

Publication Date: 06-Jun-2003
Reprinted from RatingsDirect

Research

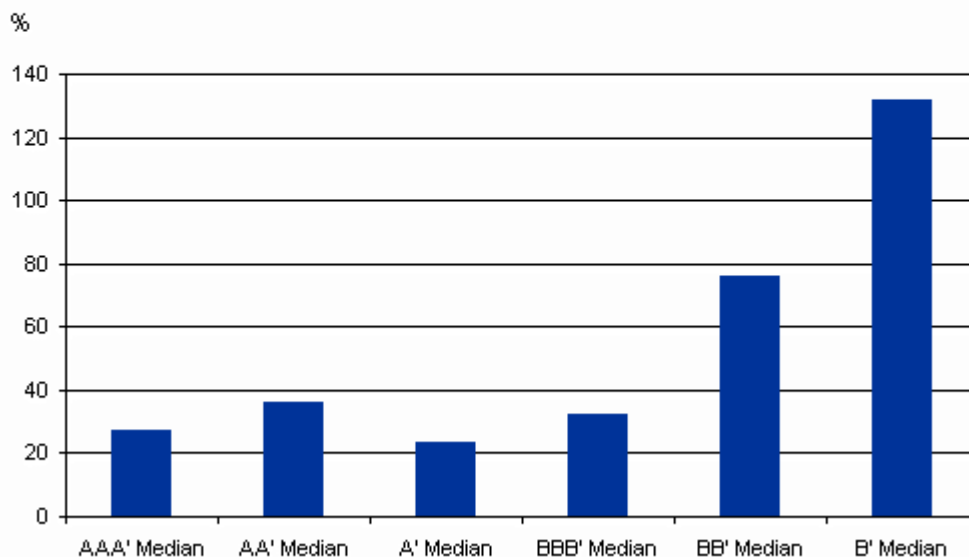
How Domestic Capital Markets Can Help Sovereign Creditworthiness

Analyst: John Chambers, CFA, New York (1) 212-438-7344

(Editor's note: The following remarks were drawn from a speech given by Managing Director John Chambers at the fifth annual OECD-World Bank Bond Market Forum held in Washington, D.C., on June 2, 2003.)

Among the different factors that affect sovereign creditworthiness, the external position can most benefit from a deepening of the domestic capital market. As explained in "Sovereign Credit Ratings: A Primer," (RatingsDirect, April 3, 2002), the external positions of the public and private sectors are important because debtors reliant upon commercial sources of nonresident funding are at greater risk of sudden stops of financing flows than debtors who mostly finance themselves domestically. This phenomenon is due to the home-market bias of investors, which derives, in part, from regulatory reasons but also, in part, from less asymmetry of information between borrower and investor. From this perspective, it matters little whether the source of domestic financing is bank lending or debt securities issuance. Chart 1 shows the correlation between ratings and external indebtedness.

Chart 1
Public Sector External Debt/Current Account Receipts
2003



Debtors turn to nonresident funding because it appears cheaper ex ante or because it is available. In the case of private sector borrowers, the negative externalities of borrowing abroad are spread throughout the entire economy. Private or public sector borrowers may also underestimate the risk of sudden stops of external finance, which, in turn, could create system-wide liquidity or solvency crises. To attenuate these negative externalities, some form of inward capital controls may be appropriate for countries that are not fully integrated with world financial systems, that do not have fully developed bank regulation or supervision, or

that have low sovereign credit ratings. Regarding availability of funds, this may derive from the time preference of particular creditor classes. Banks have short-dated liabilities and, thus, prefer making short-dated loans or at least loans that are repriced on a short duration; domestic capital markets tend to provide for longer-dated, fixed-rate funding.

Turning to the real economy and making the same point in a different way, debtors find domestic finance expensive or wanting in certain tenors because of inefficiencies in intermediating savings and investment or because of crowding out by public sector borrowing. Such inefficiencies are most often associated with wide bank intermediation spreads, which can derive from high operating costs; the drag of nonperforming loans; the cost of maintaining high reserve requirements at the central bank; or rent-seeking activity when a few banks hold oligopolistic market positions. Here again, developing domestic capital markets can help, as such inefficiencies that exist in bank lending may be less prevalent than in the domestic capital markets.

Whether for bank deposits or for domestic bonds, domestic savings instruments need to compete with offshore instruments for the top-earning segment of a population, absent effective outward capital controls. Although tax reasons could account for the greater attractiveness of offshore instruments to taxable domestic individual investors versus foreign institutional investors, a more important reason may simply be a desire to invest in deeper, more liquid markets, or in a more stable currency. As domestic capital markets deepen, they will be able to compete more effectively for domestic funds.

Savings comprise private and public savings. Private savings are motivated first by prospective returns but also by other factors, including uncertainty, marginal effective income tax rates, corporate profitability, and levels of capital stock. Public savings depend upon the government's fiscal stance and the composition of its expenditure mix. Weak public finances raise the cost of financing for all borrowers and absorb limited domestic resources. There is a high correlation between fiscal flows, debt stocks, and ratings.

Chart 2
General Government Balance/GDP
2003

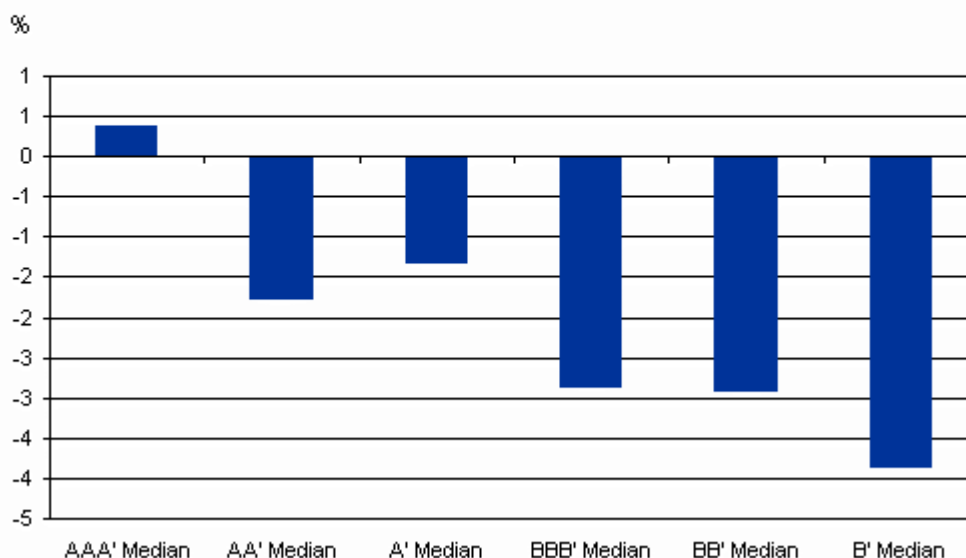
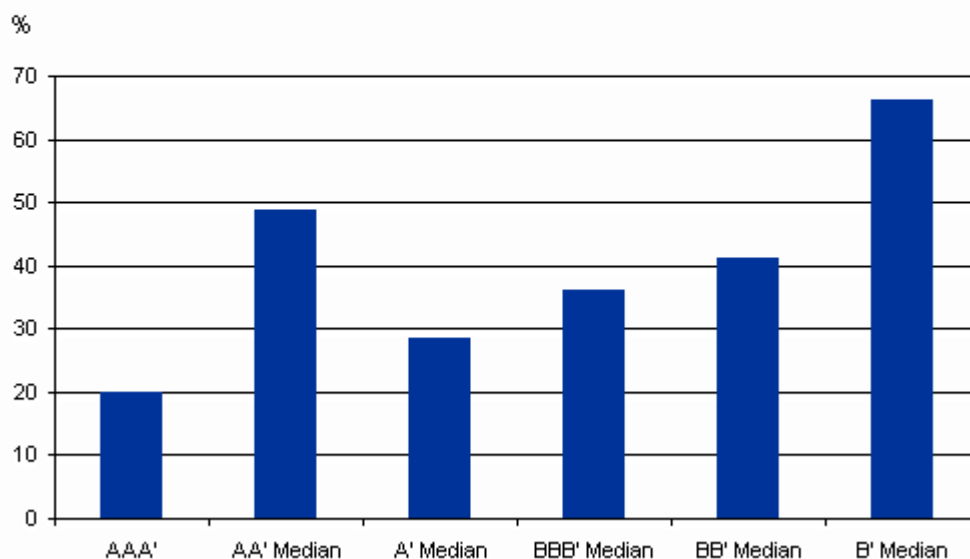


Chart 3

Net General Government Debt/GDP

2003



To the extent that the ex post cost of domestic debt is below the ex post cost of external debt (because of currency depreciation or because domestic interest rates are not fully correlated with international interest rate movements), domestic debt can ease a sovereign's fiscal burden.

Having a deep domestic capital market can also help in pursuing an independent monetary policy. It is more effective for a central bank to manage short-term interest rates through open market operations using government securities than to make direct loans. For providing emergency assistance to financial institutions, it is more efficient for a central bank to lend against marketable debt securities than against collateralized loans.

■ Desirable Characteristics of a Domestic Capital Market

For a given interest rate, the most attractive instrument for public debt management is a long-term local currency fixed rate instrument. The nominal cost of the instrument is known in advance. The central bank has control over the currency of issue. The risk of unexpected inflation is held by the investor (albeit matched by the risk of unexpected disinflation or deflation, which is borne by the government).

Inflation-linked local currency debt is also an attractive instrument. Its nominal cost is not known in advance, although its real cost is fixed. Of course, government revenue may not track inflation. Inflation-linked bonds can give investors and issuers alike important signals on market expectations about future inflation. On the other hand, indexing of financial contracts could give some impetus to indexing other contracts, such as wages, which could add to inflation inertia. The Republic of Chile has had an inflation-linked market for two decades; it also suffered from wage indexation.

Foreign-currency-denominated or foreign-currency-linked domestic debt has few advantages over debt issued in the international capital markets. Although domestic investors may be marginally less likely to reallocate their dollar portfolios abroad than international investors are to switch their allocation from one country to the next, the cost of servicing the debt will depend upon future currency movements. The greater the percentage of dollarization, be it in the banking sector or the domestic capital market, the less freedom the central bank enjoys in monetary or exchange-rate policymaking, given the balance sheet impact of a

currency depreciation. The recent debt crisis of the highly dollarized Oriental Republic of Uruguay shows vividly how a sharp depreciation of the local currency placed government debt dynamics on an unsustainable path and rendered much of the private sector insolvent.

To foster the development of a domestic capital market, several elements are required. These include:

- A strong and independent securities and exchange commission, with sound regulations;
- An extended period of macroeconomic stability;
- A strong legal system and bankruptcy procedures;
- A set of resolution mechanisms incorporated into standard bond indentures, including (for example) collective action clauses;
- A coordinated and advanced payment, settlement, and custodial system; and
- A developed base of natural buyers of long-dated securities, specifically pension funds and insurance companies.

However, domestic capital markets can seize up even with stable macroeconomic conditions and good regulation, and policymakers need to be prepared. In Korea, for example, the domestic capital market has grown rapidly, and corporate debt outstanding is roughly 27% of GDP. Investment trusts are major investors in the money markets. Trading arms of large conglomerates finance themselves in the local capital markets. Credit card companies, many of which are owned by large conglomerates, also used to finance themselves primarily in the money markets. When the trading arm of SK Corp., SK Global, announced a US\$1.2 billion (Korean won equivalent) accounting fraud, many investment trusts were directly exposed. They suffered withdrawals from their open-ended funds. They did not, in turn, roll over much of their placements with industrially owned credit card companies—partly because of their own liquidity problems, and partly because they distrusted the solvency of the sector, which had been experiencing increasing delinquency rates. The government had to step in to persuade a syndicate of banks to provide a US\$5 billion (Korean won equivalent) bridge loan to the sector, while it demanded that credit card company shareholders increase their subsidiaries' capitalization. Without the liquidity support the sector would have crashed, and many credit card holders would have crashed with it. In this case, which appears to have been a liquidity rather than a solvency problem, government intervention was warranted. However, direct government assistance, which was granted freely to insolvent well-connected firms in several newly industrialized Asian economies during the Asian financial crisis, should be withheld from ailing private sector companies to avoid problems of moral hazard.

Another factor that regulators need to keep in mind is the proper sequencing of reform. The introduction of mark-to-market rules for Brazilian investment trusts in June 2002, when the market was experiencing turbulence due to changing investor perceptions of political risk, was, in retrospect, ill-timed; the increased transparency further spooked investors and caused withdrawals.

Regulators also need to be prepared for the unexpected. When the Chileans moved to dematerialize their nation's money markets, they uncovered outright theft and malfeasance at one of its dealers that temporarily disrupted the government bond market.

Finally, policymakers will want to make sure that there are independent mechanisms in place to help investors assess credit risk. Rating agencies have a role to play here. By providing timely, forward-looking estimates of default probability, rating agencies offer investors an important complement to their own credit analysis and help make the pricing of credit risk more efficient.

This report was reproduced from Standard & Poor's RatingsDirect, the premier source of real-time, Web-based credit ratings and research from an organization that has been a leader in objective credit analysis for more than 140 years. To preview this dynamic on-line product, visit our RatingDirect Web site at www.standardandpoors.com/ratingsdirect. Standard & Poor's.



Published by Standard & Poor's, a Division of The McGraw-Hill Companies, Inc. Executive offices: 1221 Avenue of the Americas, New York, NY 10020. Editorial offices: 55 Water Street, New York, NY 10041. Subscriber services: (1) 212-438-7280. Copyright 2000 by The McGraw-Hill Companies, Inc. Reproduction in whole or in part prohibited except by permission. All rights reserved. Information has been obtained by Standard & Poor's from sources believed to be reliable. However, because of the possibility of human or mechanical error by our sources, Standard & Poor's or others, Standard & Poor's does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions or the result obtained from the use of such information. Ratings are statements of opinion, not statements of fact or recommendations to buy, hold, or sell any securities.