

Session 19:

Challenges in Developing Capital Markets

Overview Course of Financial Sector Issues

Speaker:

Sergio Schmukler (World Bank)

October 19, 2006, 1:30 PM

Background Material

- # De la Torre, A. and S. Schmukler, 2006. Emerging Capital Markets and Globalization: Challenges for Developing Countries *Stanford University Press* and *The World Bank*, 2006. Originally released as Whither Latin American Capital Markets?, and references therein, www.worldbank.org/laccapitalmarkets.
- # Other useful references
 - # Levine, R. and S. Schmukler, 2006. Migration, Spillovers, and Trade Diversion: The Impact of Internationalization on Stock Market Liquidity, forthcoming, *Journal of Banking and Finance*.
 - # Levine, R. and S. Schmukler, 2006. Internationalization and Stock Market Liquidity, *Review of Finance*, 10:1, 153-187.
 - # Claessens, S., D. Klingebiel, and S. Schmukler, 2005. Stock Market Development and Internationalization: Do Economic Fundamentals Spur Both Similarly?, *Journal of Empirical Finance*, 13:3, pp. 316-350.
 - # De la Torre, A., J.C. Gozzi Valdez, and S. Schmukler, 2006. Stock Market Development under Globalization: Whither the Gains from Reforms?
 - # De la Torre, A., J.C. Gozzi Valdez, and S. Schmukler, 2006. Financial Development in Latin America: Big Emerging Issues, Limited Policy Answers, forthcoming in A New Agenda on Economic Development for Latin America, Ricardo Hausmann and Andres Velasco, eds., Fundacion CIDOB.
 - # De la Torre, A. and S. Schmukler, 2004. Coping with Risk Through Mismatches: Domestic and International Financial Contracts for Emerging Economies, *International Finance*, 7:3, 349-390.
 - # De la Torre, A. and S. Schmukler, 2005. Small Fish, Big Pond. What Is the Future for Domestic Capital Markets in a Globalized Economy? *Finance and Development*, 42:2.

Presentation

- ✚ Policy thinking on financial development
 - ✚ How did we get here?
 - ✚ Where do we stand?
- ✚ Disconcerting facts
- ✚ Big emerging issues, limited policy answers
 - ✚ Rethinking policy based on the evidence
 - ✚ Focus on the actual workings of financial intermediation
 - **Equity markets**
 - **Bond markets**
 - **Pensions**
- ✚ Final thoughts

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Evolution of Policy Thinking on Financial Development

- ✚ Two main drivers over the past three decades
 - ✚ Paradigm shift towards market-based financial development
 - ✚ Interpreting and reinterpreting financial crises

Paradigm Shift Toward Market-Oriented Policy

✚ Premise

- ✚ Government interference generates distortions that lead to, *inter alia*, financial repression, unsound risk management, and moral hazard

✚ Policies to break away from “financial repression”

- ✚ State interventionism yields to *regulated* laissez-faire
 - Dismantling of directed lending, credit ceilings, administered i-rates
 - Policy reorientation towards improving the enabling environment
- ✚ Liberalization of local financial markets
 - Market-determined interest rates and market-based monetary policy
 - Privatization of public banks and public enterprises
- ✚ Integration with international financial markets
 - Attracting foreign banks and portfolio investors by opening entry...
 - ... requires freedom to exit, i.e., significant opening of capital account

Interpreting and Reinterpreting Financial Crises

- ✚ Poor fundamentals are dangerous in open financial systems
 - ✳ Refrain from bad macro policies that undermine finance and invite attacks
 - E.g., avoid: fiscal/external disequilibria; rapid money printing; real ER overvaluation; persistent FX reserve loss
- ✚ Multiple equilibria, self-fulfilling attacks, contagion – all real threats
 - ✳ Counteract capital market imperfections and limit risk
 - Enhance transparency to reduce information asymmetries
 - Consider prudential regulations to dim bubbles and cushion bursts
 - Undertake credible pre-commitments (e.g., hard pegs)
 - Avoid sliding into “vulnerable zones” through weak macro policy
- ✚ Major mismatches (maturity, duration, currency) in debtor balance sheets can be “ticking bombs”
 - ✳ Reduce mismatch-induced credit risk
 - Enhance government debt management to focus on risk, not just cost
 - Align incentives (e.g., by moving to flexible e-rates to avoid one-sided bets)
 - Prudential regulations specifically designed to reduce mismatches
 - Focus on systemic risk – which breeds mismatches (as “coping devices”)

The Two Drivers Are Linked

- ✚ The two drivers have interacted, shaping the policy thinking
 - ✚ Ups and downs in love affair with free financial markets
 - ✚ Wide range (and oscillating) views on exchange rate policy
 - ✚ “Moral hazard” versus “globalization hazard”
 - ✚ How to enhance complementarities between market discipline and regulation/supervision
 - ✚ Sequencing debate on financial market liberalization
- ✚ Despite back-and-forth process, strong push for
 - ✚ Pro-market financial reforms
 - ✚ International financial integration
 - ✚ Financial and monetary stability
 - ✚ Financial development – depth, diversity, and breath

Where We Stand

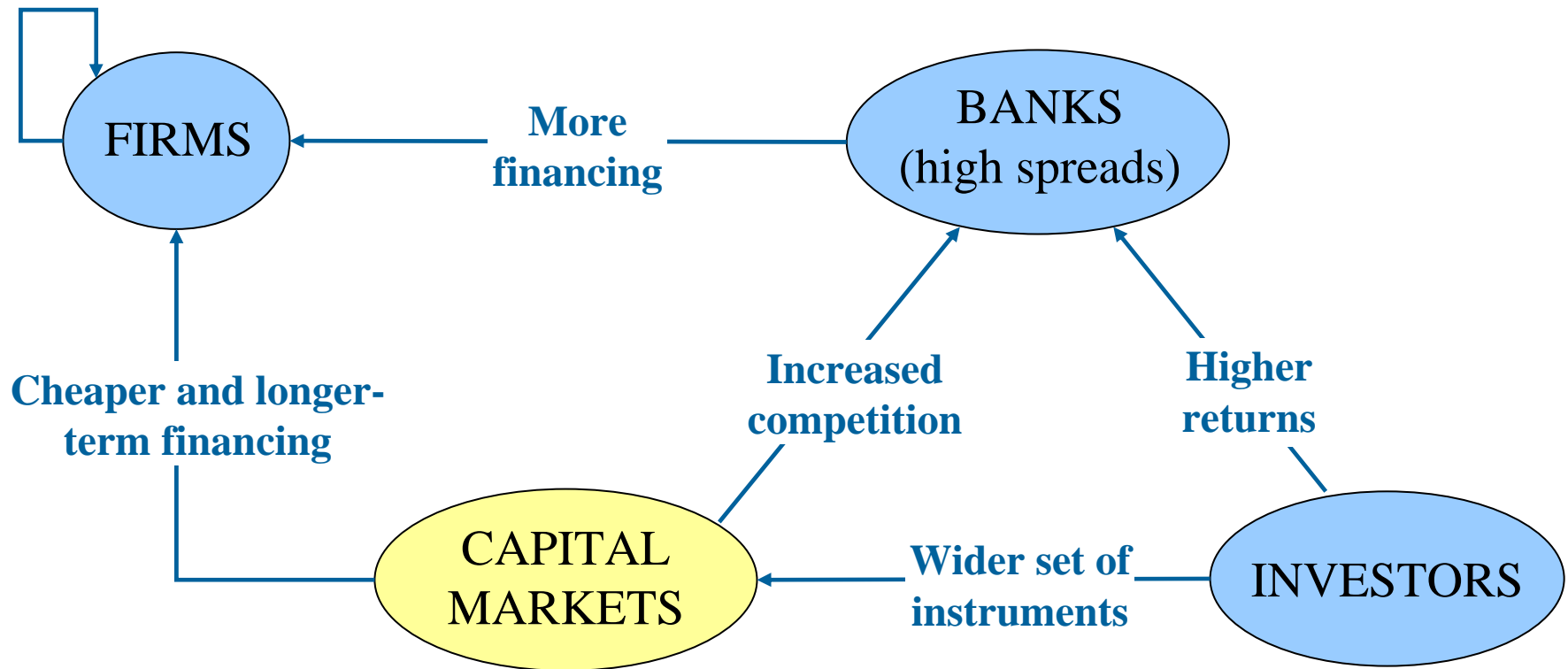
Basic Tenets

- ✚ Let financial markets work
 - ✚ Funds to flow from savers to investors at market prices, and well-priced risks to be borne by those more willing and able to do so
 - ✚ Well managed and supervised intermediaries to occupy center stage
- ✚ Role of government
 - ✚ Ensure financial stability – this remains as the primary focus of policy
 - ✚ Improve enabling environment to facilitate private financial contracting
- ✚ Some specific policy prescriptions
 - ✚ Inflation targeting cum exchange rate flexibility – key to macro stability
 - ✚ Enhance creditor rights systems and debtor information registries
 - ✚ Strive to converge with international standards
 - ✚ Allow (cautiously?) integration with international financial system
 - ✚ Foster local currency debt markets

Where We Stand

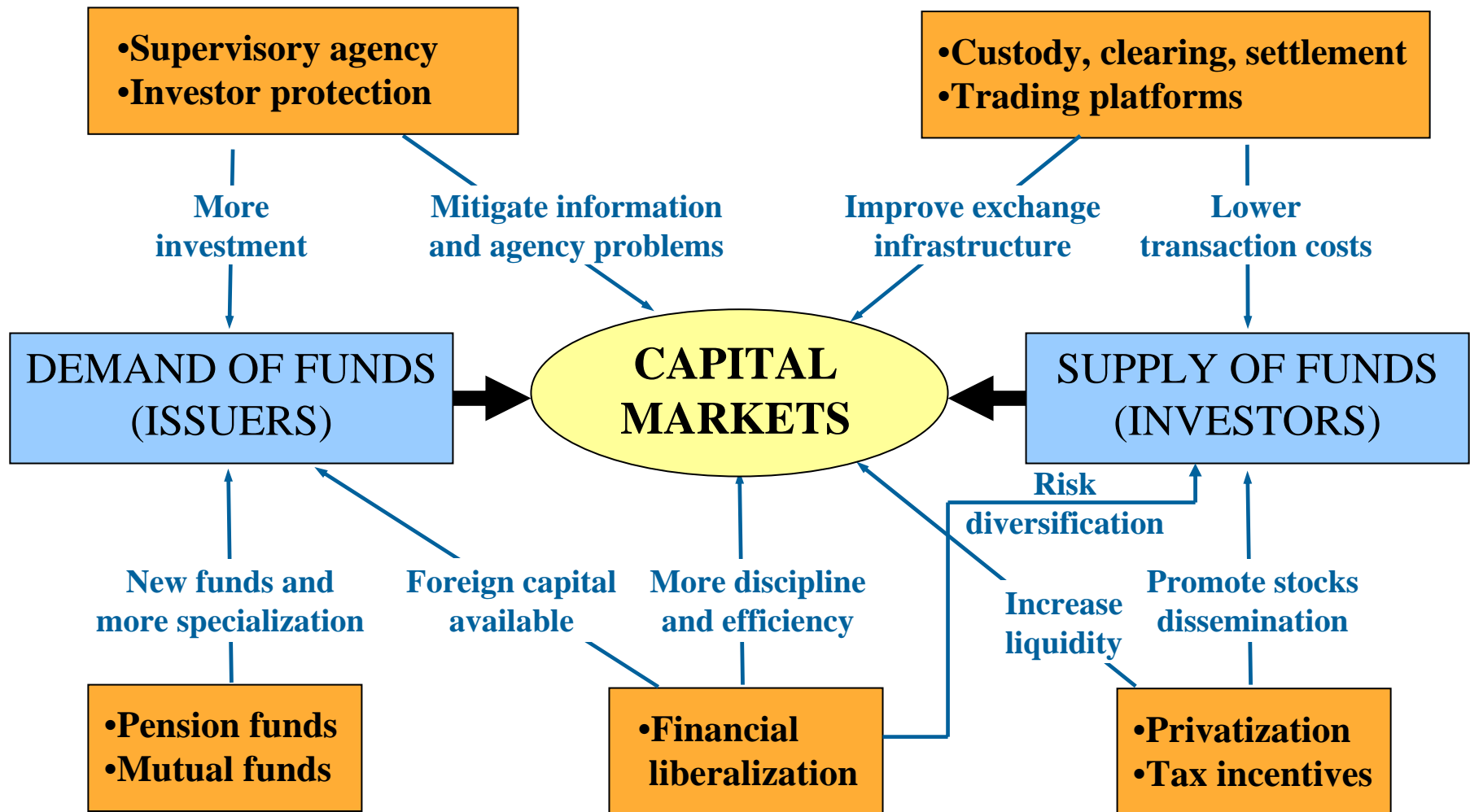
Functioning of the Financial System

- ✚ Capital markets can introduce competition and generate more and cheaper financing

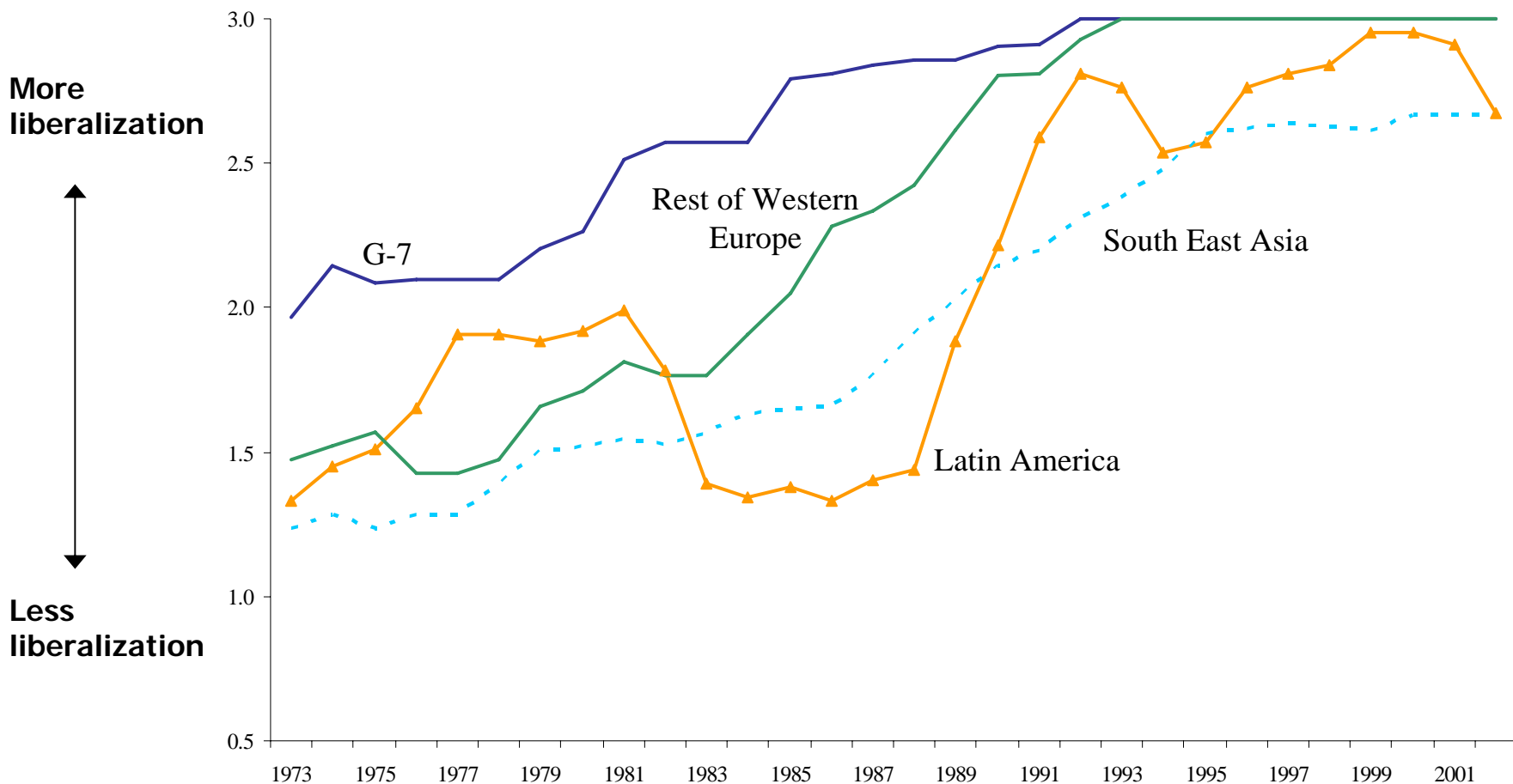


Where We Stand

Functioning of the Financial System



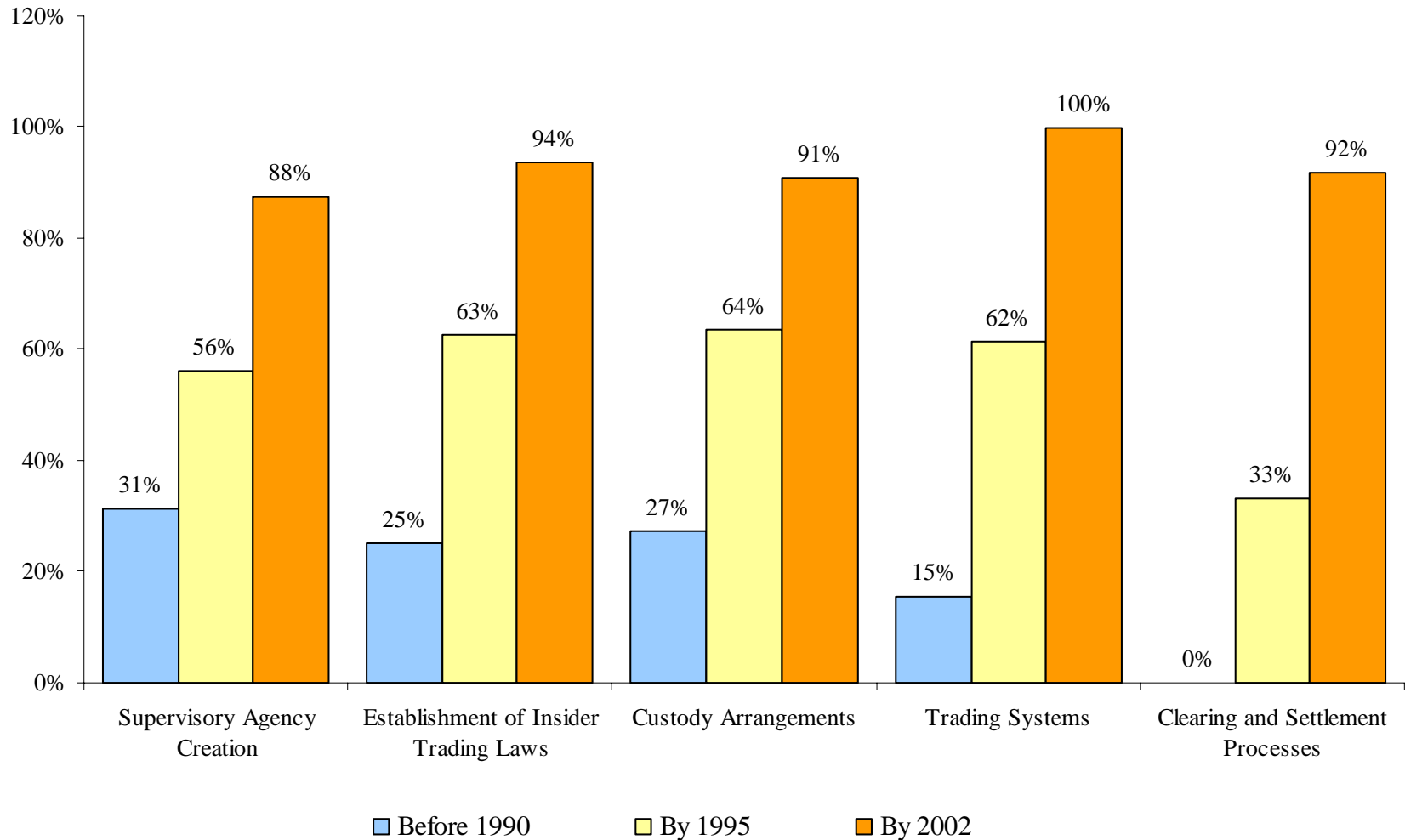
Financial Liberalization



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.

Capital Markets Regulation and Infrastructure

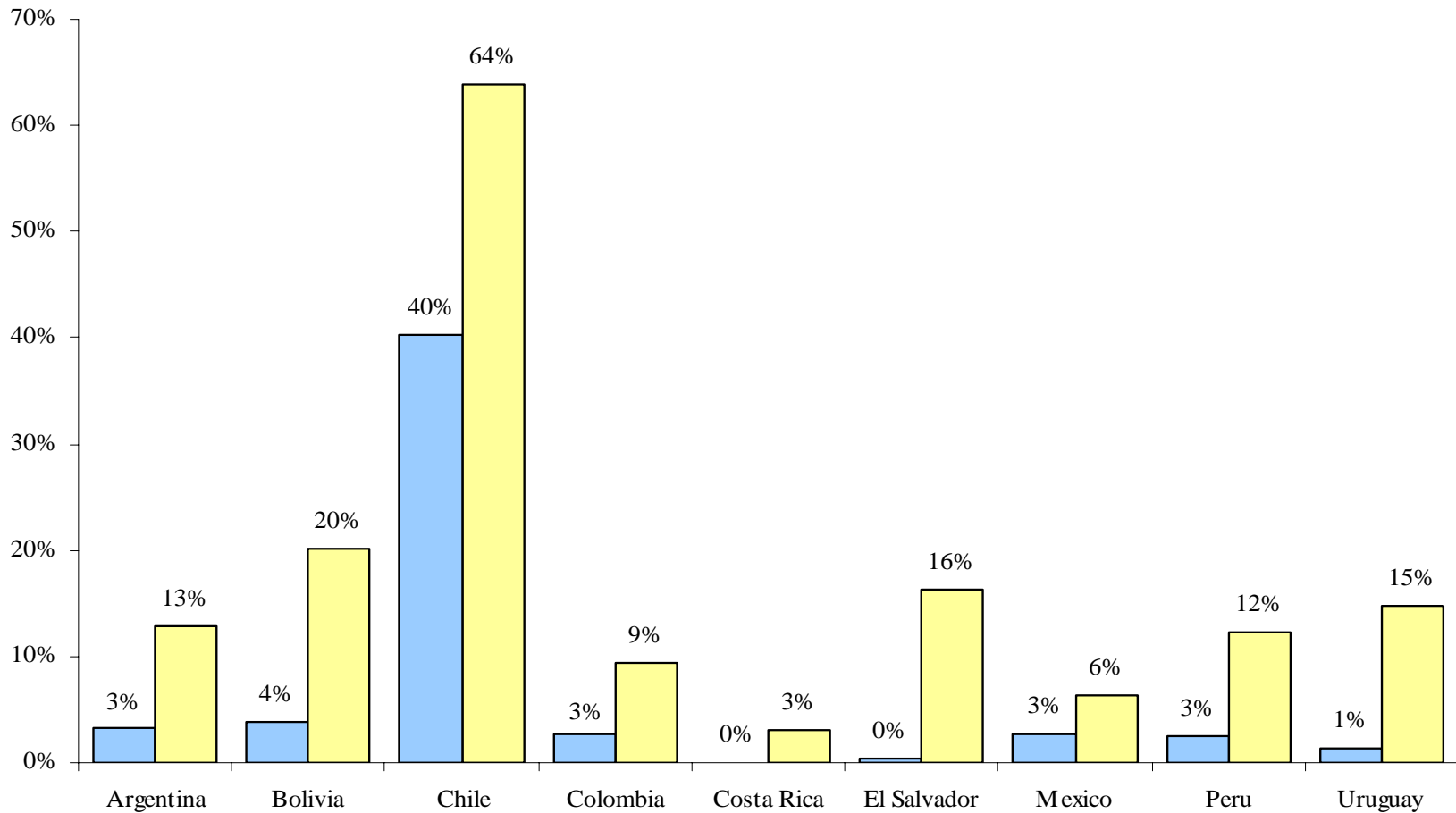
Percentage of Latin American Countries Having Implemented Reforms



Pension System Reform

Assets Held by Mandatory Pension Funds in Latin America

Percentage of GDP



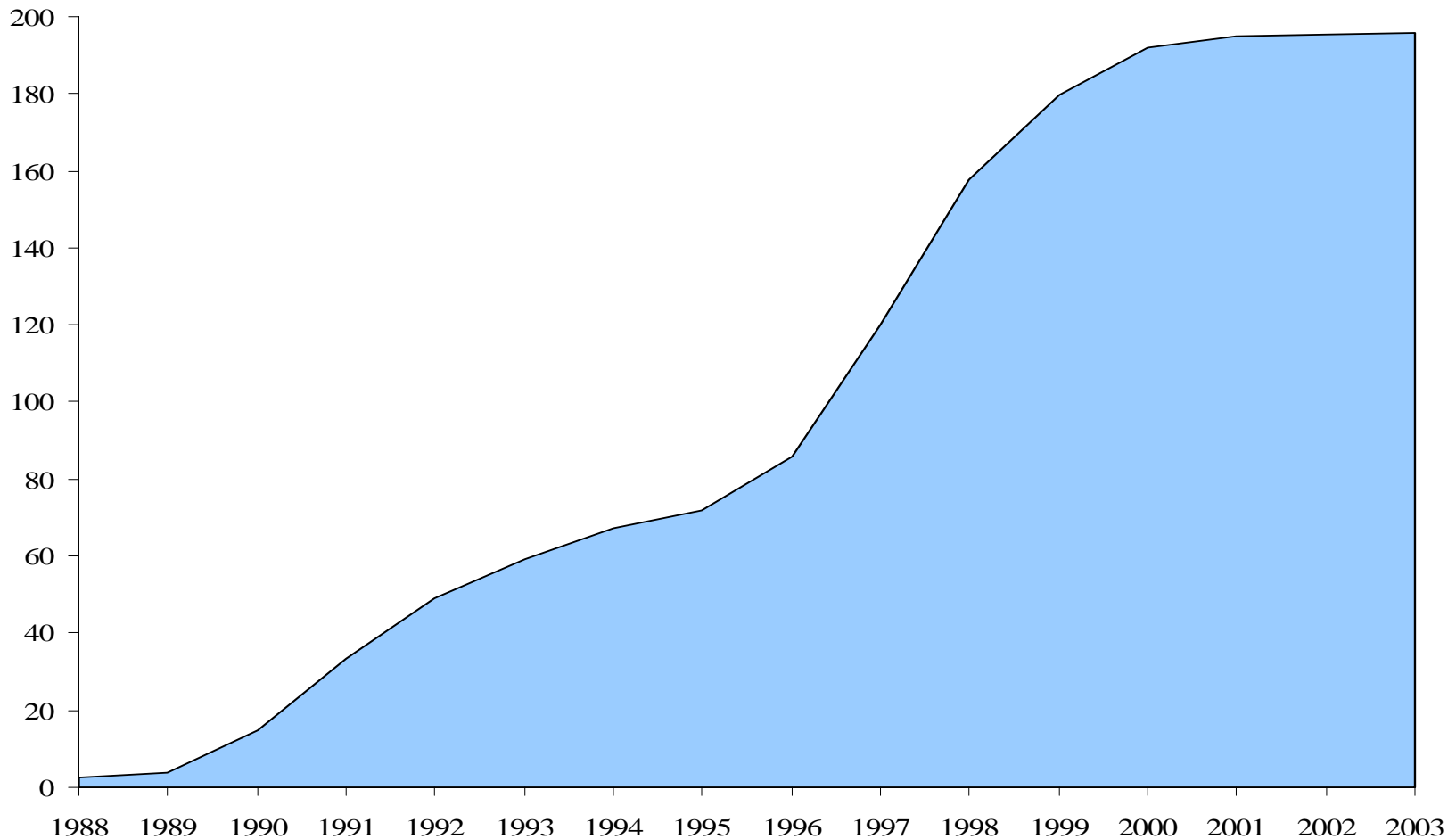
Source: AIOS

■ Dec-1998 ■ Jun-2005

Privatization

Cumulative Amount Raised by Privatizations in Latin America

Billion U.S. dollars



Source: World Bank

Presentation

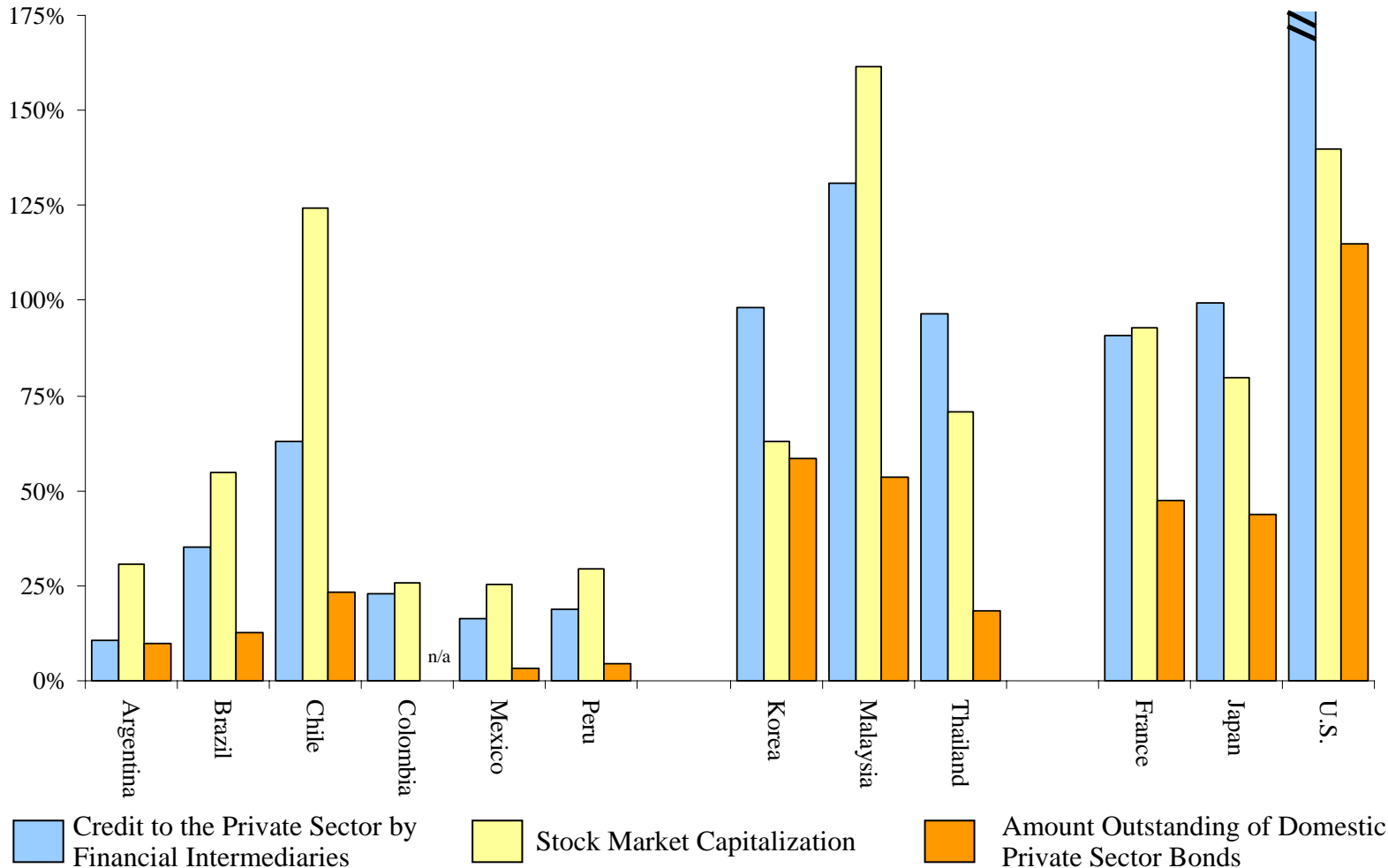
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Where We Stand – In Reality

Small and Underdeveloped Financial Systems

Financial Sector Size Across Countries

Percent of GDP, 2002

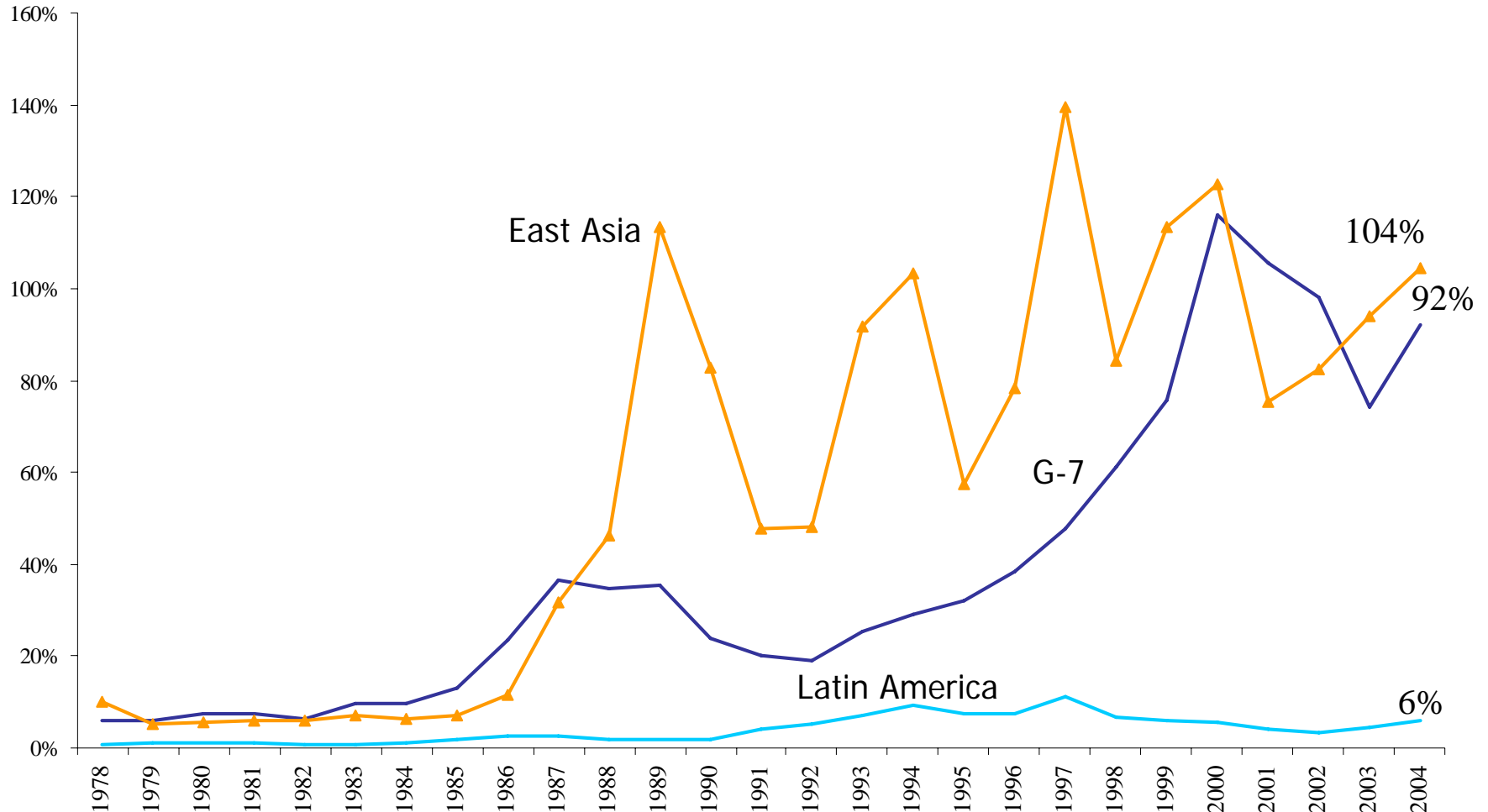


Where We Stand – In Reality

Stock Markets Not Converging and Highly Illiquid

Value Traded / GDP

Percent of GDP

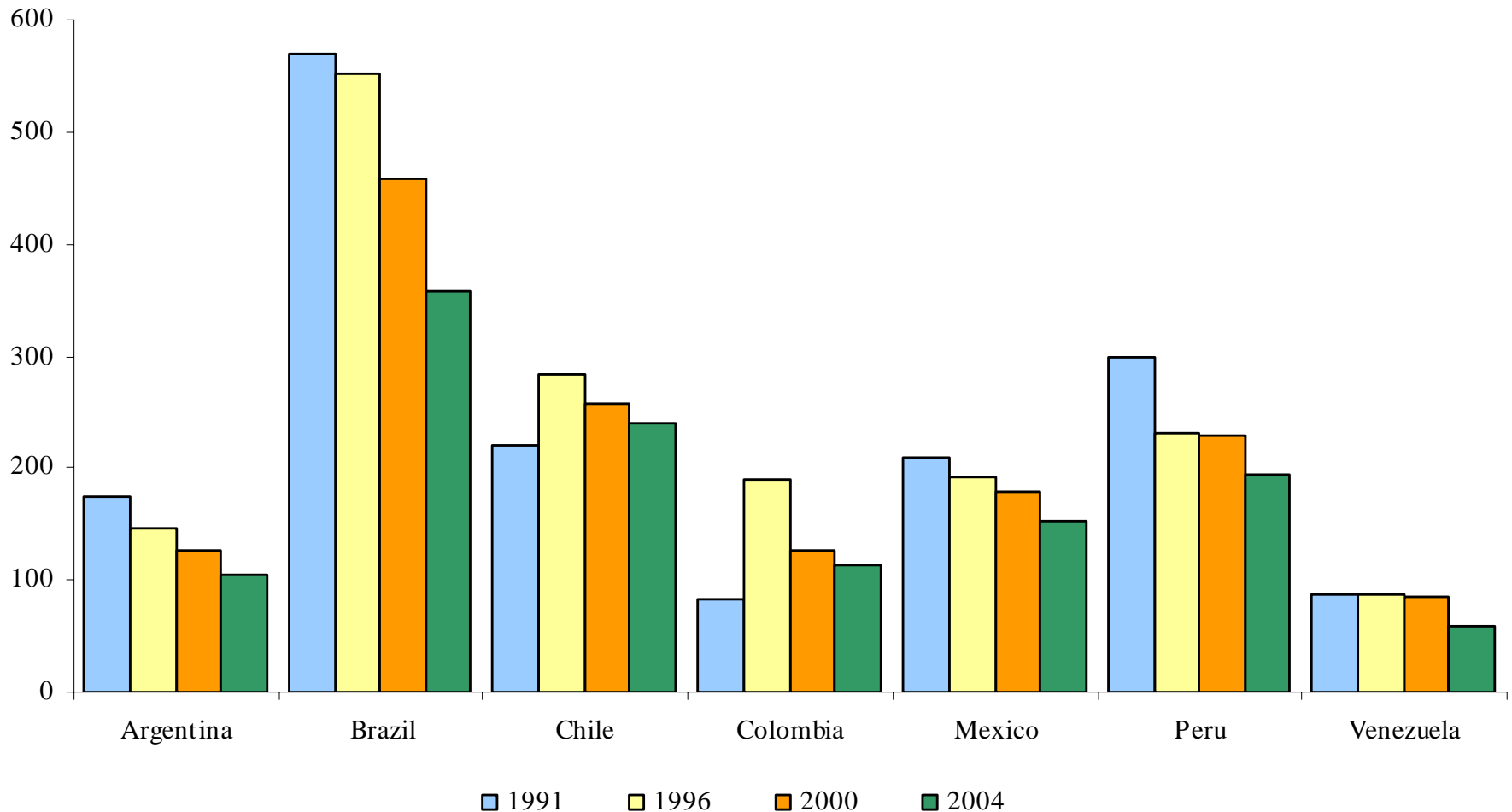


Source: S&P Global Stock Market Factbook

Where We Stand – In Reality

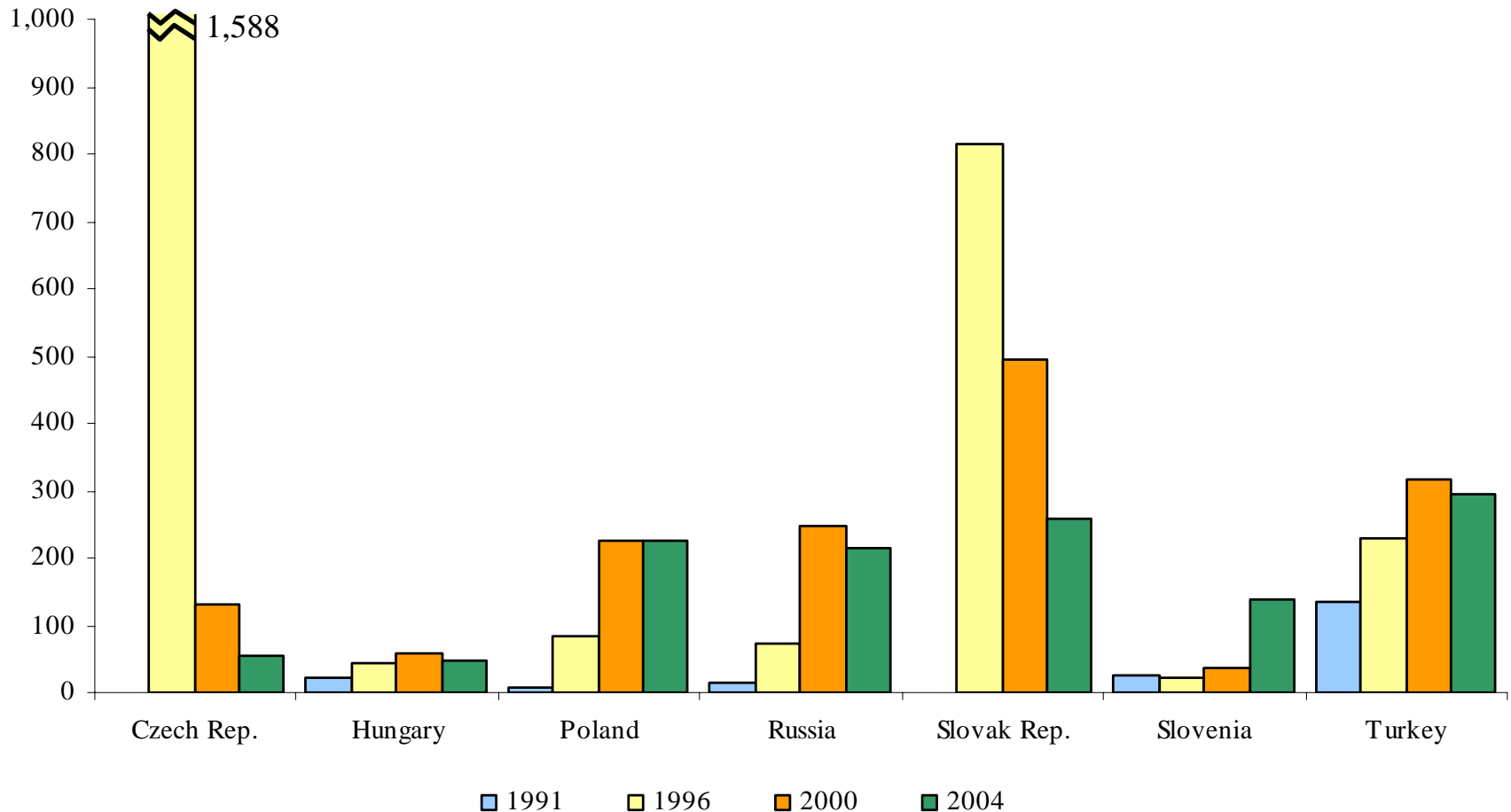
Shrinking Stock Markets in Latin America

Number of Firms Listed in Domestic Stock Exchanges in Latin America



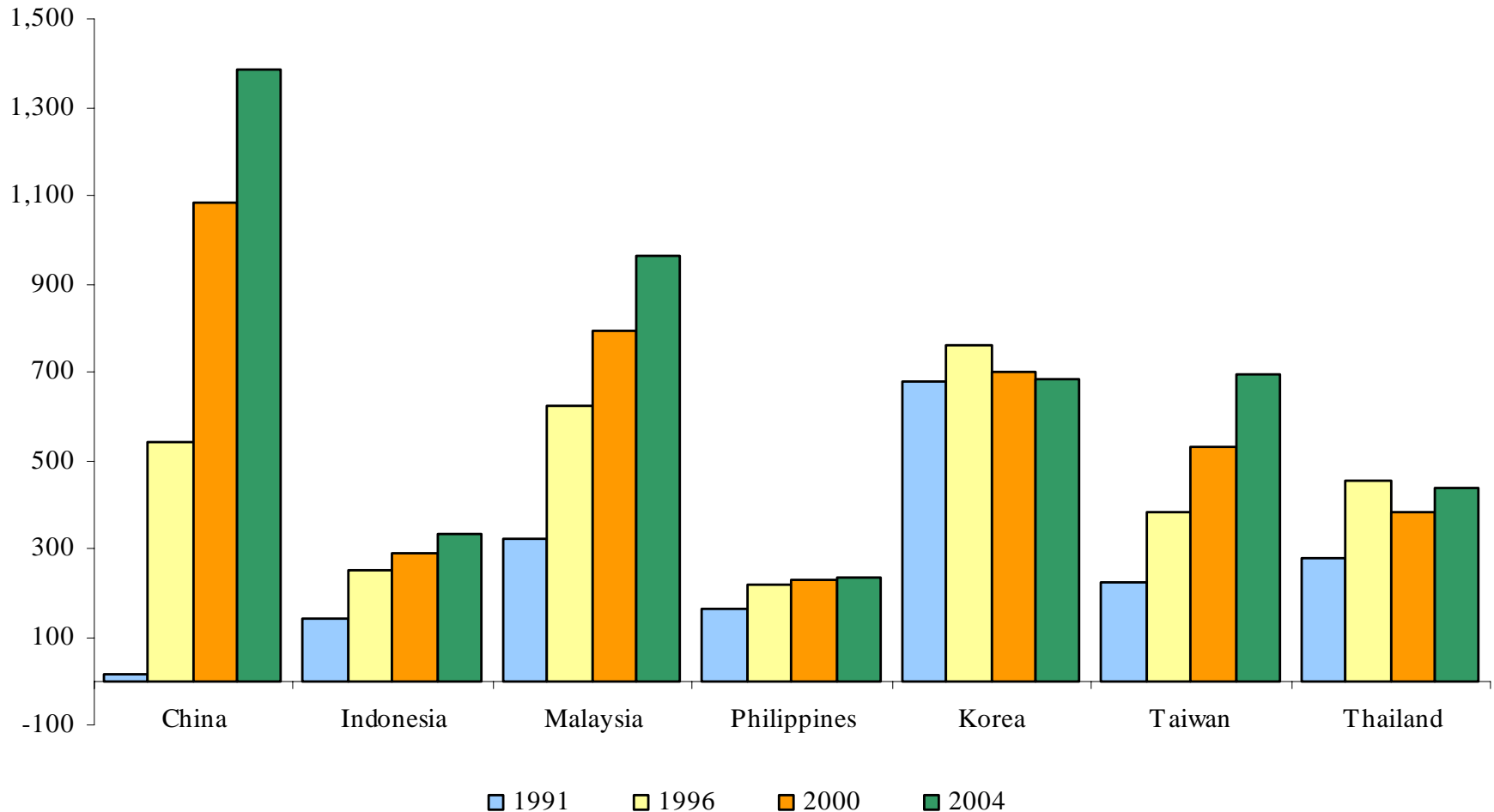
Where We Stand – In Reality ... and in Eastern Europe

Number of Firms Listed in Domestic Stock Exchanges in Eastern Europe



Where We Stand – In Reality But More Listings in East Asian Stock Markets

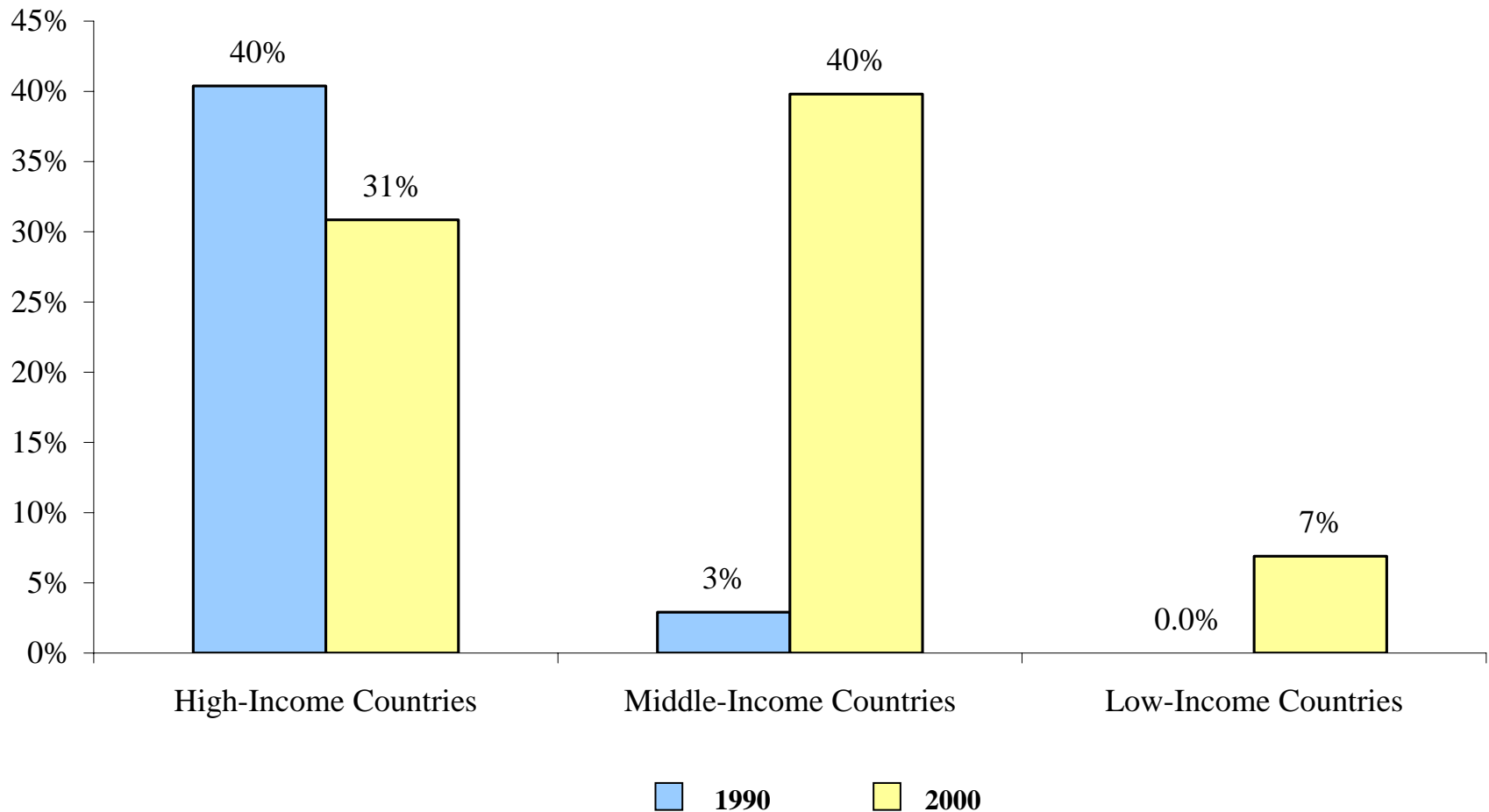
Number of Firms Listed in Domestic Stock Exchanges in South East Asia



Where We Stand – In Reality

More Foreign Activity

Value Traded Abroad / Value Traded Domestically

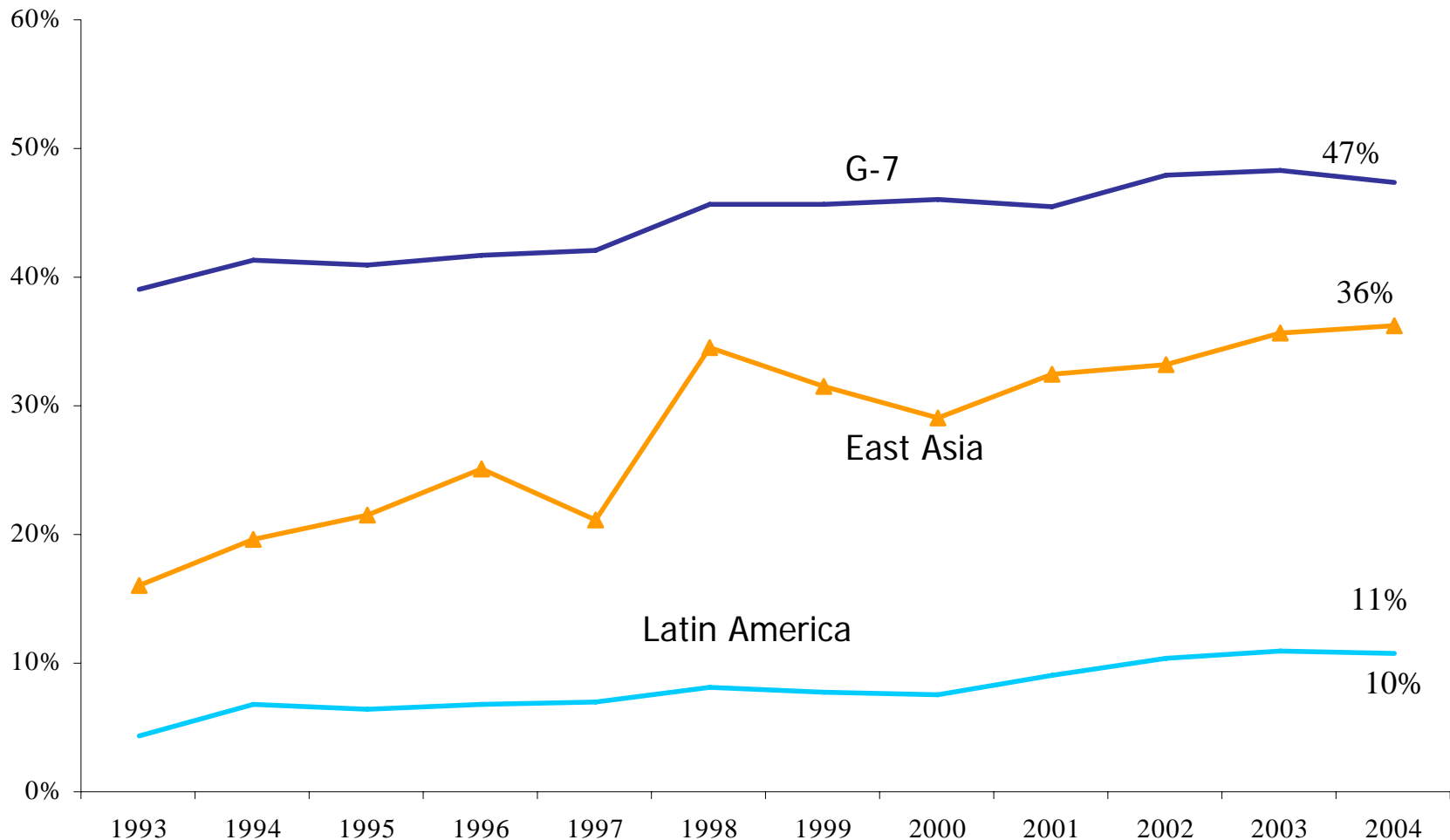


Where We Stand – In Reality

Corporate Bonds Trailing Behind and Highly Illiquid

Domestic Private Sector Bonds Outstanding

Percent of GDP

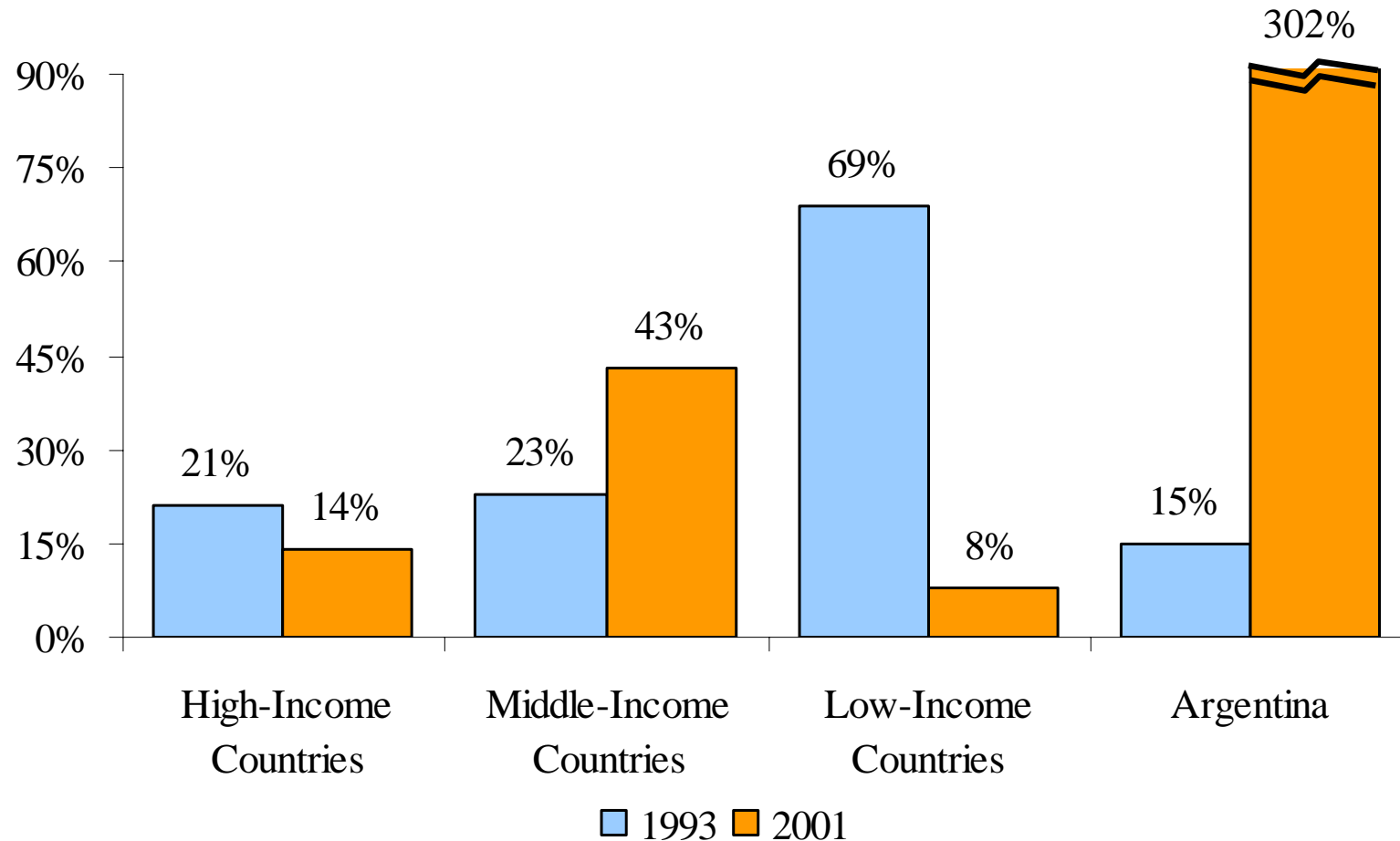


Source: BIS, World Bank

Where We Stand – In Reality

Markets Abroad for Public Sector Bonds

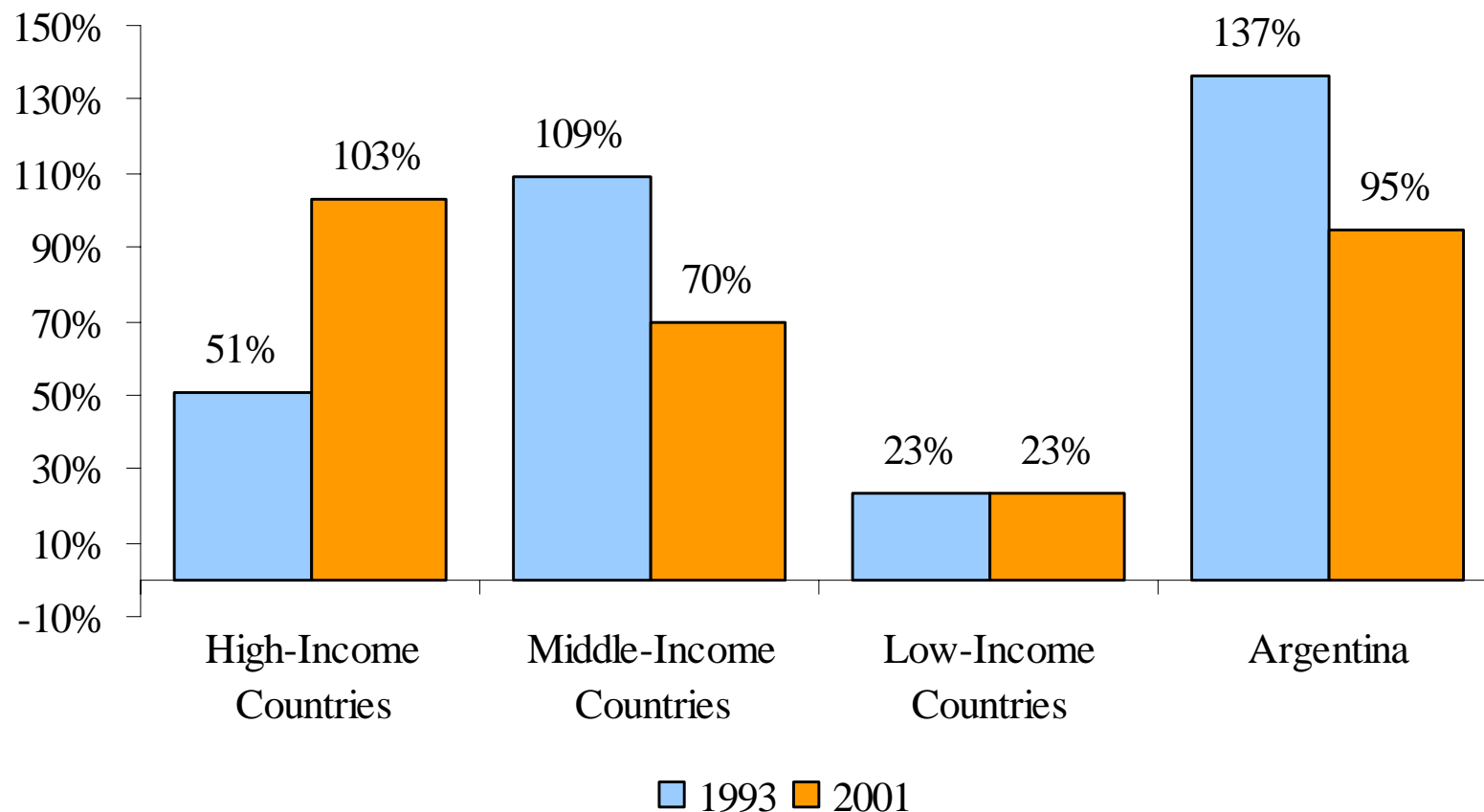
Amount Outstanding of International Public Sector Bonds / Amount Outstanding of Domestic Public Sector Bonds



Where We Stand – In Reality

Markets Abroad for Private Sector Bonds

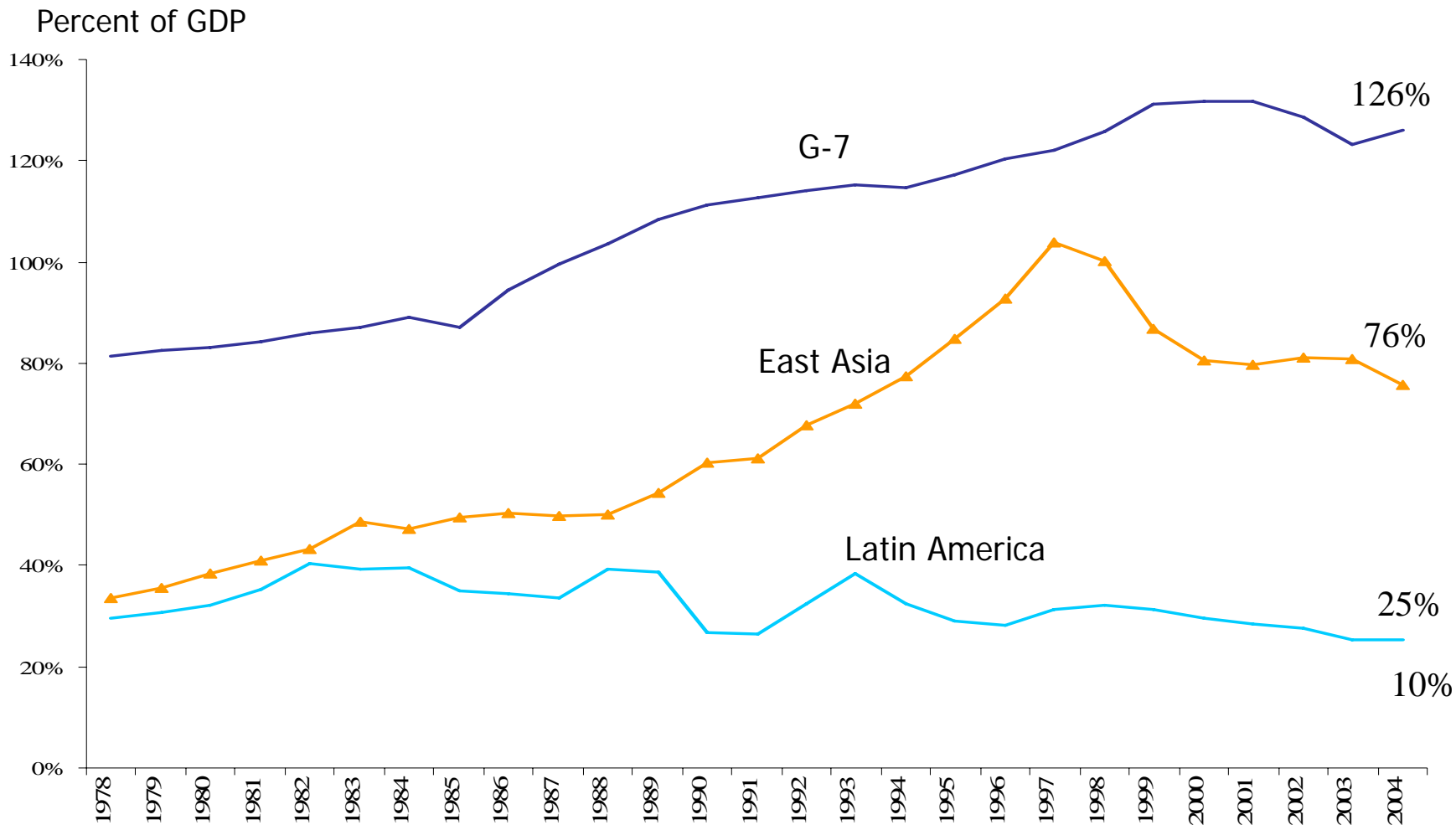
Amount Outstanding of International Private Sector Bonds / Amount Outstanding of Domestic Private Sector Bonds



Where We Stand – In Reality

Credit From Financial Inst. Has Not Compensated

Credit to the Private Sector by Financial Institutions



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Rethinking Policy Based on Evidence

✚ Evidence

- ✚ Incomplete markets, i.e., insufficient contracts
- ✚ Shallow markets, i.e., insufficient depth & breath (where contracts exist)
- ✚ Growth taking place in many countries without formal financial deepening

✚ Not obvious that financial system is now as useful as initially expected

- ✚ Is it providing a suitable range of financing contracts?
 - Long-duration local-currency debt contracts?
 - Working capital and investment finance for SMEs and small farmers?
 - Housing finance for non-rich households?
- ✚ Is it broadening access and leveling the opportunity playing field?
 - Financing unconnected but efficient newcomers that lack fixed collateral?
- ✚ Is it distributing risks towards those who can best manage them?
 - Security in old age income?
 - Insurance and hedging products?

Rethinking Policy Based on Evidence

- ✚ Reexamine how financial intermediaries operate, given globalization
 - ✚ Equity markets
 - ✚ Bond markets
 - ✚ Pensions
 - ✚ Banking
- ✚ New policies to arise from well-grounded assessment of how system actually works and of what is hindering a more efficient operation

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Equity Markets

Main Characteristics

- ✚ Variable-income securities: payments depend on the issuer's performance
 - ✚ No default risk
- ✚ Firm performance might be affected by exchange rate fluctuations, but these effects are passed on to investors via changes in dividend payments
 - ✚ Internationalization does not generate vulnerabilities in the balance sheet of issuers

Equity Markets

Main Issues under Study

- ✚ Domestic stock market development and internationalization have increased over the last decades
 - ✚ What are the factors behind stock market development?
 - ✚ How do fundamentals impact the internationalization process?
 - ✚ What is the impact of internationalization on domestic stock markets?
- ✚ Over the last two decades many countries undertook extensive reforms to foster capital market development
 - ✚ Did these reforms have the expected positive impact on domestic capital markets?
 - ✚ What was the impact of reforms on stock market internationalization?

Equity Markets

Two Views on Fundamentals

- ✚ Two possible views on how economic fundamentals influence domestic stock market development and internationalization
 - ✚ Better fundamentals spur more developed domestic stock markets and reduce the use of international markets
 - Firms want to escape a poor domestic environment
 - Related to the “bonding” argument
 - ✚ Better fundamentals increase the attractiveness of assets to foreign investors and lead to more use of international markets
 - Macroeconomic and institutional factors determine the willingness of international investors to supply financing to firms
 - Firms from good institutional environments will be granted access to international markets

Equity Markets

Two Views on Internationalization

- ✚ Two possible views on how internationalization affects trading and liquidity of firms that remain in the local market
 - ✚ Internationalization improves domestic market liquidity
 - Internationalization transforms a segmented market with low liquidity into an integrated market with high trading activity and liquidity
 - Internationalization induces a compositional shift in domestic trading towards domestic firms, as trading of international firms migrates abroad
 - ✚ Internationalization hurts the liquidity of domestic firms
 - Migration and spillovers
 - Domestic trade diversion / Substitution effects

Equity Markets

Outcomes

✚ Fundamentals

- ✚ Better fundamentals foster domestic stock market development
- ✚ Internationalization is affected in the same direction and by the same factors that drive the development of domestic stock markets
- ✚ Fundamentals accelerate internationalization; better fundamentals increase international activity relative to domestic activity

✚ Internationalization is negatively associated with the turnover of domestic firms

✚ Reforms

- ✚ Reforms foster domestic stock market development
- ✚ Reforms also have a positive impact on the participation in international equity markets
- ✚ Reforms accelerate internationalization, leading to a higher share of international activity relative to domestic activity

Equity Markets

Main Issues for More Research

- ✚ Pro-internationalization bias
 - ✚ Reforms boost internationalization relative to local market activity
 - ✚ Internationalization, in turn, undercuts local stock market liquidity
- ✚ Size matters for stock market development
 - ✚ Size of market – network and agglomeration effects; pools of funds
 - ✚ Size of issues – liquidity
- ✚ Is there a “light” version of local stock markets for small countries?
 - ✚ Structurally illiquid, lower disclosure, more private placements and OTC?
- ✚ Is regional integration superior to global integration?
 - ✚ Problem of small size of issues is independent of type of integration
 - ✚ Are information asymmetries reduced at a regional level?

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Bond Markets

Main Characteristics

- ✚ Fixed-income securities: commit the issuer to payments that are independent of its performance
- ✚ Price risk
 - ✱ Local currency (“peso”) interest rate risk and exchange rate risk, as manifested in the (relative) volatility of these variables
- ✚ Default (or credit) risk
 - ✱ Probability of default and capacity to pay problems generated by a spike in the real rate of interest and devaluation
- ✚ Litigation risk
 - ✱ Risk of loss in the process of value recovery, given default
- ✚ Dilution risk
 - ✱ Possibility that the sovereign might liquefy its liabilities through a surprise inflation spiral (arises from time inconsistency problem)
- ✚ Confiscation risk
 - ✱ Menace of a forcible breach of financial contracts, imposed by the sovereign by decree

Bond Markets

Main Characteristics

- ✚ Currency denomination: Borrowing in foreign currency exposes debtors in the non-tradable sector to real exchange rate risk
- ✚ Duration: Short-term debt exposes borrowers to abrupt changes in market sentiment and liquidity crises
- ✚ Jurisdiction: Writing contracts in jurisdictions with better legal institutions offers creditors superior protection against litigation and confiscation risk
- ✚ Short duration, dollarization, and the choice of a foreign jurisdiction are coping mechanism used by agents to hedge against the systemic risks of emerging markets

Bond Markets

Outcomes

- ✚ Dominance of dollar over short-duration peso
 - ✳ Dollar: a better cover for dilution and litigation
 - ✳ Peso: covers for (relative) exchange rate volatility but might lead to underinsurance at high spread levels
- ✚ Short duration and dollarization are coping mechanisms that can engender credit risk exposure
 - ✳ Short duration and dollarization carry the seeds of their own demise (stylized Latin history)
 - ✳ Investor hedges price risk and takes credit risk in exchange for a claim (option to litigate)
- ✚ A foreign jurisdiction offers the investor superior protection against litigation and confiscation risks
- ✚ The *equilibrium outcome* in emerging markets favors contracts that hedge against price risk at the expense of exposure to default risk, and not the other way around
 - ✳ Value of the option to litigate in the event of default

Bond Markets

Main Issues under Study

- ✚ Encouraging developments in a few countries (Chile, Mexico, Colombia)
 - ✚ Rise in local currency debt markets—mainly for government debt
 - ✚ Does reduction in currency mismatches imply the emergence of other types of mismatches (e.g. duration)?

- ✚ However, liability short-termism and dollarization remain salient features of fixed-income markets in most Latin countries
 - ✚ Is there redemption from “original sin” (issuing of long-duration local-currency debt in international markets) for all?
 - ✚ How much do initial conditions and small market size matter?

- ✚ Interaction between sovereign and corporate bond markets
 - ✚ Government paper dominate debt markets in most Latin countries
 - ✚ Crowding-out versus the market development role of government bonds

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Pensions

- ✚ Low coverage coupled with high risk of poverty in old age
 - ✚ Shift to mandatory defined-benefit individual pension accounts (“pillar 2”) might not provide enough incentives to participate in system
 - ✚ High fiscal cost of transition has restricted governments’ capacity to provide a floor against old age poverty
 - Pay-as-you-go “promises” became formal government debt, tying fiscal hands
 - Absent major tax reform, government has to borrow from “pillar-2” funds
- ✚ Long-term funding – barking at the wrong tree?
 - ✚ Pension funds are pure asset managers – they do not need long assets to hedge a long liability (they do **not** have a liability)
 - Monitoring is necessary to mitigate agency problem but leads to short-term investment horizons and herd mentality among fund administrators
 - Short-term performance de-linked from long-run goals of saving for old age
 - Regulation could change this, but likely at the expense of freedom of choice
 - ✚ Lack of stable long-term funds is due to underdeveloped annuities markets

Pensions

- ✚ Incomplete pooling of risks of insufficient savings & outliving savings
 - ✚ Lack of anti-poverty floor and delayed/discontinuous access to annuities lead to unduly low-return low-risk pension fund portfolios
 - Workers bear all market risk (& pay high commissions!) in accumulation phase
 - Workers face interest rate risk at one-off moment of shift to annuities
 - ✚ But, will Latin countries be able to (i) fund and manage a safety net for the elderly poor and (ii) sustain sound annuities markets?

- ✚ International risk diversification and local market development
 - ✚ Int'l diversification of pension funds would reduce risk for a given return
 - ✚ But, why have a local pension fund industry if global portfolio is superior?
 - ✚ Int'l diversification effects on local market development are unclear
 - Unilateral lifting of restrictions to international investment is unattractive
 - Even under multilateral opening, global portfolio might not include local assets
 - However, int'l diversification can help develop currency derivative markets

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Final Thoughts

- ✚ Much of the current policy emphasis is driven by stability concerns and efforts to converge to international standards
 - ✚ Int'l standards are largely unrelated to big emerging issues
 - ✚ Misguided view that financial development equals convergence to standards
 - Historically, standards came late in financial development, not at the beginning
- ✚ Big emerging issues for the policy agenda have less to do with financial stability and more with completing financial markets and reassessing previous policies

Final Thoughts

✚ Completing markets

- ✚ How to ensure a reasonable range of services for households and firms?
- ✚ How to overcome short-termism and dollarization (credit risk)?

✚ Where is the market?

- ✚ Which services should be provided at home, and which from abroad?
- ✚ Which services should be provided at regional and international level?
- ✚ Is there a suitable version of local equity markets for small countries?
- ✚ Are there any good examples to follow? East Asia?

✚ Role of government

- ✚ Should government policy go beyond improving the enabling environment?
- ✚ How can systemic risks be reduced?
- ✚ How can countries cope with systemic risk?

Final Thoughts

- ✚ Beyond formal financial systems
 - ✚ How much financing goes on outside the formal financial sector?
 - ✚ How to integrate the various parts of the system to bridge access gaps?
- ✚ In sum, all previous questions challenge current and past reform agenda
- ✚ Capital market policies need serious rethinking in emerging economies

END