

Whither Latin American Capital Markets?

The Financial Sector in Latin America: New Trends and Implications for the Real Economy
U.N. Economic Commission for Latin America and the Caribbean

Santiago, Chile, April 28-29, 2005



Sergio Schmukler
with Augusto de la Torre

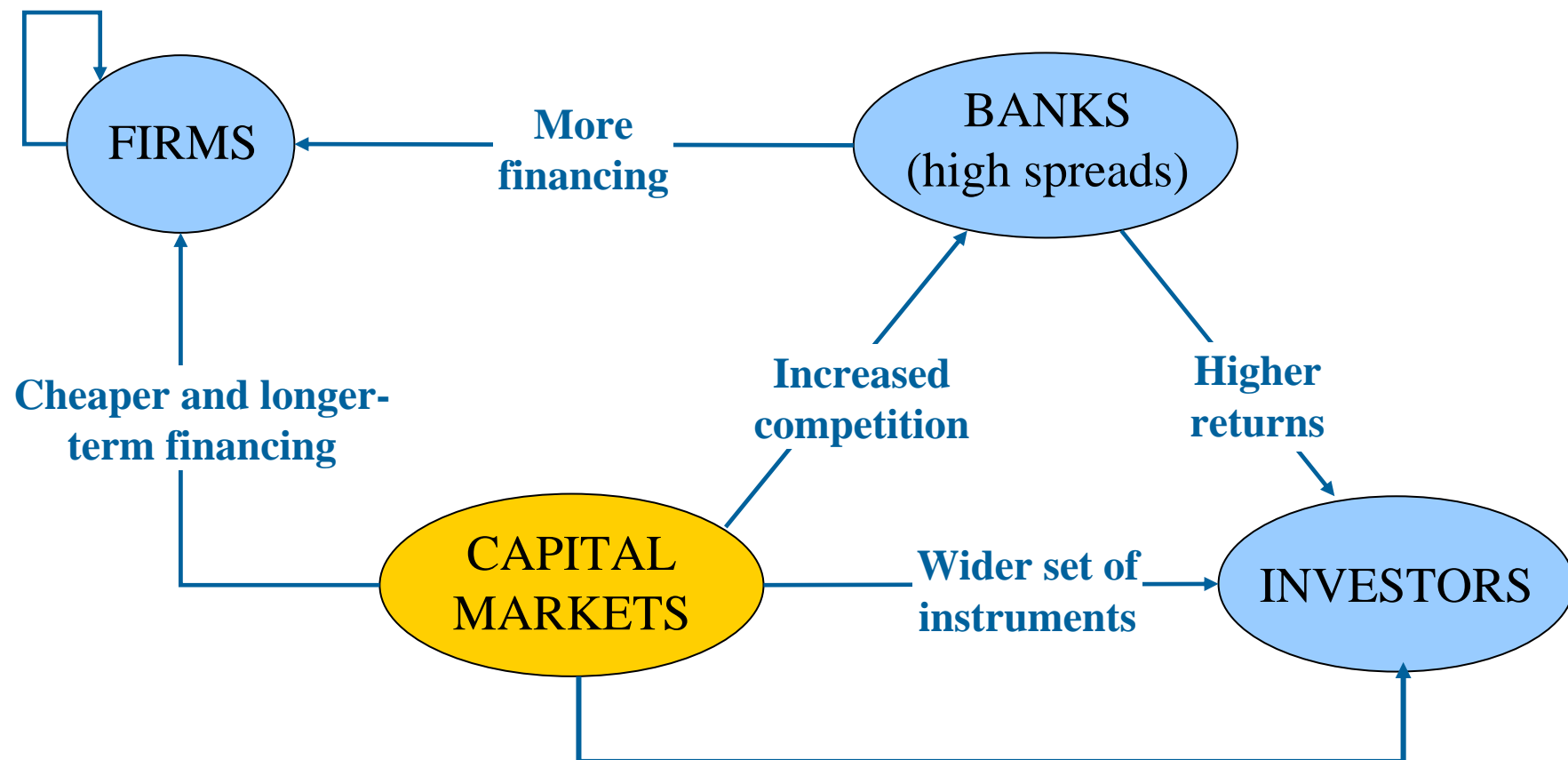
Structure of Presentation

- ✚ Despite Intense Reform Effort Latin Financial Systems Have Under-Performed
- ✚ What Went Wrong?
 - ✚ H1: Insufficient/Inconsistent Reforms
 - ✚ H2: Wrong Sequencing
 - ✚ H3: Wrong Expectations
- ✚ Back to Basics
 - ✚ Financial Globalization
 - ✚ Size
 - ✚ Segmentation of Access

Despite Intense Reform Effort
Latin Financial Systems Have
Under-Performed

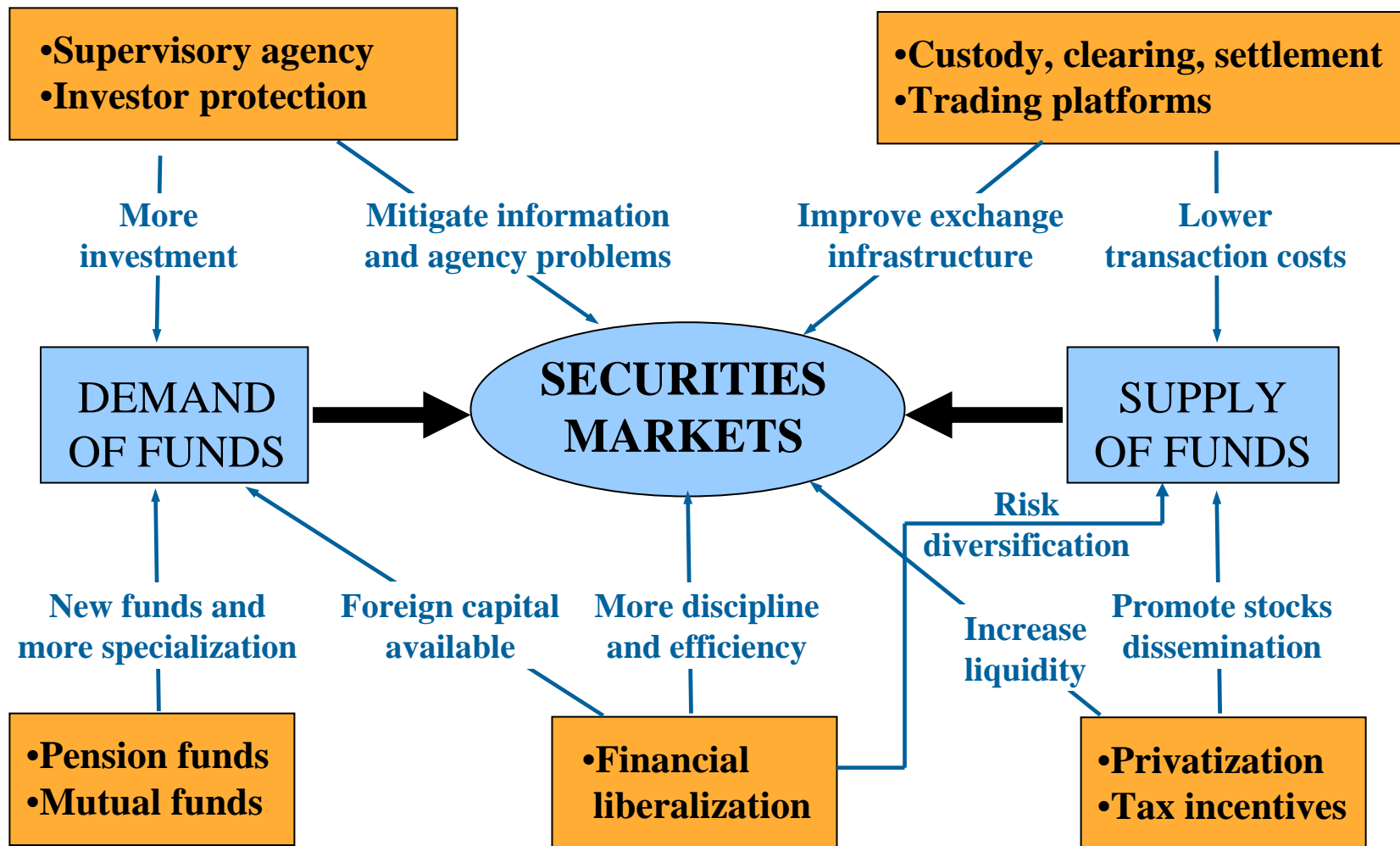
The Logic of Capital Markets Reform

A Development Focus...



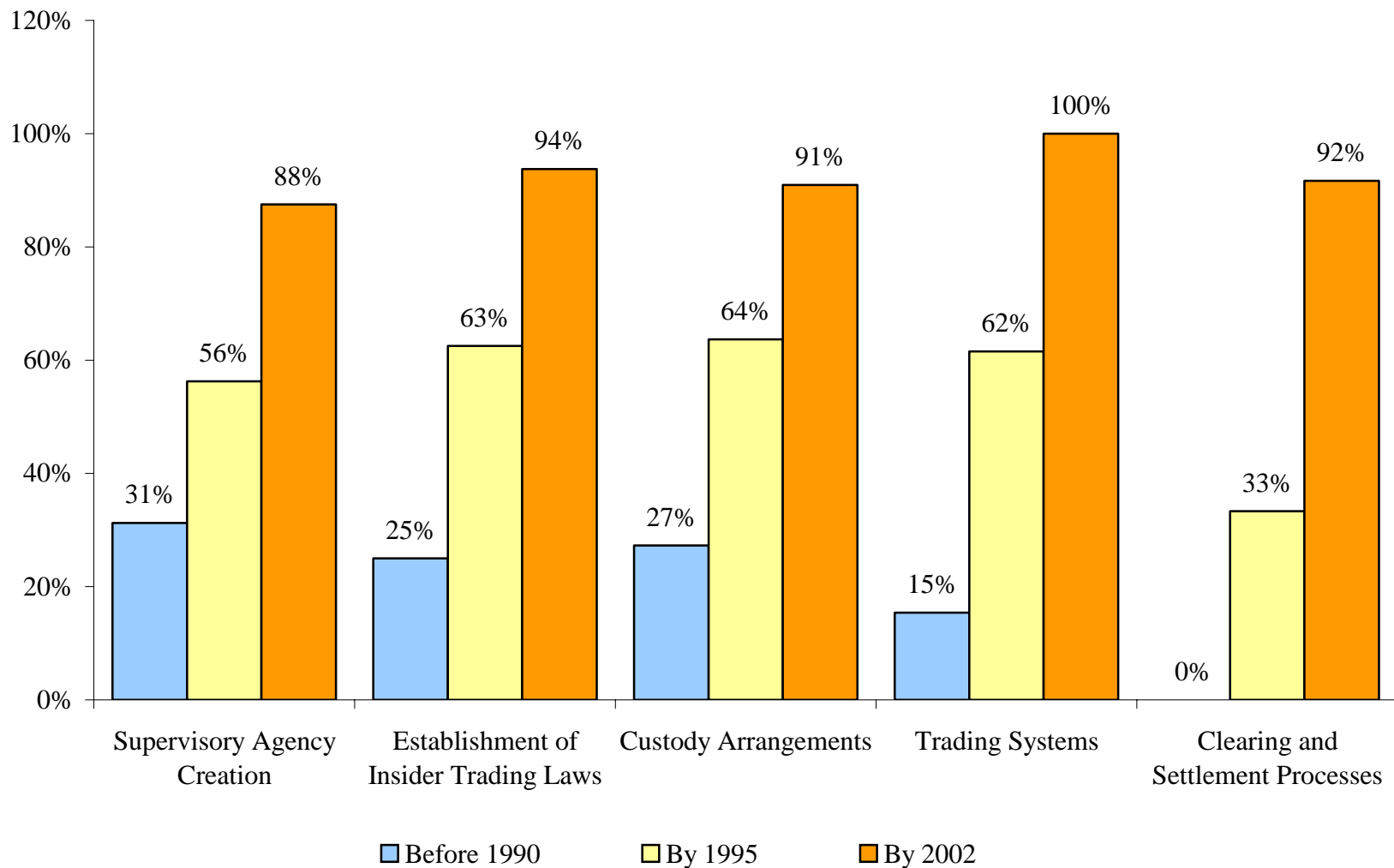
The Logic of Capital Markets Reform

...Integrated and Multidimensional



Latin American Countries Were Active Financial Reformers in the 1990s...

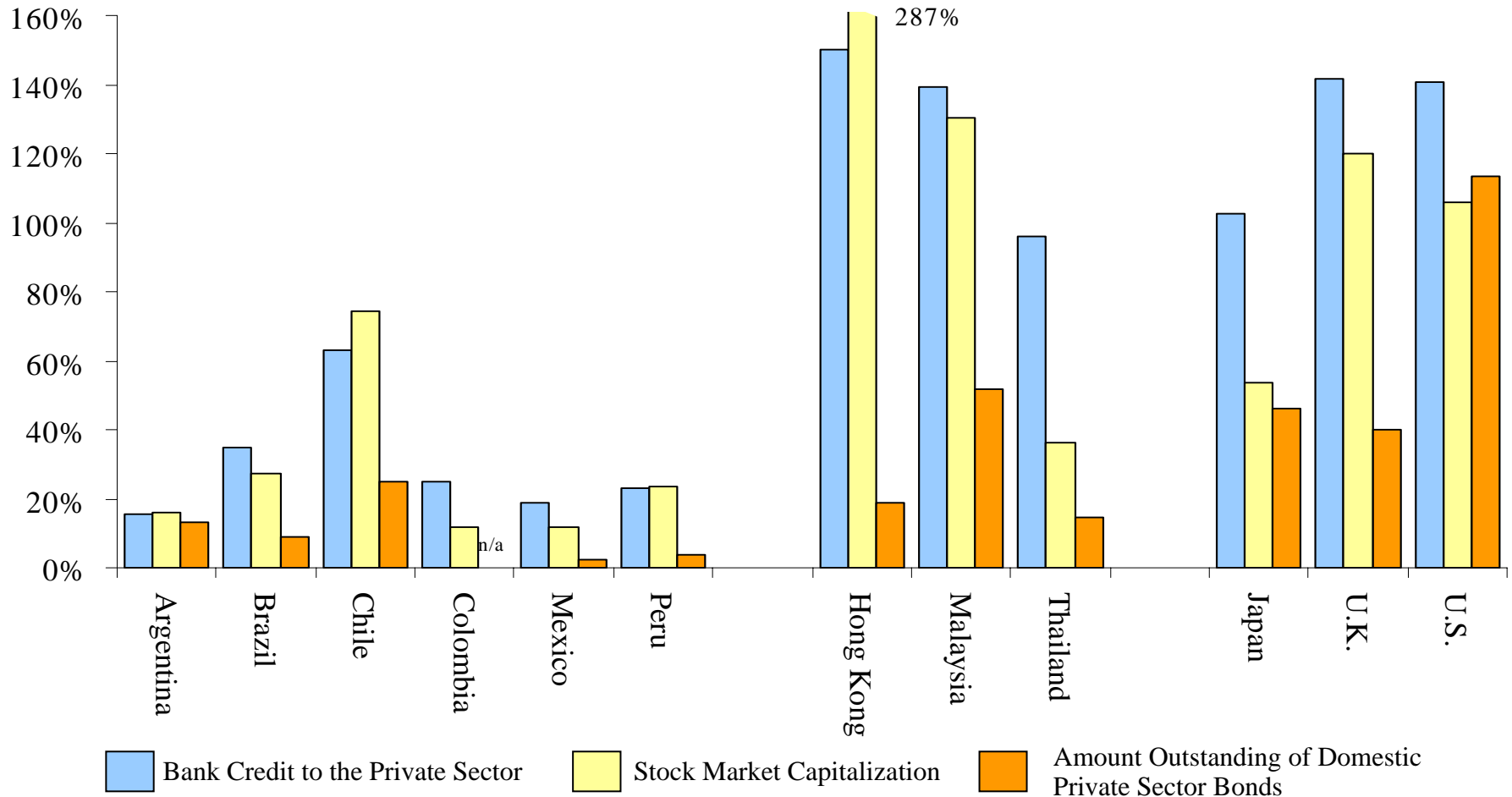
Percentage of Latin American Countries Having Implemented Reforms



...But Latin Financial Markets Remain Comparatively Small and Underdeveloped

Financial Sector Size Across Countries

Percent of GDP, 2002



What Went Wrong?

H1: Insufficient/Inconsistent Reforms

H1: Thesis and Diagnosis

- ✚ What needs to be done is well-known
 - ✚ Guided by international standards and codes
- ✚ Reform is not easy...
 - ✚ It is complex and multidimensional
 - ✚ Application to country circumstances is challenging
 - ✚ Crises are part of growing pains
- ✚ ... but reforms are right and will get us “there”
 - ✚ Perseverance will eventually pay – witness Chile
 - ✚ “There” = mini Wall Streets?
- ✚ Latin under-performance is due to reform shortfall and inconsistent reform implementation

H1: Assessment

Reform Impact is Not Obvious

- ✚ Econometric evidence shows that reforms boost domestic stock market activity *as well as* its internationalization...
- ✚ ... but not symmetrically – “pro-internationalization bias”
 - ✚ Reforms favor stock market internationalization *more than* local stock market development (De la Torre and Schmukler, 2004)
- ✚ Bias may be because internationalization takes place *at the expense* of local market development
 - ✚ Internationalization hurts local markets via trade migration, spillover, and diversion effects (Levine & Schmukler, 2004)
- ✚ LatAm is different – it has a “domestic market shortfall”

H1: Assessment

Reforms Fostered Stock Market Development...

Dependent Variable: Market Capitalization / GDP

Financial liberalization	0.244	***				
Infrastructure reform			0.427	***		
Institutional reform					0.233	***
Enforcement of insider trading laws						0.469 ***
Pension reform						0.440 ***
Privatization						0.285 ***
No. of Observations	1,108	605	568	816	368	904
No. of Countries	49	23	33	33	17	39
R-squared	0.23	0.26	0.11	0.28	0.20	0.26

Least square regressions estimated using fixed effects models for countries implementing reforms between 1975 and 2002. A constant is estimated but not reported.

*, **, *** mean significant at 10, 5, and 1 percent, respectively

H1: Assessment

...But Favored Stock Market Internationalization

Dependent Variable: Value Traded Abroad / Value Traded Domestically

Financial liberalization	0.077	***				
Infrastructure reform		0.415	***			
Institutional reform			0.154	***		
Enforcement of insider trading laws				0.155	***	
Pension reform					0.361	***
Privatization						0.089
						*
No. of Observations	341	156	260	313	114	311
No. of Countries	32	13	23	27	11	28
R-squared	0.02	0.15	0.05	0.06	0.13	0.01

Least square regressions estimated using fixed effects models for countries implementing reforms between 1975 and 2000. A constant is estimated but not reported.

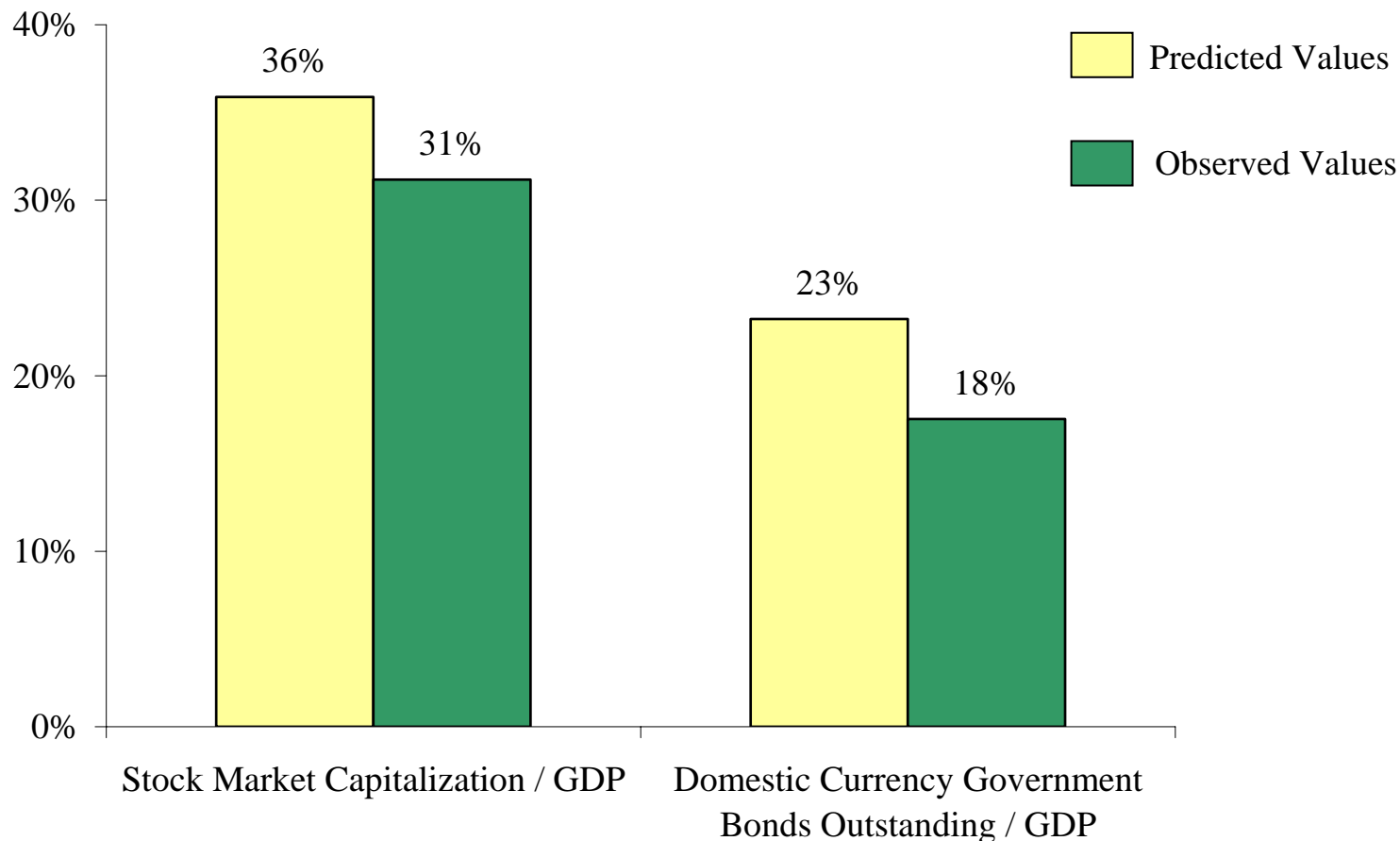
*, **, *** mean significant at 10, 5, and 1 percent, respectively

H1: Assessment

Latin “Shortfall” in Domestic Mkts, Given Fundamentals

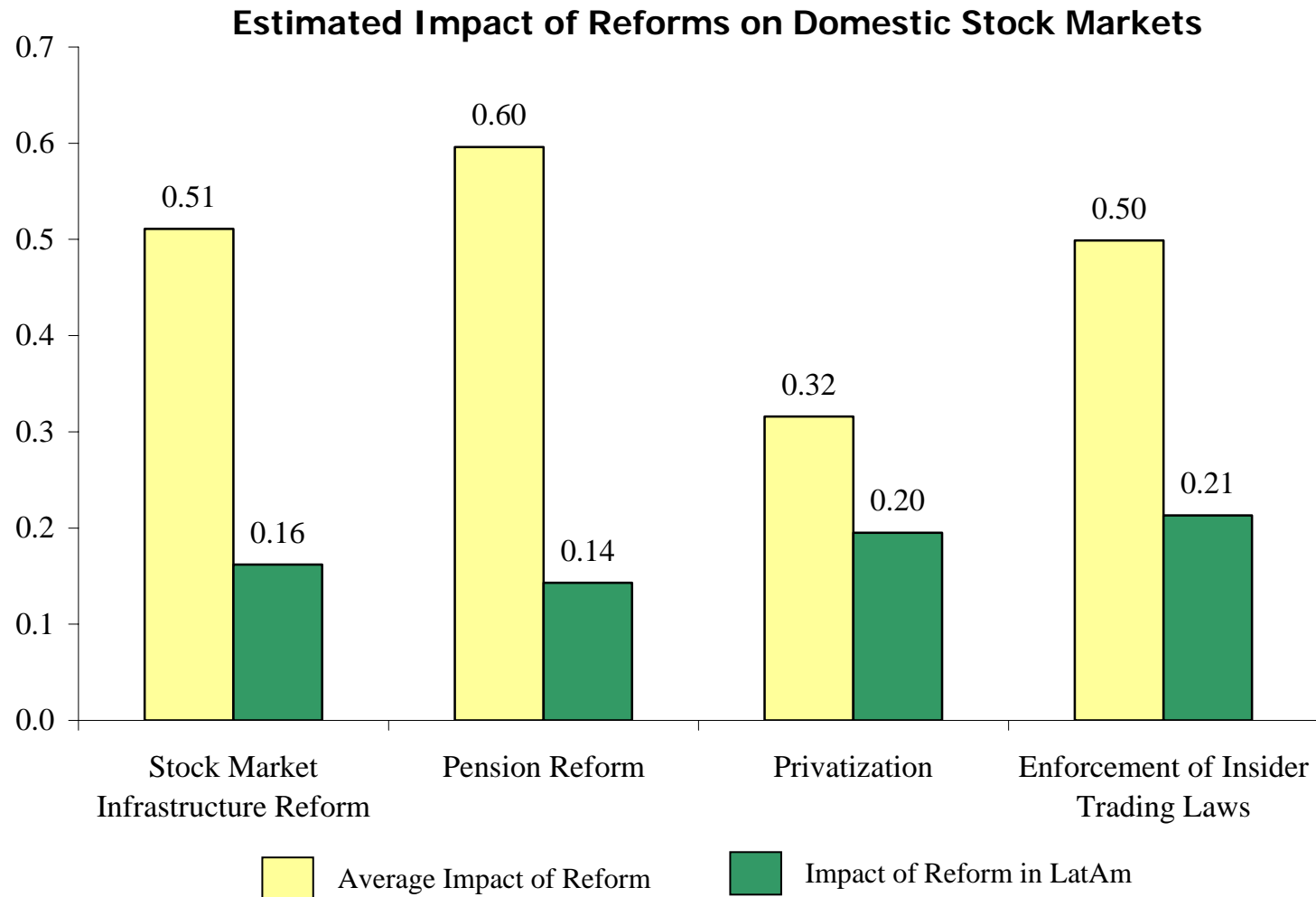
Predicted and Actual Stock and Local Currency Bond Market Development for LatAm, Given Fundamentals

(Average 1996-2000)



H1: Assessment

Latin “Shortfall” in Reform Impact on Local Stock Mkts



What Went Wrong?
H2: Wrong Sequencing

H2: Thesis and Diagnosis

- ✚ Int'l standards say where to go but not how to get there
- ✚ Sequencing is essential
- ✚ Financial fragility and underdevelopment is the result of wrong sequencing
 - ✚ Premature liberalization (before institutional & regulatory strengthening) magnifies boom-bust cycles
 - ✚ Premature int'l financial integration (before development of local currency debt markets) accentuates mismatches and vulnerability
 - ✚ Inattention to preconditions (ignoring building-block nature of financial development) renders certain reforms ineffective

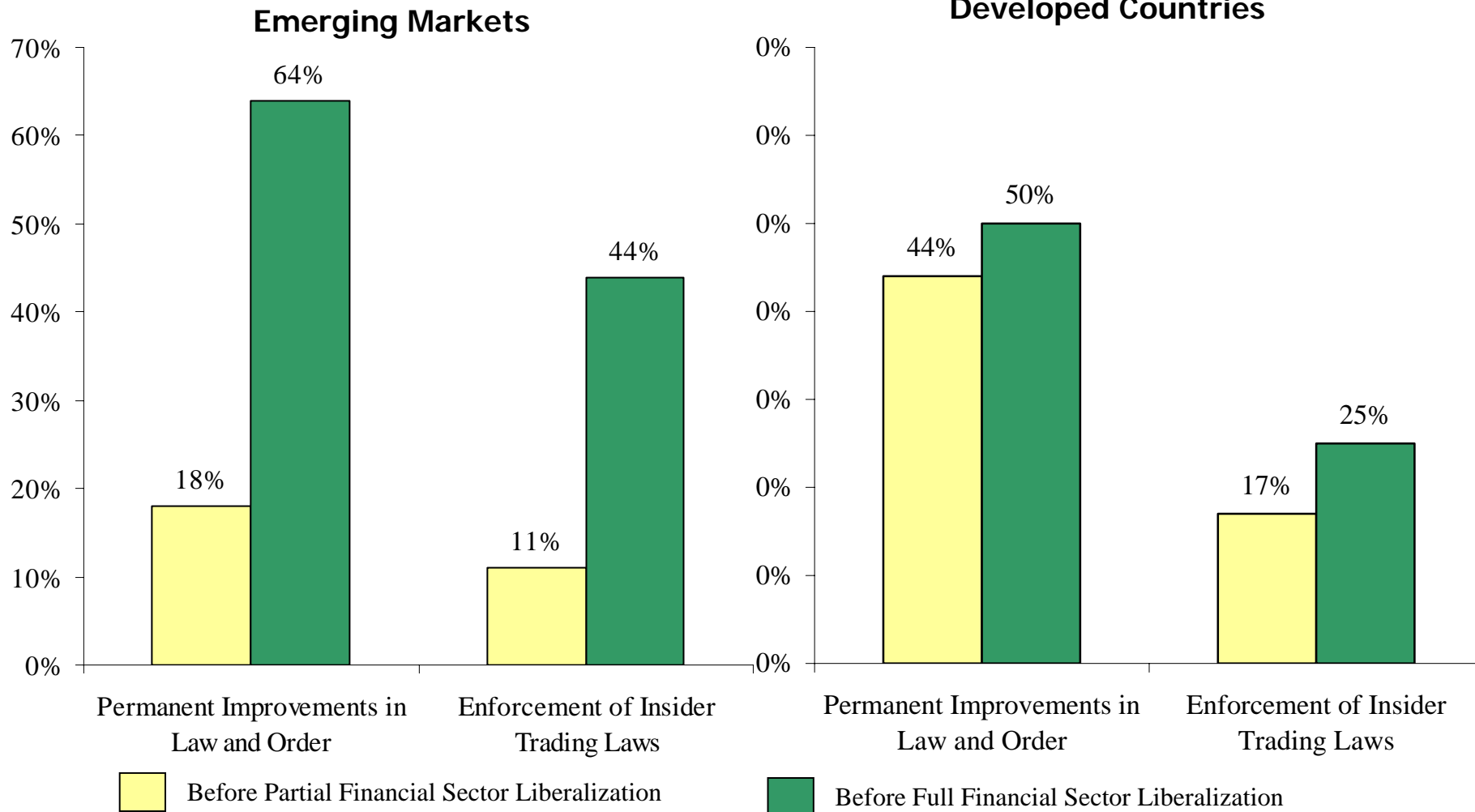
H2: Assessment

- ✚ No evidence that liberalization itself engenders mismatches
- ✚ Mismatches also arise in closed financial systems
 - ✚ Currency mismatches via off-shores
 - ✚ Duration mismatches
- ✚ Closed systems are not immune to crises (of different type)
- ✚ No evidence that faulty sequencing hinders financial development permanently...
- ✚ ... but evidence that liberalization stimulates reforms
- ✚ It is doubtful that financial systems can be kept closed
 - ✚ Given globalization trends, financial engineering, technology
 - ✚ Especially in countries that are already liberalized and open

H2: Assessment

Liberalization Stimulates Reform

Percentage of Countries Having Implemented Reforms



What Went Wrong?
H3: Wrong Expectations

H3: Thesis and Diagnosis

- ✚ For all their insights, H1 and H2 have shortcomings
 - ✚ H1 underestimates actual reform effort in LatAm...
 - ✚ ... and its predictions are dissonant with “pro-internationalization bias” and “domestic shortfall”
 - ✚ H2 naively assumes that resistance to reform will yield in the absence of competition at home and from abroad...
 - ✚ ... and it has not shown that liberalization and financial opening are harmful in the long run
 - ✚ H1 and H2: both assume that developed financial markets are the goal and benchmark for developing countries
- ✚ Step back, revisit basic issues, and adjust expectations

Back to Basics

1. Financial Globalization
 2. Size
3. Segmentation of Access

Financial Globalization

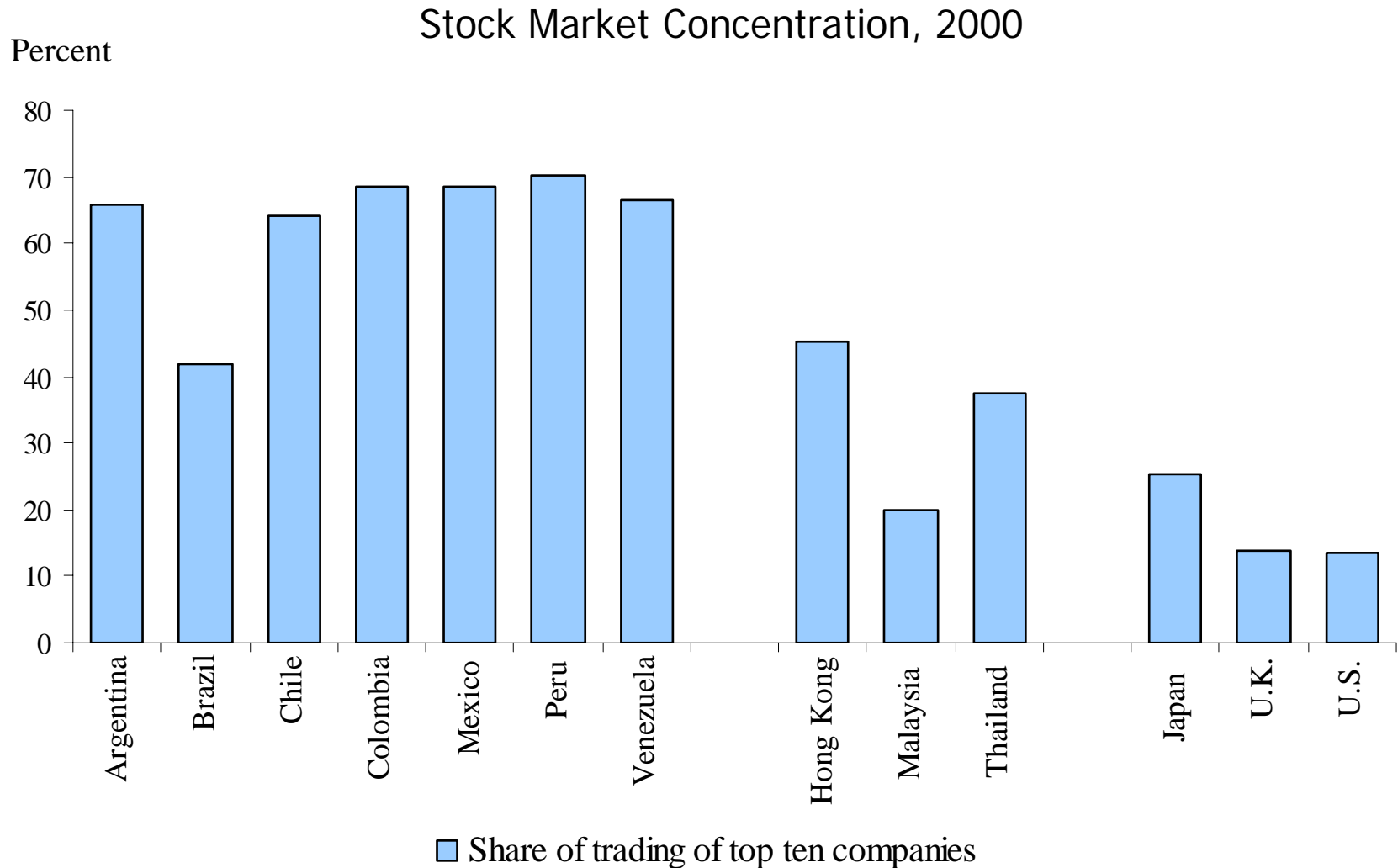
- ✚ It is not a detail!
 - ✚ Measuring financial development by domestic variables alone is misguided – what matters is access to financial services
- ✚ It can magnify weak-currency problems in debt markets
 - ✚ Weak currencies are those not easily accepted as store of value
 - ✚ In small open economies, the shock-absorption function of local currencies could undermine their store-of-value function
- ✚ It can undercut development of local stock markets
 - ✚ Stock market internationalization can have negative spillovers on the local market but does not result in balance sheet vulnerabilities

Size

- ✚ Liquidity is a positive function of size of market and issues
 - ✚ Ongoing clustering of world-wide liquidity in few int'l centers
 - ✚ Illiquidity begets illiquidity
 - ✚ Illiquidity hampers “price revelation” – core function of capital mkts
- ✚ Larger economies and financial markets facilitate the development of local currency debt markets
- ✚ Size of issues matter for risk diversification
 - ✚ Small issues are too marginal or redundant in risk diversification strategies of local and foreign institutional investors
 - ✚ Small issuers/issues are not included in portfolios of pension funds when their investment regulations are relaxed (the case of Chile)

Segmentation of Access

A Few Large Companies Dominate Latin Stock Markets

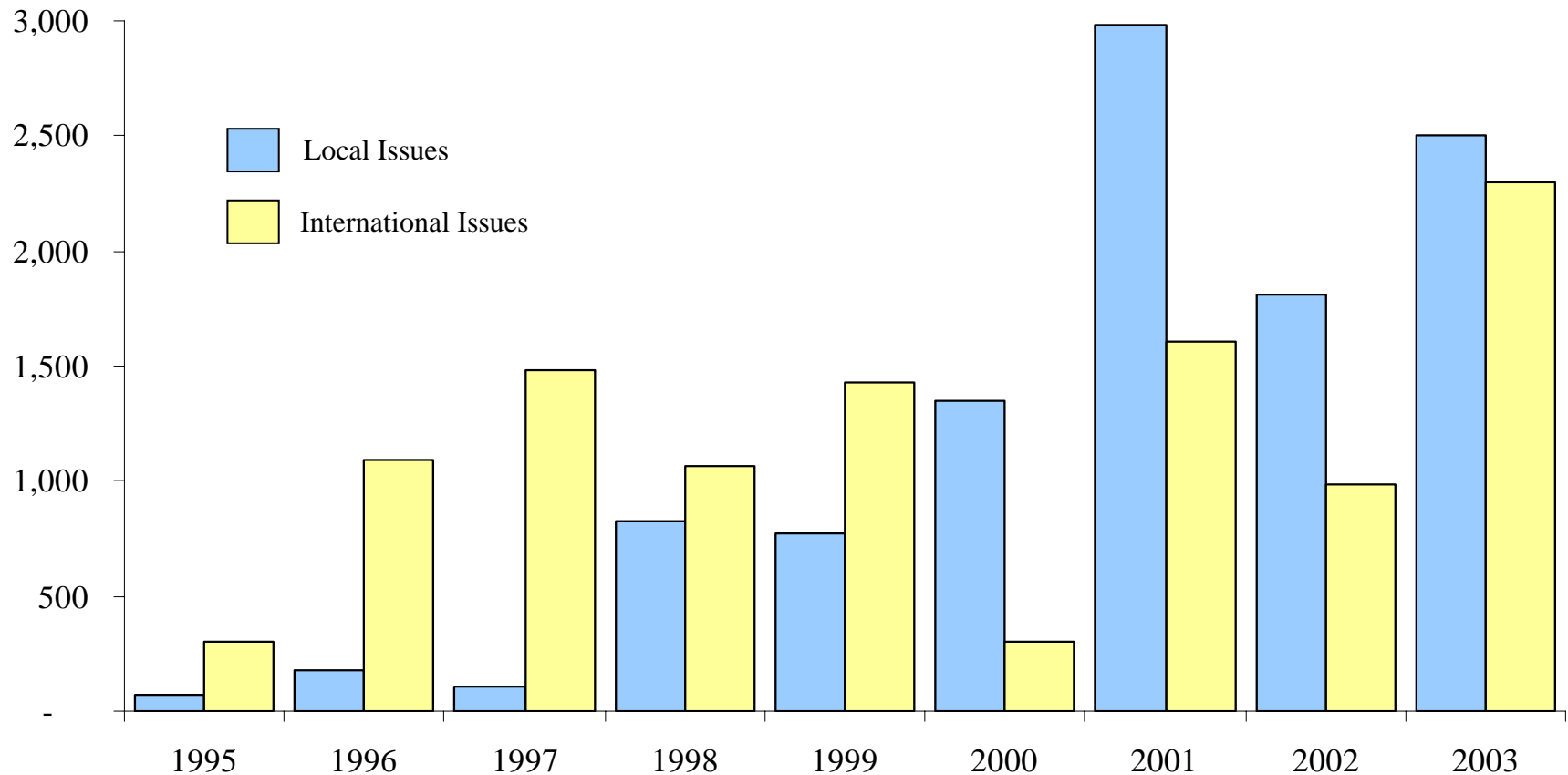


Segmentation of Access

Even in Successful Corporate Bond Mkts, Like Chile's...

Chile - Corporate Bonds issues in Domestic and International Markets

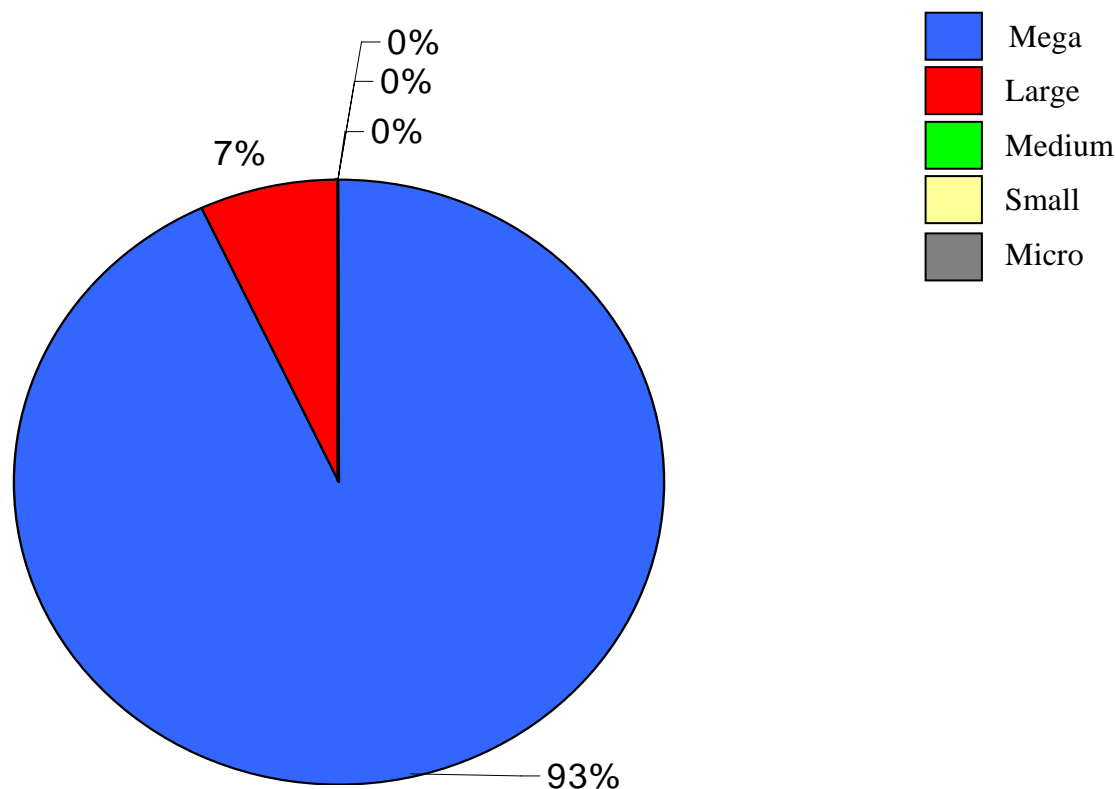
Million U.S. dollars



Segmentation of Access

... Only A Few Large Companies Have Access

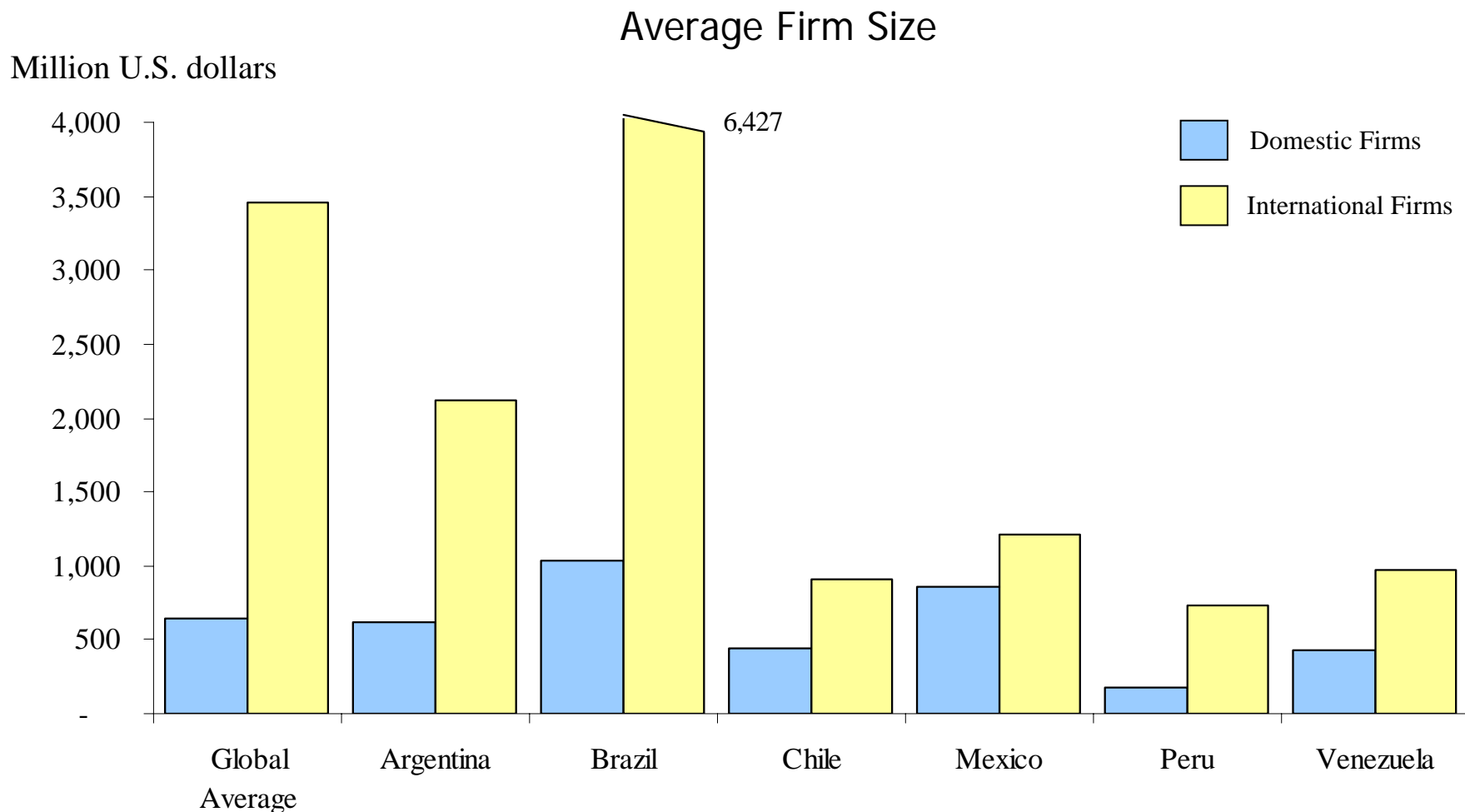
Chile – Corporate Bond Issues in the Local Market by Firm Size
(Cumulative Issues for 2000-2003)



Mega firms are defined as those with annual sales net of VAT above UF600,000 (US\$17.2 million); large firms have sales between UF100,000 (US\$2.8 million) and UF600,000; medium firms have sales between UF25,000 (US\$0.7 million) and UF100,000; small firms have sales between UF2,400 (US\$68,688) and UF25,000 and micro firms have sales below UF2,400. Micro firms represent around 82 percent of all firms, while small firms are 15 percent and medium firms two percent. Large and mega firms combined account for only one percent of all firms. *Source: World Bank (2004)*

Segmentation of Access

Only the Largest Firms Have Access to Int'l Mkts



Domestic firms are firms listed in domestic stock markets which do not access international equity markets. International firms are those identified as having at least one active depositary receipt program, or having raised equity capital in international markets, or trading in the London Stock Exchange, NYSE, or NASDAQ. The data for international firms corresponds to their size on the internationalization year.

Segmentation of Access

Banks Too May Be Discouraged from Lending to SMEs

- ✚ In weak contractual environments, Basel- and AML-type regulations may undermine SME access to finance
 - ✳ Banks' ability to engage in “relationship finance” with opaque SMEs in informal sector is hindered
 - ✳ Bank credit exposure to the local sovereign is encouraged
 - As it does not require regulatory capital
 - ✳ But contractual and informational environment is not yet conducive to “arm’s-length” or “impersonal” lending to SMEs
- ✚ Unintended effects of Basel- and AML-type regulations?
 - ✳ Crowding out *and...*
 - ✳ ... a bias in favor of “commoditized lending” (consumer, micro)
 - Lending to SMEs is not easily “commodity-izable”

Conclusion

Rethinking the Reform Agenda

- ✚ Abandon hope of creating mini-Wall Streets
 - ✚ No one-size fits all
 - ✚ Difference between int'l financial centers and peripheral markets
 - ✚ Local markets should be complementary rather than replicative
- ✚ Reassess role of regional integration vis-à-vis global integration
- ✚ Emphasize links between capital markets and the rest of financial service providers and the real sector
 - ✚ Financial structures and hybrid products linking multiple stakeholders
 - ✚ Unrealistic to expect that firms of all sizes will have direct access to bond and stock markets
- ✚ What matters is access, regardless of where or by whom provided

Conclusion

More Questions than Answers

- ✚ How to overcome the Latin “shortfall” in local currency debt markets without barriers to international integration?
 - ✚ The key missing market is for long-duration peso debt
 - ✚ Is there a role for multilateral development banks?

- ✚ Can small Latin countries overcome the size problem and generate a suitable version of local stock markets?
 - ✚ One that features systematic illiquidity and accepts the pro-internationalization bias of reforms

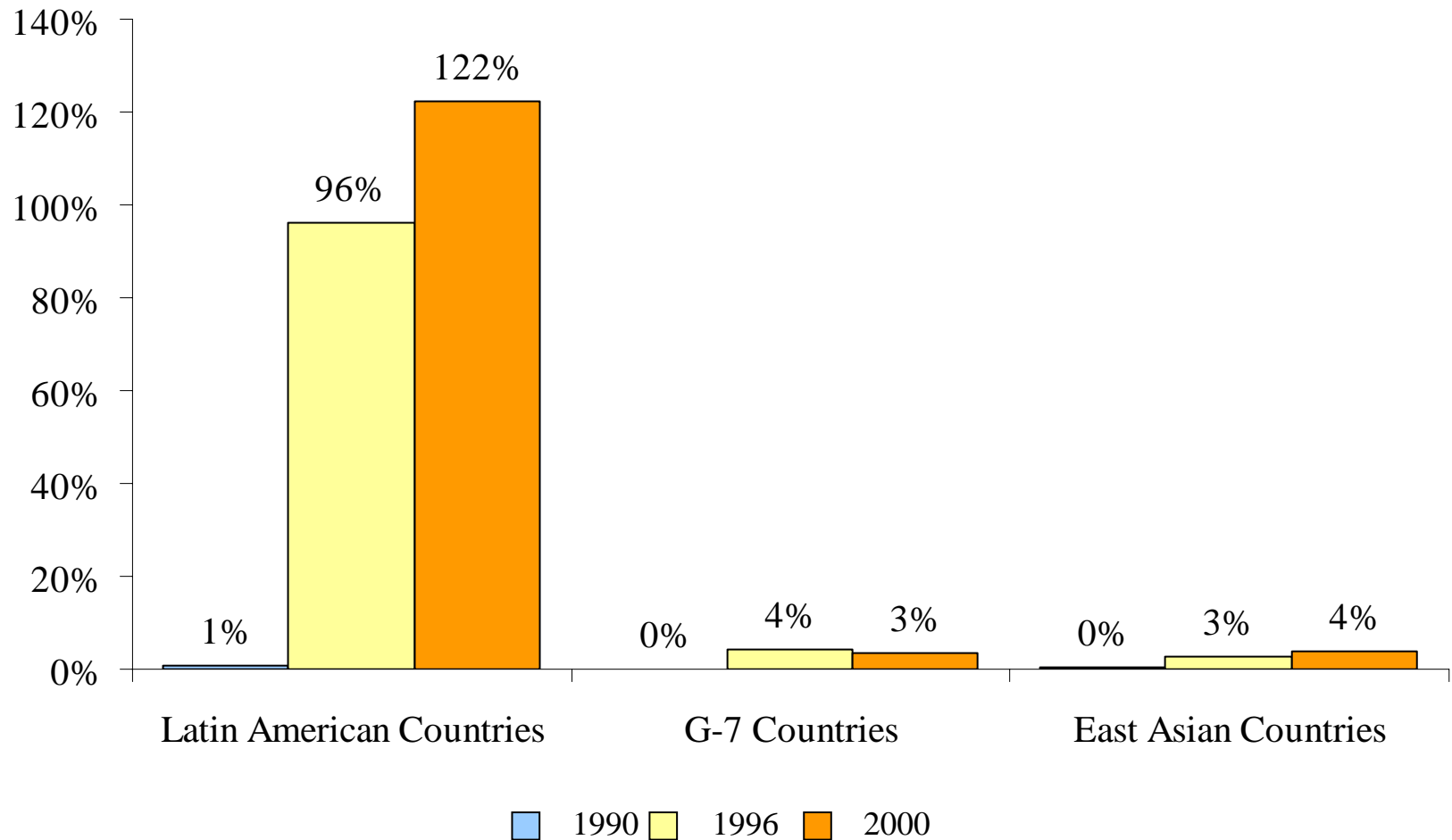
- ✚ How can SME access to finance be broadened where Basel- and AML-type regulations coexist with a weak contractual environment and financial globalization?

END

Bonus Material

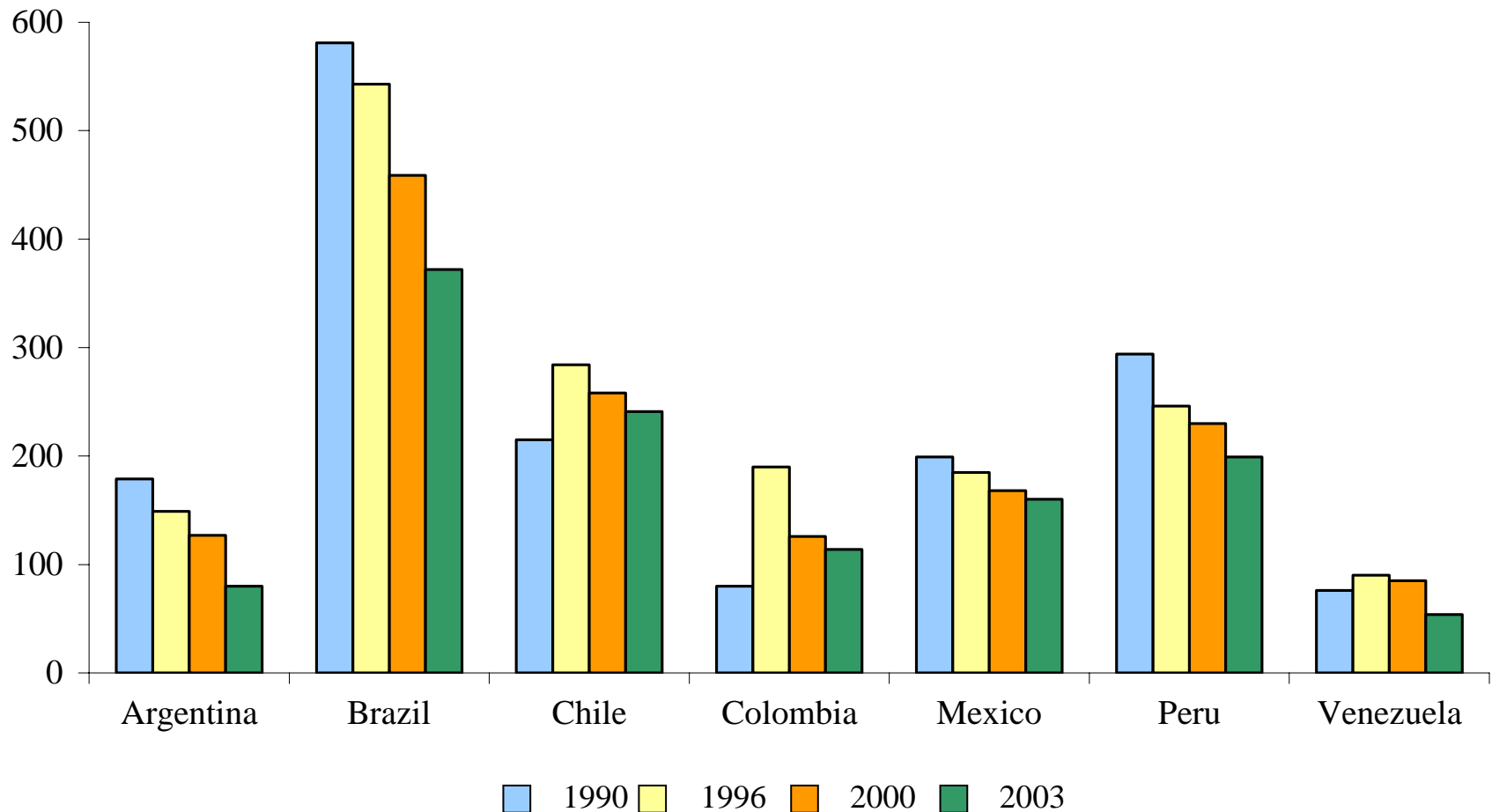
Latin America Has Been a Leader in Stock Market Internationalization

Ratio of Value Traded Abroad to Value Traded Domestically



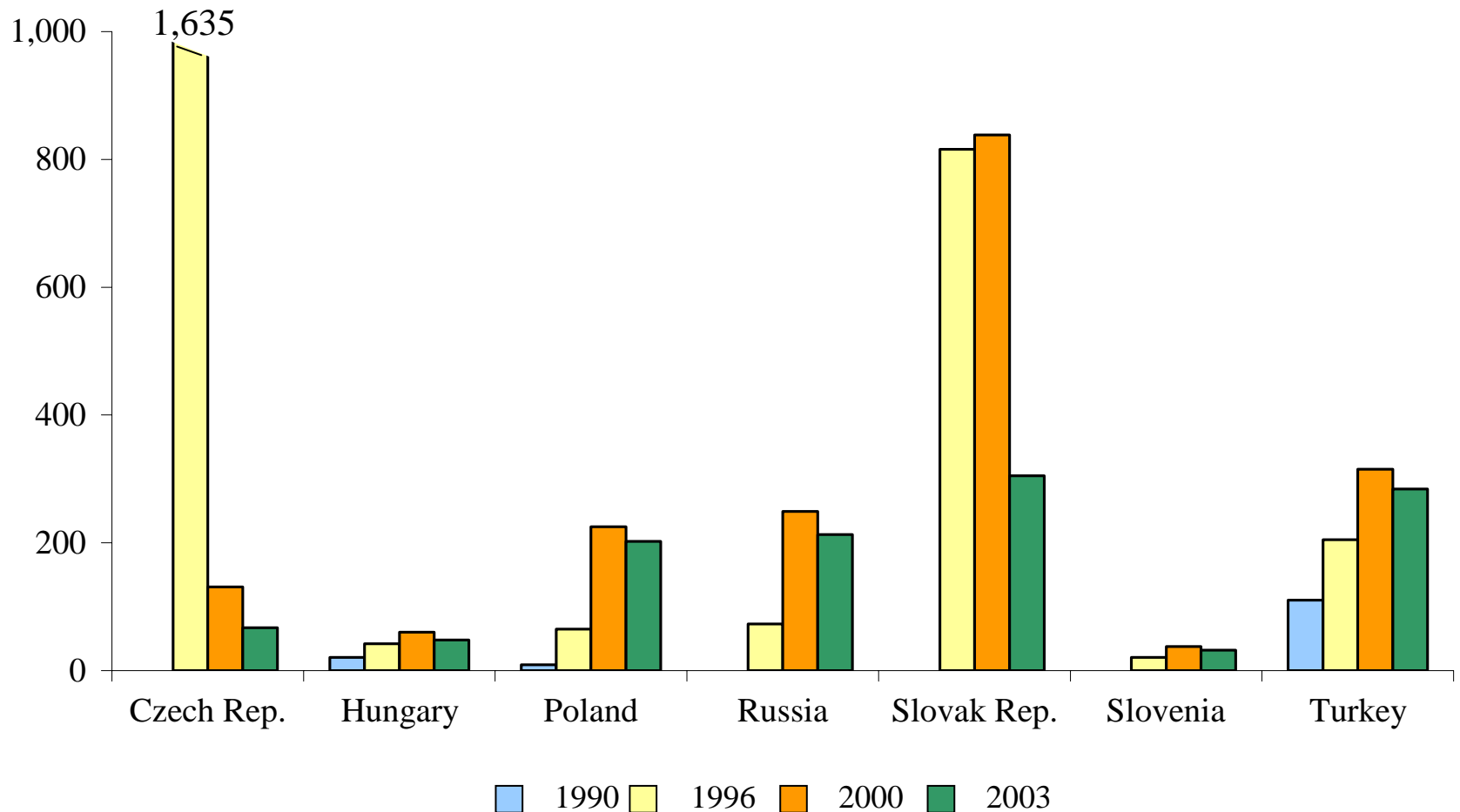
Significant De-Listings in LAC Stocks Markets...

Number of Firms Listed in Domestic Stock Exchanges in Latin America



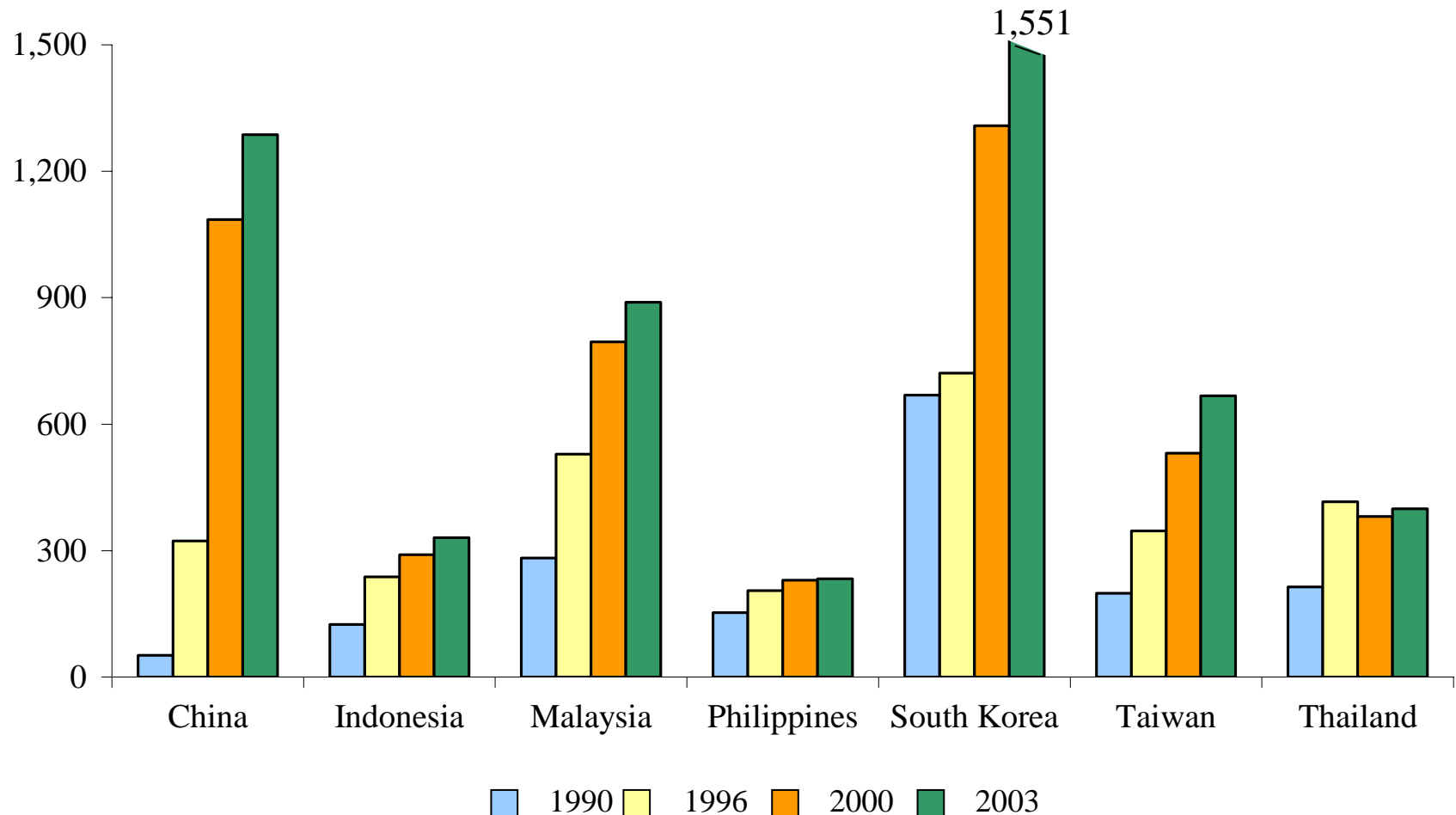
...And in Markets in Eastern Europe

Number of Firms Listed in Domestic Stock Exchanges in Eastern Europe



But More Listings in East Asian Stock Markets

Number of Firms Listed in Domestic Stock Exchanges in South East Asia



H1: Assessment

Internationalization Hurt Local Stock Markets

Dependent Variable: Log of One Plus the Turnover Ratio of Domestic Firms						
Share of internationalized firms	-1.39 ***	-2.98 ***	-3.01 ***	-2.55 ***	-2.93 ***	-2.56 ***
Log of one plus aggregate turnover ratio in international markets	0.24 ***	0.18 ***	0.17 ***	0.22 ***	0.17 ***	0.19 ***
Log of GDP per capita			0.20 ***			0.16 ***
Law and order				0.05 ***		0.04 ***
Capital account liberalization					-0.01	-0.02
Log of total assets		-0.06 ***	-0.06 ***	-0.06 ***	-0.06 ***	-0.06 ***
Number of firms	2,400	1,531	1,530	1,509	1,517	1,494
Number of observations	12,762	7,312	7,298	7,233	7,138	7,045
Country dummies	Yes	Yes	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes	Yes	Yes
R-squared	0.70	0.71	0.71	0.71	0.70	0.70

Least square regressions with robust standard errors for a panel of data covering over 3,000 firms across 55 emerging market countries during the years 1989 to 2000.

*, **, *** mean significant at 10, 5, and 1 percent, respectively