Small Fish, Big Pond

Traders on the stock market floor in Buenos Aires, Argentina.

What is the future for developing country capital markets in a globalized economy?

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THE world's financial system—and particularly capital markets—has undergone substantial changes during the past three decades, with financial depth, diversity, and globalization increasing sharply. While most of this change has taken place in financial centers and developed countries, it has also occurred in developing countries to a significant extent. Many developing countries tried to deepen their securities markets by introducing major reforms, especially during the 1990s. They liberalized their financial systems, improved their investment climates (through macroeconomic stabilization and better business environments), developed new supervisory frameworks and institutions, and improved the basic infrastructure for capital market operations. Many countries also implemented comprehensive pension reforms and privatized state-owned enterprises, hoping to encourage capital market development.

As reforms intensified, so did expectations regarding capital market development in developing countries. These high expectations, however, have not been met in many countries. After nearly two decades of reform, the state of capital markets in developing countries is quite mixed. The pace of growth, though rapid overall, has not been as dramatic as in developed nations. Some developing countries have experienced stagnation or even contraction of their securities markets, particularly for equity and domestic currency–denominated bonds. Latin American countries, in particular, have embraced financial globalization more vigorously than have Asian countries, but have lagged considerably behind Asia in terms of deepening their domestic securities markets. These developments are disheartening: they are too meager a payoff relative to the intense reform efforts. They are also puzzling because of the lack of clarity and consensus on how to modify the capital market reform agenda.

This article attempts to shed some light on the mixed results, arguing that greater attention must be given to the roles that globalization and size play in securities markets development. It concludes that policymakers will need to reshape their expectations and take a new approach to building up domestic capital markets.

Insights into weak capital markets

It is difficult to explain the poor performance of domestic stock and bond markets across developing countries with reference only to macroeconomic and institutional fundamentals—such as monetary stability, overall economic development, economic size, and rule of law—or capital market–related reforms. In fact, the empirical results of a recent World Bank

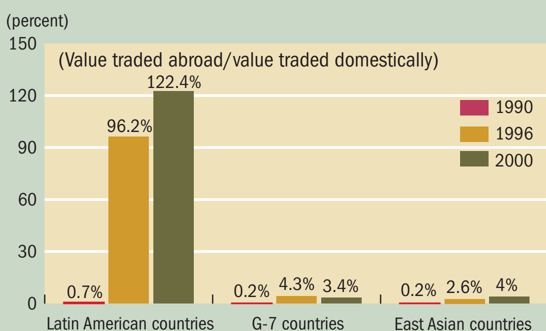
study comparing Latin American capital markets with those of other regions show that better fundamentals foster *both* domestic stock market development and its internationalization—in terms of the issuance and trading of securities abroad—but not symmetrically. As fundamentals improve, stock issuance and trading abroad actually increase *relative* to domestic activity. Similarly, the introduction of capital market-related reforms has a larger positive impact on stock market internationalization than on local stock market activity.

Contrary to expectations, this internationalization of equity markets has, in addition, not "crowded in" local market activity. Instead, in many cases, local stock market liquidity has been undercut. As the local liquidity of firms that issue securities on overseas stock markets declines, negative spillovers occur: the liquidity of the firms that do not go abroad is negatively affected. Moreover, there are trade diversion effects. The remaining liquidity in the domestic stock market tends to concentrate on the firms that have already accessed international capital markets.

These effects have been particularly strong in Latin America, resulting in the slow development of domestic securities markets. Latin American local markets are not only below what could be expected, given the region's economic and institutional development, they have also been less responsive to the introduction of reforms. Conversely, Latin America exhibits an "excess" degree of stock market internationalization, which is partly explained by the intense privatization process that led to a shift of new issues to international markets and has been reflected in significant delistings (see chart). While certainly an outlier, Latin America is not alone, as some of the smaller developed and developing countries in Europe are facing similar patterns. East Asia, in contrast, displays a different behavior, with several of its domestic markets for equities and corporate bonds developing relatively well.

Greener pastures

The proportion of Latin American equity securities traded abroad significantly exceeds that of other regions.



Sources: Bank of New York and Standard & Poor's Emerging Markets Database.

Note: The series are calculated by aggregating firm-level data for each country. The chart plots the averages across countries of the ratio of the value of equity securities traded on U.S. stock exchanges (as American depositary receipts) relative to the value of equity securities traded on local stock markets. The data for Group of Seven countries are averages for Canada, France, Germany, Italy, and Japan. The United Kingdom and the United States are not included because they are considered international financial centers. The data for East Asian countries are averages for Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Taiwan, and Thailand. The data for Latin American countries are averages for Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

A puzzling gap

How do these results help explain the gap between the high expectations and intense reforms of the 1990s, on the one hand, and the low level of development of domestic capital markets, on the other? They give reason to question whether traditional views on the gap hold up. One such view ascribes the gap to impatience, and imperfect and incomplete reform efforts, recommending that market forces be given time to work while forging ahead with further reforms. In this view, the basic elements of necessary reforms are well known—since "best practices" are already described in various international standards and codes. But this view largely ignores the finding that improvements in institutional and macroeconomic fundamentals and the introduction of reforms spur not only domestic securities markets development but also—and to a greater extent—the increased tendency to issue and trade securities abroad. While not invalidating the importance of reforms, this finding clearly calls for a major change in expectations and suggests that the issues associated with financial globalization must be revisited to reshape expectations appropriately.

Another view claims that the gap is due to faulty reform sequencing. It stresses the importance of establishing a good institutional and regulatory framework and developing a local market for domestic currency–denominated debt before financial market liberalization. There is nothing wrong, in principle, with the prescription to postpone full capital account opening and unrestrained competition until certain conditions are in place. But the political economy reality is that institutional reform does not happen simply because of good logic, which in most cases is insufficient to dislodge the resistance coming from those who feel the losses from reform up-front and can organize vigorously to resist change. By contrast, gains from reform accrue in the future and are spread among numerous winners who, as a result, face a collective action problem. With little incentive to act as a group, they tend to remain relatively voiceless and unorganized. Historical experience amply illustrates that external competition induces insiders to become more efficient and, as a result, changes incentives vis-à-vis reform—pushing efficient incumbents to become supporters of the very reforms they had previously resisted.

The bottom line is that both of these views either leave out or fail to adequately address critical elements. The World Bank study offers a complementary view that emphasizes the need to step back and reconsider the implications of certain basic issues—such as financial globalization, liquidity, diversification, and size—as a prior step to a more solid reformulation of the reform agenda.

Role of financial globalization. Financial globalization complicates policy actions in debt and equity markets in different ways. In debt markets, globalization magnifies problems associated with weak currencies. The current globalization wave—which is unfolding in a context of floating exchange rates—bestows benefits that increase depend-

ing on how well the local currency performs two functions simultaneously: that of shock absorber and that of a reliable store of value for savings. Performing these two functions well is already difficult for all but the few currencies used internationally as reserve assets. It is drastically more complicated if, in addition, the local currency is not fully accepted, even at home, as a reliable receptacle for savings. This situation encourages the arrangement of financial contracts that are either heavily dollarized (in a strong foreign currency) or predominantly of short duration, creating large unhedged exposures in debtors' balance sheets that make the financial system vulnerable to sudden, large depreciations of the real exchange rate or increases in the real interest rate, respectively. In these circumstances, policy is not only constrained but it is also liable to be torn between the goals of the currency as a shock absorber and store of value.

In contrast, the internationalization of equity markets does not create balance sheet mismatches for equity issuers and therefore does not create systemic vulnerability, even if the integrating country has a weak currency. Equity contracts are not subject to default risk because they do not commit the issuer to paying flows that are independent of its performance. Although the performance might be affected by real exchange rate fluctuations, such effects are passed on to equity investors via changes in dividend payments. But because internationalization hurts the local stock market's liquidity, the internationalization of equity issuance and trading may create a policy dilemma—possibly accentuated by the fact that, as a developing economy becomes more integrated into global financial markets, incentives for issuers of equity securities rise unambiguously in favor of issuing abroad rather than at home. In effect, once corporations can break the cost and size thresholds required to issue equity at reasonable prices in the deeper, significantly more liquid global financial centers, there would be no apparent advantage in issuing in domestic stock markets.

Role of liquidity, diversification, and size. For many developing countries, particularly smaller ones, illiquidity begets illiquidity by limiting the capacity of investors to unwind their positions without affecting prices, thereby discouraging the entry of new players, which, in turn, further limits liquidity. The implications are far-reaching, given that illiquidity fundamentally hinders "price revelation"—one of the most distinctive functions of securities markets vis-à-vis banking markets. Similarly, evidence strongly suggests that, in many developing countries, domestic securities markets do not seem to add much directly to risk diversification, beyond the function already performed by local banks, while risk diversification by international portfolio investors tends to marginalize small countries and small corporate issuers.

Illiquidity and insufficiently diversified portfolios are intrinsically related to a prevalent structural feature of many developing countries' capital markets: small size. The small size of both markets and corporations matters for liquidity, which is a positive function of scale economies and agglomeration effects. When liquidity is impeded by the small size of an economy, the basic question is whether suitable domestic securities markets exist for small, open economies and what would be their expected role. Moreover, risk diversification within small economies is limited by asset scarcity. To the extent that there is a fixed cost to invest, investors would require investments of a minimum size, which would tend to segment the market, exclude small issuers and issues, and limit the scope of risk diversification.

Reshaping the reform agenda

As policymakers weigh new approaches to developing a domestic capital market, they might want to begin by determining whether it could realistically meet the size thresholds for sustaining a liquid domestic secondary market for private sector securities. For countries that meet these size thresholds, formulating suitable reforms would be relatively easy, not least because they could learn from the experience of developed capital markets. Reforms would still need to be significantly reshaped, however, particularly to better accommodate financial globalization. Sketching a suitable reform package for a smaller country's domestic securities markets is a more daunting challenge because much more thought and analysis is needed to take into account the constraints implied by its small size. This sketch would have to be accompanied by a realistic definition of what can be expected from such unavoidably illiquid securities markets. Related issues also arise regarding the participation of small firms in capital markets, irrespective of country size.

Capital market reforms for developing countries should envisage improved integration into international financial markets with complementary financial development at home. Avoiding financial globalization is neither realistic nor desirable in the long run, not least because integration induces reform. A broader vision would emphasize linkages between financial markets and, in particular, the ways in which capital markets in developing economies can enhance the workings of the financial system as a whole. Such linkages are crucial, for instance, in the markets for housing, infrastructure, and structured finance, where local and international securities markets can help engineer suitable products, such as asset-backed securities, spreading risks among a greater number of players, and bringing new institutional investors to the scene. Greater financial market competition, coupled with constant improvements in the contractual environment, will ultimately deepen and broaden the provision of financial services, producing new "bridging" vehicles and instruments to fill any potential access gaps. ■

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This article is largely based on the Latin American and Caribbean Regional Study "Whither Latin American Capital Markets?" (Washington: World Bank), led by de la Torre and Schmukler, and several background papers. The full report and background papers are available at http://www.worldbank.org/laccapitalmarkets.