and its actions in this regard are among the most positive features in India and Sri Lanka, and to a lesser but increasing extent in Pakistan. Bangladesh is interested in developing bond financing and is looking at steps to help develop the primary market. Nepal is also interested but in many respects has more pressing issues on which to focus. India, Sri Lanka, and Pakistan in particular have created working groups between the government and market participants and with other regulators to identify problems and solutions.

\textbf{Macroeconomic Environment:} The macroeconomic and policy environment in South Asia supports bond market development in some respects and in some countries. To varying degrees, each of the five countries has been shifting to a more market-oriented, less government-controlled economy, a shift that has been slower than in many other parts of the world.

\textsuperscript{20} India has a solid core of intermediaries affiliated with major foreign firms such as Goldman Sachs, Merrill Lynch, and ABN Amro.
The real GDP in the countries as a group has been growing at a healthy pace and is projected to continue climbing at about 5 to 6 percent a year between 1997 and 2006. Savings rates are relatively high (see table 2), except in Nepal and Pakistan. In addition, inflation and exchange rates are stable, and interest rates have been declining over the past several years. At the same time, the countries have relatively high deficits as a percentage of GDP, and crowding out may be a problem—reflecting the strong role played by the government in each of the countries. This, too, is expected to decline as the governments reduce their involvement in commercial activities.

Not surprisingly, the statistics for financial sector structure show considerable room for developing corporate bond markets as another financing vehicle. The size of bond financing relative to GDP is tiny compared with other countries in the world and compared with other financial resources in each country. (Sri Lanka and Pakistan also suffer from some political instability—the war in Sri Lanka and a fairly recent coup in Pakistan.)

**Taxation.** Several of the countries have been reducing stamp duties and other taxation that negatively affects bond markets.

**Second-Layer Factors**

The strongest point here is that India and Sri Lanka, and now Pakistan, are working to develop their local government bond markets in ways that will help support development of the local corporate bond market.

**Government Securities Market.** All five countries have some sort of government bond market, which is an outgrowth of the strong role played by the government in each country. India’s market is by far the largest in absolute terms and is furthest along in its development.

India and Sri Lanka have been strengthening their primary markets in the past two to three years to make them more market oriented, competitive, and liquid. India’s primary market is large, and a primary dealer community has been introduced, along with new instruments, a wider range of maturities, and an expanding yield curve.
Today’s focus is on improving liquidity (trading value is high but volume is low) with better trading, financing, and hedging mechanisms. India also has new regulations requiring banks to mark securities to market and meet new asset-liability management guidelines that will encourage banks to manage their portfolios in ways that will contribute to market activity. Sri Lanka also is strengthening its primary dealers but, as Konigson notes, needs to build a more market-oriented yield curve and to improve trading, clearing, and settlement infrastructure. The government has rescinded stamp duties on RPs to encourage trading.

The other three markets have relatively undeveloped primary markets and essentially no trading. Pakistan’s market is fragmented, with a wholesale and a retail segment and sizable rate distortions between the two. Interest rates are high, often not market determined, and there is no real yield curve or market makers. Trading is limited (retail securities, the bulk of offerings, cannot be traded) and is done primarily by local banks for liquidity management. Bangladesh’s market is small and undeveloped, with essentially no yield curve and intermediaries with limited skills and profits. It consists mainly of long-term savings certificates with high interest rates. Only rates for T-bills are market oriented. Nepal’s market has market-oriented T-bills, but all other securities are controlled by the central bank. A small network of dealers does marketing, but not market making.

**Banking Sector.** As might be expected, banks dominate the financial systems in these countries, so their ability to be lenders, intermedia-

### Table 3. Fixed Income Markets to GDP

<table>
<thead>
<tr>
<th>Country</th>
<th>Government Securities Outstanding/GDP (%)</th>
<th>Corporate Securities Outstanding/GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>18.5 (NA)</td>
<td>8.30 (8.0)</td>
</tr>
<tr>
<td>Pakistan</td>
<td>9.9 (5.2)</td>
<td>0.5 (0.5)</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>17.0 (5.0)</td>
<td>0.6</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>6.0 (1.0)</td>
<td>0.2</td>
</tr>
<tr>
<td>Nepal</td>
<td>14.9 (9.3)</td>
<td>NA</td>
</tr>
</tbody>
</table>

* Sri Lanka has outstanding government securities worth 44% of GDP, but only the amount noted above is negotiable.

Source: South Asia country surveys and symposium presentations.
aries, investors, and issuers affects market development. Where markets exist, the banks are significant investors but tend to buy and hold. Banks are sizable issuers, particularly in Sri Lanka, where they have been the largest bond issuers in the past few years to obtain Tier 2 capital, and they dominate as intermediaries. Bangladesh and Nepal both have weak banking systems and limited numbers of other issuers, investors, and intermediaries to take their place, which will constrain market growth.

Central Market Infrastructure. India, Pakistan, and very recently Sri Lanka, have established credit-rating entities. India has four agencies, one that is viewed as dominant and Pakistan has two CRAs (introduced prematurely, perhaps). There are no rating agencies in Bangladesh or Nepal.

Creating Liquidity

Liquidity is a problem in the corporate bond markets of all five countries because of the structure of the issuer and investor bases, limited issuance, and lack of financing and hedging tools for intermediaries. These elements are being worked on in India and Sri Lanka, and to a lesser extent in Pakistan.

In terms of trading mechanisms, Sri Lanka and Pakistan (Bangladesh as well) are promoting bond listing and trading on their order-driven stock exchanges, particularly through special tax treatment, which might constrain market liquidity. India, on the other hand, does not want to use the National Stock Exchange’s order matching system to trade bonds, but instead plans to use the NSE as a reporting system—to quote bids and offers and then confirmed trades.

The structure of the issuer and investor bases was discussed earlier. In India, the stamp duty has been a constraint on corporate bond trading but was recently removed. Prospects for trading are good in India because there are many large-scale issuers who may need funds on a regular basis. Prospects in Sri Lanka may be more limited owing to the small size and number of the corporations.

Again, the fact that government markets are growing in India and Sri Lanka will help create a more active dealer community that
will learn about trading. Financing and hedging tools are a constraint in all of the markets, but India, Sri Lanka, and to some extent Pakistan are working on these. More work needs to be done if the dealers in the government and the corporate markets are to perform well. India has an active RP market, has introduced forward rate agreements and interest rate swaps, and is considering introducing short selling. Sri Lanka plans to introduce short selling. Konigson notes, however, that dealers in the corporate bond market may find it difficult to hedge their transactions because they are not allowed to also trade government securities. Pakistan does not have short selling, but does have RPs.

CONCLUSION

Emerging market countries can benefit from having local-currency fixed-income markets. These markets can reduce risks and help prevent or absorb crises caused by international financial flows and increased volatility that comes from having more open, liberalized financial markets and economies. But active markets can only develop in certain conditions: above all, they need suitable issuers and investors, and an environment that makes those parties interested in transacting in the market. This chapter briefly touched on the key elements needed. It suggests that the conditions needed have yet to appear in many emerging market countries. Although such countries will still want to benefit from the risk reduction and diversification that bonds offer, they may have to do so in limited ways to start, expanding the market over time as conditions improve.

These conditions, it must be emphasized, are not only technical. Many require a change in attitude and behaviours. Others are controlled by government bodies that are not interested in building bond markets. These factors complicate the process considerably. Clearly, “inside” regulators and market participants need to look at the overall situation and realistically assess the problems that exist and how to address them. In this way, they will better gauge what can be built and when.

The five South Asian countries span the spectrum of stages of development: at one extreme, India is on the way to developing ac-
tive primary and secondary markets; at the other extreme, Nepal has a considerable way to go on the path of development before it can really consider creating bond markets. The other three countries—Sri Lanka, Pakistan, and Bangladesh—lie in between. The country surveys in this volume offer specific recommendations concerning what might be done to move forward in each country.

It is encouraging that many of the “inside” regulators in South Asia are working with market participants and with other regulators to identify obstacles to market development and how to fix them. That is a useful exchange of information, not only for bond markets, but for overall economic change.