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Featured G

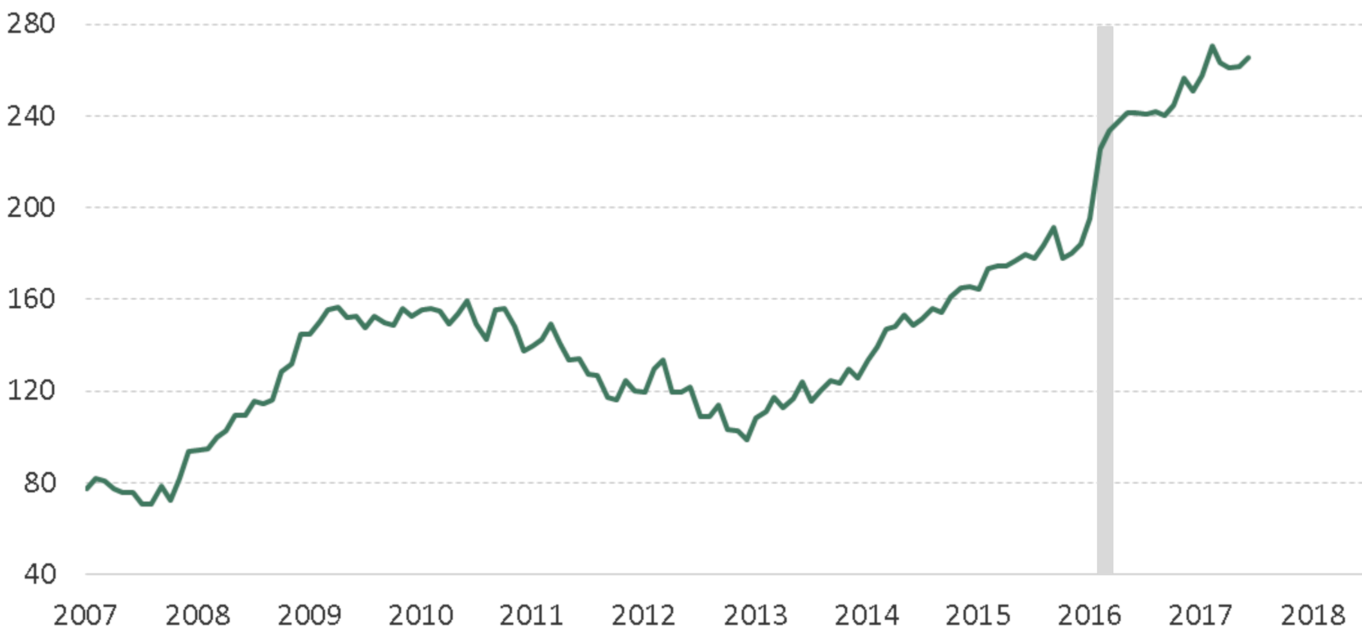
Central Banks are Not the Only Bond Buyers

Markets are understandably anxious about the move towards tightening by major central banks. This anxiety seems magnified in emerging markets (EMs) that have benefitted from substantial foreign inflows into their domestic debt markets. To the extent that quantitative easing (QE) benefitted EMs, the conventional thinking is that the end of QE will really hurt EMs. To be sure, we think foreign holdings of domestic bond markets are a statistic worth tracking, but markets seem to be missing the substantial secular shifts undergone within EMs since the Federal Reserve launched its first QE program in 2008. Changes in bank regulations, liquidity management practices, and credit cycle trends have changed the makeup of local bond markets and may have diminished the impact of foreign market participants. The EM universe is expansive, so let's focus on ownership of domestic bond markets in Poland, Hungary, and Brazil.

In Poland, the government introduced a tax on bank assets effective on February 2016. Domestic government bonds are exempt from this tax and a result, bank holdings of bonds increased sharply (Chart 1). Holdings have gone up from zl195 billion to zl265 billion—a 35% increase. Banks now hold about 40% of total government bonds, which in turn constitute about 14% of total bank assets.

Chart 1: Domestic Bank Holdings of Government Debt

End of Period, Billions of Polish Zloty, As of 6/30/2017



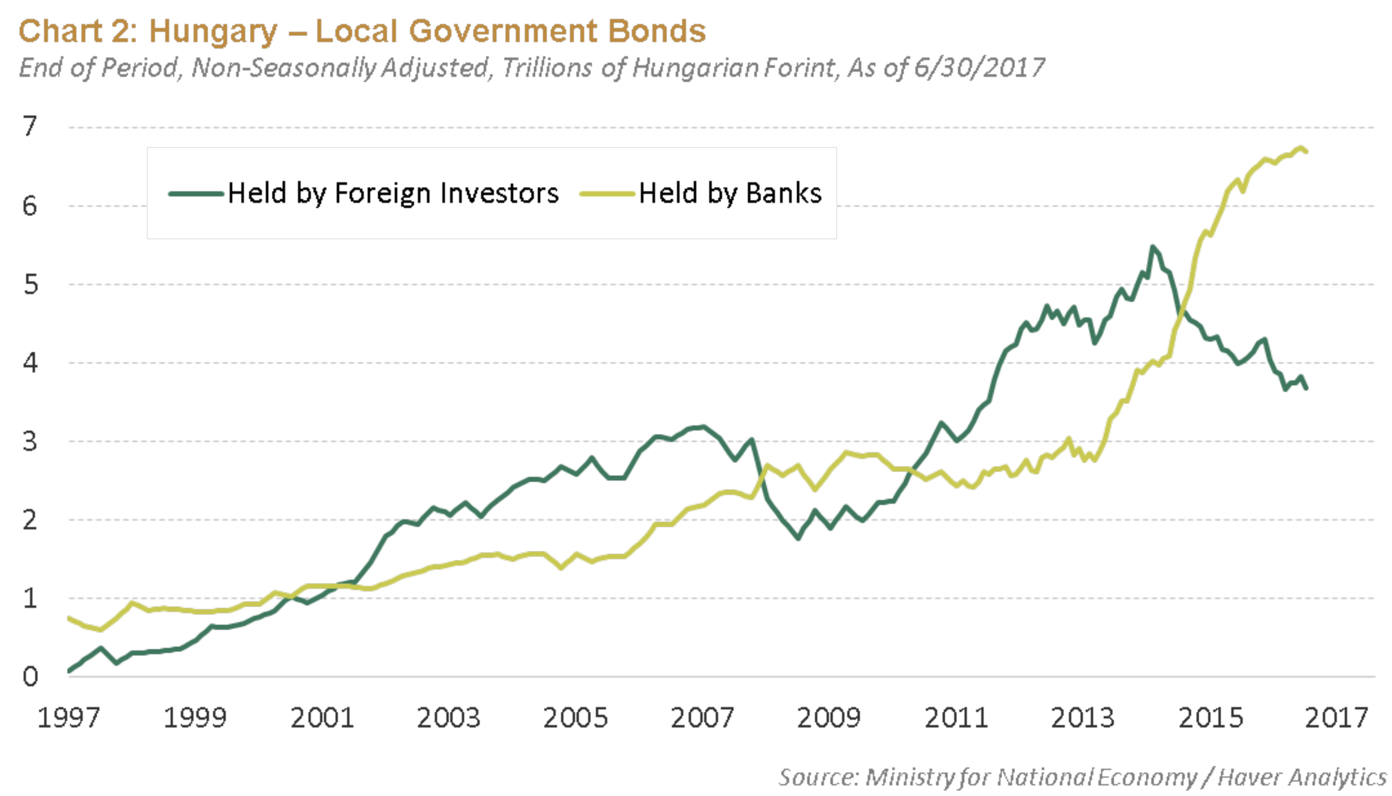
Source: Ministry of Finance / Haver Analytics

In Hungary, the central bank has implemented a number of unconventional monetary easing measures over the last few years. To cite just a few, the central bank:

- Cut the overnight deposit rate to -0.05%

- Capped access to a number of its short-term deposit facilities
- Entered into interest rate swap agreements with banks to allow them to hedge duration risk

The net result of all these measures is that the Hungarian National Bank forced domestic banks to use excess cash to buy government securities and move further out the curve. Since 2013, bank holdings of government bonds have more than doubled, more than offsetting the reduction in foreign participant bond holdings (Chart 2).



Brazil experienced a similar shift in bond ownership from foreign funds to domestic banks, but for very different reasons. In Brazil, private-owned banks started to cut back lending in 2015. Amid a slowing economy and rising real rates, lending opportunities were becoming scarcer. Banks reduced their loan books while simultaneously increasing their holdings of domestic securities. Banks buying government bonds helped to offset foreign selling as a result of the ongoing political crisis. Since January 2016, foreign holdings of government debt declined by R$79 billion, while domestic bank holdings increased by R$112 billion.

These are just a few examples to highlight how the composition of debt holders has changed, but domestic banks elsewhere in EM have exhibited similar shifts. In Malaysia, government bond holdings constitute over 25% of local bank assets amid ample domestic liquidity. Turkish banks have favored loan growth over bond holdings in recent years, but that could soon be reversing. In Thailand, political protests in 2010 led to a collapse in loan growth, which was matched with an increase in bank holdings of government debt. Absent from this conversation today—and the subject for another blog post—is the growing importance of local insurance and pension systems as well. The end of QE matters, but secular shifts in bond holders may go a long way to explaining the relative resilience of domestic bonds relative to exchange rates in recent years.

For more on why developed market tightening should be different for EMs, watch this short clip.

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