Emerging Market Private Sector Access to Capital Markets

The Role of the Domestic and Foreign Investor Base

GEMLOC Advisory Services Roundtable

May 29-30, 2008

Eliot Kalter
President, EM Strategies
Senior Fellow at the Fletcher School
EM domestic bond market capitalization has grown and is now between 20-40% of GDP; this compares with 130% of GDP in advanced economies.
Corporate domestic issues are still a small component of total domestic debt—with large variation across countries.

Composition of Emerging Market Outstanding Domestic Debt
(Percent of GDP, end 2005)

Source: BIS
Local Markets Still Leave Limited Options for Private Sector Financing

EM capital markets for the private sector continue to be dominated by banks and are characterized by short-term lending and illiquidity (especially in Latin America).

Although bond markets have achieved a significant increase in volume, most of it is accounted for by government paper.

Private sector has increased access to equity markets in Asia, but generally private access to EM bond and stock markets is characterized by a high degree of concentration and lack adequate liquidity.

While AAA corporations can access the bond markets externally, or in some cases domestically, mid-sized companies have limited options.

Asset backed securities have begun to bring more private sector firms to the capital markets, but still in its infancy.
An example: even Mexican private capital market offers only limited options for private financing

**Corporate Debt: Challenges and Opportunities**

This lack of financing through capital markets is also evident from the firms’ perspective. Capital markets represent a small share of total financing and corporate resources come mainly from suppliers and commercial banks credit.

![Credit to the Private Sector (% of GDP)](chart1)

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<tr>
<th>Year</th>
<th>Certificados Bursátiles</th>
<th>Non-banking financial institutions</th>
<th>Banking</th>
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<td>2000</td>
<td>2%</td>
<td>7%</td>
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<td>2005</td>
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<td>2006</td>
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![Firms' financing resources (% of total financing)](chart2)

- **Securities:** 19%
- **Suppliers’ Credit:** 61%
- **Commercial Banks:** 8%
- **Development Banks:** 4%
- **Foreign Banks:** 12%
- **Other firms in group:** 16%

Source: Banxico and CNBV

Source: Banxico (2006). Credit market survey
Structured Securities Can Increase Financing Options

- Total issuance of structured securities in Mexico reached over US$6 billion in 2006—tripling in volume since 2004—the largest annual issuance volume in Latin America, surpassing Brazil.

- In other EM regions, securitized issuance is considerably less with the exception of South Korea.

- However, the volume in Mexico is still small when compared with:
  - The market for domestic government securities (US$255 billion).
  - Structured finance markets in industrial countries (ranging from US$150 billion in Japan to US$1.5 trillion in the United States).
Securitization also is still in its infancy in EM Asia

http://asianbondsonline.adb.org/asiabondindicators/default.php
The Role of Domestic Institutional Investors Has Grown

However, these investors remain subject to a wide range of regulations across EM countries and offer a limited range of risk appetite, 2005
The Foreign Investor Base Plays a Critical Role in Increasing EM Private Sector Access

Broadening the foreign investor base enhances EM private sector access to capital markets:

- Diversity of investment objectives, styles and time horizons
  - Access to broader range of risk appetite

- Increased portfolio of investors and opportunities
  - Reduced reliance on investor/country specific circumstances

- Enterprises can enhance their competitiveness and creditworthiness through tapping forms of capital not available domestically (i.e., structured finance/private equity)

- Enhanced liquidity in primary and secondary domestic markets
  - Intellectual/technology transfer to local participants
  - Foreign investors trade securities rather than buy and hold
Access to Foreign Investment Opportunities Plays a Critical Role for Market Stability, Returns and Depth

Sizable EM savings is looking for investment opportunities:

- Limited availability of domestic financial opportunities appropriate for institutional investors and puts premium on external investments
- Broadening EM institutional investors access to foreign investments gives:
  - Diversity of financial markets, instruments and currencies with reduced reliance on home country circumstances
  - Reduced risk through portfolio diversification
  - Intellectual/technology transfer to EM institutional investors
  - Financial equilibrium that avoids mispricing of risk (avoids common occurrence of low domestic interest rates reflecting captive demand)
  - Eventually, deeper domestic capital markets
However, the levels of foreign participation remain low outside the EU region and significant restrictions remain on EM investments abroad.

**Foreign Investor Participation in Local Bond Markets, end-2006**

*In percent of total domestic bonds*

![Bar chart showing foreign investor participation in local bond markets as of end-2006 with data for selected countries: Hungary, Uruguay, Poland, Czech Republic, Indonesia, Korea, Turkey, Brazil, Mexico, Thailand. Sources: BIS, AsianBondsOnline and IMF estimates. Data for Indonesia as of June 2007.*
Private Sector Access: The Way Forward

Bottom Line: Access to a broad investor base facilitates stronger EM capital markets and private sector financial options

Access to a broader investor base requires:

- Continued emphasis on strong economic and financial policies
  - Concerns about inflation and exchange rate policy
- Financial market openness and liquidity
  - Concerns about restrictions on financial instruments and foreign participation
- Strong market infrastructure (trading, clearing and settling)
  - Reduced market costs to allow smaller issues
- Improved institutional quality (corporate governance, regulatory quality, rule of law)
  - EM private sector culture must be fostered to adapt to new environment
The Good News
While EM controls on capital outflows remain high
EM controls on capital inflows are declining for all regions except Asia

Capital Control Index


1 Unweighted averages of country-specific indices.