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History and Development of the LDC debt Market

The crisis of the LDC's was the birth to the secondary debt market. The sovereign debt renegotiation in the early years (1982-85) just did not work (BUCHHEIT, Lee C., Moral hazard and other delights, *IFLR*, April 1991). The deferral of principal maturities; the syndication of the occasional new money loan; the linking of both activities to an IMF-endorsed economic stabilisation programme for the debtor country, did not give the result hoped for.

The banks saw the debt reconstruction as an instrument to bestow on the sovereign borrower an orderly and early return to normal debt service capacity was not working (unanimity requirements and amendments to restructuring agreements or syndicated loans were difficult). Much was also due to the creditors themselves. The creditors adjudged it prudent not to permit much latitude in which the borrower's presumed self-destructive impulses could operate:

1. restructuring windows were kept short (a window is the period during which the maturing principal of old loans was subject to rescheduling);
2. new money was made available only in instalments and only upon the satisfaction of conditions applicable to each instalment;
3. events of default in the restructuring documentation were extremely rigorous in comparison with pre-crisis loan agreements;
4. every aspect of the commercial bank restructuring or new money package was inextricably linked to an IMF stand-by or extended fund arrangement and a concurrent restructuring of Paris Club debt (The Paris Club was formed in 1956. It is an informal group of creditor governments from major industrialized countries. It meets on a monthly basis in Paris with debtor countries in order to agree with them on restructuring their debts).

The real fiscal misbehaviour of the borrowers or sovereign debtors were more political in origin. The existence of restrictive conditions in commercial bank restructuring agreements was rarely sufficient by itself to cause a sovereign to resist temptation of a moral hazard.

In the mid-1980's, something happened in the sovereign debt business: banks started selling their sovereign loans at a discount from face value. The *secondary market* emerged. Shortly after the beginning of the Latin American debt crisis in 1982, a small secondary trading market for sovereign loans gradually began to develop among commercial banks.

While major money center banks continued to hold loan assets and participated extensively in frequent debt restructurings by debtor nations, some smaller commercial

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banks preferred to sell their non-performing LDC loans and end their relatively minimal exposure to developing countries.

Other banks wished to rearrange their credit portfolios by exchanging loans they had made to one debtor country for another bank's loans to a second country. For accounting and other reasons, sellers tended to be non-U.S. financial institutions or U.S. regional banks rather than U.S. money center banks. In 1983 and 1984, a small group of enterprising traders began to conduct the highly specialized business of intermediation between sellers and buyers of LDC loans.

Trading activity increased substantially in 1986 and 1987 after several debtor countries (Chile and Mexico) adopted debt-for-equity exchange programs as part of their debt restructuring packages. Specifically designed to operate as a permitted exception to the usual rule that payments under syndicated loan agreements had to be made pro rata to all members of the lending syndicate, these programs allowed debt holders to exchange their debt claims for equity in state-owned or other companies, or for other local assets. Trading activity continued to grow after 1987, as commercial banks in the United States and elsewhere increased their loan loss reserves, making it more commercially viable to sell loans at less than face value.

The implementation of the Brady Plan in 1989-90 further accelerated the growth of the LDC debt trading markets, as the announcement of each successive agreement-in-principle set off a new wave of loan trading as well as trading of the proposed new instruments on a when-issued basis. In addition, each completed Brady restructuring resulted in the issuance of new Emerging Markets debt securities, which were specifically designed to be more easily tradable than defaulted loans.

By 1990, it was apparent that what had started as sporadic, highly individualized loan sales transactions had developed into a large, sophisticated trading market with many active participants from the commercial banking and broker-dealer communities. The new Brady bonds also encouraged the entry of broader classes of investors into what had become known as the Emerging Markets. By 1998, after over a decade of defaults, all major Brady restructurings had been completed, signaling the transformation from an unsecuritized loan market to a bond market and paving the way for many former debtor nations to re-enter the voluntary global capital markets.

During the 1990's, the market for Emerging Markets debt grew not only in volume, but also in the types of instruments traded, the number of trading houses and investors involved, and the size of the market in relation to others worldwide. The investor base for Emerging Markets instruments expanded from its traditional investors to include many crossover investors from the more mainstream high-yield and high-grade investment areas.

Investors were drawn to the Emerging Markets during this period by high yields and high growth potential as well as by a general market trend toward positive economic and political reforms and improving economic performance in many Emerging Market countries. Despite these encouraging trends, however, investments and trading opportunities throughout the Emerging Markets all share certain characteristics and present some common risks. In addition to customary risks stemming from the issuer's economic or financial performance and its capacity to service its payment obligations, investments in Emerging Markets involve a variety of cross-border risks such as legal and regulatory uncertainty, enforcement difficulties, foreign exchange fluctuations and restrictions and the possibility of currency devaluations or changes in government or government policies. These cross-border risks are magnified in the Emerging Markets by the emerging characteristics of each country's political structure, regulatory and legal system and economy.

Although the higher yields available in Emerging Markets investments generally reflect the significant nature of these risks, the volatility of such investments in recent years has been considerable, and in fact at times outright daunting for many investors more accustomed to the relative stability and greater predictability of the more traditional markets in developed countries.

Despite improving fundamentals in many EM countries (accompanied by numerous credit rating upgrades), the growth of the Emerging Markets trading industry since 1990 has been punctuated by a series of market events that emphasized the potential volatility and riskiness of Emerging Markets investments.

A long period of growth in both trading volumes and asset values was interrupted in 1994, first by the market's adverse reaction to rising general interest rate levels in the spring and then by the sharp decline in investor confidence that occurred after Mexico's peso devaluation in mid-December. The Mexico devaluation set in motion a so-called 'Tequila effect' of contagion that depressed market values throughout the Emerging Markets during early 1995. Following the massive rescue package organized for Mexico by the U.S. and other G-7 nations, however, investor confidence in the Emerging Markets recovered significantly by mid-1995, and trading volumes and asset prices, as well as capital flows, showed considerable growth for the next several years.

Sovereigns and other Emerging Markets issuers generally took advantage of favorable market conditions from 1996 through early 1998 to refinance a portion of their stock of debt, and investors increasingly sought the higher yields available in local currency instruments and more market-oriented dollar-denominated assets. Local currency asset values fell sharply following the onset of financial and economic difficulties in Southeast Asia in mid-1997. By mid-1998, market contagion had spread these difficulties to Russia, which in turn led to a severe, and more general, contagion throughout the Emerging

Markets in the latter half of 1998. The resulting loss of investor confidence eventually led to Brazil's January 1999 devaluation of the real. These events and their contagion effects, raised questions regarding the effectiveness of fundamental analysis in isolating potential investment opportunities in the Emerging Markets.

Market trading volumes, which had grown rapidly in the 1990's, peaked at U.S. $6 trillion in 1997 and then fell off sharply after the Russian default in mid-1998, as investors re-evaluated the volatility and returns on Emerging Markets investments and dealers reduced their trading lines.

Despite rising interest rate levels and growing concerns about the private sector's role in resolving sovereign financial crises (the so-called 'burden-sharing' debate), 1999 and 2000 were generally characterized by increased trading activity and growing investor confidence in the Emerging Markets, sparked in large part by Brazil's rapid economic recovery, Mexico's upgraded credit rating to investment grade and Russia's successful 'London Club' debt restructuring.

By 2004, secondary market trading volumes had rebounded to U.S.$4.7 trillion, and the market was characterized by the steady retirement of Brady bonds through the issuance of global bonds and Eurobonds. Despite Argentina's massive default in December 2001, the EM trading and investment market in the 2002-2005 period was characterized by continuing improvement in credit fundamentals and a decline in market contagion. By 2005, trading in local market instruments had increased to over 45% of total trading activity.
On an emerging market different sort of debt instruments are being traded. A debt instrument is a written promise to repay a debt. Examples include bills, bonds, notes, CDs, GICs, commercial paper, and banker's acceptances.