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GUIDANCE NOTE FOR DEVELOPING GOVERNMENT LOCAL CURRENCY BOND MARKETS

EXECUTIVE SUMMARY

This guidance note was prepared by International Monetary Fund (IMF) and World Bank Group staff under a project undertaken with the support of grants from the Financial Sector Reform and Strengthening Initiative, (FIRST).¹The aim of the project was to deliver a report that provides emerging market and developing economies with guidance and a roadmap in developing their local currency bond markets (LCBMs). This note will also inform technical assistance missions in advising authorities on the formulation of policies to deepen LCBMs.

Deep and efficient domestic government debt markets help provide resilience to shocks in times of financial turbulence and convey multiple economic benefits. Recent financial crises, including the turmoil in financial markets caused by the coronavirus disease (COVID-19) pandemic, have shown that efficient LCBMs can increase financial resilience by mitigating currency risk, which is often a source of financial distress. In addition, the development of LCBMs is a cornerstone of broader capital market development that helps to price risk appropriately, allows participants in financial markets to better manage their portfolios, and provides a more effective conduit for monetary policy. In turn, these factors help boost a country's long-term economic growth potential.

Developing domestic debt markets is a complex process that requires multiple and interdependent policy actions. Though broad guidelines and general principles to develop LCBMs are readily available, their translation into specific reforms is a daunting task because it requires actions from a broad range of stakeholders, including the debt manager; the central bank; regulators; the providers of trading, payment, clearing, and settlement systems; and other policy makers. As countries tend to be at different levels of development along these various dimensions, the further development of their LCBMs will be path-dependent and require a country-specific, customized approach.

To anchor this approach, this guidance note provides a comprehensive and systematic framework for LCBM development. It fills a gap in the current literature by going beyond merely

¹ FIRST is a multi-donor grant facility that provides short- to medium-term technical assistance to promote sounder, more efficient, and inclusive financial systems. FIRST is currently supported by five donors: the Department for International Development of the United Kingdom (DFID), Germany's Federal Ministry of Economic Cooperation and Development (BMZ), the Ministry of Finance of Luxembourg, the Ministry of Foreign Affairs of the Netherlands (MFA), and the State Secretariat for Economic Affairs of Switzerland (SECO), as well as the World Bank Group and the IMF.

recommending best practices to fully recognizing the obstacles that hamper the implementation of LCBM reforms. It starts from a systematic assessment of the preconditions for success and the stages of market development along the typical six major building blocks of LCBM development: money market, primary market, investor base, secondary market, financial market infrastructure, and the legal and regulatory framework. Applying a series of specific indicators, the guidance note framework allows for (a) the identification of gaps in a country's LCBM, (b) the assessment of a country's stage of market development, and (c) the identification of possible peers that may provide replicable lessons.

The guidance note discusses commonly faced challenges and bottlenecks in the journey to efficient and deep LCBMs. In particular, the guidance note explores how to overcome difficulties in implementing some existing best practices. Experience points to the interdependent nature of the required development actions and the need for supportive actions outside the narrow field of LCBM agents. The challenges discussed and accompanying policy guidance draw from the IMF and World Bank's extensive technical assistance (TA) provision in this area, cross-country experience in LCBM development, and results from a recent survey of country authorities.

The guidance note intends to be a resource for a wide range of stakeholders interested in government bond market development. Country authorities and TA providers can use the diagnostic on the level of LCBM development to design a proper sequence of policy actions to further improve the functioning of the domestic government debt market. Country authorities and IMF/World Bank country teams can use the guidance note to identify key macroeconomic and financial issues linked to LCBM development and integrate it into their policy analysis and advice. The diagnostic findings regarding weaknesses in LCBMs also can be used to help identify financial vulnerabilities and their remedies, in the authorities' ongoing financial sector surveillance and in the context of Financial Sector Assessment Programs and Financial Sector Stability Reviews.

Approved by
Miguel Savastano
(IMF) and Caroline
Freund (World Bank)

Prepared by Hideo Hashimoto, Yen Mooi, Guilherme Pedras, Arindam Roy, Kay Chung, and Tadeusz Galeza from the International Monetary Fund (IMF); Zsolt Bango, Jose Antonio Gagnani, Bryan Gurhy, and Cindy Paladines from the World Bank Group; and Michael G. Papaioannou and Peter Katz (IMF experts) under the supervision of Thordur Jonasson from the IMF and Anderson Silva from the World Bank Group, respectively. The authors would like to thank peer reviewers from the IMF and the World Bank Group, and external reviewers for their input and comments to this note.² The views expressed here are solely the authors' and should not be attributed to the World Bank Group, the IMF, their Executive Boards, or their management.

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Abbreviations

ASEAN	Association of Southeast Asian Nations
ATM	average time to maturity
ATR	average time to re-fixing
BMA	Bond Market Association
BoA	Bank of Albania
CCP	Central Counterparty Clearing House
CIS	collective investment scheme
CSD	central securities depository
DeMPA	Debt management performance Assessment Tool
DSA	debt sustainability analysis
DVP	delivery versus payment
ETP	electronic trading platform
FMI	financial market infrastructure
G20	Group of Twenty
IFI	international financial institution
LCBM	local currency bond market
LMOs	liability management operations
IMF	International Monetary Fund
MoFE	Ministry of Finance and Economy
MT	monetary targeting
OTC	over-the-counter
PD	primary dealer
PDMO	Public Debt Management Office
RTGS	real-time gross settlement
TA	technical assistance
T-bill	treasury bill