G8 2007
Finance Ministers Meeting
Potsdam, May 19, 2007

# G8 Action Plan for Developing Local Bond Markets in Emerging Market Economies and Developing Countries

Modern and efficient domestic market structures make important contributions to financial intermediation, financial stability and sustained economic growth. Deep and well functioning local currency bond markets in Emerging Market Economies (EME) as well as in developing countries are key in this respect.

- Developed local currency bond markets reduce foreign exchange risks for local borrowers and the vulnerability to exogenous shocks, especially against the backdrop of risks of abrupt changes in the direction of global capital flows.
- Local currency bond markets reduce the local enterprises' dependency on loans and broaden the opportunities of investment financing.
- The liberalisation of capital accounts needs to be encouraged, with due attention to the appropriate pace and sequencing, to support the development of local currency bond markets.
- The development of local bond markets can improve financial intermediation.

Sound macroeconomic policies, robust market infrastructure and a strong transparent legal framework are key for a broader participation from long-term domestic and foreign investors and enhance the efficient international diversification of capital. In this respect, EME have undertaken a great deal of reforms to reduce their dependency on external finance. Further reforms are necessary to deepen their domestic bond markets, and given countries´ and regions' different stages of development and the different natures of their domestic financial systems, sequencing and prioritization of reforms will be different in each country.

In consultation with other relevant international institutions and partners from emerging and developing countries, considering the results of the workshop on "Developing Bond Markets in Emerging Market Economies", held on May 9/10, 2007 in Frankfurt, we identified policy issues that contribute towards further progress aiming at enhancing long-term growth, financial stability and market efficiency in EME.

We ask our Deputies and the IMF and World Bank to report before our meeting in October 2007 on how to implement this action plan. We ask the IMF and World Bank, in cooperation with other relevant international institutions, to regularly report, on this basis, on the progress of the implementation of this action plan. These reports which we will discuss at our future meetings, when appropriate, should cover the following key policy issues:

**1. Strengthening market infrastructure and public debt management**
There is a need to enhance the regulatory framework and risk-based prudential regulation, removing non-prudential barriers to entry and investment, nurturing a vibrant credit culture, implementing international standards and practices (including documentation), improving the human capital of both local market participants and regulators and promoting efficient and transparent markets.
Clearing and settlement systems using international best practices enhance the integration of international financial markets, improve confidence in the EME markets themselves and reduce risks and transaction costs. We reaffirm the IOSCO (International Organization of Securities Commissions) principles for securities regulation and the CPSS (Committee on Payment and Settlement Systems) / IOSCO recommendations for securities settlement systems.

- We note the contribution of the G 30 Action Plan towards enhancing the interoperability of settlement systems and call upon the private sector to consider developing a similar action plan for all markets, not just for advanced markets. We call upon CPSS and IOSCO to consider the advisability and applicability of a standard communication protocol, such as the Giovannini Protocol that was developed for the EU.

IMF and World Bank's diagnostic work identified common weaknesses in securities settlement systems. We believe that technical assistance (TA), provided bilaterally and multilaterally, should be targeted to meet common weaknesses and we support ongoing efforts in this respect. These weaknesses include: lack of independence of the regulator and of supervision by regulators; lack of enforcement of existing rules due to a shortage of resources and skills in the regulator; weak risk management practices in financial intermediaries and weaknesses in legal frameworks for mutual funds; weaknesses in governance of securities settlement systems.

- First, we encourage EME to develop and implement a sound regulatory and supervisory framework. We also call on EME, supported by bilateral and multilateral efforts, to consider benefits from Self-Regulatory Organisations development, by improving regulatory certainty and clarity, foreign investment promotion, removal of capital and exchange controls, elimination of transaction taxes, and reduction or elimination of withholding taxes on interest and capital gains earned by foreign investors
- We support the efforts of the IMF and World Bank to provide TA in these areas.

The main direction of policy should be towards the creation of a liquid local currency government bonds market for benchmarking purposes.

- We encourage EME to improve institutional arrangements to increase liquidity, for instance by establishing a primary dealer system in those countries where it would be appropriate.
- We welcome the further issuance of local currency bonds by the International Finance Institutions (IFI) and other investment grade issuers as long as this does not crowd out private domestic issuers.
- We encourage the EME to pursue sound sovereign debt management including securitization of receivables.

**2. Broadening and diversifying the investor base**

Broadening and diversifying the investor base is one of the most important steps towards deepening local bond markets in EME. The development of the domestic investor base is a priority that can be fostered by improving the regulatory environment and lowering barriers for foreign investors. We call upon the IFI to support the expansion of the domestic institutional investor base by helping to design enabling reforms of private pension systems, mutual funds and insurance markets.

- We ask the IMF to examine best practice regarding the development of the domestic institutional investor base and to evaluate to what extent a further easing of the impediments for institutional investors in EME can contribute to more efficient diversification of funds and the development of local domestic bond markets.
- We invite EME to adopt measures designed to make local currency bond markets more attractive to long-term institutional investors particularly by establishing a level playing field for all investors.
- We encourage EME to establish enabling market access reforms, in particular by avoiding investment and other restrictions.

**3. Developing of derivative and swap markets**

Derivative and swap markets help to address exchange rate and interest rate risks. While in some EME derivative markets have significantly grown in recent years, in most EME these markets remain underdeveloped, particularly those for interest rate derivatives. The development of those markets needs to be underpinned by an appropriate infrastructure and regulatory framework, consistent with the conditions of the local financial system

- We call on EME, aided by multilateral and bilateral efforts, to support derivative market development, once their markets have reached the appropriate stage of development and liquidity, by improving the regulatory, legal and market infrastructures.
- We encourage EME to upgrade their respective accounting standards.
- We support the joint IFC/World Bank Capital Markets Advisory Group, which is, together with the ongoing efforts, enhancing the IFI's capabilities to provide TA in this area.

**4. Broadening the database**

Limited aggregated data on EME bond markets, particularly on currency composition and maturity and coverage of corporate bond markets hampers the analysis of the local currency bond markets.

- We strongly support World Bank creation of indicators for bond market development.
- We support joint IFI initiatives to improve the quality, comparability, and consistency of local currency bond market data, especially on aggregate institutional investors' capital flows, and currency and maturity structures, including debt structures and composition of capital flows, to identify underlying weaknesses and risks in individual EME bond markets that need to be remedied.
- We ask IMF, World Bank, OECD and BIS to undertake a stocktake of currently available data on local debt markets and identify any gaps, with a view to consolidating the information. In addition, we call on the FSF for a progress report of the implementation of the recommendations for data requirements of the FSF Working Group Report on Capital Flows (April 2000) and comparable initiatives.

**5. Promoting regional initiatives**

We noted with great interest that a regional bond market initiative by 10 ASEAN countries and China, Japan and Korea (Asian Bond Markets Initiative) is making progress in areas such as diversification of bond issuers and instruments. This initiative is based on a strong political commitment and appropriate involvement of the Asian Development Bank. Regional bond markets could also provide the critical mass necessary to justify costly investments in infrastructure such as trading platforms, valuation services, clearing, settlement and custody services, and accredited regional rating agencies for the smaller EME.

- We encourage the IMF and World Bank to enhance regional cooperation to develop local currency bond markets where that would be effective.

**6. Developing bond markets in less developed countries, particular Sub-Saharan African countries**

The specific challenges faced by developing countries, particularly Sub-Saharan African countries in developing local bond markets include the different debt structures and level of market infrastructure. Interested Sub-Saharan African countries are invited to adopt the guidelines and recommendations (best practices) outlined in this action plan. We encourage these countries to continue to implement the necessary macroeconomic and banking system reforms, which are preconditions for the sustainable development of capital markets and highlight the importance of sub-Saharan African countries taking full account of debt sustainability considerations when undertaking any new bond issuance, in particular ensuring consistency with the IMF/World Bank Debt Sustainability Framework

- We ask the IMF and the World Bank to provide, in close cooperation with the multilateral development banks and major bilateral providers of TA, policy advice and TA to build and strengthen regional and/or local bond markets.

**7. Technical assistance**

Various IFI and multilateral and bilateral agencies provide TA to develop local currency bond markets in EME and developing countries. These institutions are invited to improve TA and its coordination to avoid duplication and overlap.

- We support internal reorganisations within the IFI - where necessary - to streamline TA on bond market development.
- We support an intensified and regular exchange of knowledge and experience between debt managers, regulators, investors, representatives of clearing and settlement systems and international market associations in G8 countries and EME (for instance support of regional cooperation by the World Association of Debt Management Offices and the Latin American Countries Debt Group), possibly by workshops or seminars of individual G8 countries in EME or developing countries.
- We are committed to continue bilateral TA by providing technical expertise (e.g. through our national agencies) and financial support.