Summary of the G–20 Workshop on Developing Strong Domestic Financial Markets, 26–27 April 2004

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The Group of 20 (commonly known as the G–20) brings together representatives from the finance ministries and central banks of 19 member countries from every region of the world as well as the European Union (EU). Officials from the International Monetary Fund (IMF) and the World Bank also participate in the G–20. Established in 1999, the G–20 is an informal forum that seeks to promote an open and constructive dialogue among major industrial and emerging-market economies on key issues related to the international monetary and financial system. Since 2002, the chair of the G–20 has rotated on an annual basis. Germany holds the 2004 chair.[1] In 2005, the chair will pass to China.

In April 2004, the Deutsche Bundesbank and the Bank of Canada co-hosted a G–20 workshop in Ottawa titled, "Developing Strong Domestic Financial Markets." The workshop broadened and deepened earlier work by deputies of finance ministers and central bank governors, launched in 2003 under the Mexican chair, on the importance of building institutions in the financial sector that will foster economic development and growth. At the Ottawa workshop, G–20 representatives, prominent academics, market participants, and members of international financial institutions met to share experiences and explore the role that robust domestic financial markets can play in economic growth and development and, where possible, to develop policy recommendations.

General Summary

Participants agreed that strong domestic financial markets are a key factor in economic growth and development, and that appropriate policies, institutions, and incentives are at the heart of market development. There was also a consensus that strong local banking systems and securities markets reduce countries' external vulnerability through enhanced collection and better allocation of domestic savings and by attracting foreign investment in instruments denominated in domestic currency as an alternative source of external funding. It was agreed that currency mismatches (i.e., foreign currency liabilities and domestic currency assets) were a common element in recent financial crises in emerging-market economies. It was also agreed that such mismatches should be assessed by examining the discounted present value of a country's future income and expenditure flows under alternative exchange rate assumptions. Participants broadly supported the sequence of market reforms: first, establish sound macroeconomic policies; then liberalize domestic financial markets while maintaining prudential supervision and regulation; next, open the current account; and, finally, eliminate restrictions on capital movements, starting with the liberalization of long-term flows. Questions were raised, however,

1. For more information on the G–20, please consult the G–20 Web site at http://www.g20.org. Member countries include Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States. Canada chaired the G–20 from its inaugural meeting in December 1999 to the end of 2001. In 2002, the group was chaired by India, and in 2003 by Mexico.

concerning the speed of liberalization. Participants broadly endorsed the concept of exchange rate flexibility for countries with widely opened capital accounts, agreeing that a high degree of exchange rate flexibility provides an incentive to monitor and control currency mismatches.

It was also recognized that, over the past decade, many emerging-market economies have made substantial progress in strengthening their domestic financial markets. Local bond markets are now the dominant source of funding for governments. There has been a surge in domestic corporate bond issues as well, although progress has been slower in this segment of the market. A driving force behind the development of local securities markets has been the rapid growth of non-bank institutional investors, in particular, pension funds in Latin America and insurance companies in Asia, which have a strong appetite for long-term investments, given the long-term nature of their liabilities.

Despite the significant progress that has been made in improving domestic financial markets in recent years, G–20 members recognized that currency mismatches will remain an important source of vulnerability for the foreseeable future and that further policy efforts are necessary to contain risks. Co-operation in the development of regional financial markets could also be fruitful, especially for smaller markets.

Participants agreed that further work is necessary to strengthen domestic financial markets. There was also broad agreement that the continued sharing of experiences among the G–20 countries is an important avenue for advancing this work. Areas deemed critical for fostering strong domestic financial markets included the following:

i) Sustained sound macroeconomic policies were identified as an essential precondition for the development of domestic banking systems and bond markets, especially the ability of domestic borrowers to issue long-term debt denominated in domestic currency. Appropriate incentives were also viewed as key, with most participants endorsing a substantial degree of exchange rate flexibility for countries with liberalized capital movements as a means of encouraging better management of currency mismatches.

ii) Further work is required to strengthen the financial infrastructure, focusing in particular on implementing and enforcing internationally recognized codes and standards, including those related to corporate governance and transparency. As well, robust payments and settlement systems should be established. Accounting rules should not discriminate against borrowing in domestic currency relative to foreign currency borrowing. Strong contract law and property rights are also essential for market development.

iii) Work must continue on strengthening banking systems because strong banking systems and strong securities markets complement each other. Many participants also agreed that foreign bank entry would help to increase local funding of domestic business and to reduce currency mismatches.

iv) Other practical steps to reduce currency mismatches and to strengthen domestic bond markets include more efforts by governments to reduce the proportion of foreign-currency-denominated or exchange-rate-linked debt in their total debt, and the establishment of a domestic benchmark yield curve.

v) Prudential oversight must take currency mismatches into account from both a micro and a macro perspective.

Session 1: Challenges in the Absence of Strong Domestic Financial Markets

Presenter: Mr. Philip Turner, Bank for International Settlements

Mr. Turner focused his remarks on currency mismatches, an important factor in triggering or aggravating financial crises in emerging-market economies.[2] Currency mismatches arise when borrowers incur foreign currency liabilities to finance domestic activities. In the aftermath of large exchange rate depreciations, economies with currency mismatches can experience serious adverse effects. Financial intermediaries can come under pressure, owing to mismatches in their own balance sheets or to corporate insolvency. This, in turn, can lead to a decline in economic activity.

Mr. Turner took issue with the concept of "original sin," an hypothesis which traces currency mismatches to a fundamental inability of emerging markets to borrow abroad in their own currency (Eichengreen and

2. Mr. Turner drew from a recent book that he co-authored with Morris Goldstein, *Controlling Currency Mismatches in Emerging Markets* (2004).

Hausmann 1999; Eichengreen, Hausmann, and Panizza 2003). While he agreed that very few emerging-market economies are able to issue debt abroad in their own currency, he argued that it was important to take a broader view of currency mismatching and its implications. It is important to look at the currency of denomination of all debts, including local bank lending and debt contracts, and to evaluate the impact of a change in the exchange rate on the discounted present value of all future income and expenditure flows.

Mr. Turner developed a measure of the aggregate effective currency mismatch (AECM) as a stress test for an economy in the event of a large currency depreciation. The AECM consists of three elements: net foreign currency assets, exports of goods and services, and the foreign currency share of total debt. Using this indicator for important emerging-market economies, he noted that China and India had avoided aggregate mismatches, while other Asian economies that had been vulnerable in 1997 had now virtually eliminated their aggregate mismatch. However, Argentina, Brazil, and Turkey continued to have mismatches in 2002 and thus remained vulnerable to a large depreciation of their currencies. He also noted that Brazil had made substantial progress in limiting the issuance by the government of dollar-linked paper.

Finally, Mr. Turner outlined an agenda for a six-step domestic policy that would reduce the vulnerability of emerging-market economies with open capital markets to exchange rate depreciation. This included a high degree of exchange rate flexibility (combined with a monetary policy that targets inflation) to remind players of exchange rate risk; greater transparency and better data in order to facilitate the monitoring of currency mismatches; government borrowing only in local currency to reduce currency mismatches in the economy as a whole and to improve macroeconomic discipline; foreign bank entry to increase the share of local currency lending and to encourage better banking skills; elimination of impediments to bond-market development; and increased "mismatch awareness" as part of prudential oversight.

Discussants: Dr. Alexandre Schwartsman, Central Bank of Brazil, and Dr. Erdem Basci, Central Bank of Turkey

Mr. Schwartsman agreed with Mr. Turner's thesis, endorsed his policy recommendations, and argued that a country's future lies in the hands of policy-makers. Good domestic economic policy will permit emerging-market economies to reduce their vulnerability to currency mismatches. He contended that the development of Brazil's local-currency bond markets was undermined by several factors, including uncertainty over property and savers' rights as well as macro policy. He noted that Brazil has taken steps to reduce its vulnerability by allowing its exchange rate to float and by decreasing the amount of dollar-linked bonds issued by the government. Foreign banks are also welcome in Brazil.

Mr. Basci echoed many of Mr. Schwartsman's comments, noting that the real origin of Turkey's vulnerability has been government deficits. Like Brazil, Turkey adopted a flexible exchange rate, which has led to improved risk management. He also noted that while maturities on Turkish debt instruments were short, they have been lengthening. He updated Mr. Turner's AECM analysis for Turkey, noting that Turkey had eliminated its currency mismatch in 2003, owing to a decline in foreign currency government debt. A decrease in domestic real interest rates in recent years caused by a fall in domestic inflation has encouraged a shift away from foreign currency borrowing to local currency borrowing.

General discussion

Participants debated whether currency mismatches can be significantly reduced by appropriate economic policies and institution building in emerging-market economies or whether they are beyond the control of policy-makers. There was a broad consensus that the original-sin explanation for currency mismatches was too narrow, or even unfounded. While small industrialized countries, with few exceptions, are unable to issue international bonds in their own currency, they have been able to develop strong banking systems and deep local bond markets that attract significant foreign interest. It was further noted that countries with large trade surpluses or high reserve holdings are perceived as more capable of sustaining currency mismatches than those with weak payments and reserves positions.

Most participants appeared to endorse the policy recommendations outlined in Mr. Turner's presentation, although it was evident that the call for a high degree of exchange rate flexibility is most relevant for countries that have already widely liberalized their capital account.

Session 2: Financial Intermediation and Economic Growth

Presenters: Professor Gerard Caprio, World Bank; and Professor Martin Hellwig, Max Planck Institute for Research on Collective Goods

Professor Caprio surveyed the evidence on the contribution of financial sector development to economic growth. Studies indicate that sound financial institutions and markets can make an important contribution to growth, mainly by improving productivity through a more efficient allocation of savings. Having said this, neither the financial structure per se (i.e., reliance on financial intermediaries vs. capital markets) nor the nationality of financial services providers matters for growth. Thus, it is better to build a solid financial infrastructure than to aim for a particular model.

The key is to recognize that well-functioning markets need both accurate and timely information and strong legal and regulatory underpinnings. To get the basics right, the authorities have to be aware of the incentives that an institutional structure can create, for good or bad. In practical terms, this means that supervisors of the financial system must be both publicly accountable and independent of the institutions that they regulate. While technical expertise and technology to reduce informational and transactions costs in the financial sector can be bought, the legal framework must be developed within the country. Experience shows that legal frameworks that protect outside creditors / investors favour financial development and investment.

In a complementary presentation, Professor Hellwig focused on long-term sustainable growth. He made three major points. First, the chief impetus today for long-term growth is innovation, financed in large part by risk capital (venture capitalists and stock markets, notably in the United States). In contrast, the second industrial revolution, which was geared to exploiting scale economies (mass production), was fuelled by internal finance. Consequently, the best financial structure had to take into account the characteristics of the main drivers of economic growth. Second, the availability of information and the nature of contractual arrangements affect the efficiency of the financial system. Asymmetric information leads to agency problems, favouring debt finance and monitoring of borrowers by financial intermediaries. When information is more widely available, capital markets function more efficiently. Incentives, rewards, and controls (via regulation) condition risk taking, as well as inclinations for misreporting, and even fraud. Third, while financial innovations such as securitization and derivative markets have allowed a greater diversification of risk, the extent to which risks have been shifted to contractual savings that are managed by pension funds and insurance companies needs to be examined. If they are bearing too much risk now, moving from public to private sector pension schemes will be less attractive.

Discussants: Mr. Glenn Stevens, Reserve Bank of Australia; Mr. Edward Gramlich, Board of Governors of the Federal Reserve System; and Dr. Akira Ariyoshi, Japanese Ministry of Finance

Mr. Stevens concurred with both presentations. He noted that Australia had benefited from financial reforms by promoting competition and by accepting flexibility in financial prices. He encouraged emerging-market countries to move faster on reforms, acknowledging that training and retaining qualified personnel for prudential supervision is a challenge. Mr. Gramlich also agreed with the presenters' comments. He added that countries with both banking and capital market systems were more resilient to shocks. He also stressed the importance of the legal system and the continuing need to adapt it to financial innovation. Mr. Ariyoshi spoke of the difficulty of moving the Japanese banking culture from a relationship basis to an arm's-length basis. Despite substantial reforms, including financial deregulation and improved disclosure and accounting rules, the actual shift in market structure has been slow to date. Japan's experience has been that building a new financial system is resource-intensive and that the benefits are slow to emerge. Perseverance is required; otherwise, a crisis may be needed before significant reforms are considered.

General discussion

Several points were raised in the general discussion. It was noted that, since the financial resources of emerging-market economies are limited, increasing domestic savings ratios in poorer countries is important, and greater official development assistance would be welcomed. For many developing countries, there is also the challenge of identifying viable projects that might interest domestic or foreign investors. With respect to institution building, it is important to get things right the first time. The development of domestic markets was also viewed as most relevant for countries with high savings rates, such as those in East Asia.

Session 3: The Sequence of Financial Liberalization and Supervisory Reforms

Presenter: Professor Ronald McKinnon, Stanford University

Professor McKinnon placed financial crises in an historical perspective. Before the Great Depression, economic and financial policies were dictated by the exigencies of the gold standard. Large-scale capital flows prevailed, and financial crises were common. For the most part, however, these crises were resolved relatively quickly, through a combination of fiscal consolidation, a reaffirmation of sound monetary policy, and lending by international banking houses acting as crisis managers.

The Great Depression discredited the gold standard, which led to the Bretton Woods system of pegged, but adjustable, exchange rates following World War II. Most countries resorted to restrictions on capital accounts and domestic financial repression to maintain the pegged rates and finance domestic development.

These policies had undesirable effects. Capital controls led to the growth of unregulated markets as banks sought to evade them, while the widespread adoption of explicit or implicit deposit insurance encouraged banks to reduce their capital / asset ratios. And, as capital controls and domestic regulations were progressively eased or evaded through the 1980s, these factors combined to lead to overborrowing. Financial repression was replaced by financial crashes.

These weaknesses underscored the importance of following the appropriate order of financial liberalization. According to Professor McKinnon, the starting point is fiscal balance, followed by domestic financial liberalization and the development of prudential bank regulations. Current account liberalization should proceed in tandem with domestic financial liberalization. Capital account liberalization should be the final element of the sequence, with long-term capital flows, especially foreign direct investment, liberalized before short-term flows (McKinnon 1993).

To minimize the risk of financial crises, Professor McKinnon favoured a new monetary order to stabilize exchange rates, using the U.S. dollar as the key currency. He recommended that debtor emerging-market economies encourage illiquid forms of capital inflows, such as direct foreign investment; develop their domestic financial markets; lengthen the maturity of obligations linked to the exchange rate; limit the net foreign exchange positions of banks; and use capital controls if bank regulations are weak. Creditor emerging-market economies, which, he argued, suffer from "conflicted virtue" should do much the same thing.[3] However, they should encourage less liquid capital outflows. He also recommended that these economies "nationalize" capital outflows through national savings programs (citing as an example Singapore's Provident Investment Fund) or reserve accumulation. To make the system function, obligations would also be imposed on the United States, whose currency would anchor the system. The United States would be required to maintain open capital markets, focus policy on stabilizing the U.S. price level rather than the exchange rate (and refrain from pressuring others to change their rates), and reduce its trade deficit through higher domestic savings.

Discussants: Mr. Ruogu Li, People's Bank of China; and Mr. Pierre Jaillet, Banque de France

Mr. Li noted that, before 1978, the People's Bank was the only bank in the country. Today, the Chinese financial system includes not only several domestic commercial banks, but 178 foreign bank branches or subsidiaries and 120 other foreign financial institutions. Capital markets have also grown rapidly, with more than 1,400 companies now listed on various exchanges. While many capital restrictions remain, Mr. Li noted that important steps have been taken to liberalize the system, including the introduction of a single, unified exchange rate in 1994. Moreover, of 43 capital account transactions monitored by the IMF, eight have been liberalized, while 11 other restrictions have been eased. The others will be gradually relaxed, depending in part on the strength of the banking system. In this respect, Mr. Li stressed the importance the Chinese authorities attach to financial stability and the sequencing of reforms.

Mr. Jaillet also acknowledged the degree to which the liberalization of the French financial sector followed the McKinnon "order." The starting point, he said, was the creation of deep, liquid markets for public debt instruments. Consistent with the McKinnon paradigm, however, a commitment to long-run fiscal discipline was necessary to reduce the risk premium on long-term bonds. At the same time, wide-ranging

3. Creditor countries are virtuous because they are large savers, but have conflicted feelings about their virtue because the implications of their virtue—continuous upward pressure on their exchange rate—is undesired.

reform of the legal environment, as well as strengthening the prudential regulatory and supervisory framework, contributed to the development of domestic capital markets. These, in turn, necessitated the adoption of a new market-led framework for monetary policy. Mr. Jaillet also noted that restrictions on current account transactions had been liberalized before the 1980s, when gradual capital account liberalization began as part of the elimination of controls that was entailed in the integration of European economic and monetary systems. Drawing on the French experience, Mr. Jaillet concluded that trade liberalization should go hand in hand with domestic financial liberalization. Moreover, financial liberalization should be carried out cautiously and gradually, with the sequencing of reforms tailored to the specific nature of the economy.

General discussion

There was broad agreement with Professor McKinnon's proposed sequence of reforms, especially the proposition that sound macroeconomic policies are a prerequisite for successful financial liberalization. There was less agreement, however, on his recommendation of a system of fixed exchange rates based on the U.S. dollar. Some participants questioned the claim that creditor emerging-market economies that are subject to "conflicted virtue" would face continuous pressure to appreciate their currencies, resulting in deflation. While extrapolative expectations might pose a potential risk if the proposed revaluation failed to eliminate the gap between the actual exchange rate and the perceived equilibrium rate, it was not clear why there would be expectations of further appreciation once the perceived equilibrium rate was reached.

With respect to China, there was a broad consensus that bank balance sheets would have to be strengthened before the authorities proceeded with further capital account liberalization. Yet some participants expressed concerns that too little attention had been paid to exchange rate issues: a more flexible exchange rate regime would reduce the risks associated with capital account liberalization in China. It was also noted that it is difficult to foster the use of hedging instruments under fixed exchange rates. Mr. Li responded by noting that the goal of the Chinese authorities is to liberalize long-term capital flows before short-term flows. Moreover, the exchange rate should reflect overall competitiveness, not just the competitiveness within the traded-goods sector. He opined that the current exchange rate is broadly appropriate. Professor McKinnon also observed that, in the current Asian context, which is characterized by a *de facto* currency zone, it might be disruptive if only one country moved to a floating rate.

Keynote Address

Professor Barry Eichengreen, University of California, Berkeley

In the keynote address to workshop participants, Professor Eichengreen noted that there are two views on the extent to which local financial markets have developed in emerging-market economies in Asia. An optimist would highlight the growth in the size of local markets, the growing diversity of issuers since the 1997–98 Asian crisis, and the expectation that rapid growth would continue in light of strong demand for investment instruments, given high domestic savings ratios. A pessimist, however, would stress the limited number of high-grade borrowers and the lack of liquidity, as well as the fragmented nature of local markets and regulatory obstacles. Professor Eichengreen suggested that the truth probably lies somewhere between these two extremes.

He also noted that Asian governments have done much to build the necessary infrastructure to develop their bond markets. At the national level, among other initiatives, calendars for government bond issues have been established. Effort has been made to address the supply / demand mismatch by encouraging issues of corporate bonds. At the regional level, co-operation among various groups has led to the launch of the Asian Bond Fund, which is helping to address the problem of small markets.

Professor Eichengreen argued strongly from a number of perspectives in favour of greater exchange rate flexibility in Asia. He noted that the 1997–98 Asian crisis demonstrated that growing capital account convertibility, while a necessary requirement for deep local and regional markets, is risky in the absence of exchange rate flexibility. Exchange rate flexibility would encourage the development of financial instruments for hedging purposes. Finally, by severing the link with the U.S. dollar, the present high correlation between Asian and U.S. yields would diminish, increasing the attractiveness of Asian securities for those seeking to diversify their portfolios.

Session 4: Infrastructure Building and Governance

Presenters: Dr. Amar Bhattacharya, World Bank; and Ms. Sabine Miltner, Institute of International Finance (IIF)

Dr. Bhattacharya focused his remarks on policies and institutions. He underscored the importance of supervisory principles relating to banks, securities markets, insurance, and the payments systems that have been established by the international standard-setting bodies. He also noted the importance of principles dealing with corporate governance, audit and accounting standards, insolvency, and creditor rights, as well as money laundering and the financing of terrorism. While G–20 countries have largely adopted internationally accepted standards, Dr. Bhattacharya thought that attention now needs to be directed towards enforcement. More broadly, he believed that reforms are just beginning to penetrate business culture in many emerging-market economies.

Dr. Bhattacharya also contended that financial markets in many emerging-market economies suffer from a lack of transparency. Progress is required at all levels: non-financial corporations, financial institutions, and the supervisory and regulatory authorities. Opaque markets are also reinforced by entry barriers, a lack of contestable markets, and government ownership. Opaque ownership structures and non-arm's-length transactions also contribute to deficient private sector monitoring.

Dr. Bhattacharya concluded with an examination of the legal issues pertaining to emerging markets. He noted that G–20 countries have different legal systems (e.g., common law vs. civil code) that gave rise to different practices. While some traditions provide stronger legal protections than others, markets have often developed compensatory devices.

In a complementary presentation, Ms. Miltner examined corporate governance in emerging-market economies from the viewpoint of the investor community. Most broadly, she noted that countries that protect their shareholders tend to have larger capital markets because investors are willing to pay a premium for companies with good corporate governance. Drawing on principles established by an IIF working group on corporate governance and transparency, Ms. Miltner stressed five key elements of good governance: minority shareholder protection; the structure and responsibility of boards of directors; accounting and auditing; transparency of ownership and control; and the regulatory environment. She also noted that corporate governance is a process (IIF 2002, 2003). Investors are aware that it takes time to implement good corporate governance practices. What is important is that there be ongoing progress.

Finally, Ms. Miltner turned her attention to the state of corporate governance in major emerging-market economies, noting that they share some common features. First, ownership and control structures are often opaque, contributing to a lack of accountability. As examples, she cited the oligarchs in Russia, the *chaebols* in Korea, and family-based conglomerates in Indonesia. China, too, poses challenges, given its mix of private- and state-controlled firms. Second, boards of directors frequently lack independence. Third, disclosure is often inadequate. Finally, enforcement is often weak, reflecting, for example, a lack of suitably trained judges and well-equipped regulators.

Discussants: Ms. Shyamala Gopinath, Reserve Bank of India; and Dr. Mikhail Senatorov, Bank of Russia

Ms. Gopinath provided a comprehensive overview of India's regulatory framework, underscoring the importance of a sound framework for market development. She noted the sequence of planned market reforms that has occurred since the early 1990s. These have included the liberalization of foreign exchange markets, the deregulation of interest rates, the development of a government securities market, and the introduction of an over-the-counter (OTC) market in derivatives. Interest rate futures were introduced in 2003. A gross real-time settlement system was also recently introduced to provide real-time payment finality. Thus, over the past decade, Indian financial markets have been transformed, moving from fixed exchange rates and administered interest rates to market-determined rates with efficient price discovery and a well-developed payments and settlement system. Some remaining issues, such as permitting the short-selling of government securities, will be addressed at the appropriate time. Discussion is currently underway concerning the elimination of the legal ambiguities associated with OTC derivatives and netting legislation. Work is also underway to move to screen-based trading of government securities.

In his overview of the Russian payments system, Dr. Senatorov noted that there are two major players in Russia, the Bank of Russia and a private payments system. Payments processed through the central bank account for slightly less than 50 per cent of payments by volume and 60 per cent by value. While almost all of these payments are electronic, they have not been centralized. Instead, most transactions were processed regionally. The majority of payments are in the form of payment orders: payment by cheque is almost unheard of. Since 2001, payment cards have grown rapidly in popularity in Russia. Virtually all are debit cards and are used mostly for cash withdrawals. The Russian authorities envisage moving towards a two-tiered payments system, including a "mass payments" system and a gross real-time settlement system.

General discussion

In the ensuing general discussion, participants generally concentrated on issues related to corporate boards and disclosure. Many participants commented on the importance of a corporate culture that supports appropriate risk management. Concern was also expressed regarding the ability of firms to find competent, independent board members. One participant observed that this is a problem even in major industrialized countries. Dr. Bhattacharya concurred, noting that, in many emerging-market economies, a shortage of qualified people in an environment of interconnected businesses makes it very difficult to find qualified individuals who are truly independent.

There was also considerable discussion on the appropriate degree of transparency. While participants broadly agreed that greater disclosure is important, some wondered whether there could be too much disclosure. In certain industrialized countries, rising disclosure requirements have acted as an incentive for publicly held companies to go private. Ms. Miltner responded that greater disclosure is something investors wanted. While a case for too much disclosure could be made in theory, the issue was irrelevant in emerging-market economies.

Session 5: Building Strong Local Securities Markets

Presenter: Dr. Donald Mathieson, International Monetary Fund

Dr. Mathieson outlined the results of an IMF study, *Emerging Local Securities and Derivatives Markets* (Mathieson et al. 2004). He reviewed the experience with capital-flow volatility in the 1990s, noting that crises in emerging-market economies resulted both from problems in these economies and problems in mature markets that spilled over to them. In response, emerging-market economies have adopted numerous complementary strategies to protect themselves. Among them are : i) better external asset and liability management, including a buildup of international reserves; ii) continued use of capital controls; iii) adapting policies and reinforcing supervision to the degree of capital account openness; and iv) developing local securities markets. Several emerging-market economies had been successful with number (iv), since domestic bonds had become the major source of public sector funding.

He observed that several principles had been broadly accepted by the international community as a means of strengthening local securities and derivative markets, such as improving market infrastructure and establishing benchmarks, raising the level of corporate governance and transparency, and creating an institutional investor base. With respect to the latter, he underscored the growing importance of private pension funds in Latin America, as well as to a lesser extent in central Europe, and life insurance companies in Asia.

Many issues, however, were still being debated. Dr. Mathieson noted, for example, that observers were divided over the merits of issuing indexed bonds. He argued that there is a difference between bonds linked to the exchange rate and bonds linked to inflation, favouring the latter. While understanding the reasons for bonds linked to the exchange rate, he recommended their elimination as quickly as possible, since the exchange rate can move sharply, leading to a dramatic increase in debt-servicing costs. Other issues in the "grey zone" included the extent to which local rating agencies should be encouraged, the role of government in developing local equity markets, the extent to which foreign investors should be encouraged, the challenges posed by derivatives markets, and the interaction between the development of national markets and their regional integration.

Finally, Dr. Mathieson made a plea to the G–20 to increase the availability of data on local securities markets through the development of user-friendly Web sites that would supply information on bonds such as issuance, yields, and their currency composition.

Discussants: Dr. Alberto Ades, Goldman Sachs and Company; Mr. Wolfgang Fritsch, Deutsche Bundesbank; and Mr. Alonso García Tamés, Ministry of Finance, Mexico

Mr. Ades added a few complementary points. He stressed the need for macroeconomic stability and a low-inflation environment to improve the attractiveness of local securities markets. Funded social security systems were also important to create a demand for domestic securities. Foreign investors could help in developing more liquid markets, though he noted a dilemma: local markets may become deeper but at the risk of exposure to greater volatility. On the question of indexed bonds, he thought that inflation indexing was valuable. However, bonds that index debt servicing to gross domestic product (GDP) have many problems (notably data revisions) and are of little interest to fixed-income investors.

Mr. Fritsch talked about the German *Pfandbrief* as a possible avenue for developing local bond markets in emerging-market economies. The *Pfandbrief* is a special form of "covered" bank bond that was instrumental in developing long-term bank lending and domestic securities markets in Germany after World War II. It is used for two specific purposes: to finance residential or commercial property and to fund local authorities, thereby granting borrowers indirect access to securities markets. Compared with other private sector bonds, its main attraction is that it offers strong guarantees to bond investors. First, the bonds are backed by either property mortgages or access to the tax income of local authorities. Second, the issuing banks are committed to backing their bonds with their own capital. There has never been a default of a *Pfandbrief*. He also noted that the *Pfandbrief* represents the biggest segment of the German bond market, with important holdings by foreign institutional investors, and that similar instruments closely modelled on the tried and tested German system are available in many other European countries (including transition economies).

Mr. García spoke of Mexico's successful experience in developing local securities markets and outlined two key preconditions for success. First, there is a need for macroeconomic stability. In Mexico, this involved four mutually reinforcing components: fiscal discipline, prudent autonomous monetary policy, a flexible exchange rate, and sound debt management. The second vital precondition is a strong legal and institutional framework. In Mexico, reforms were implemented to improve accounting standards and transparency in the public sector and in the banking industry. Complementary measures included efforts to develop an institutional investor base, a derivative market (MEXDER) to hedge risks, as well as issuance of public debt at various maturities to complete the yield curve and to provide benchmarks to improve market liquidity.

General discussion

Participants agreed that foreign investors could improve the liquidity and competitiveness of local financial markets. Concern was expressed, however, that they might increase asset-price volatility. Many participants also noted that, while there has been considerable success in developing local markets for public debt instruments, progress had been more limited with respect to corporate bonds. Other issues explored included whether countries should favour local or regional market strategies; how to regulate different institutions; how to avoid distortionary incentives for risk taking; the extent to which securitization should be encouraged; and the extent to which capital markets (which might draw off higher-quality borrowers) would increase the riskiness of bank-loan portfolios.

Session 6: Concluding Observations

Presenter: Dr. Morris Goldstein, Institute for International Economics

Noting the diverse membership of the G–20 and the utility of the forum for sharing experiences, Dr. Goldstein identified seven key policy themes. The first theme was that domestic financial markets are increasing in importance in many emerging-market economies, in both size and function. He noted two caveats in particular that countries would do well to heed. First, while it is better to have a larger share of debt owed to domestic creditors for a given ratio of debt to GDP, the level of debt is also important. In this respect, he cited recent IMF work which indicated that defaults in emerging-market economies have occurred at relatively modest levels of debt to GDP. The second caveat was that governments need to continue to improve bank soundness, especially given the potential fiscal liabilities associated with bank failures.

The second theme was the importance of diversification. If the golden rule of real estate is "location, location, location," Dr. Goldstein argued, then the key message from the workshop was "diversification, diversification, diversification." He noted that the development of multiple sources of finance (e.g., banks and securities markets) would be helpful in the event of a loss of access to any particular source.

Dr. Goldstein's third theme was that policy incentives are at the heart of building capital markets. The challenge is to create the right incentives for both private sector participants and the authorities to foster market development and prudential supervision.

The fourth theme was the need for appropriate sequencing of liberalization. Dr. Goldstein noted that there was broad support for Professor McKinnon's ordering: fiscal balance followed by domestic financial sector reforms and the opening of the current account before the liberalization of capital flows (beginning with foreign direct investment).

The fifth theme was the importance of implementing and enforcing standards and codes, such as those relating to transparency and corporate governance. Dr. Goldstein noted that the most powerful incentive for complying with standards and codes would be in the lower market borrowing costs that resulted from compliance; more evidence on this link would be most useful.

The sixth theme was that market liquidity matters. Governments could promote market liquidity through, for example, greater transparency in the scheduling of borrowing programs, the promotion of effective settlement and clearing systems, and the introduction of new financial instruments to help complete financial markets. Macroeconomic policy frameworks were considered equally important, since high and volatile inflation deters the development of local bond markets.

Finally, Dr. Goldstein argued that it is important to control currency mismatches, which were an element common to every financial crisis over the past decade. In assessing the extent of a mismatch, he contended that a broad definition of assets and liabilities is important.

He concluded by noting that there was wide support for a broad agenda of domestic reform, which would emphasize the importance of putting into place policy regimes that are robust to a range of shocks. This policy agenda would include greater exchange rate flexibility combined with inflation targeting; prudent debt-management practices; and fostering domestic capital markets both to reduce emerging-market economies' reliance on foreign currency borrowing and to develop financial instruments that can help hedge and better manage financial risks.

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