Keeping it Local: A Secure and Stable Way to Access Financing

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Paychecks for teachers, new hospital equipment, social assistance programs, and other public expenditures. All depend to large extent on governments' ability to fund them. When governments—particularly those in emerging and developing economies—need money to pay these and other goods and services, they often turn to bond markets, where they interact with investors seeking to buy government bonds.

But borrowing in foreign currencies in international bond markets can leave these countries exposed to volatile exchange-rate movements. To avoid risks from currency fluctuations, many have invested large resources in recent years to develop local-currency government bond markets.

These bond markets can have a wide range of benefits. They can form the basis of a robust financial system to support growth, and the productive use and allocation of savings. They can help finance budget deficits in a non-inflationary way. And they can facilitate cutting taxes in tough economic times and support the use of other countercyclical fiscal policy measures. A local-currency bond market can also make an economy more resilient to sudden movements in foreign capital flows.

Moreover, local-currency bond markets can support effective monetary policy and act as an important information source for policymakers. They serve as the cornerstone of the development of domestic financial markets by providing risk-free benchmark rates. When they are developed, these markets become more stable and less risky sources of funding—an important factor in making debt more sustainable.

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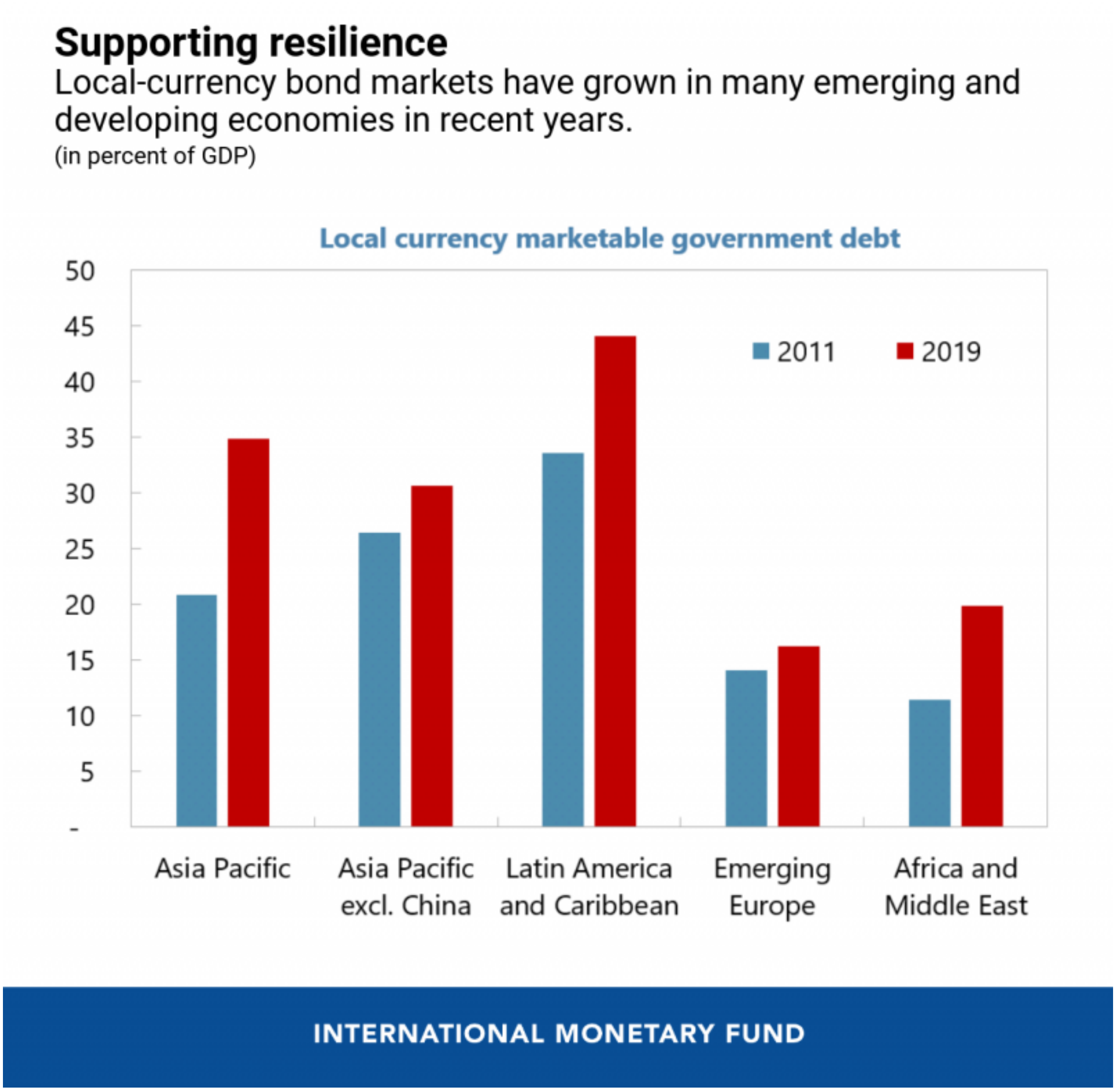

Developing the markets, one at a time

Local-currency bond markets have grown in many emerging and developing economies in recent years. Yet considerable potential exists to further deepen these markets. Unfortunately, there is no well-defined "recipe" for developing a local-currency bond market given the varying needs of each country. However, there are some common principles.

Establishing and developing domestic debt markets is a long and complex process, requiring multiple and interdependent policy actions. Along the way, benefits and risks for macroeconomic and financial stability need to be addressed.

Against this background, the new *Guidance Note for Developing Local Currency Bond Markets* addresses these policy issues—by providing comprehensive, systematic, and practical solutions. The Guidance Note was developed jointly by IMF and World Bank staff with support from the Financial Sector Reform and Strengthening Initiative—a collaborative partnership seeking to strengthen various parts of the financial system.

The Guidance Note presents a systematic roadmap for policymakers conducting analysis of emerging and developing economies local currency bond markets. The Note identifies six key building blocks of development: (i) money market, (ii) primary market, (iii) investor base, (iv) secondary market, (v) financial market infrastructure, and (vi) the legal and regulatory framework. It also presents *enabling conditions*, for market development.

In addition, the Note makes the following contributions:

- **An indicator-based diagnostic framework based on specific questions and a simple scoring system.** Once applied, the framework grades each country in terms of the various dimensions of successful development of local currency bond markets. Corresponding development gaps and priorities can be readily identified and compared with peers to inform solutions.
- **A catalogue of common problems and solutions to key aspects of local currency bond market development.** Most problems, such as the fragmentation of the market, with the existence of a large number of instruments, have well established remedies, such as the issuance of benchmark securities by reopening previously issued instruments.
- **A guide for designing market reform plans.** The guide considers political economy issues and interactions among reforms, such as central bank operational autonomy and coordination arrangements with the debt management office.

Feeding into capacity-development work

The diagnostic framework presented in the Guidance Note offers a simple and systematic approach that countries can use to assess development levels of their markets, identify problems, and monitor progress as policies are implemented. At the same time, the findings gleaned from the application of the framework can help shape the delivery of related capacity-development work in these countries.

Together with country authorities and other international financial institutions, a financial sector development strategy could be drawn up or updated—following on the work of the Financial Sector Reform and Strengthening Initiative—and mapped into IMF and World Bank work aimed at sharing knowledge and building skills among officials in emerging and developing economies.

Integrating market development into policy advice

The Guidance Note can also be helpful to better inform policy recommendations across the IMF's and World Bank's core areas of work, including fiscal and monetary policy, financial stability, capital market development, management of foreign flows, business cycles, and economic growth.

In many cases, a wide spectrum of reforms is needed to help develop local currency bond markets, and often careful consideration is needed to determine optimal sequencing and timing of the reforms. The IMF and World Bank are ready to play a catalytic role in helping coordinate the reforms through their regular monitoring of economic and financial conditions, as well as their ongoing dialogue with fiscal and monetary authorities.