Local Markets[1]

Barry Eichengreen

September 27, 2023

1. Introduction

Economists today are probably more inclined toward Joseph Schumpeter's view of the positive role of financial markets in economic development (of capitalism as "innovation fueled by finance") than Joan Robinson's skeptical view (that "finance is simply handmaiden to industry and commerce"). Financial markets mobilize savings, fund investments, allow diversification that mitigates risk, and provide means-of-payment, unit-of-account, and store-of-value-services that are critical for economic growth.

The question is *what kind* of financial markets.

2. Mobilizing Domestic Saving

One view, which goes back 25 years, emphasizes the desirability of markets in local-currency loans and securities. Historically, developing countries when borrowing externally have denominated their debts in dollars to appeal to foreign investors. But when banks, firms and households borrow in dollars, the borrower and, indeed, the economy are exposed to financial shocks. If something causes the local currency to weaken, servicing and repaying those debts out of local currency incomes becomes more expensive, sometime prohibitively. This currency mismatch between the denomination of assets and liabilities can be destabilizing. The Asian Financial Crisis of 1997-8 epitomizes the point. Recent literature on the "global financial cycle" emphasizes that such volatility can arise not just when there is a policy problem in the borrowing country but when the Federal Reserve raises interest rates on dollar-denominated securities – in other words, for reasons not of a country's own making.

The solution, policy makers concluded, was to develop markets with the capacity to issue and place domestic-currency debt. Creating underwriters, market-makers, regulators and the other constituents of a deep and liquid market in domestic currency-denominated debt securities will encourage residents and foreigners to invest in those securities, and thus provide the stable finance required for economic development and growth. The Asian Bond Market Initiative and Asian Bond Fund, established in the wake of the region's 1997-8 financial crisis, were policy initiatives along these lines. Governments in other parts of the world took analogous steps. These initiatives have borne fruit in countries as diverse as Indonesia, Peru and South Africa, where foreign investors now hold substantial shares of government debt denominated in local currency.

Alas, the financial-instability problem didn't go away. The currency mismatch was just transferred from the balance sheets of local borrowers to the balance sheets of foreign lenders, who now had other dollar incomes and expenses but foreign-currency-denominated investments. If the borrowing country suffered an adverse shock – a burst of inflation for example – those

[1] This note was commissioned by the World Bank, IFC and EBRD to encourage discussion and comment within the development finance community. Its findings, interpretations, and conclusions are those of the author and should not be attributed to the World Bank Group or EBRD, their affiliated organizations, or members of their Board of Executive Directors or the countries they represent.

foreign investors were hit by a "double whammy." The local currency value of their investments dropped due to higher inflation and interest rates. The dollar value dropped even more because the exchange rate of the borrowing country weakened. This double whammy was felt most powerfully, and the increase in capital-flow volatility was greatest, where investors held long-duration bonds, rendering the interest-rate effects largest. The result could be more financial volatility, not less, as foreign investors scrambled to liquidate their positions in advance of the prospective losses. Central banks, in order to insulate the economy from this volatility and support the exchange rate, might then be compelled to accumulate even larger foreign reserves, engaging costly purchases of low-yielding foreign bonds in order to enable to government to safely issue high-yielding domestic debt.

Evidently, simply developing the financial infrastructure needed to borrow in local currency doesn't solve the instability problem if countries rely on foreign investors. Durably solving that problem requires cultivating a population of lenders who are not subject to this currency mismatch and are able to manage duration risk. It means funding domestic investment out of domestic savings in stable fashion, and reducing dependence on foreign finance.

These conclusions are not new. Multilateral financial institutions have long cautioned that excessive dependence on foreign finance exposes countries to the risk of a "sudden stop" in international capital flows, with destabilizing economic and financial consequences. (A quarter of a century ago, when the author was at the International Monetary Fund, the in-house rule of thumb was that warning lights should flash when net capital inflows reached 4 percent of GDP.) Recent experience generalizes the point. It adds that the capacity to issue local-currency debt and place it with foreign investors doesn't relax this constraint. It fails to finesse the problem.

Writing even earlier, in 1933, John Maynard Keynes advised that governments should "let finance be primarily national." For 21st century policy makers, this is not an argument for "national self-sufficiency" (this being the title of Keynes's historic lecture). But it *is* an argument for avoiding excessive dependence on foreign finance by developing local markets on which domestic savers and investors can be brought together efficiently and reliably.

3. The Policy Toolbox

There is no simple recipe for developing the capacity to finance domestic investment out of domestic resources. To start, there must be an adequate pool of domestic savings. Saving can be promoted by tax policies that do not artificially favor or subsidize consumption, and by monetary policies that ensure that savings retain their value. Fiscal discipline helps by ensuring that the public sector does not absorb funding needed by the private sector or place pressure on the central bank to inflate. Independent fiscal councils and independent central banks, together with monetary and fiscal transparency, can solidify this commitment to sound and stable policies that encourages agents to place their savings in domestic-currency assets, including long-duration assets, at home.

Well-developed financial markets that allocate capital to high-return projects, by maximizing the rewards, can sharpen the incentive for residents to save. This means developing both banks and capital markets, because the two entities carry out different functions and serve different segments of the economy, and because they complement one another.

Commercial and investment banks (financial intermediaries, or just "banks" for short) have a comparative advantage in developing long-term relationships with customers and meeting unexpected as well as expected financial needs. Capital markets enable borrowers to secure stable finance for long-term projects and provide a venue through which savers and investors can take bets on unproven technologies. Historical scholarship on the so-called pecking-order theory of finance suggests that banks generally develop first, since the informational and regulatory requirements for the smooth operation of securities markets are more demanding. (Whether recent developments in fintech might alter this historical sequencing, shortening the lag between development of the banking system and development of capital markets, is an interesting question.) To date, early financial development in low-income countries is mainly synonymous with banks.

Because banks are in the business of maturity transformation, they are fragile. Because they operate in "information impacted" segments of the economy, where information about the condition and prospects of both borrowers and their lenders is not instantly and freely available to outside observers, confidence problems affecting specific intermediaries can spread contagiously within the banking system. These are not arguments against developing a banking sector. Rather, they are arguments for rigorous capital and liquidity regulation and for strict supervision of banks' internal controls and lending practices. They are arguments for the central bank to develop its lender-of-last-resort capacity to prevent liquidity problems from spreading within the banking system and in order to prevent illiquidity from being transformed into insolvency. They are arguments that regulators should develop the capacity to identify problem banks and intervene early to prevent contagion from spreading via the interbank market, limit resolution costs, and avoid creating so-called zombie banks (which evergreen nonperforming loans rather than lending to new clients). Because monetary policy has financial-stability implications, while macro- and micro-prudential policies have macroeconomic implications, the two sets of policymakers should share information and ideally coordinate with one another.

Debate on whether foreign bank entry helps or hurts is inconclusive. Some studies find positive spillovers of best practice from experienced foreign banks to domestic start-ups; they emphasize the benefits of competition. The presence of foreign competitors forces local banks, in order to retain market share, to raise standards and improve practices. Others conclude that foreign banks tend to cherry pick the best customers, leaving local banks weakened. Their entry thereby reduces rather than increasing the intensity of competition in low-income developing countries in particular.

The prerequisites for developing well-functioning securities markets are, if anything, even more demanding. Networks of brokers and dealers are needed to settle transactions, maintain inventories of securities, and provide liquidity to the market. This may mean having banks already in place with the capacity to hold inventories of government and corporate bonds and act as broker/dealers. Securities regulators should establish and enforce listing and disclosure requirements enabling investors to inform themselves about the condition of issuers, thereby limiting adverse selection (this being the market-for-lemons problem where dubious issues prevent sound issuers from listing). Regulators should encourage the development of underwriters – investment banks and others – to vet issuers and attach their good names to reputable issues. Rating agencies, domestic as well as foreign, can play useful information-dissemination roles.

Policy makers wishing to foster securities markets should encourage the development of a diverse population of investors, including institutional investors – insurance companies, pension funds, mutual funds, and others – with different mandates and time horizons, so that investors are not all inclined to buy (or sell) at the same time. Regulation should limit the leverage of those market participants in order to prevent destabilizing cascades of forced sales when asset prices decline. An additional way of fostering a diverse population of investors is to encourage foreign investor participation although, as emphasized in Section 2 of this note, this can be a mixed blessing.

4. Substitutes or Complements

Often, banks and security markets are portrayed as alternative ways of mobilizing savings and funding investments. In reality, the two are complements rather than substitutes. Already mentioned is the role of banks as security dealers and underwriters. In addition, banks can act as interest-rate swap market makers, offering their clients fixed and floating-rate cash flows. Banks not in a position to hold this interest-rate risk on their own balance sheets can shed it by selling their swaps to other banks. Doing so will broaden the base of investors in capital-market securities carrying one or the other cash flow by enabling investors to better match the structure of assets and liabilities.

In particular, the existence of a liquid swap market will make it easier for investors to limit duration risk. The existence of this market will allow investors to separate market risk (deriving from changes in monetary and macroeconomic conditions) from credit risk (the performance of the individual investment). In turn, this will increase their appetite for long-term fixed-rate securities appropriate for funding infrastructure projects, making it easier for governments and corporations to fund those projects.

A final advantage of a banking system able to support a liquid swap market at various durations, in conjunction with a liquid government bond market, is a well-defined yield curve, whose existence will enhance the transmission of monetary policy. This is especially useful in countries where the government bond market is underdeveloped and lacks liquidity. Insofar as this makes for a more stable monetary and macroeconomic environment, it will further encourage saving, facilitating domestic finance of investment projects.

To be clear, the existence of a banking system with the capacity to deal in interest rate swaps does not make the underlying duration risk magically disappear. If domestic and foreign investors reluctant to hold duration risk are able to shed it via the swap market, it ends up somewhere else on the consolidated financial balance sheet. Specifically, it ends up on the balance sheet of the bank that holds the financial "hot potato." (The same would be true if domestic banks provided currency swaps to relieve domestic companies issuing foreign currency debt, or foreign investors holding local currency debt, of their currency mismatch.) But because they hold diversified asset portfolios, banks may be better able than, say, nonfinancial enterprises to assume this risk. Insofar as banks develop robust internal controls and risk-management practices, their capacity to do so will be further enhanced.

5. Conclusion

Multilateral development banks around the world are undertaking a variety of initiatives to enhance the depth and liquidity of financial markets and their associated institutions in emerging markets and developing countries. For example, the World Bank's initiative on "Private Capital Facilitation" has as its objective enhancing the depth, liquidity and tenor of infrastructure debt markets. It aims to do so by aggregating and packaging EMDE "loan assets" into investable securities designed to serve as attractive investment vehicles for institutional investors. But if those institutional investors are foreign, they are subject to the double whammy of correlated credit and currency risk and prone to cut and run.

The currency mismatch and associated volatility will be less if institutional investors are local. But developing a large and diverse population of domestic institutional investors is a long-run project in low-income countries, whereas the need for finance for development is urgent.

Building a banking system capable of meeting some of these needs can be done more quickly. Developing a well-functioning banking system is no mean task, as detailed in this note. But the prerequisites are well known: they include stable monetary and fiscal policies and rigorous supervision and regulation. This banking system can provide working capital and otherwise meet the liquidity needs of enterprise. Eventually, it can underwrite and place the debt securities of local corporations. It can redistribute the duration and currency risk of debt securities issued by local enterprises, enhancing the appeal of those securities to institutional investors. Such financial operations will strengthen the transmission of policies, thereby enhancing the macroeconomic stability that is a prerequisite for banking and financial development.

The development-finance initiatives of the World Bank and other multilaterals should continue to stand on two legs: not just capital markets but also banks. Moreover, there is an argument for starting by working through banks, since their presence and operations are important prerequisites for the subsequent development of security markets.