

# Domestic Capital Markets and Financial Integration: Issues and Challenges

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*X LAC Meets the Market*

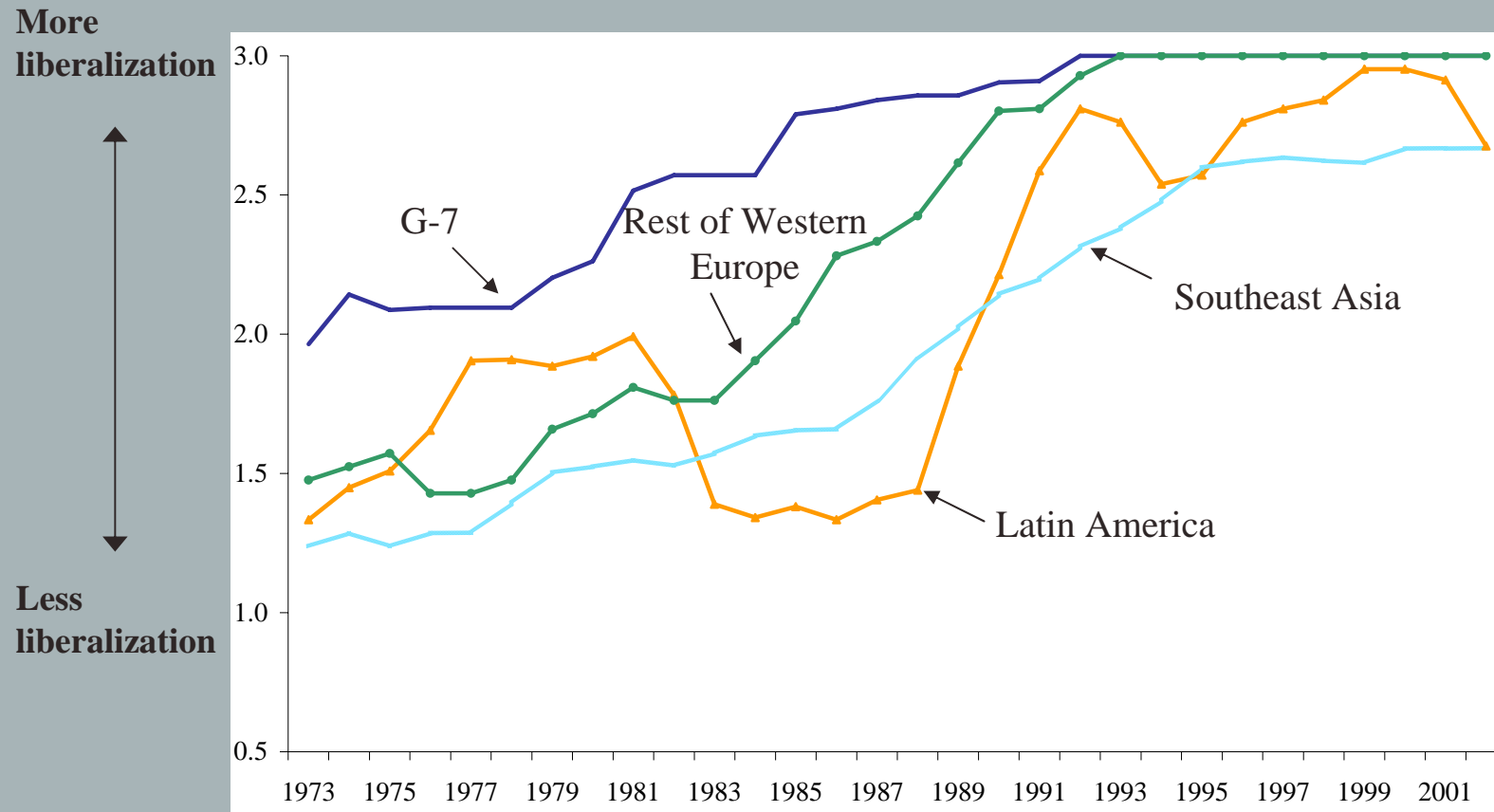
*Washington D.C.*

*April 2005*



# Intensity of Reforms

## Financial Liberalization

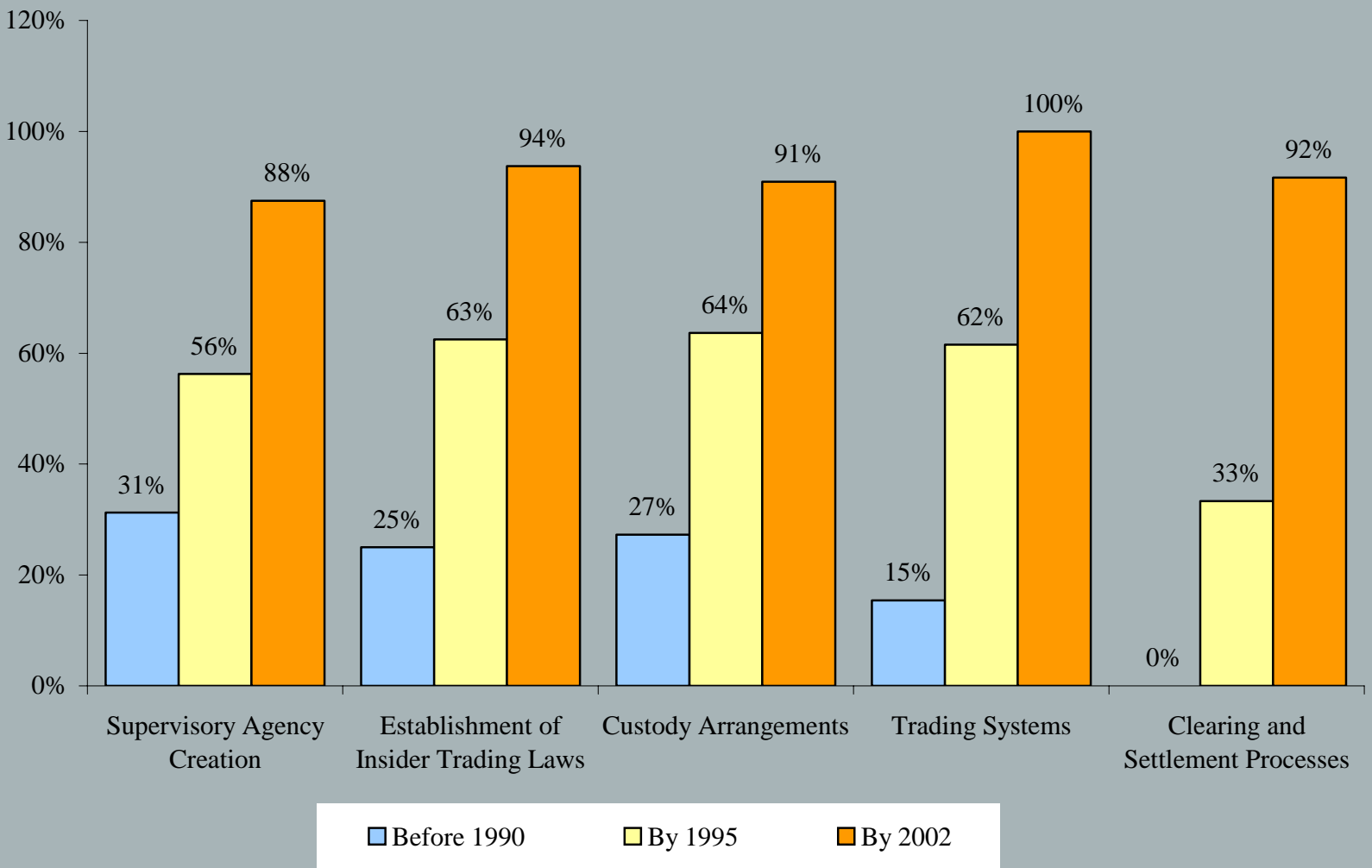


The liberalization index is calculated as the simple average of three indices (liberalization of the capital account, domestic financial sector, and stock market) that range between 1 and 3, where 1 means no liberalization and 3 means full liberalization. These data are then aggregated as the simple average between countries of each region.

# Intensity of Reforms

## Capital Markets Laws, Regulation, and Infrastructure

Percentage of Latin American Countries Having Implemented Reforms

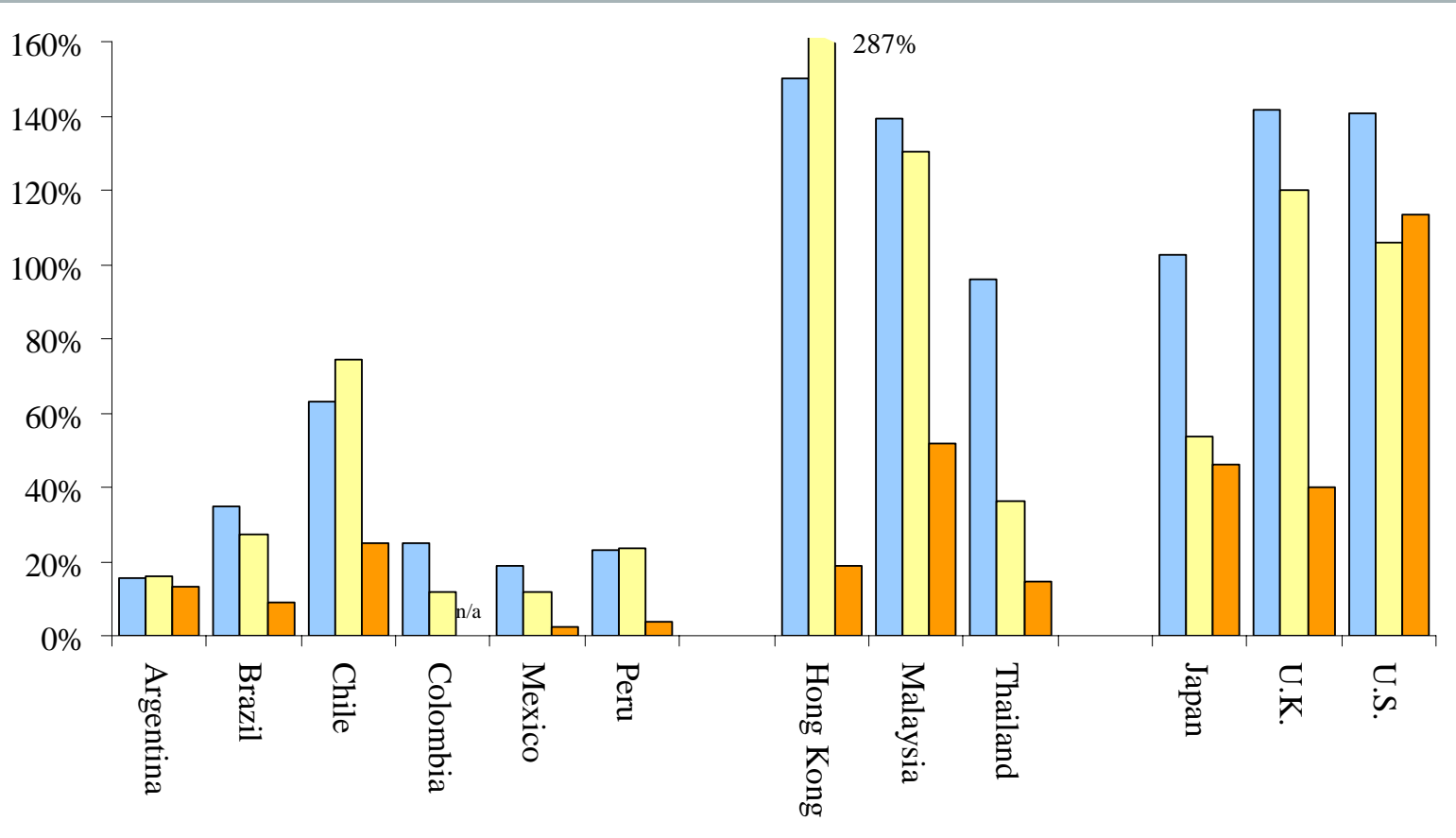


# Stylized Outcomes

## LAC Local Financial Markets Remain Underdeveloped

### Financial Sector Size Across Countries

Percentage of GDP,  
2002



Bank Credit to the Private Sector

Stock Market Capitalization

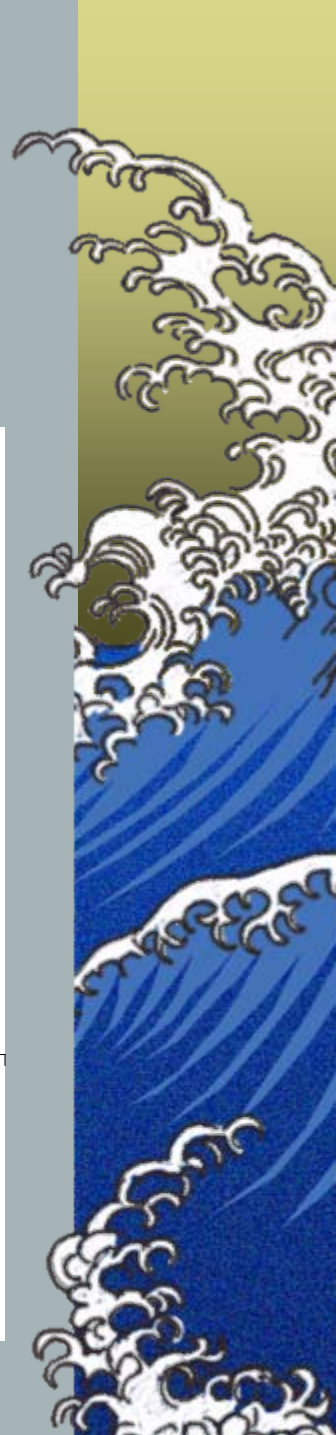
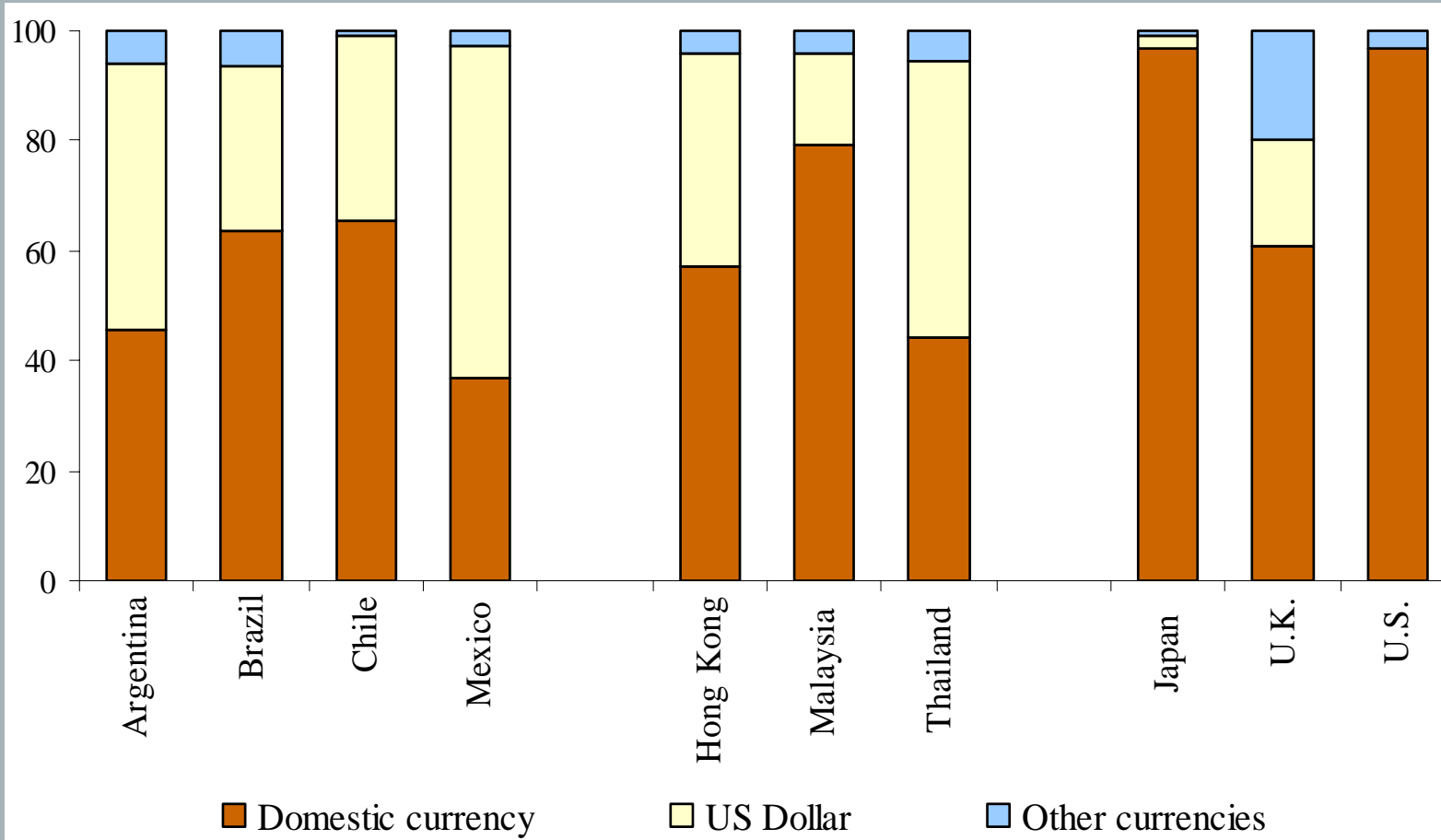
Amount Outstanding of Domestic Private Sector Bonds

# Stylized Outcomes

## Dollarization Affects Corporate Bonds

Private Sector Bonds by Currency (end-2000)

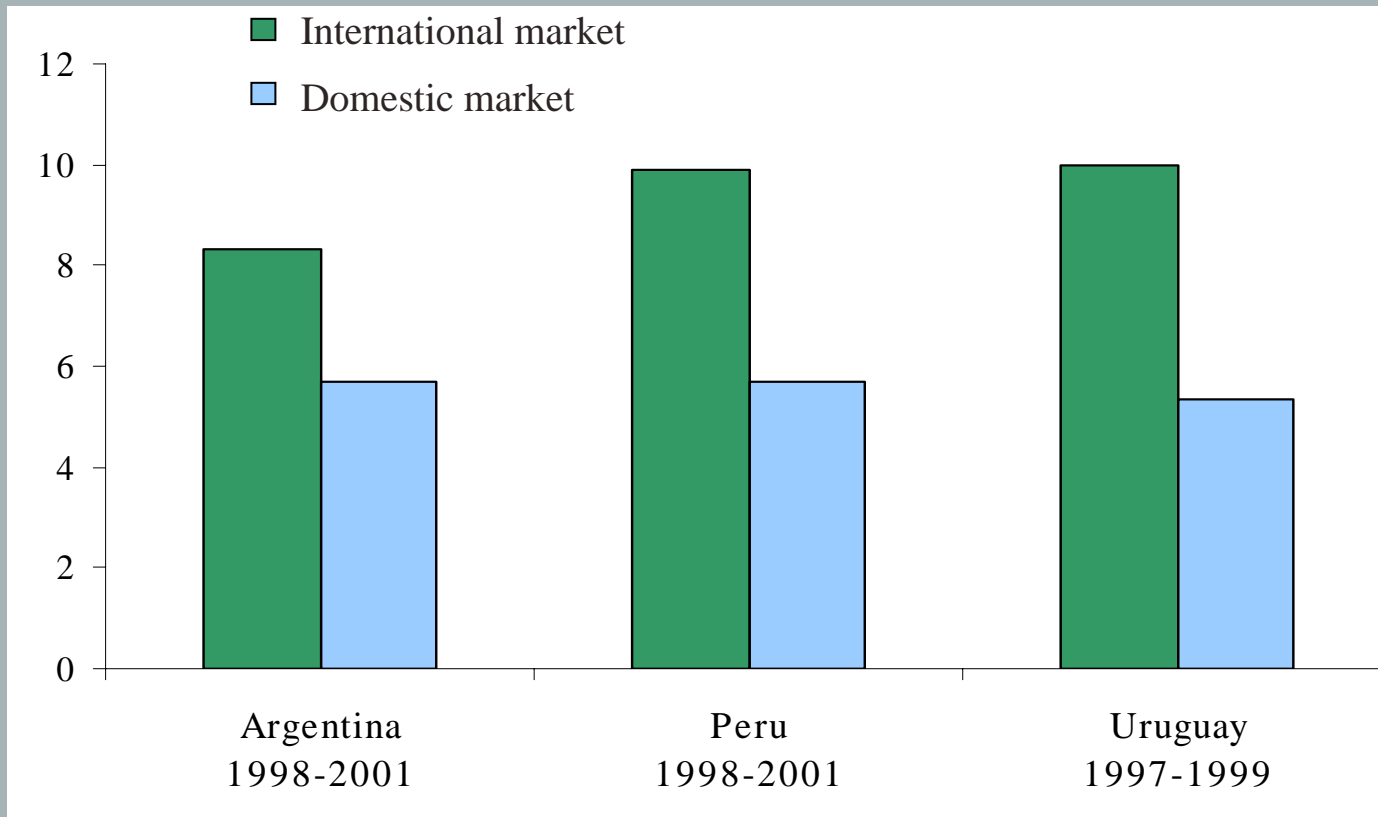
Percent



# Stylized Outcomes

## Long Maturities Easier to Obtain Abroad, But in Dollars

**Maturity of Corporate Dollar Bonds by Jurisdiction**  
In years



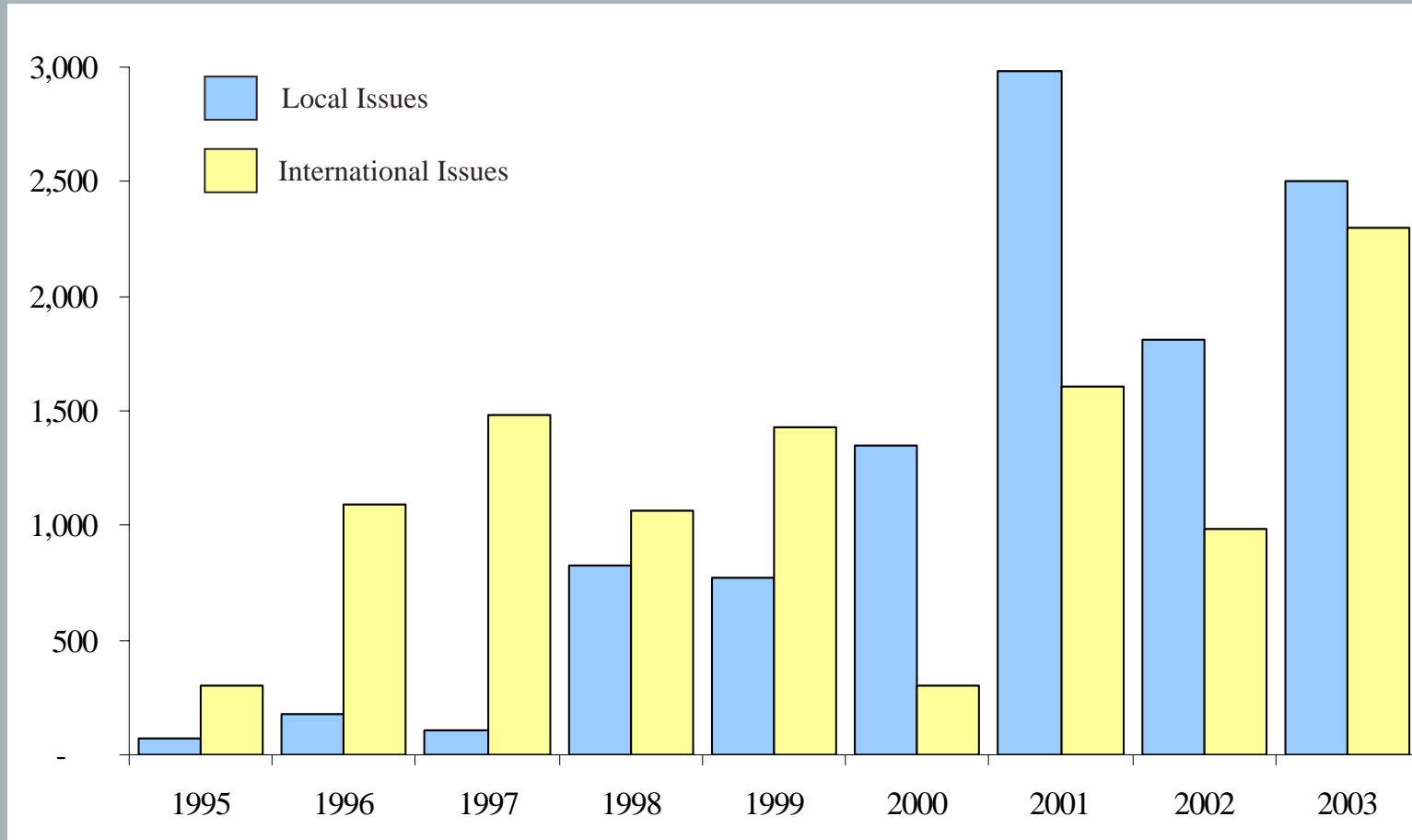
Average maturities are weighted by amount issued. Maturities shorter than one year are excluded from the sample. Different periods of time are displayed due to limitations in the availability of data.

# Stylized Outcomes

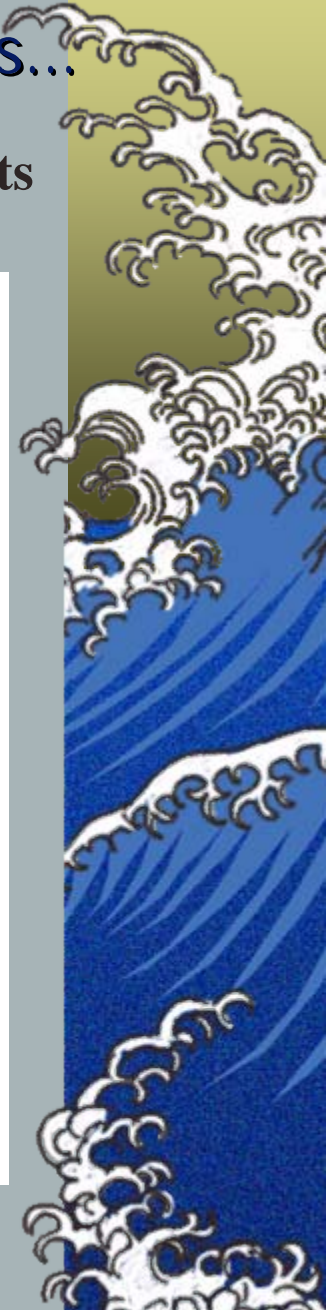
## Even in Successful Corporate Bond Mkts, Like Chile's...

### Chile - corporate bonds issues in domestic and international markets

Million U.S. dollars



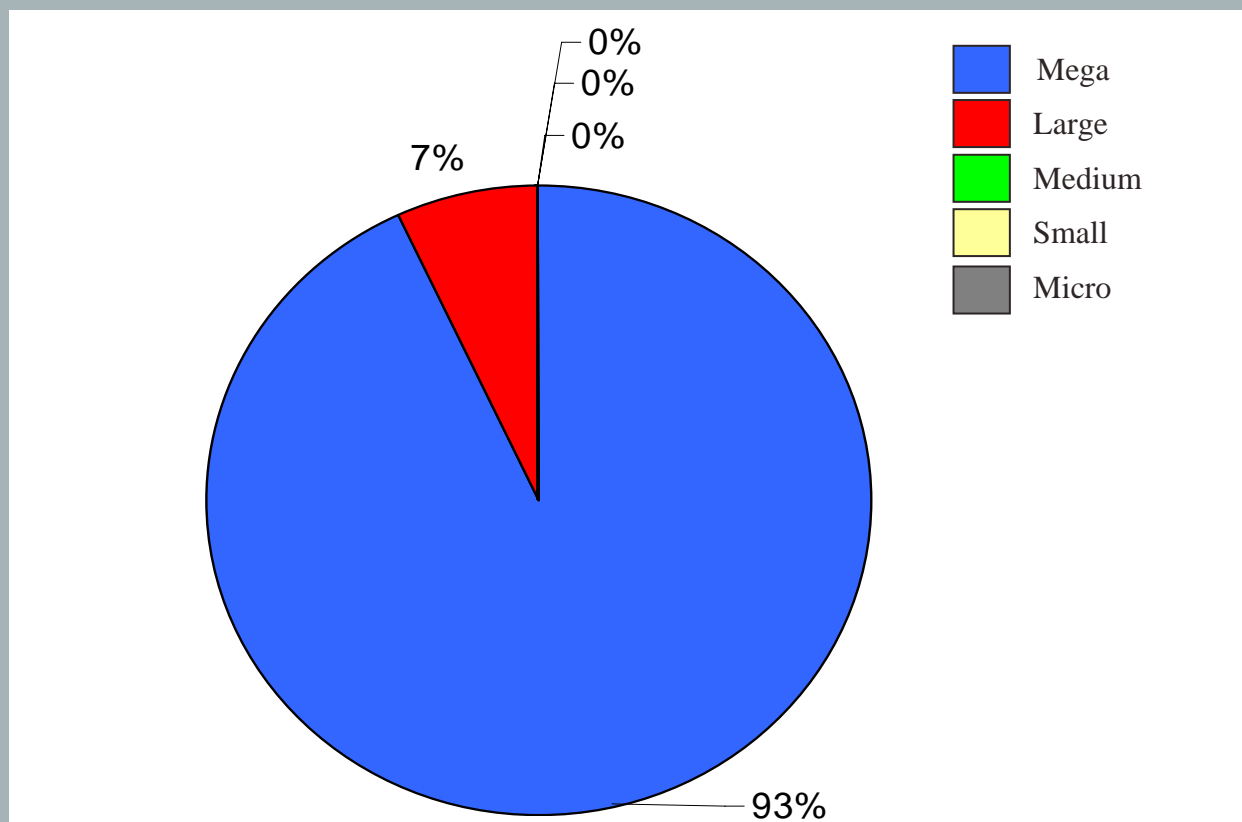
Sources: SVS, Larrain Vial Brokerage, Euromoney, Bondware, Bloomberg



# Stylized Outcomes

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

Chile – corporate bond issues in local market by size of enterprise  
(2000 - 2003)

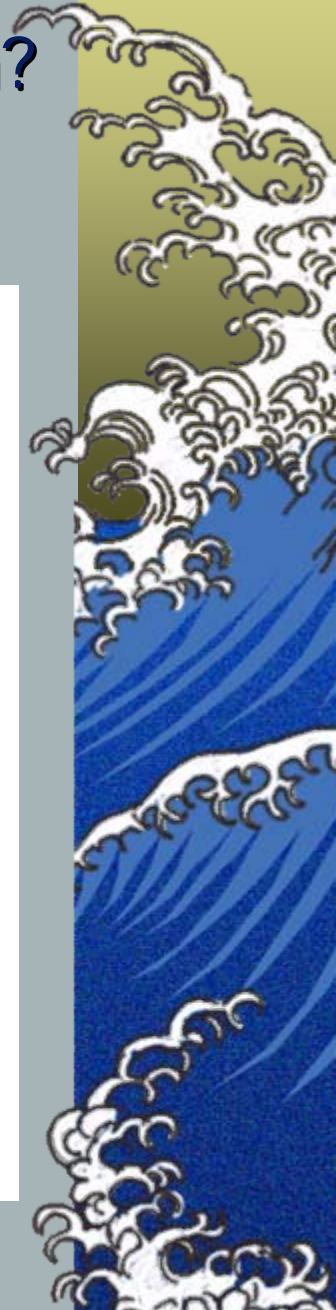
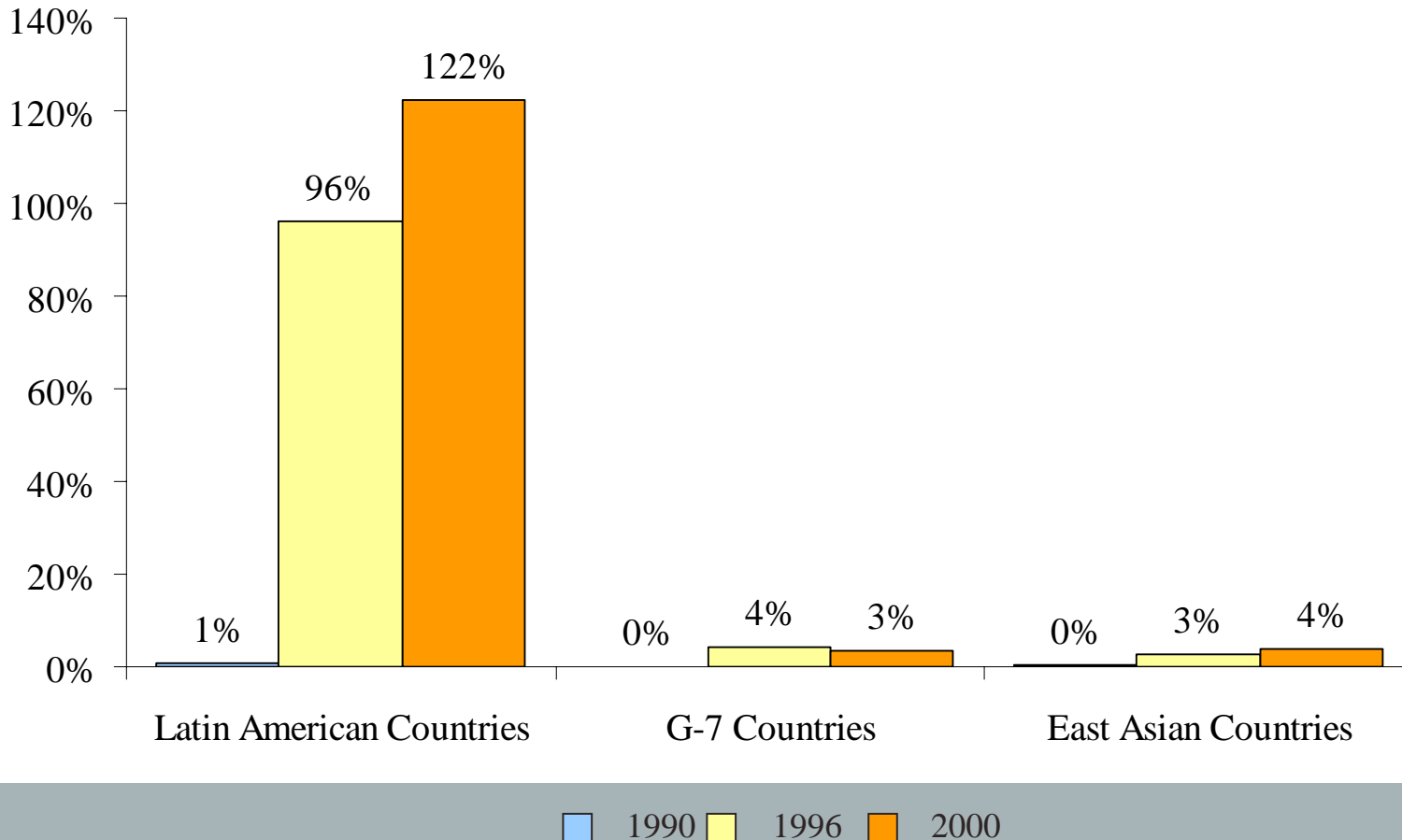


Mega firms are defined as those with annual sales net of VAT above UF600,000 (US\$17.2 million); large firms have sales between UF100,000 (US\$2.8 million) and UF600,000; medium firms have sales between UF25,000 (US\$0.7 million) and UF100,000; small firms have sales between UF2,400 (US\$68,688) and 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)

# Stylized Outcomes

## LAC : Excessive Stock Market Internationalization?

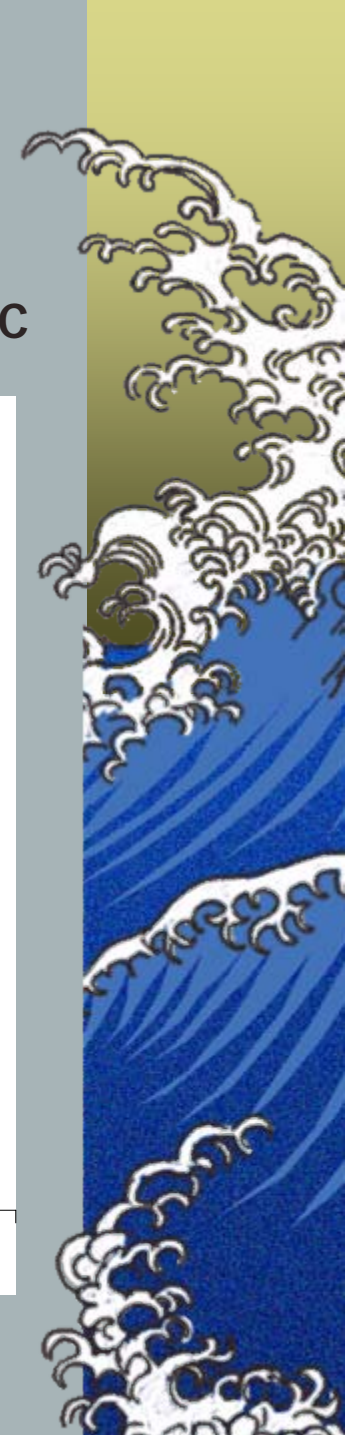
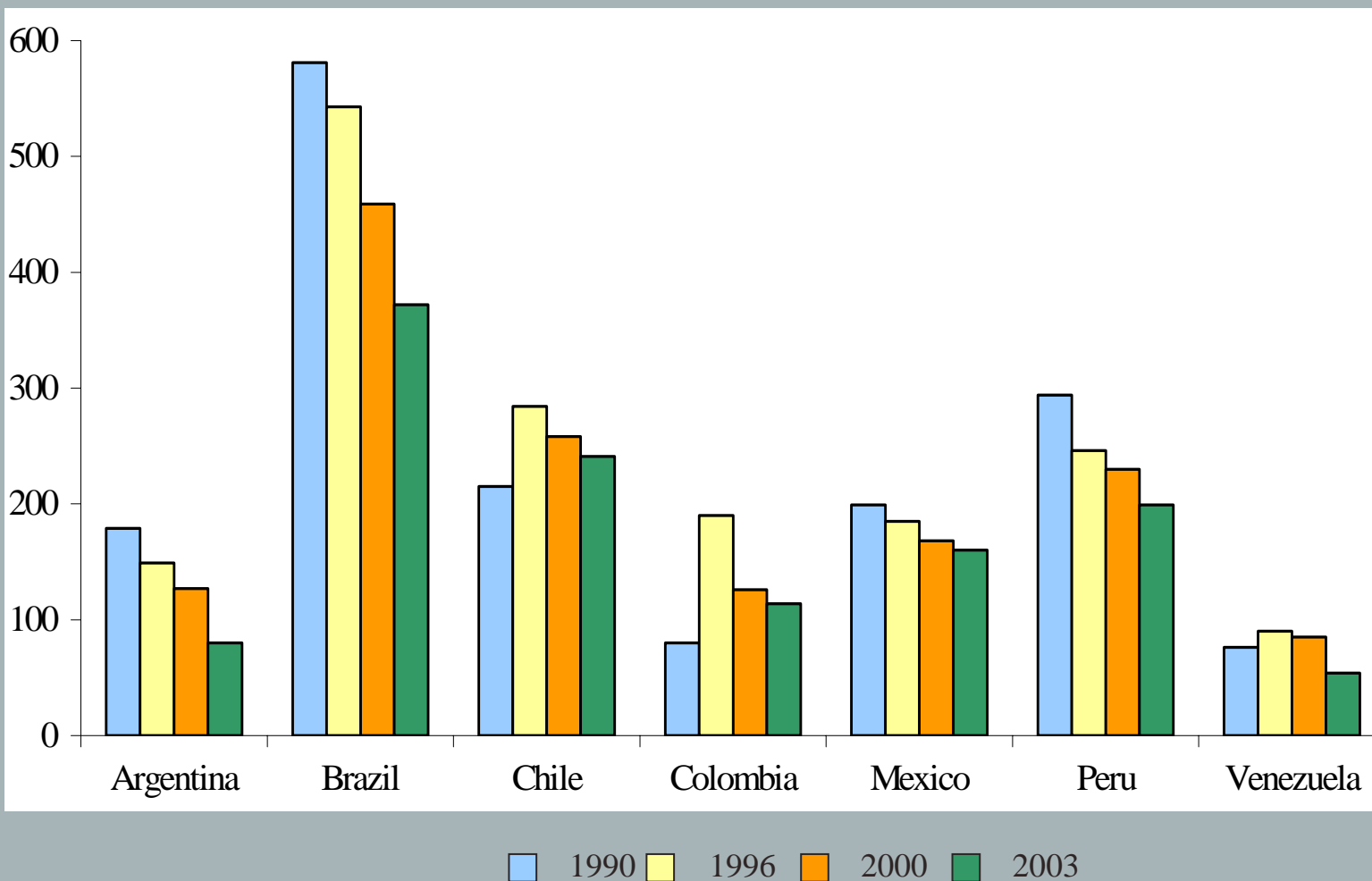
Ratio of Value Traded Abroad to Value Traded Domestically



# Stylized Outcomes

## Significant De-Listings in LAC Stocks Markets

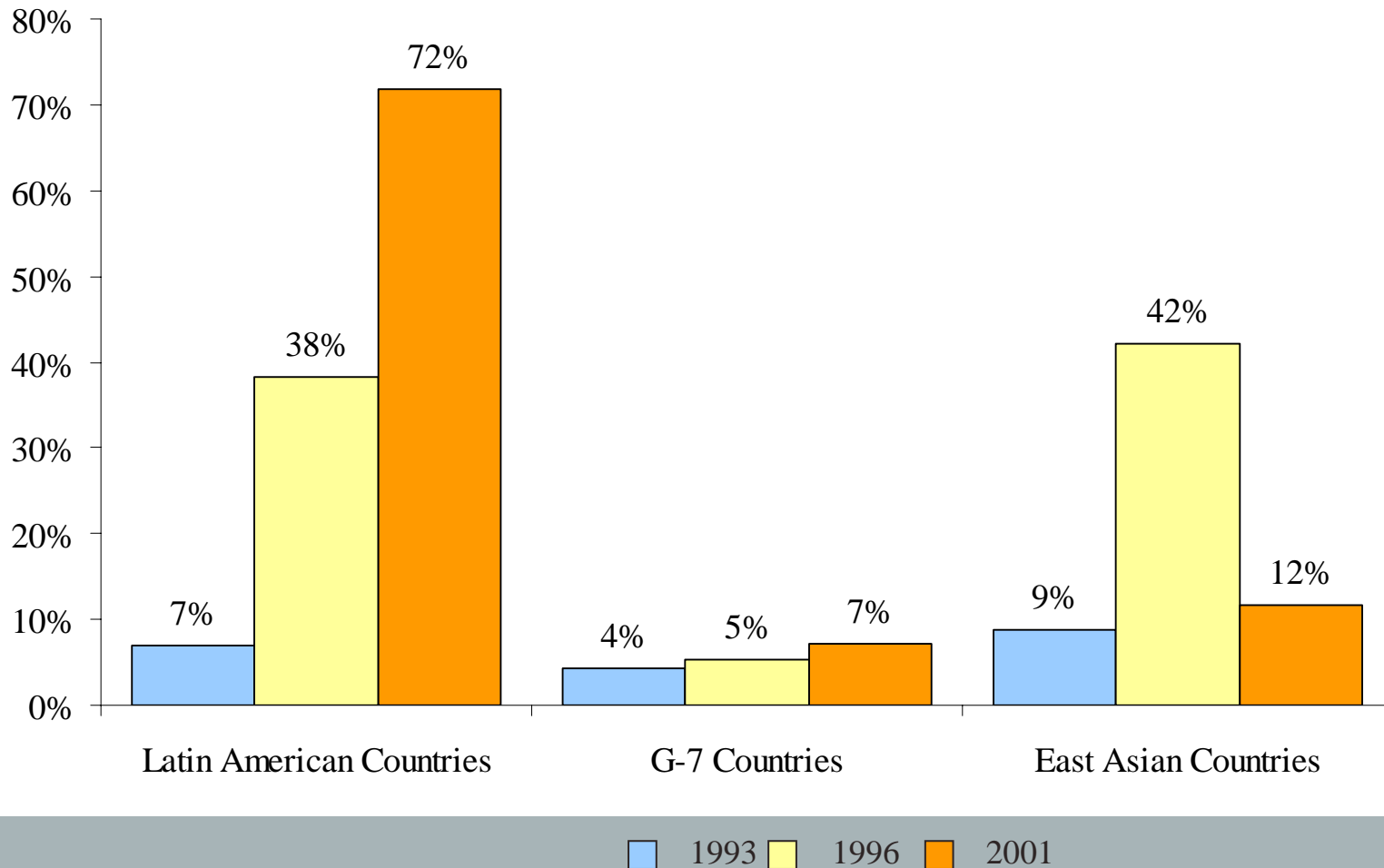
Number of Firms Listed in Domestic Stock Exchanges in LAC



# Stylized Outcomes

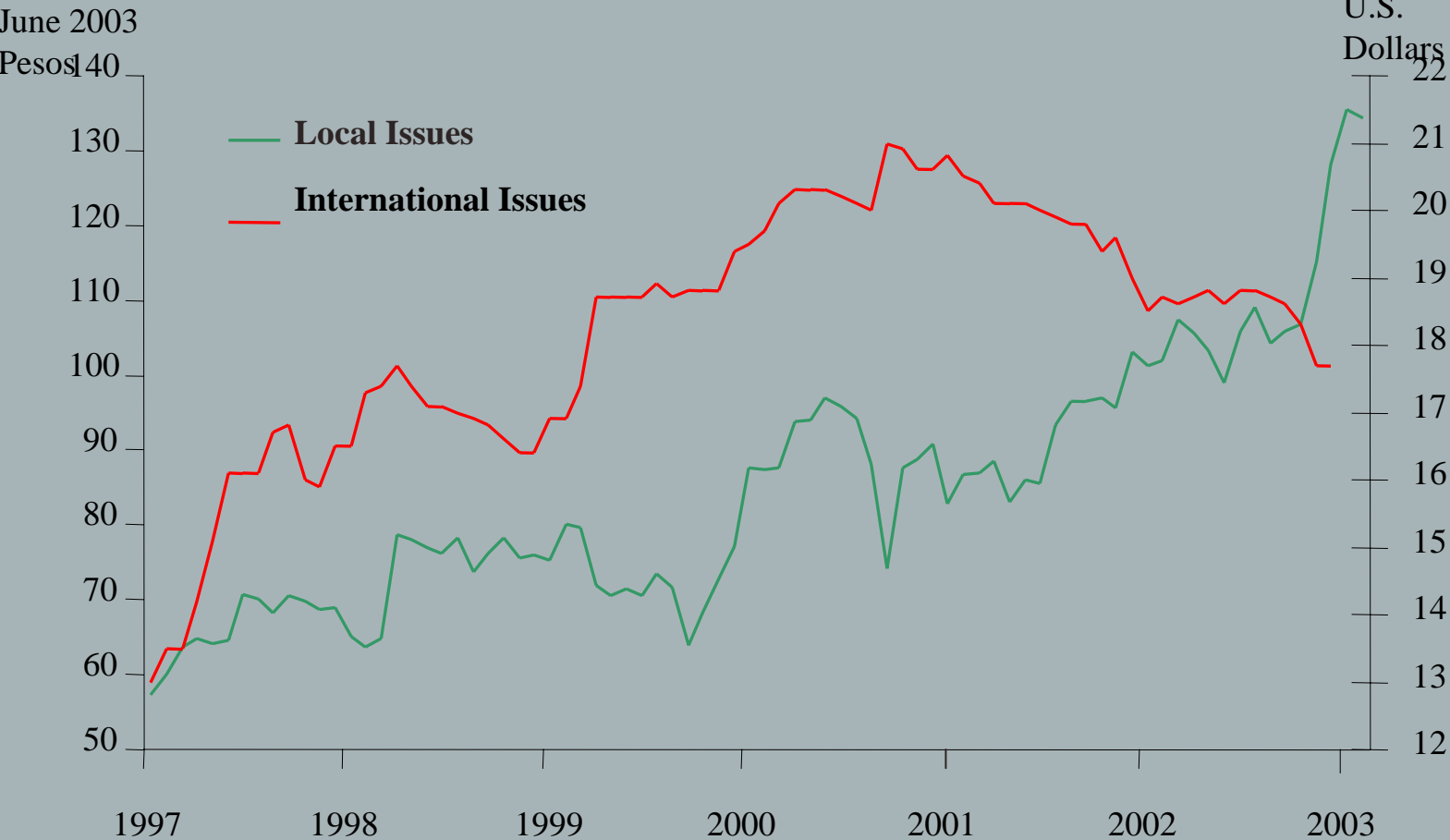
## LAC: Excessive issuance of bonds in foreign markets?

### International Government Bonds to Domestic Government Bonds Outstanding



# A success in the making: Bond Markets in Mexico After the Tequila Crises

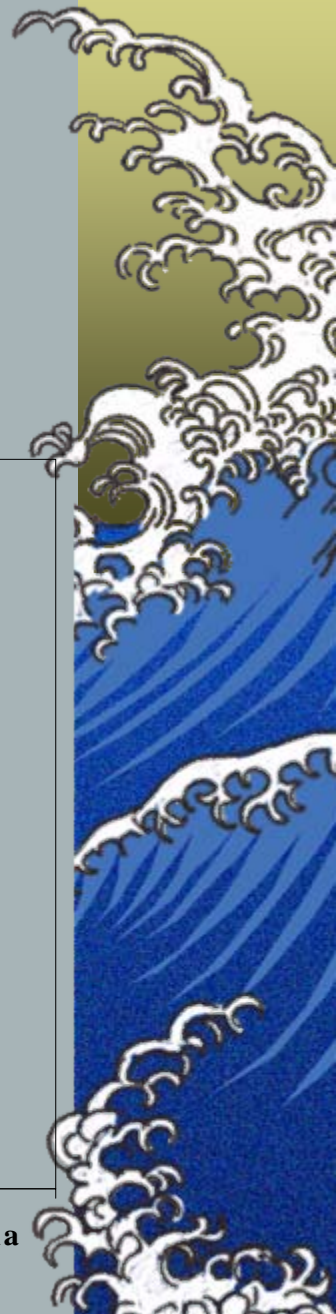
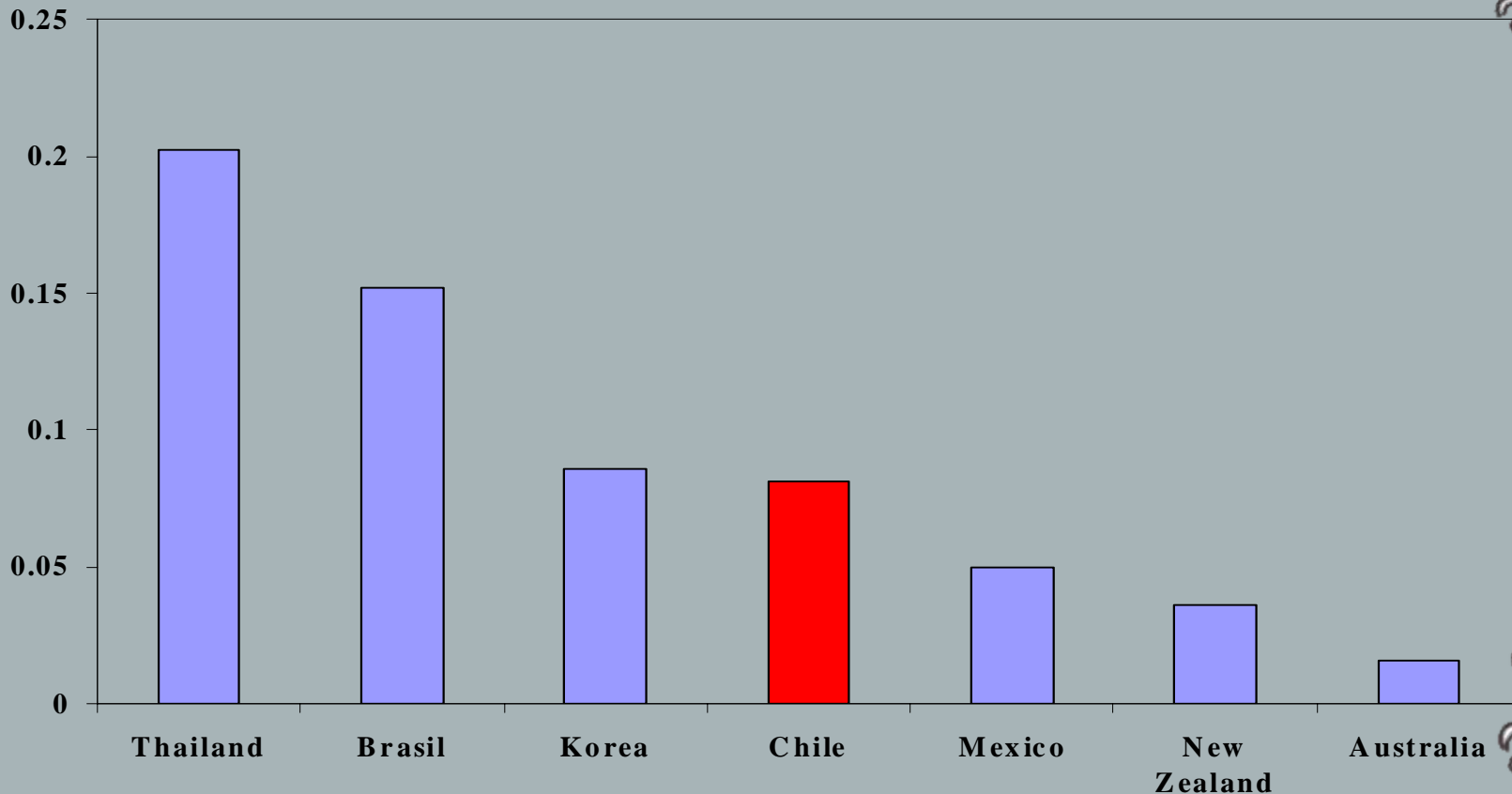
**Bonds Issued by the Private Sector**  
**Stocks in Billions**



# A success in the making: Derivative Markets in Chile and Mexico

The local market for NDFs shows respectable liquidity

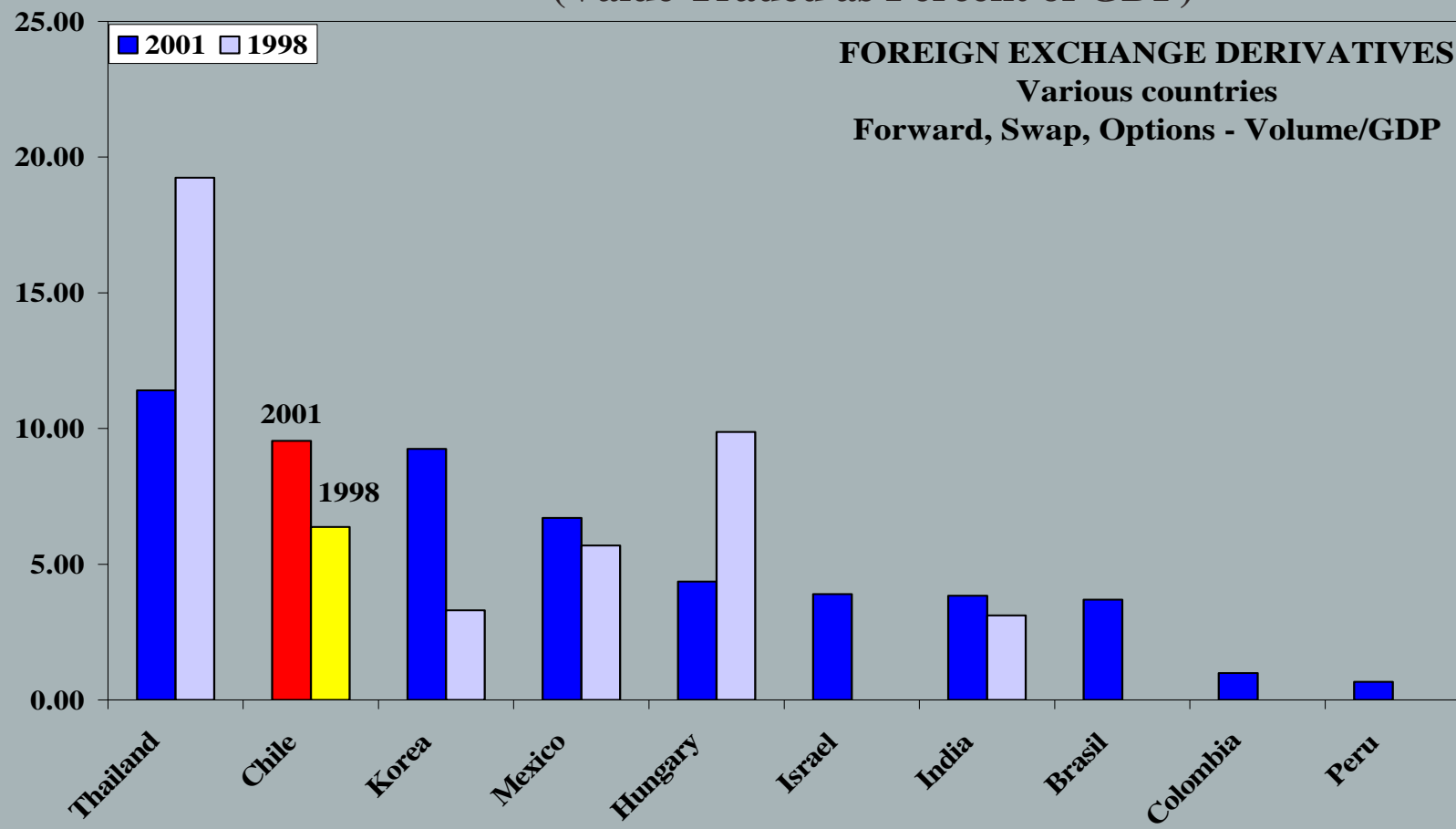
Various countries  
1 Month Forward bid-offer spread (%)



# A success in the making: Derivative Markets in Chile and Mexico

Growing and already large local mkt for FX derivatives

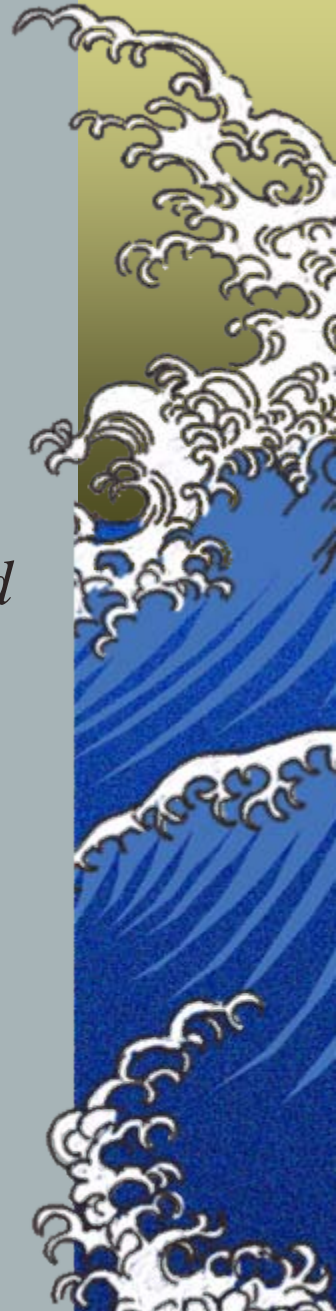
Foreign Exchange Derivatives, Various Countries  
(Value Traded as Percent of GDP)



# Bond Market Development

## Some Econometric Results

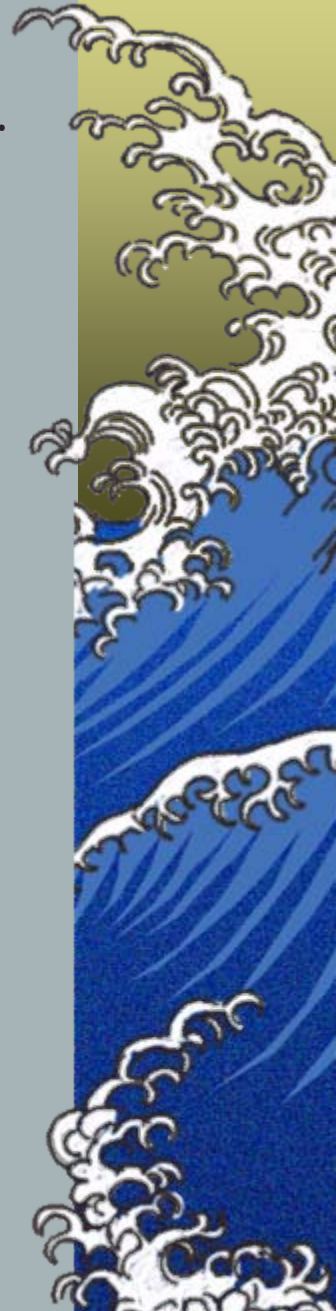
- ✚ *Better macroeconomic and institutional fundamentals foster both local and foreign currency bond markets*
- ✚ *Size matters – larger countries and local financial sectors facilitate the development of local currency bond markets*
- ✚ *Less flexible exchange rate policies increase the share of foreign currency bonds*



# Stock Market Development

## Some Econometric Results

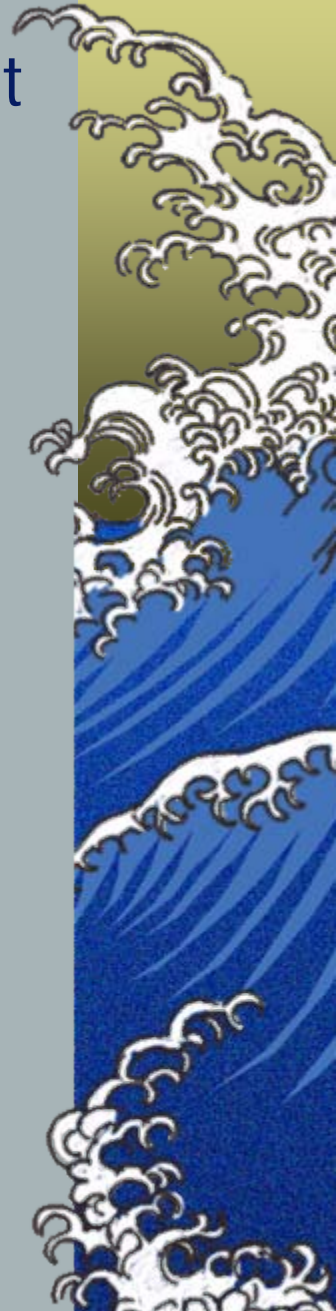
- ✚ *Better macroeconomic & institutional fundamentals foster*
  - *Domestic stock market development...*
  - *...as well as the internationalization of equity trading and issuance*
  - *But there is a pro-internationalization bias – fundamentals accelerate internationalization, increasing the ratio of int'l to domestic activity*
- ✚ *Reforms are found to have similar impacts (on domestic & internationalization dimensions) over time within countries*
  - *Results are not just driven by cross-country variations*
- ✚ *Internationalization adversely affects turnover of domestic (non-internationalized) firms*
  - *Trade migration, negative spillovers, and trade diversion*



# Latin Securities Markets

## Key Result: "Shortfall" in Local Market Development

- ✚ *Latin America is different – robust econometric result*
  - *Domestic stock markets are less developed than predicted by fundamentals and less responsive to reforms*
  - *Internationalization of Latin stock trading and issuance is higher than predicted by fundamentals and more responsive to reforms*
  - *Domestic currency bond markets are less developed, controlling for fundamentals and size*
  
- ✚ *Latin America is an extreme, but it is not alone...*
  - *Witness Eastern Europe and even Western Europe*
  
- ✚ *...and East Asia is at the other extreme*
  - *Is East Asia the future or the past?*



# Some Key Questions for the Discussion Sessions

- ▶ *How is financial globalization affecting domestic capital markets?*
  - ▶ *Is it making them grow or shrink?*
- ▶ *What can domestic capital markets offer that international capital markets could not?*
- ▶ *How to develop domestic markets for long-term local currency debt, without barriers to international integration?*
  - ▶ *Is there a role for IFIs?*

