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OCCASIONAL VIEW

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Are Emerging Markets bond indices public goods?

By Jan Dehn

In our view, one of the few certainties about the world of tomorrow is that global financial conditions will tighten. There will be less money available and competition will intensify among the nations to maintain their share of the shrinking global financial pie. This raises an important question: how are Emerging Markets (EM) countries going to protect their access to foreign capital?

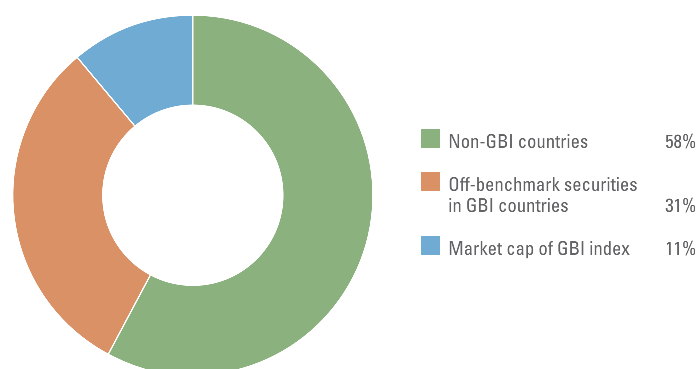
The answer is surprisingly simple: They will join the benchmark indices, particularly the local currency bond indices. We think one of the major trends in EM over the next few years will be a large increase in the market capitalisation of the main EM local bond indices.

Why will this become a dominant strategy and how will it benefit EM?

- **First**, EM countries will want to protect and develop their local markets, which are already by far their most important funding sources. They strongly prefer to borrow in their own currencies, because local funding is typically far less fickle than foreign funding and FX risks are mainly borne by foreigners. We estimate that the total EM fixed income market this year could reach USD 16-19trn and about 90% will be in local currency and half of that will be government bonds.[1]
- **Second**, EM countries will join benchmarks in greater numbers, because by doing so they can turn benchmark awareness and passive investing among EM investors to their own advantage. For example, a fully passive investor, while rare in EM, will buy anything as long as it appears in an index. EM markets are still new markets for many, institutional as well as retail, and new entrants can be more benchmark aware. Many, not all, institutional investors in EM local markets hug benchmarks to various degrees. As of Q1 2014, Standard Chartered Bank data showed that USD 644bn of foreign money follows GBI-EM-GD benchmarked strategies.

  The share of foreign retail money in the GBI-EM-GD has also gone up from 4% in 2009 to 15% in 2013, though the share declined to 11% after the outflows of 2013. And retail-like money in EM has become much more benchmark hugging: Morningstar data shows that between 2009 and 2013 the tracking error of the four largest managers of local currency debt mutual funds in the US, halved from 2.92 to 1.64. Jointly they account for 92% of the total US mutual fund market in EM local currency bonds.

Fig 1: **Structure of the USD 8.4trn EM local currency government bond market (Ashmore 2014 estimate)**



Source: Standard Chartered Bank, JP Morgan, BAML, Ashmore.

Looking forward, we think EM countries that pre-position for index inclusion as a way to maintain their access to global financial markets will be among the winners. They will have better market access precisely as access to global capital becomes a more important differentiating factor within the EM universe. Several EM countries already completely understand this direction of travel and have already taken steps to ensure their access to global capital:

- Russia has made its local market Euroclearable over the past few years
- Colombia has significantly lowered barriers to entry in its local market
- Mexico has deliberately built local markets over the past decade and staunchly resisted all suggestions of capital controls
- Nigeria has joined the GBI-EM-GD
- Brazil quickly reversed tack on IOF taxes after realising capital controls were a bad idea

But the biggest changes in index composition still lie ahead. The next few years should see far more EM countries taking steps to enter the main local benchmark indices. In principle, we think there ought to be at least as many EM countries in the local indices as there are EM countries in the Dollar indices – currently

[1] That is not to say that Dollar bonds are not useful for EM governments. After all, Dollar yield curves give access to different pools of capital and form an important part of any country's financial infrastructure. But local currency markets are special, because they already constitute the backbone of funding in EM countries. Dollar bonds are only central today for some Frontier Markets issuers, whose domestic bond markets have not yet reached sufficient size.

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the balance is 61 versus 16 in favour of Dollar indices. By far the most important future entrants will be China and India. India's total domestic bond market (government and corporate) is close to USD 900bn, while China's domestic market is close to USD 4trn. Both countries are, in our view, moving towards capital account liberalisation for fixed income investment.

Challenges for issuers and index providers

The challenges facing EM countries if they want to enter local bond indices are relatively simple to overcome; they basically involve removal of capital controls and, ideally, improving local settlement procedures, for example by allowing local paper to settle via Euroclear or Clearstream.

Index providers might face more formidable challenges. Index providers have naturally tended to include securities in their indices in which they make markets (if they do not trade the bonds they incur costs purchasing pricing data from local suppliers). But as the traditional index providers – mainly large investment banks – see their presence in EM local markets diminish since 2008/2009 due to regulatory and other changes, more and more EM local bonds will be issued, owned, and traded locally, by local players. The days are rapidly fading when investors in EM local markets have to go to New York or London to trade, say, Uruguayan peso bonds or corporate debt in Ghanaian cedis.

We also expect greater pressure from issuers and investors on index providers to produce more representative indices. EM local markets are inadequetly represented in the main EM fixed income benchmark indices. For example, the 16 local bond markets represented in the JP Morgan GBI-EM-GD (the world's most used EM local currency government bond index) only capture 11.5% of total outstanding securities (USD 970bn out of an estimated total universe of USD 8.4trn of local government fixed income securities). Local currency corporate bond indices are even less representative.

By contrast, EM dollar bonds, while not perfectly represented in the indices either are nevertheless far better represented than local markets. The market cap of the JP Morgan EMBI index covers 43% of outstanding securities (about USD 350bn out of a USD 822bn market). One might speculate as to why Dollar bonds are so much better represented in the indices, despite being a ten times smaller market. One possible reason is that Dollar bonds are readily traded in New York and London, where pricing information is readily available to index providers at low cost.

Are EM local bond indices public goods?

Benchmark indices, particularly in local markets have important public goods elements and their inadequate private provision is evidence of a classic market failure. As such, should benchmark indices for EM local market be provided by international public sector institutions such as the IFC or the IMF? We believe they should, although this would not be without risks, including the risk of political interference. We believe this risk would be a price worth paying given how inadequately local markets are currently covered by private index providers. Besides, we see no reason why existing privately provided benchmark indices could not co-exist alongside publicly provided indices.

More comprehensive index coverage would help to stabilise EM local markets, assist in their development, and encourage better index representation by existing private providers. Better indices would improve the capability of EM issuers to maintain their share of global capital in a world of tighter financial conditions. And above all more comprehensive indices would improve global asset allocation by offering a broader range of opportunities for global fixed income investors whose exposures currently continue to be excessively concentrated in the heavily indebted developed countries.

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