Towards recovery and resilience in frontier financial markets

Policy Brief

frontclear
A financial markets development company

"Money markets are a cornerstone of the financial system. Banks, non-bank financial institutions and non-financial corporations all rely on money markets for their short-term funding, liquidity management and collateral needs. As a result, dislocations in money markets can severely undermine the stability of our financial system."

ECB, Executive Board Member Isabel Schnabel[1]

[1] Speech: Shifting Tides in Euro Area Money Markets: from the global financial crisis to the COVID-19 pandemic, 23 November 2020.

The Covid-19 pandemic is expected to cause the worst global recession since World War II and has delivered a financial shock in emerging markets comparable to that of the global financial crisis.

With the unprecedented and sudden global contraction in economic activity, millions of jobs and livelihoods have been lost. The impact on global poverty is truly unprecedented. The World Bank estimates that the pandemic-induced recession will push an additional 88 million to 150 million people into extreme poverty. Eight out of 10 'new poor' will be in middle-income countries.[2]

Monetary and fiscal responses have proven critical to staving off worst-case scenarios and will continue to play an outsized roll in the recovery.

Central banks across the globe have intervened at unparalleled levels to support FX markets, lower interest rates and stave-off urgent needs in the money market. They have also facilitated moratoriums on debt to households and SMEs and allowed restructured loans to not be classified as non-performing (NPLs). Governments have responded with massive fiscal stimulus to support the real economy to survive the crisis and minimise scarring. In doing so however, governments have placed outsized pressure on local currency bond markets which may drag economic recovery efforts for years to come.

Money Markets and the Economy

Source: Frontclear

Interest rate setting

A well-functioning money market allows for the evolution of predictable, more stable short-term rates that will be priced in fixed income markets such as government and corporate bonds and mortgage debt instruments.

Monetary policy transmission

A well-functioning money market enables the central bank to influence longer-maturity rates by steering very short-term money market rates, affecting the monetary supply and amount of credit in the economy.

Efficient allocation of liquidity

Normally functioning money markets foster better allocation of financial resources and unlocks dead capital, allowing for the transfer of funds from those who have it to those businesses and others that need funds for investment.

Risk mitigation

Access to normally functioning money markets enable banks to hedge currency risks and mitigate credit and market risks, together contributing to the overall resilience of banking systems and thus the economy.

Value of local currency

More active and participatory local currency money markets support dedollarisation and the real value of local currency cash and securities such as government securities, thereby reducing the costs of government funding and improving the stability of the currency.

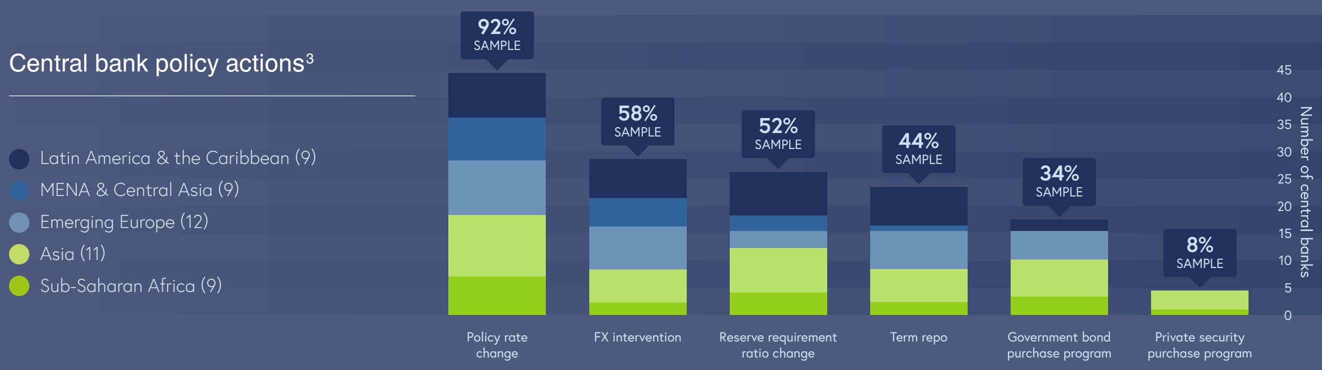
[2] Poverty and Shared Prosperity 2020: Reversals of Fortune (2020). IBRD/WB, p. 21.

Those emerging markets with well-developed local currency money and bond markets were positioned to respond forcefully.

The chart below, from the IMF October 2020 Global Financial Stability Report, highlights that while most emerging market central banks surveyed quickly adopted an accommodative monetary stance and utilised reserves to support FX markets, others were able to intervene more forcefully through the provision of term repo to banks. For the first time, several emerging market central banks ventured into the quantitative easing realm and supported the bond market directly by introducing government bond asset purchase programmes.

However, there were many more frontier markets that entered the shock already vulnerable, having high debt-to-GDP ratios and an over-reliance on foreign currency commercial debt. This impaired their ability to respond fiscally. Furthermore, frontier markets with shallow local domestic capital markets and under-developed monetary policy frameworks had more limited options to respond to the monetary shock.

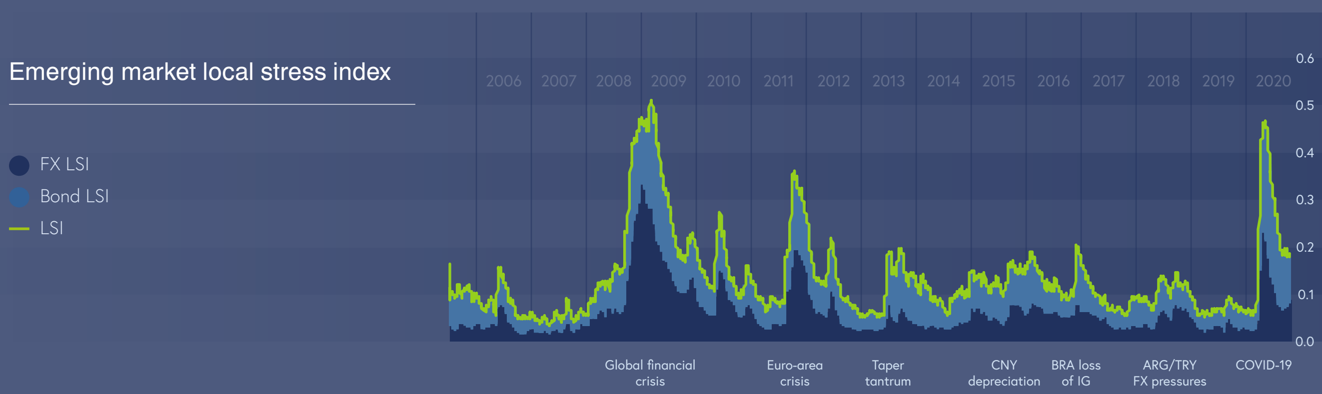
Central bank policy actions[3]



Local currency bond markets played a critical role in absorbing the shock and came under more stress compared to the global financial crisis.

The IMF Local Stress Index (LSI),[4] introduced in 2020, provides unique insight into the impact of the Covid-19 pandemic on emerging market FX and bond markets. Foreign participation in local currency bonds of emerging and frontier markets has increased significantly in recent years and the Covid-19 pandemic triggered a sharp sell-off of these assets. Whilst the FX market shock was more muted than in the past (see below), this reversal of financial flows out of emerging markets occurred at the same time as governments were drastically increasing supply to fund their response to the crisis. As the LSI indicated, this led to a pronounced stress in the local domestic bond market and suggests that many local bond markets do not have sufficient depth to absorb sharp flow reversals.

Emerging market local stress index



[3] Global Financial Stability Report: Bridge to Recovery (October 2020). IMF, p. 56.
[4] The LSI focuses on local market liquidity and stress indicators (such as bid-offer spreads, realised volatility, and other risk premium measures). ibid. p. 61.

Global financial reforms have played a key role in preventing the pandemic from triggering a wider global financial crisis.

The IMF analysis also notes that stress in global FX markets was comparatively lower than in previous global crises, notwithstanding that the scale of the flow reversals were on par with that of the financial crisis. There are many possible reasons for this, with the IMF citing the rapid establishment of swap funding lines with emerging market central banks and structural changes in the market as key factors.

Certainly the wider reforms introduced after the global financial crisis also ensured the global system was well positioned at the start of the pandemic: The global banking system entered the COVID-19 crisis with relatively high capital and liquidity buffers.[5] The reformed market structure points to the gained efficacy – a significant reduction in counterparty credit risk and (potential) for market contagion in interbank markets. Most advanced money markets have over the past decade steadily moved from trading primarily unsecured to primarily secured (repo).[6] Derivatives markets have become safer, more resilient, and more transparent. The result has been a more stable global money market and a more resilient financial system that was able to respond forcefully to the pandemic.

Local currency bond markets played a critical role but lack sufficient depth.

Deep and efficient domestic government debt markets help provide resilience to shocks in times of financial turbulence and convey multiple economic benefits.[7] These markets mitigate currency pressures and are central to broader capital market development, facilitating appropriate pricing of risk, allowing participants in financial markets to better manage their portfolios, and providing a more effective conduit for monetary policy. In turn, these factors help boost a country's long-term economic growth potential and ability to weather external shocks.

The IMF LSI ultimately highlights that the depth of many local currency bond markets has not matched the increase in foreign participation, which has left the system vulnerable. In many emerging and frontier markets, a few top banks are often the sole providers of liquidity and there is insufficient participation by pension funds, insurance companies and asset managers. Moreover, repo markets are sorely under-developed, which prevents liquidity from flowing in the system. Indeed, Frontclear research found that of the more than 120 frontier markets surveyed, only 24 have a repo market and of these, only one-third are found to be functioning.[8]

Overall, money market related financial infrastructure has not received sufficient policy attention, and this has undermined stability and increased the pressure on the central bank as lender of last resort in many emerging markets.

[5] Global Financial Stability Report: Bridge to Recovery (October 2020). IMF, p. ix.
[6] Various: BIS OTC Derivatives Statistics; ISDA reports; ICMA reports.
[7] Guidance Note for Developing Government Local Currency Bond Markets (March 2021). IMF WBG, p. 1.
[8] Frontclear Study – Repo: OTC or Exchange Traded? (June 2018), Frontclear, p.23.

Money Market Diagnostic Framework (MMDF)

Source: Frontclear

Launched in 2018 by Frontclear, EBRD and OG Research, the MMDF has now been implemented in more than 10 developing countries. The deployment of the MMDF is an invaluable in-depth analytical exercise, offering central bank regulators insights into the current status (a baseline) and priorities to develop their money market. The resulting report and recommendations serve as a starting point for sequential money market development and offer a foundation on which to coordinate follow-on technical assistance. The MMDF is implemented together with regulators and the MMDF portal offers beneficiaries the opportunity to compare results and participate in joint policy discussions.

The MMDF generates a visually represented baseline drawn from an in-depth, query-based assessment of a country's money market.

Assessment grounded on four building blocks central to money market development

Building blocks	1 Current level of MM development	2 Environment	3 Cental Bank (CB) activity	4 Resources
Topics	Market participants	Monetary policy framework	Counterparties	CB HR
	Market segments	Payment system	Reserve requirement	Market HR
	Benchmark rates, yield curve	Post-trade infrastructure	CB operations	Information technologies
	Collateral in interbank operations	Credit risk	Banking sector liquidity	
	Information available for market participants	Transaction costs	Collateral in CB operations	
		Prudential regulation	Information for regulators	
		Legal infrastructure	Communication	

Each of the four building blocks are evaluated based on the degree to which underlying topics are in place and functioning

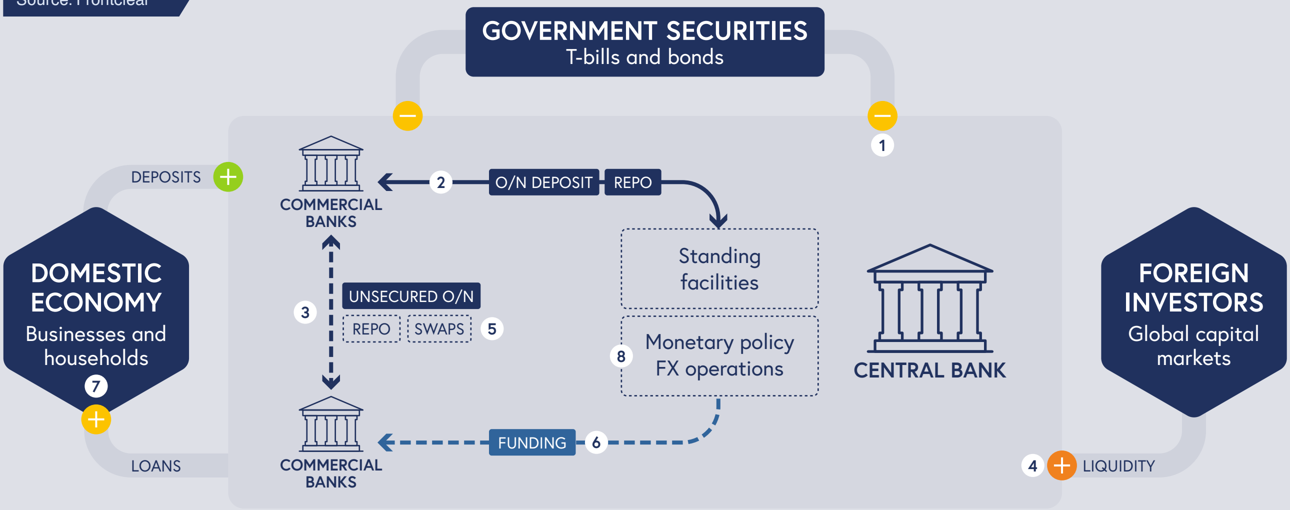
Development of money markets starts with detailed diagnostics, legal and regulatory reforms, and capacity building.

More stable and inclusive money markets are a prerequisite for increasing depth in local currency bond markets. The nucleus of the money market is interbank lending, where banks borrow and lend to each other using financial instruments such as repurchase agreements (repos) and hedge balance sheet risks through derivatives. Central banks and banks rely on interbank markets to deal with immediate liquidity concerns and to transmit changes in monetary policy.

Many emerging markets face a structural challenge: extensive market segmentation and over-reliance on the banking sector as the only local source of liquidity. Under normal market conditions, let alone in a crisis, (perceived) counterparty credit risk quickly dislocates banking relationships. Without access to the interbank system and in particularly repo, banks hoard liquidity as a primary risk mitigator. Larger banks experience lower borrowing costs and often only trade with one another. Smaller players, who often play an outsized role in serving SMEs, are locked-out or have high borrowing costs despite overall liquidity in the market. The financial system's overall financial soundness and role to effectively extend loans and financial products to the real economy, suffers.

Market Segmentation in Frontier Markets

Source: Frontclear



Takeaways

- 1 Benchmark government securities are not always in place or available.
- 2 Punitively priced vertical repo.
- 3 Largely overnight O/N unsecured markets characterised by wide spreads reflecting high and diverse perceptions of counterparty credit risk.
- 3 5 Limited/no horizontal repo (fragmented interbank).
- 4 6 Limited bank access to liquidity.
- 3 5 7 Shallow swap markets; banking system unable to hedge risks, attract investment and serve clients - stockpiling reserves.
- 8 Monetary policy does not transmit through the system.

Ultimately, ex-ante establishment of local financial infrastructure is the only way to build better resilience against future shocks.

With the prolonged pandemic, many emerging markets will face challenges for years to come. The sharp increase in government debt will lead to further crowding-out of the private sector and more macro-economic instability. In some countries, extensive debt relief and/or restructuring will be the only way out. Yet, there is also a broad swath of lower- and middle-income countries with very nascent money markets with structural challenges.

These warrant immediate global attention and policy intervention.

Without a participatory and inclusive money market that facilitates access for all market participants, the prolonged COVID-19 uncertainty will continue to deplete financial system reserves and slow recovery. This cost of shallow money markets will likely become even more prevalent in 2021 onwards as the extent of the damage to bank balance sheets becomes clearer and their access to the market continues to diminish. In the absence of functioning markets, economic recoveries will be slow and may yet trigger local financial crises. Ultimately, the establishment of local financial infrastructure, including local clearing and settlement infrastructure, will be vital to ensuring a more robust response to future crises.

A System Approach

Source: Frontclear

An inclusive interbank market will be central to recovery and to improved resilience to future shocks. The Umbrella Guarantee Facility (UGF) is a systemic approach to reducing a market's counterparty credit risk – the key challenge behind market segmentation. In the UGF, all interbank transactions among eligible banks in a country are guaranteed. This mitigates counterparty credit risk and allows liquidity to flow among tiers in the system, while simultaneously building-up operational experience with best practice documentation (GMRA and ISDA) and transaction knowledge (e.g. margining, collateral management). UGFs reflect pre-CCP market infrastructure and a secure approach to a more inclusive interbank market.

A global policy partnership towards recovery and resilience in frontier financial markets.

Frontclear is a development finance company established in 2015 to promote the development of more stable and inclusive money markets in developing countries. Frontclear is committed to diagnosing and addressing strategic deficiencies in frontier markets through the provision of technical assistance and guarantees to cover counterparty credit risk. Frontclear sits at the crossroads between the development finance community, global beneficiary banks and financial associations and local regulators, to further the development of frontier money markets.

"Bilateral donors, DFIs, and MDBs have already participated in setting-up specialised guarantee providers, such as GuarantCo, Frontclear, or AGF. By pooling resources and offering targeted support, such institutions may solve the problems of fragmentation and inefficiencies of development finance in particular geographies."

– The Role of Guarantees in Blended Finance, OECD 2021

Summary

This policy brief has highlighted the pivotal role that money markets play during economic shocks and calls for accelerated focus on these markets as a key means to deepen local currency bond markets in emerging and frontier markets. A global dialogue between donors, the development finance community and emerging and frontier market authorities, is urgently needed to increase resources and capacity in this area.

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Our investors