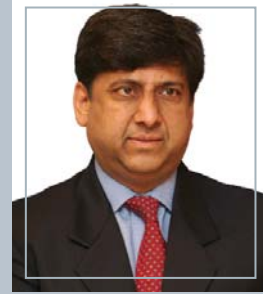


Market view



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Developing countries in Asia need billions of dollars in foreign investment to spark infrastructure investment. The demand is enormous. But investors are still wary of taking currency mismatch, interest-rate and refinancing risks, having learnt hard lessons from the Asian financial crisis. As a result, all emerging countries in Asia are now mindful of the benefits of developing local capital markets to help attract long-term foreign investment. Traditionally, commercial banks have been suppliers of long-term financing in Asia and have relied on short-term deposits for their funding requirements. Such a practice, especially in a weak banking environment, exposes the banking sector to systemic risks.

Central banks, policy makers and securities regulators are now pushing for deep and liquid capital markets. And here the definition of capital markets is much wider. It includes swap markets, bond markets and equity-capital markets – countries are now developing all three components. It is now widely acknowledged that developing swap markets is as necessary as developing fixed-income markets to promote foreign-investment-led economic growth.

So, in terms of sequencing, swap-market development has to be undertaken in parallel with bond-market development. Indeed, countries are now aware of the major issues and challenges, such as lack of market depth for local-currency and underdeveloped legal, political and institutional infrastructure in local capital markets.

Asian Development Bank (ADB) has taken a leadership role in promoting local capital markets by developing its local-currency lending initiative. The objective is to provide long-term local-currency funding in all of the countries the bank operates in. ADB looks for alternatives that are best suited for individual circumstances, but the idea is to inject long-term local-currency financing for targeted sectors that generate economic growth. These sectors include and are not just limited to infrastructure, manufacturing, housing, small and medium-sized enterprises, and micro finance.

Developing local capital markets has a number of associated development benefits. It helps stimulate economic growth. It also creates depth and extends maturities in the capital markets. It provides a natural hedge to borrowers by matching currency of revenue with currency of borrowing. In addition, it retains foreign direct investment, strengthens the banking sector,

improves financial intermediation and develops local benchmarks. The expectation is that the new funding approach will attract fresh capital to emerging countries as risks associated with short-term lending for refinancing, interest-rate volatility and maturity mismatches are removed.

ADB has two options to fund its local-currency operations: a local bond issuance or cross-currency swaps. In addition, it could provide partial-credit guarantees for debt denominated in local currency. Individual developing-country markets, the macroeconomic climate and the regulatory environment will thus dictate the modality of intervention. Some of the determining factors are adequacy of foreign-currency reserves, the maturity profile of foreign-currency borrowing, balance of payments position, internal savings rate, balance of trade, and the fixed or floating exchange rate. In undertaking its interventions under the private-sector window of ADB, it promotes market-based mechanisms that can be replicated, thus avoiding implicit or explicit subsidies. At the same time, ADB's local-currency initiative will help create a Libor equivalent benchmark for local currency in domestic capital markets.

In a path-breaking initiative, ADB has recently introduced a new mechanism for injecting long-term local-currency financing in the targeted sectors that are necessary for economic growth. Under this initiative, ADB will swap its hard currency for local currency with developing member countries for tenors stretching up to 15 years. In turn, the local currency will be lent to both domestic and foreign banks without a sovereign guarantee based on an acceptable credit rating from an international rating agency. Moving forward, ADB plans to give access to project developers that also enjoy acceptable long-term international credit ratings. Having introduced its local-currency initiative in India and the Philippines, it is now in active dialogue with host governments in Indonesia, Pakistan Kazakhstan, Bangladesh and Vietnam to promote long-term local currency-lending alternatives.

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