



Economic Premise

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Long-Term Finance in EMEs: Navigating between Risks and Policy Choices

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Emerging market economies (EMEs) are making important strides in developing long-term finance capital market vehicles to support investment in strategic areas such as infrastructure. However, since last year, EMEs have suffered from big shifts in terms of market sentiment. While EMEs' prospects were clearly overhyped in the wake of the crisis, the bleak forecasts that dominated headlines in the second half of last year were similarly exaggerated. There are still a number of factors indicating that EMEs' role in the global economy will continue to grow—just not as rapidly or dramatically as previously thought.

There are two main reasons for the shifting market sentiment regarding EME assets. First, there is the fact that the broad-based growth slowdown in EMEs that began last year apparently reflects underlying fragilities. The previous enthusiasm regarding EMEs' growth prospects stemmed from the perception that they had some postcrisis avenues of opportunity, regardless of the feeble recovery in advanced economies (Canuto, García-Kilroy, and Silva 2010). Healthy public and private balance sheets in the aftermath of the crisis and existing infrastructure bottlenecks would provide room for increased investment and higher total factor productivity in many developing countries; technological convergence and transfer of surplus labor to more productive tradable activities could continue, despite advanced economies' anemic growth; rapidly growing middle classes across the developing world would constitute a new source of demand; and, with their share of global gross domestic product (GDP) increasing, developing countries would sustain relative demand for commodities, thereby preventing prices from reverting to the low levels that prevailed in the 1980s and 1990s.

Nevertheless, EMEs' motivation to transform their growth models to explore those opportunities was weaker than expected. The global economic environment—character-

ized by massive amounts of liquidity and low interest rates because of unconventional monetary policy in advanced economies—led most EMEs to use their policy space to build up existing drivers of growth, rather than develop new ones. After a postshock, fast recovery, growth returns have dwindled, while imbalances in several EMEs have worsened (Canuto 2013a).

The second reason for shifting sentiment on EME assets has been a change of perspectives regarding the recoveries of advanced economies, particularly that of the United States, which is now deemed to be steadier than at any time since 2008. While such a scenario change entails rising prospects for exports from EMEs, it also points to normalization of the U.S. monetary policy and thus to tighter external financial conditions for those economies that do not address rising imbalances in due time. While growth prospects are still dim in the eurozone, and the European Central Bank has announced a round of unconventional policies, there has been a steady flow of resources into its sovereign debt market.

In fact, two bouts of volatility and downward adjustment of exposure to emerging markets since last year can be traced back to those factors. First, a global portfolio rebalancing was put in motion during the summer of 2013, fol-

lowing talk of the U.S. Federal Reserve shrinking—and eventually reversing—its asset purchase program (QE, or quantitative easing), a policy change that began to be effectively implemented in December (Canuto 2013b). Second, news last January about the increased possibility of a disorderly unwinding of China’s shadow banking over-leverage of latter years, associated with a burst in domestic property markets, led to a further worsening of risk-return prospects for assets in other EMEs vulnerable to a significant growth deceleration in China (Canuto 2014). Policy responses—higher interest rates, exchange rate devaluations—on the side of those countries most affected in both stressful situations have been followed by relatively stable capital flows since then.

Emerging and developing economies as a group continue to show strong growth, lower than before the crisis, but high nevertheless. The World Bank forecasts their growth to remain below 5 percent this year, but reaching 5.4 and 5.5 percent in 2015 and 2016—broadly in line with predicted potential. These economies will have to cope, however, with a changing world environment. With tighter financial conditions and a tougher financial environment, foreign investors will become more attentive to country-specific vulnerabilities, and macroeconomic weaknesses will become more costly. Financial bumps, such as those two bouts of volatility since last year, may certainly take place again. Furthermore, unless the exhaustion of old growth patterns is recognized and the needed structural reforms to enable exploration of new opportunities are pursued, EMEs will fall short from fulfilling their potential as the global economy’s main engines of growth.

Prospects for Long-Term Financing via Capital Markets

Greater susceptibility to shifts in market sentiment can weigh down EMEs in the process of developing long-term financing via capital markets. EMEs’ local currency bonds,

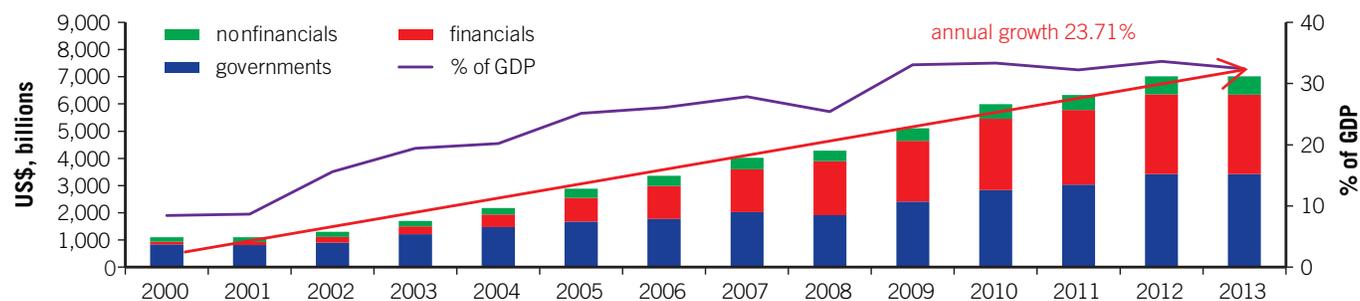
in particular, have been one of the fastest growing assets classes in the world, with average annual growth close to 24 percent in the last 13 years (figure 1). More than 80 percent of emerging market government debt is currently financed in local currency, and maturities are being extended up to or beyond 10 years in countries such as Brazil, Turkey, Mexico and Poland, providing “risk-free” price references that facilitate issuances by corporate sector institutions. Nevertheless, the gap in the development of bond markets between advanced and emerging economies remains wide. The risk is that changing conditions may stall the progress of EME bond markets.

Large and frequent swings in investor sentiment are important, but not the only concern in EME bond markets. Investors are facing larger spreads to trade and market turnover is far below the peak reached in 2010 (IIF 2014). Two causes are potentially structural: (i) stricter regulatory constraints, leading market makers to reduce their inventories, and (ii) growing participation of buy-and-hold domestic institutional investors. Larger insurance and pension fund industries in some EMEs are enhancing opportunities for long-term financing (discussed later), but the overall drop in liquidity emphasizes the need for a policy agenda to keep EME bond market development on track and to mitigate risks of “disorderly adjustments” in those EME bond markets.

On the side of government, bond market countries should focus on crisis response preparedness and on measures to support liquidity. A rich set of measures were adopted by EME governments to contain funding pressures and volatile secondary markets during the market turbulence of 2008–9 (Anderson, Silva, and Velandia-Rubiano 2013). Policy makers could draw on these experiences and build contingent plans to withstand similar shocks in the future. Secondary market liquidity could be fostered by:

- i. implementing issuance programs that reduce debt fragmentation and concentrate debt in larger benchmark instruments;

Figure 1. Outstanding EME Domestic Debt Securities by Type of Issuers



Source: BIS table 16.

Notes: EM countries included: East Asia—China, Indonesia, Malaysia, the Philippines, Thailand; Europe/Central Asia—Croatia, Hungary, Poland, Russian Federation, Turkey; Latin America—Argentina, Brazil, Chile, Colombia, Mexico, Peru; South Asia—India, Pakistan; Middle East/Africa—Saudi Arabia and South Africa. The 2013 is September, 2013. GDP is from IMF WEO October 2013.

- ii. aligning incentives of primary dealers to quote firm and competitive bid and ask prices;
- iii. developing repo markets and securities lending facilities to help market makers finance and cover their positions; and
- iv. improving secondary market architecture, including the effective design of electronic trading systems that could lead to enhanced liquidity and price discovery.

On the nongovernment bond market agenda, the main challenges are to broaden access to a wider variety of issuers and attract a diversified investor base. Significant efforts are underway to simplify securities offering procedures and minimize time and financial costs for issuers while also providing adequate disclosure to investors in countries like India, Malaysia, and Thailand. But more needs to be done. For example, greater availability and use of credit enhancement tools and securitization could amplify the breadth products and issuers, and (innovative) solutions for liquidity support, such as more effective market-making schemes, could help bonds attract a diversified group of investors.

The good news is that these agendas are in progress in several countries. Approximately 80–90 percent of the demand for World Bank advisory services in government

bond markets involves at least one of the items discussed here. Countries such as Morocco and South Africa are making substantial progress in their secondary market architecture. Similarly, countries are studying liquidity support mechanisms (Brazil) and improving regulations for securitization (Turkey), whereas multilaterals and governments are providing a wider set of guarantees and credit enhancements.

Financing Infrastructure

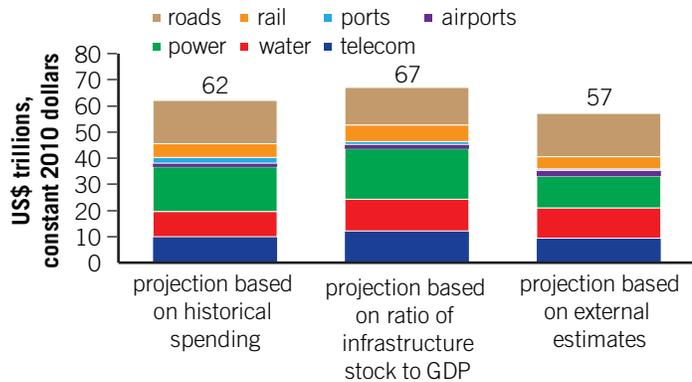
EMEs' potential to change their growth models relies heavily on their capacity to close their growing infrastructure gaps. Globally, it is estimated that infrastructure investment needs by 2030 range between US\$57–67 trillion (figure 2), of which EME requirements account for around 37 percent. Most of these investments are required for energy generation, roads and telecommunications, all of which are essential to support growth, competitiveness, and job creation.

EMEs are facing twin challenges: how to develop these projects into bankable structures and how to access long-term funding in the postcrisis era. Traditional funding sources from governments and commercial banks, while still relevant, are retrenching due to postcrisis tighter fiscal constraints and more conservative prudential regulations for banks (shorter maturities and lower risk tolerance), following Basel III. Additionally, lending from foreign banks has declined significantly since 2007, and this trend is not expected to reverse (Canuto 2013c).

In this context, EMEs need to tap new sources for long-term funding. Foreign capital is still flowing into EMEs debt (figure 3), but it is doubtful that it will be the dominant player in infrastructure finance, given perceived risks and competition for infrastructure investments in their home (advanced) economies.

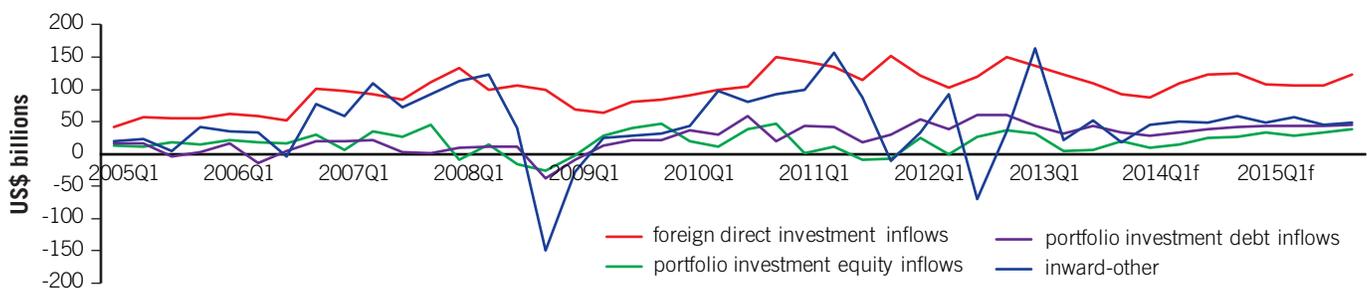
Nevertheless, EMEs have been gradually building their own pool of sizeable long-term assets managed by institutional investors, mainly pension funds and insurance companies, totaling around US\$5.5 trillion as of end 2012 (figure 4). Infrastructure assets are ideal investments for pension funds

Figure 2. Estimates of Needed Infrastructure Investments, 2013–30



Source: Dobbs et al. 2013.

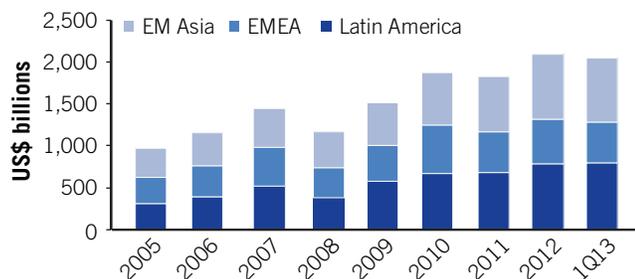
Figure 3. Capital Inflows to EMEs



Source: IIFCountry sample: BRICS, Turkey, Mexico, Chile, Poland, and Indonesia.

Note: f = IIF forecast, e = IIF estimate. Inward-Other—Other Inward Investment (mainly bank loans, but also trade credit and official lending, plus some more obscure items like financial derivatives, financial leases, and so forth).

Figure 4. Volume of Long-Term Assets Managed by Institutional Investors
a. Emerging market pension assets at US\$2.1 trillion at end-2012



Source: Official sources and J.P. Morgan

and insurance companies because they tend to match their long-term liabilities, provide inflation-protected yields, and have a lower correlation to other financial assets. An additional benefit is that a large base of domestic institutional investors could make infrastructure investments more attractive to foreign investors, because they will be perceived as a potential liquidity buffer in times of capital outflows.

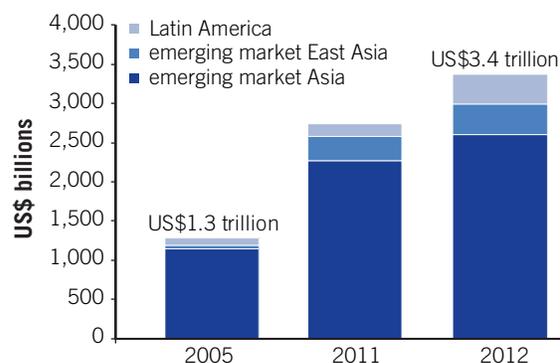
The task ahead is to develop financial vehicles that can channel EMEs long-term institutional savings into financially viable infrastructure projects. The growing share of public-private partnerships (PPP) for infrastructure projects is facilitating the development of innovative financial structures to fund these projects.

Local fixed-income markets, through infrastructure project bonds, could fill in a large share of the remaining funding gap, complemented by more traditional unlisted products, as long as policy makers develop the appropriate framework for issuers, investors, and intermediaries. Infrastructure project bonds are also an innovation in advanced economies, but are showing growing relevance, with several types of bonds and credit enhancement schemes being tested, depending on the project (for example, greenfield, brownfield).

The challenge for EMEs in developing these bonds is two-fold. The first is building a minimum fixed-income market regulatory and institutional framework so that structuring, issuance, and placement of infrastructure project bonds is cost-efficient. Most large EMEs already have that framework in place and are in a position to support such bonds. The second challenge is to develop the appropriate credit risk enhancement instruments so that project bonds have credit ratings acceptable to institutional investors, generally domestic investment grade or above (BBB-). Governments, multilateral organizations, development banks, and commercial banks should play a key role in either supporting or providing these risk-mitigating instruments.

As infrastructure financing options are developing, it is becoming clearer that public policies and the direct engage-

b. Emerging market insurance company assets approaching US\$3.4 trillion



ment of government and multilaterals in making these long-term vehicles financially viable are critical for their success. Furthermore, the development of an active infrastructure project bond market could have a number of positive externalities in reinforcing a long-term fixed-income market for a broader range of issuers. This could compensate for the higher volatility in foreign capital flows and support local fixed-income markets in EMEs that are less dependent on foreign investors.

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