

# Perspectivas sobre los Mercados de Capitales

Banco Central de Chile

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Whither Latin American Capital Markets?

[www.worldbank.org/laccapitalmarkets](http://www.worldbank.org/laccapitalmarkets)



# Structure of Presentation

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- ✚ Latin American capital markets underperformed
- ✚ What went wrong?
  - ✚ Two existing hypotheses
- ✚ Alternative explanation: back to basics
  - ✚ Financial globalization
  - ✚ Size
  - ✚ Segmentation of access
- ✚ Perspectives on capital markets

# Structure of Presentation

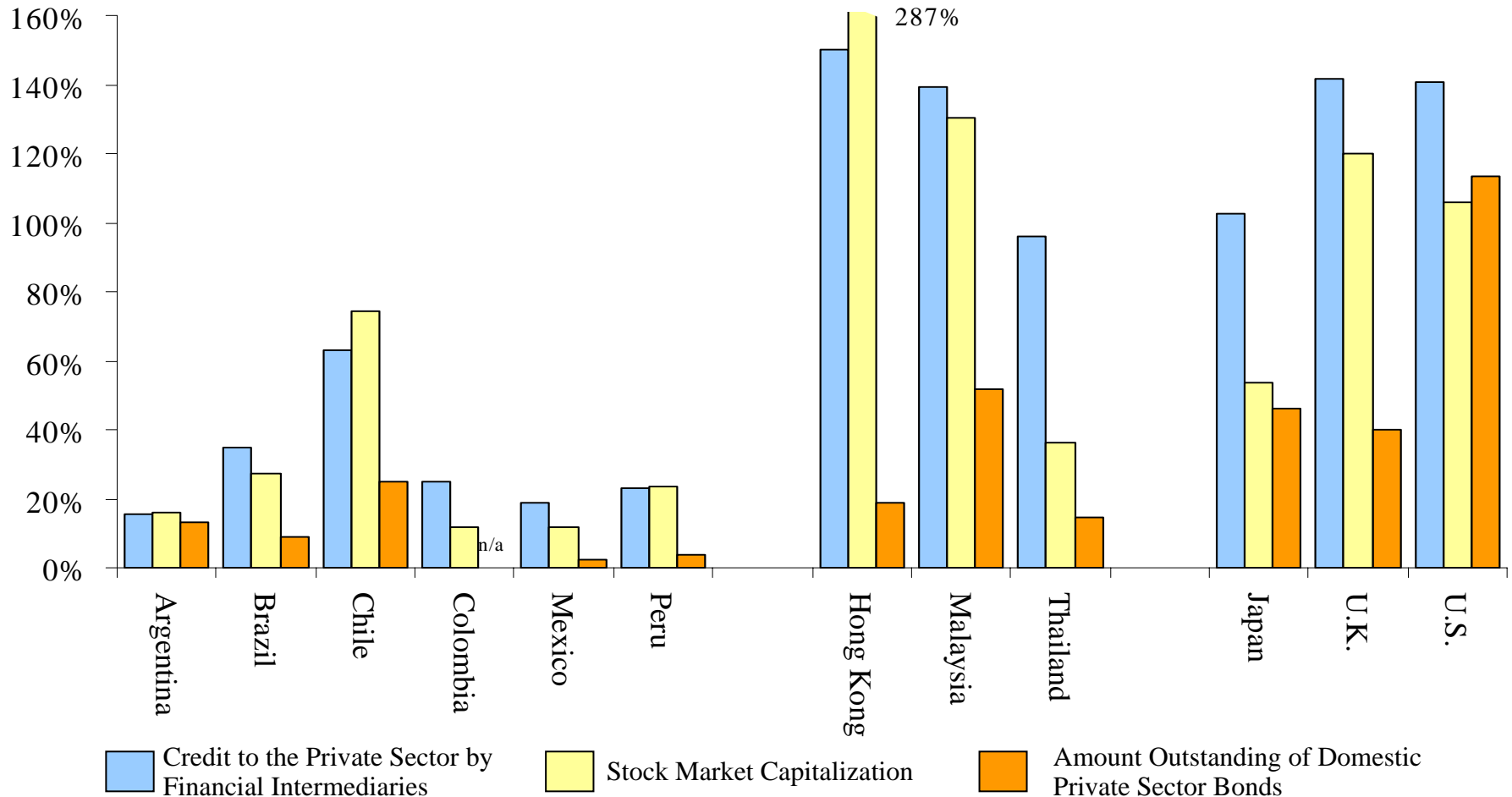
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- ✚ Perspectives on stock and fixed-income markets

# Latin Financial Systems are Small and Underdeveloped

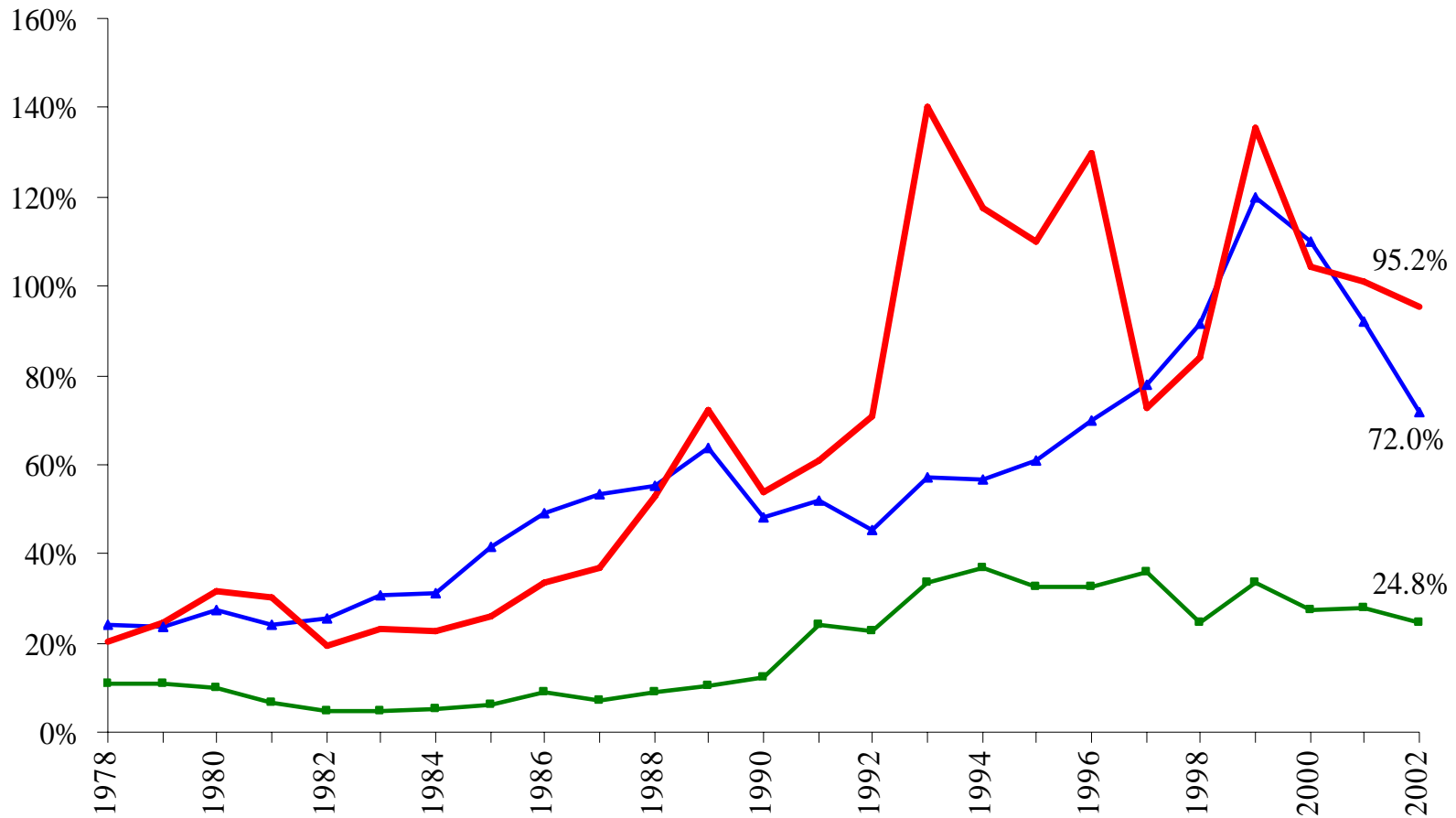
## Financial Sector Size Across Countries

Percent of GDP, 2002



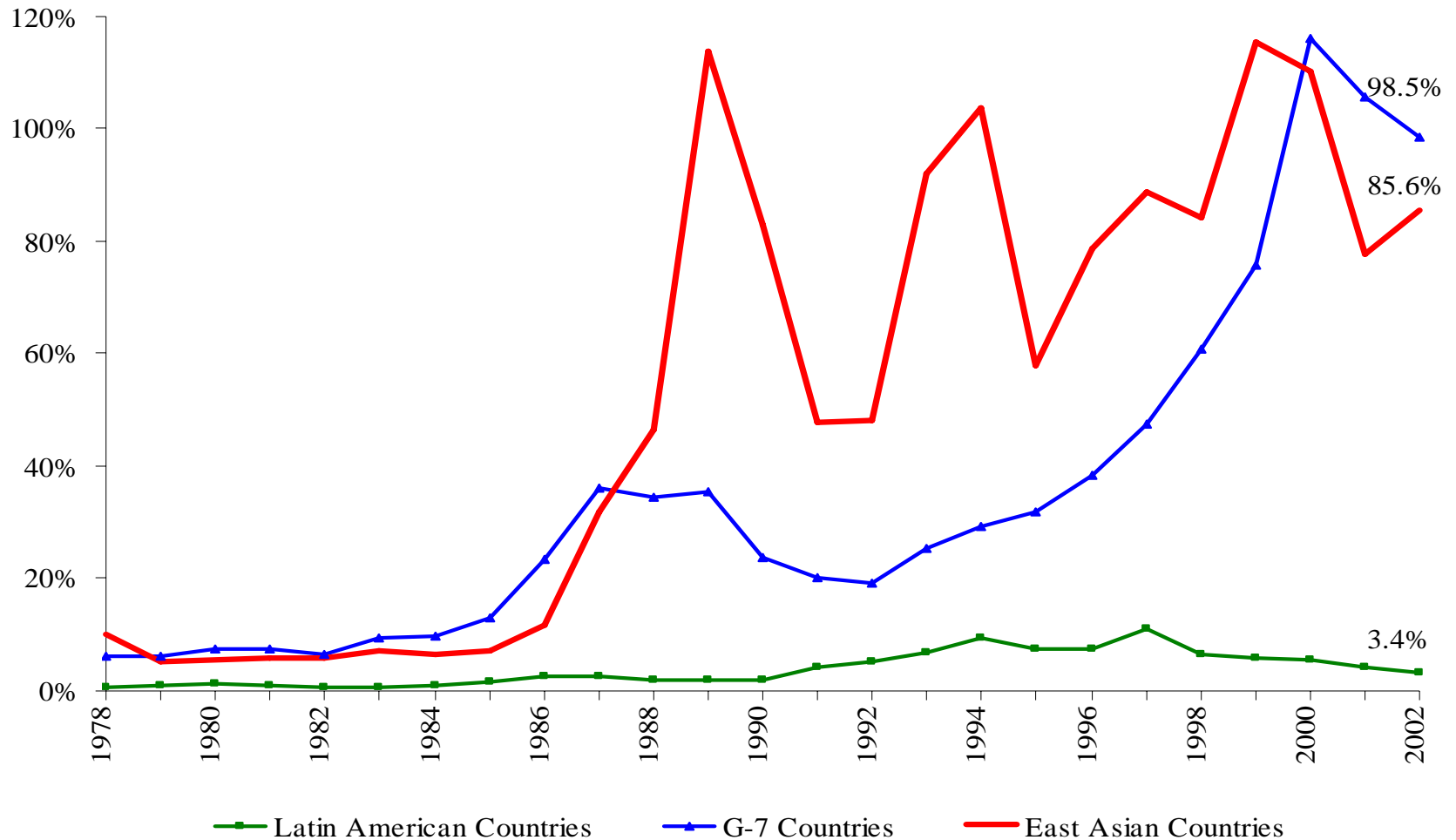
# Latin Stock Markets Not Converging

Market Capitalization / GDP



# Latin Stock Markets Not Converging

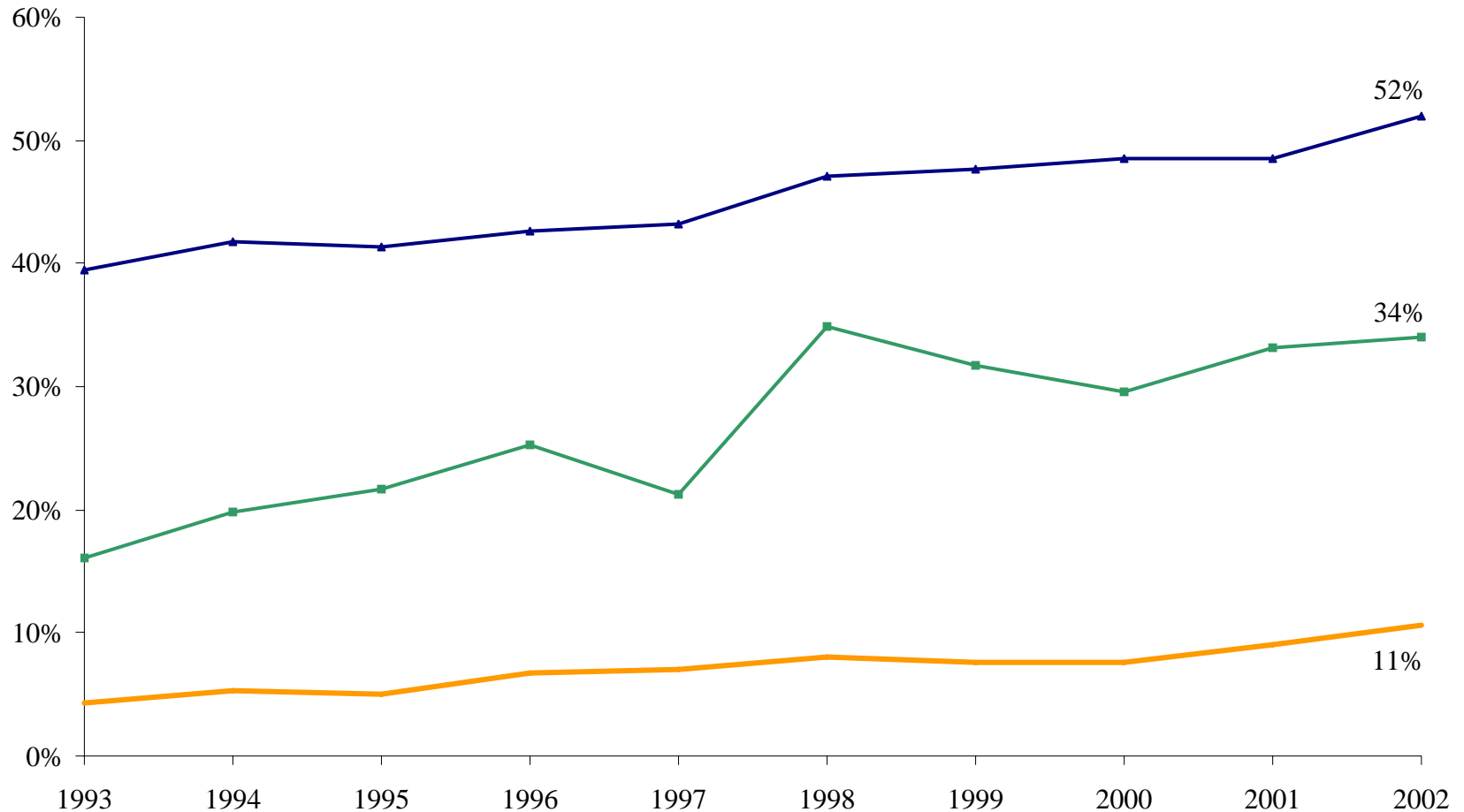
Value Traded Domestically / GDP



# Corporate Bond Markets Also Trailing Behind

## Domestic Private Sector Bonds Outstanding

Percent of GDP



Source: [Whither Latin American Capital Markets?](#), 2004.

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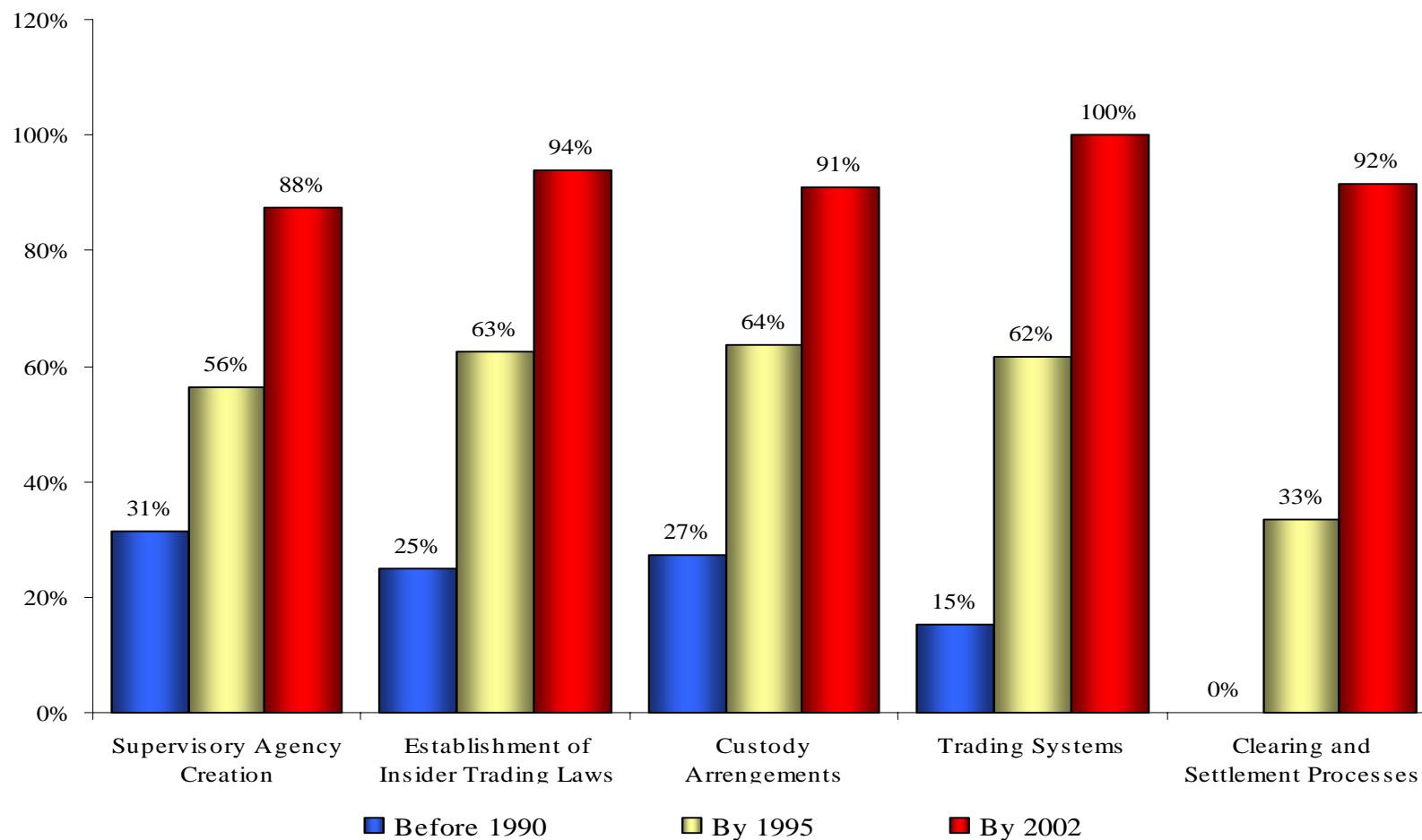
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H1:

Underperformance Due to  
Weak Fundamentals and Lack of Reforms

# LatAm – Intense Capital Mkts Reform Effort in the 90s

Percentage of Latin American Countries Having Implemented Reforms



# Reforms and Stock Markets

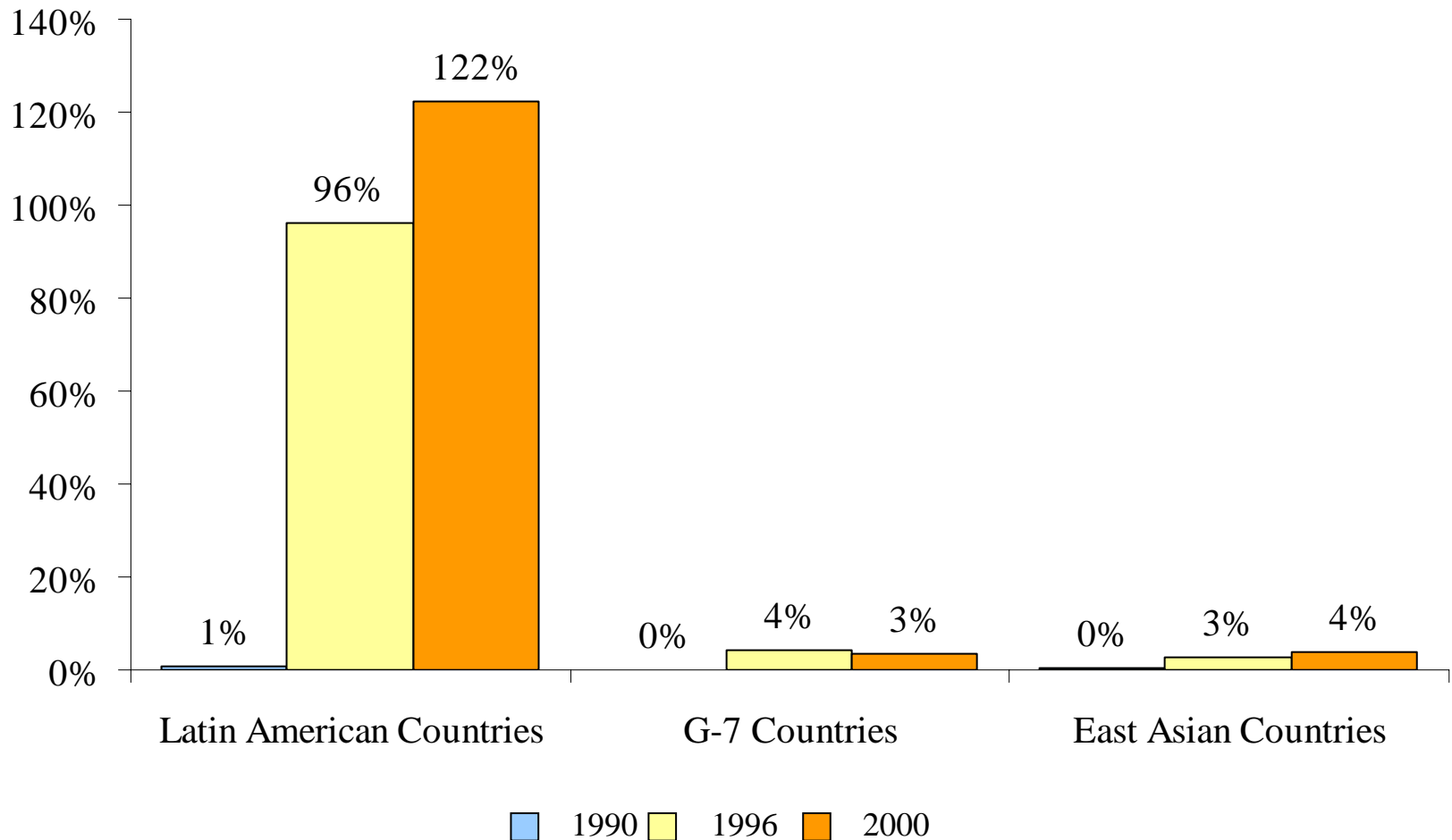
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- ✚ Reforms boost domestic stock market activity *as well as* its internationalization...
- ✚ but “pro-internationalization bias”
  - ✚ Reforms favor stock market internationalization *more than* local stock market development
- ✚ Internationalization takes place *at the expense* of local market development
- ✚ Effects are larger in the case of Latin America

# Latin "Excess" in Stock Market Internationalization

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## Ratio of Value Traded Abroad to Value Traded Domestically



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H2:

Under Performance Due to  
Wrong Reform Sequencing?

# Reform Sequencing Can Make a Difference

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- ✚ Premature domestic financial market liberalization
  - ✚ Liberalization before institutional & regulatory strengthening...
  - ✚ ... can magnify boom-bust cycles
- ✚ Premature international financial integration
  - ✚ Integration before development of local currency debt markets...
  - ✚ ... can accentuate currency mismatches and systemic vulnerability

## Sequencing is Not the Whole Story

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- ✚ 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

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# Financial Globalization

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- ✚ Is not a detail!

- ✚ Measuring financial development by domestic variables alone is misguided

- ✚ Can undercut development of local stock markets

- ✚ Stock market internationalization can have negative spillovers on the local market

- ✚ Can magnify weak-currency problems in debt markets

- ✚ Weak currencies are those not easily accepted as store of value
- ✚ The shock-absorption function of local currencies could undermine their store-of-value function

# Size

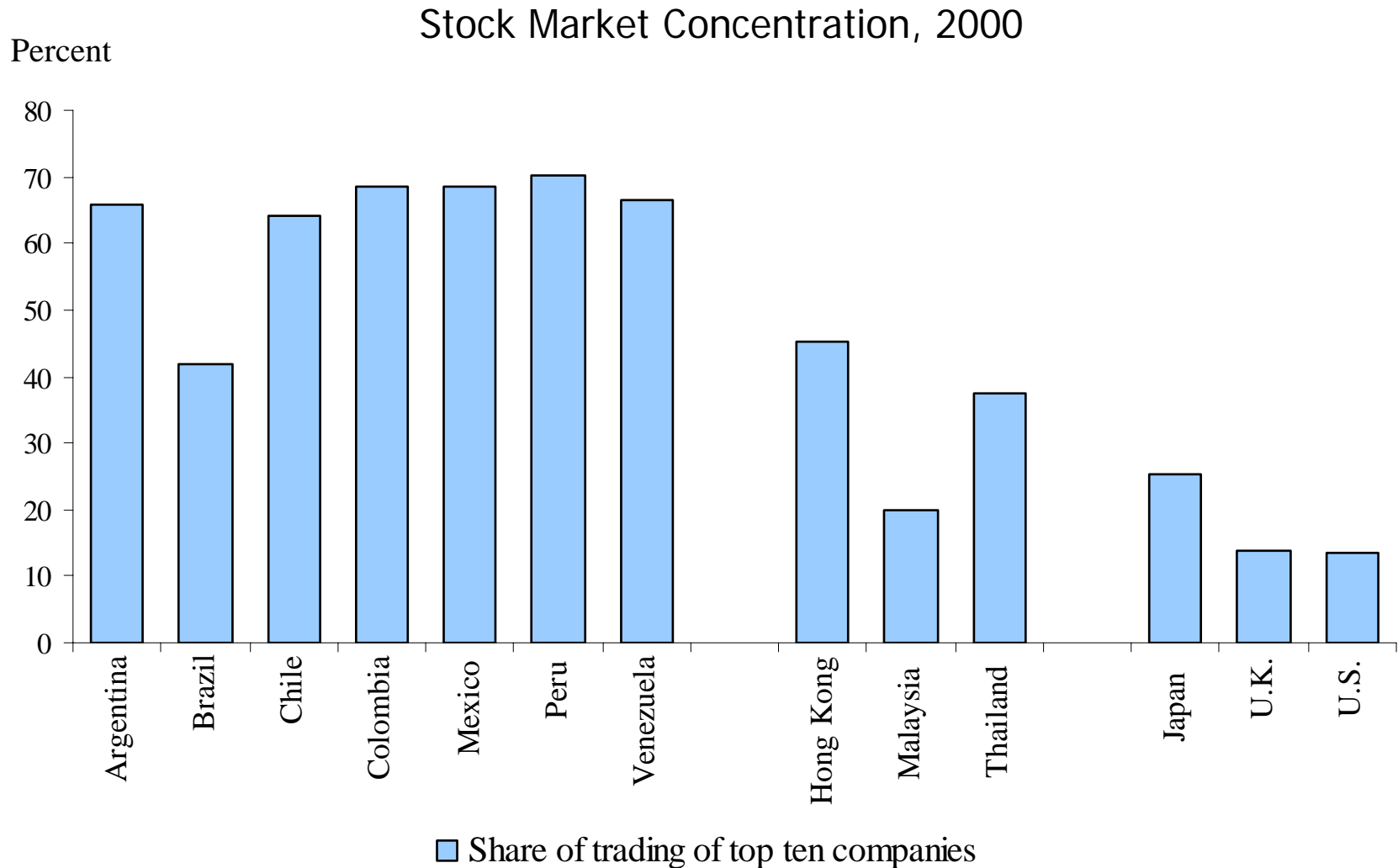
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- ✚ Liquidity is a positive function of size of market and issues
  - ✚ Clustering of world-wide liquidity in few int'l centers
  - ✚ Illiquidity begets illiquidity and hampers price revelation
- ✚ Larger economies and financial markets facilitate 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 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

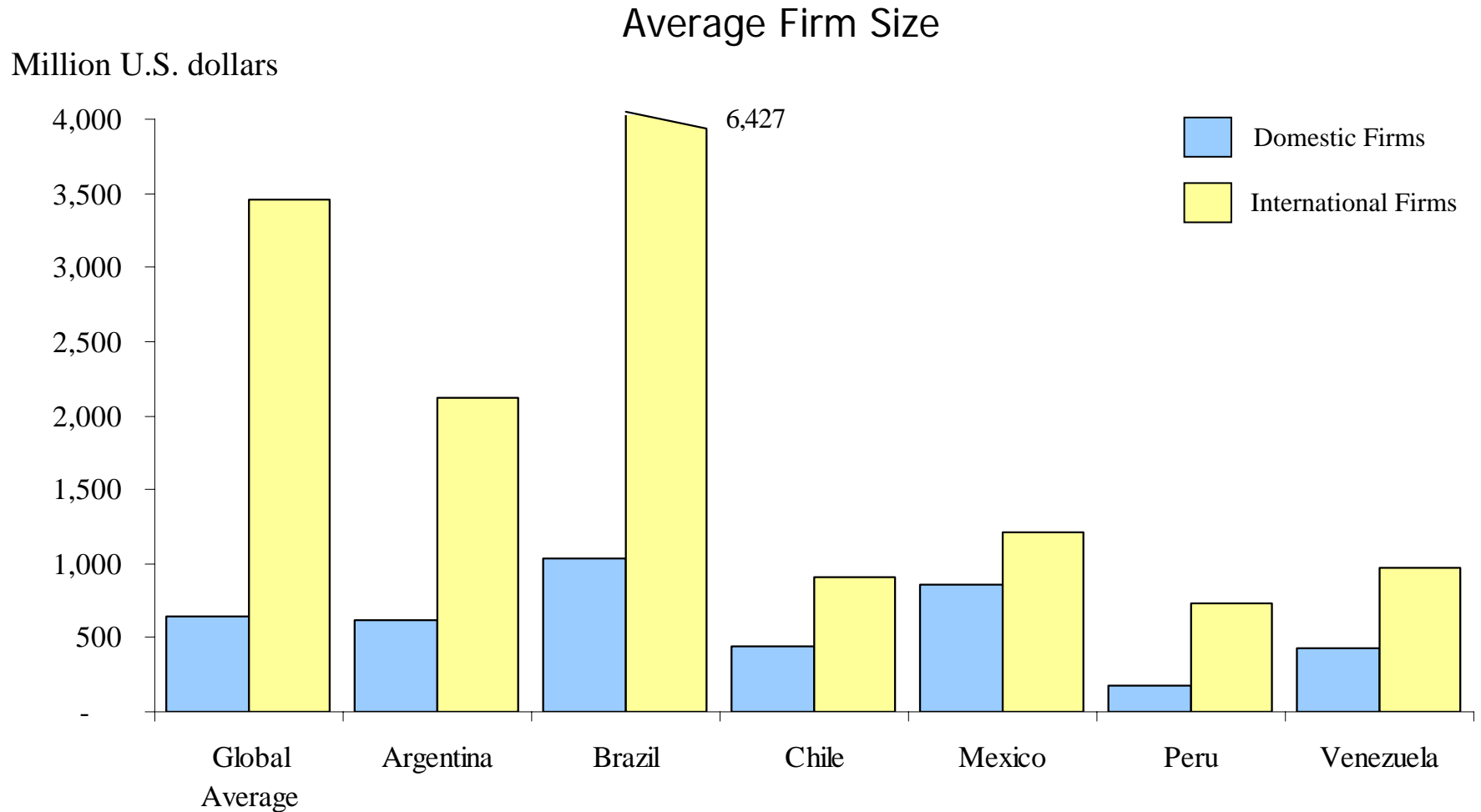
## A Few Large Companies Dominate Latin Stock Markets

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# 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.

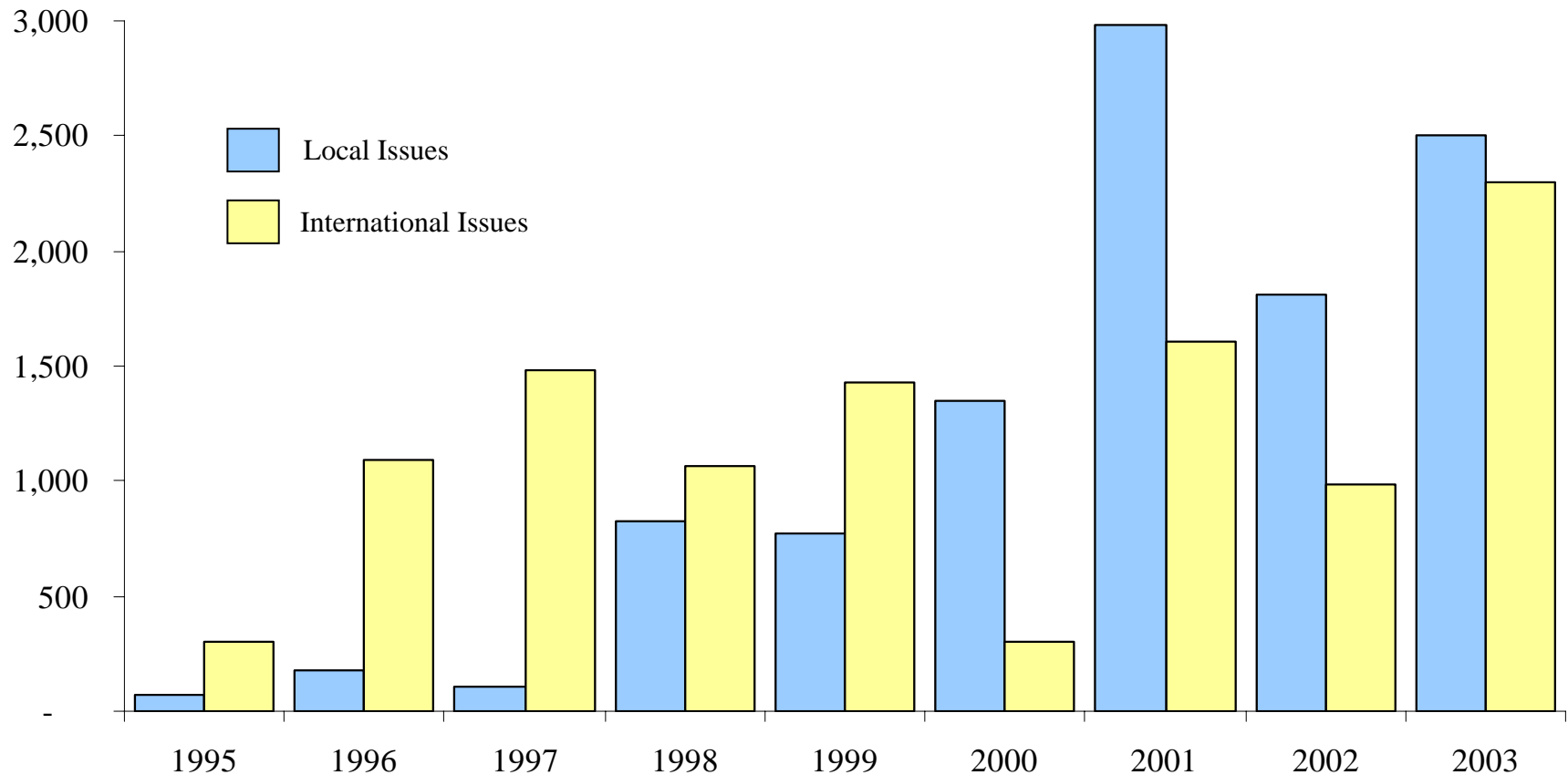
# Segmentation of Access

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

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### Chile - Corporate Bonds Issues in Domestic and International Markets

Million U.S. dollars

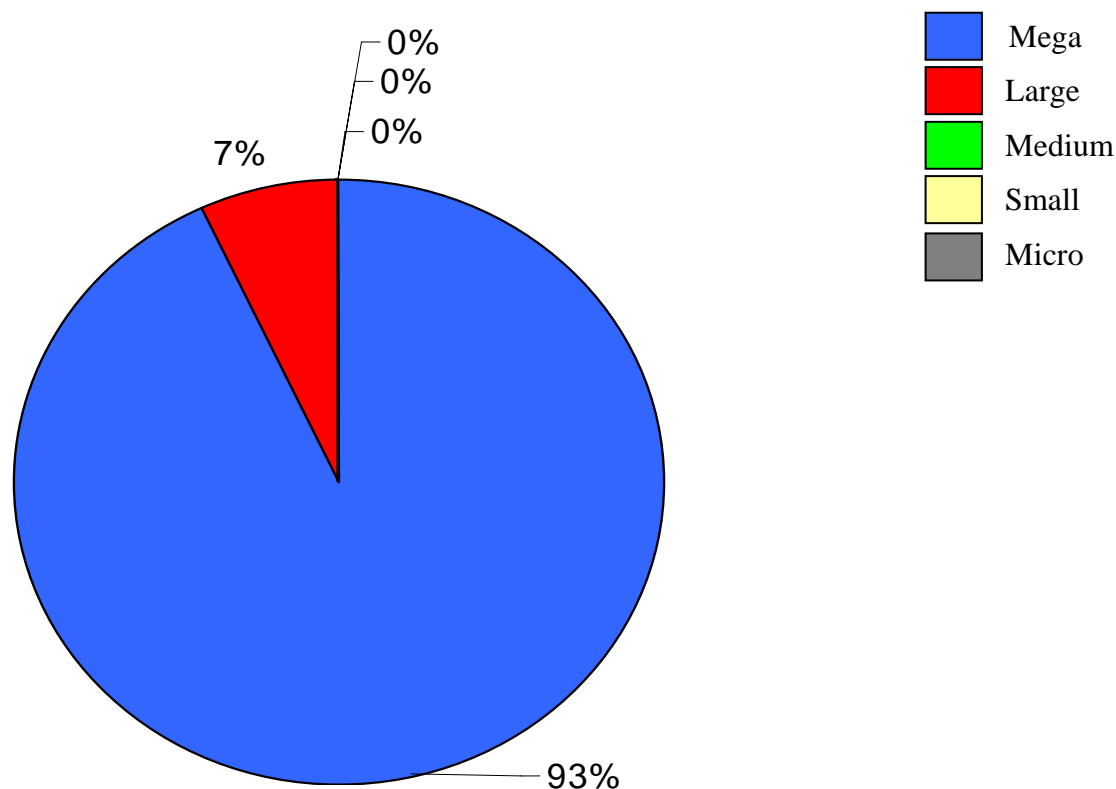


# Segmentation of Access

## ... Only A Few Large Companies Have Access

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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)*

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# Perspectives on Stock Markets

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- ✚ Pro-internationalization bias
  - ✚ Local improvements boost internationalization
  - ✚ Internationalization and size limits local stock market liquidity
- ✚ Internationalization does not generate vulnerabilities in the balance sheet of issuers
  - ✚ No default risk
  - ✚ Firm performance might be affected by exchange rate fluctuations, but effects are passed on to investors via dividends

# Perspectives on Stock Markets

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- ✚ Is there a suitable version of local stock markets for emerging economies?
  - ✚ Abandon hope of creating “mini Wall Streets” (e.g., “Nasdaqitos”)
  - ✚ Accept structural illiquidity and internationalization trend
  - ✚ Should we go for a “light” version?
    - Structurally illiquid, with lower disclosure requirements, more private placements, and OTC transactions

# Perspectives on Stock Markets

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- ✚ Regional integration superior to global integration?
  - ✚ Small size of issues is independent of type of integration
  - ✚ Are information asymmetries reduced at a regional level?
- ✚ Regional differences
  - ✚ Latin America is more internationalized than predicted
  - ✚ Reforms have led to greater internationalization and lesser domestic market development in Latin America
  - ✚ Latin America is an extreme, but it is not alone...
    - Witness Eastern Europe and even Western Europe
  - ✚ ...and Asia is at the other extreme
    - Is Asia the future or the past?

# Perspectives on Fixed-Income Markets

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## ✚ Globalization and currency mismatches

- ✚ Are current trends likely to continue?
- ✚ Role of inflation targeting cum e-rate flexibility
- ✚ Role of CPI-indexed financial contracts
- ✚ Does the reduction in currency mismatches imply the emergence of other types of mismatches (e.g. duration)?
- ✚ Is there redemption from “original sin” (issuing in l.c. in international markets) for all? Does size matter?
- ✚ Should countries target domestic or international market in issuing local currency debt? Does jurisdiction matter?
- ✚ Potential role for multilateral development banks

# Perspectives on Fixed-Income Markets

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- ✚ Interaction between sovereign and corporate bond markets
  - ✚ Crowding-out vs. development role of government bonds
- ✚ Contract features
  - ✚ Currency, duration/maturity, jurisdiction
  - ✚ Contract features cope with idiosyncratic and systemic risks
  - ✚ Contract features involve risks (related to default)
  - ✚ Why one risk over others?
    - Short-term debt given rollover and default risks
    - Dollar debt given default risk (mismatches)
    - Preference for default risk over price risk

# Perspectives on Capital Markets

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- ✚ No direct access to finance for all
  - ✚ Even in well functioning capital markets (and banking systems)
- ✚ Emphasize links, complementarities, and “bridges” in financial services
  - ✚ Financial structures & hybrid products connecting multiple actors
  - ✚ Domestic markets, international markets, banking sector, institutional investors, real sector, public sector
- ✚ What matters is access, regardless of where or by whom provided

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