

Chapter 3 Summary

Global Shocks, Local Markets: The Changing Landscape of Emerging Market Sovereign Debt

This chapter examines the evolution of emerging market and developing economies' (EMDEs') domestic debt markets and vulnerabilities to global shocks against a backdrop of rising debt levels (close to \$12 trillion excluding China). Although many EMDEs and their local bond markets have demonstrated resilience to a variety of global shocks, the contrast with those that have faced significant distress and macro instability highlights the structural and market challenges related to domestic bond market development.

EMDEs have experienced significant outflows from their domestic local currency bond markets (LCBMs) and financial stress during global shocks like the 2013 “taper tantrum.” As a result, EMDEs have sought to increase the role of resident buyers in their financing strategies. In addition, weak returns in local currency bond markets over the past decade—driven largely by continuing dollar strength—have made them a less appealing asset class for global investors. Considering these developments, EMDEs have had two main options for funding increased debt issuance: finding more resident buyers for local currency debt or continuing to rely on foreign-currency-denominated sovereign bond issuance or external loans.

A select group of major emerging markets has largely been able to rely on local currency issuance that has been increasingly absorbed by domestic investors, particularly non-bank financial institutions, amid higher domestic financial savings. This has helped reduce the risks stemming from both currency mismatch and nonresident outflows. Other EMDEs have expanded borrowings largely through relatively shorter maturity financing from domestic banks and the central bank and often continue to rely on expensive foreign currency debt. Lastly, several EMDEs have had to resort to domestic debt restructuring because of unsustainable public debt burdens.

The chapter investigates how the changes in composition of debt issuance, investor absorption, and market structure in LCBMs have influenced resilience to external shocks. It estimates the effects of global shocks on LCBMs and how they are associated with the degree of participation by nonresident versus domestic investors, as well as the split between domestic banks and nonbank financial institutions. Empirical results confirm that the presence of more nonresident investors is indeed associated with greater sensitivity of domestic markets to global shocks, while the presence of more domestic investors—notably banks—is associated with lower sensitivities.

Although these results suggest that more resident buyers of local currency debt tend to improve resilience to global shocks, this does not mean that more domestic buyers is always better. The chapter also explores the drawbacks that may be associated with an overreliance on domestic issuance and demand, especially if driven by financial repression. To this end, the chapter highlights the risk of overborrowing and the adverse feedback loops that could ensue if domestic banks were to absorb excessive amounts of sovereign debt (that is, the sovereign-bank-nexus), which could lead to large financial stability downsides in cases of debt distress or restructuring.

To conclude, the chapter provides policy advice on developing a resilient LCBM. While improving macroeconomic fundamentals—such as raising domestic financial savings and ensuring a stable macro-financial environment—remains essential, a strong policy framework and robust financial market systems are critical for channeling financial savings into a well-functioning local market. Foundational market infrastructure must be developed, legal certainty provided, and sustained efforts to deepen the investor base through sound debt management practices and market communication undertaken.

To see the full report, please refer to the English version here: <https://www.imf.org/gfsr-october2025>