Corporate Bonds Market – What isn't working? (II)

In my last week's column I indicated how factors such as open capital account, banking sector concentration, bureaucracy, interest rate spread, exchange rate volatility, fiscal balance, corruption, quality of accounting standards, and size of domestic credit impacts the development of local bonds market. I broadly indicated how smaller market size, lower skill base, bank-based financial system, prolonged fiscal deficit, wide interest rate spread, underdeveloped debt markets, along with corruption and bureaucratic processes negatively affects development of our local bonds market (especially the corporate bonds market) or the other side of it positively impact the bonds market. Let me be specific and briefly explain each of these:

Economic size. Being a small sized economy, we are less likely to have a well-developed bond markets because we lack the necessary scale efficiencies required for a deep and liquid bonds market. Unless collective efforts are made to improve macroeconomic policies and grow institutions as we strive to search for alternative ways of financing our economy and which will in turn lead to greater corporate bond market development and deeper government securities markets, which will have a virtuous influence on economic development, our bonds market may not develop.

Our experience indicate that a typical corporate bond issuance have been of relatively smaller size (average of about TZS 20 billion per issuance) to create appetite and attract multinational companies and sizable portfolio foreign investors, for instance, and to justify inclusion by leading investment banks in global bond markets indices. In addition, infrequent buying and selling of these bonds in the secondary market tend to lead to greater price volatility and discourage risk-average investors to actively participate in our bond market. Our bonds trading in a year has averaged TZS 300 billion, equivalent to TZS 1.5 billion a day (and it is important to note that these are almost totally government bonds trading)–in many measures such sizes are regarded as relatively small for multinational institutional portfolio investor(s) to participate. Why don't domestic corporations issue sizable bonds, enough to create appetite for multinational investors to participate?

Banking sector size: As at the end of 2013, our banking sector assets stood at about TZS 21 trillion and had 53 licensed banks and financial institutions. It is fundamentally well and good that we have such a relatively developed banking sector -- on the other hand our outstanding bonds market is worth TZS 3.8 trillion (corporate bonds outstanding makes just 2% of these). What does this data suppose to imply? -- greater development of bank lending may in some way discourage (corporate) bond finance because in a way bank lending and corporate bonds issuance are competitors. However, in a rather positive side -- banks may seek bond markets to place their deposit or surplus funds; as an example, the 13-corporate bonds that have so far been issued in our market, banks have been one of the key investors – hence one may argue that a developed banking sector provide a market for bonds issuances. Also banks serve as dealers and market makers in the bonds market. We may therefore say, banks may thus foster development of a liquid and well-functioning bond market, and as such, bank and bond finance could either be complements or substitutes – it is question how one decide to look at it.

Capital account openness: As is, our capital account is not yet fully liberalized, only local investors are permitted to participate on the government securities space. However, despite challenges with foreign exchange volatility that comes with increased inflow and outflow of foreign currency from foreign investors, capital account openness is very relevant to bond market development. On the one hand, openness to foreign portfolio investment, as an extension to them participating in the governance bonds issuances and its secondary market, it as well enhances governance quality of local corporations with interest for bonds issuances and access of domestic debt to foreigner investors, because of variety of their investment requirements. On the other hand, capital account controls may provide an incentive for our government and corporations within our economy to source finance from local rather than external capital markets. In theory, the government bond market is more developed in cases where the exchange rate is less volatile and capital controls are weaker – like in our case now, the corporate bond market will develop if we have a more volatile exchange rates regime and stronger capital controls. In either case – probably the debate we should engage in is: are our domestic investors capable of providing the necessary efficiency, scale and liquidity for sizable bond issuances? Or history is crying for us to consider partly liberalize our capital account and so motivate local corporate conglomerates start using the local bonds market to finance their enterprise expansion and growth?

Bank lending spread: We would expect the lending spread to be an important component in bonds market development because interest rates, being the cost of debt, would be integrally linked to the willingness to borrow through debt issuance, such as corporate bonds instruments and as is, higher interest rates discourage bond issuance in an economy. However, the bank lending spread, in contrast to the interest rate itself, could also logically mean a reflection of the degree of competition and efficiency in the bank sector and thus, a higher spread could encourage the bond market, if it is associated with greater inefficiency. Is this the case for us? If not, what isn’t logically working? and what should be done to rectify our situation?

Fiscal balance: Fiscal policy can affect bond market development in several ways. On one hand, a well-developed government securities market may indirectly promote the development of a corporate bond market in that it helps promote a class of dynamic, profitable fixed-income dealers, it also facilitates the creation of a deep and liquid bonds market which is a precursor to the development of the corporate bonds market. On the other hand, a large supply of government debt securities may crowd out private debt securities, slowing corporate bond market development, like has been in our case, among other factors. With current yields range of 15%-17% (depends on maturity) in the government bonds primary market it makes it less desirable for private corporate bonds issuances because as is, its only fair that investors would prefer risk free government bonds with such returns compared to risky corporate bonds even if it pays returns that has a smaller risk premium margin.

With an understanding that these are some of the factors that may either facilitate or constrain development of our local bonds market -- what should be key and probably essential in this context is for us is to evaluate what can we do to advance the state of bonds market as a key financing vehicle for enterprises and economic development.

In my next column I will explain other aspects necessary for our bonds market development and I will conclude.