CENTER FOR FINANCIAL MARKETS
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FRAMING THE ISSUES

Strengthening Capital Markets in Developing Countries

By Staci Warden

November 2014

CM4D

Framing the Issues: Strengthening Capital Markets in Developing Countries

A summary report based on discussions at a
Milken Institute Center for Financial Markets roundtable on capital markets development
held March 14, 2014 in Washington, D.C.

By Staci Warden

Overview

On March 14, 2014 the Milken Institute Center for Financial Markets (CFM) hosted a working roundtable titled "Framing the Issues: Strengthening Capital Markets in Developing Countries."[1] The day-long event in Washington, DC convened scholars, officials from development agencies and international financial institutions (IFIs), private investors, and other business and finance leaders for the purpose of better understanding the importance of, and fundamental issues for, deepening capital markets in developing countries. This document summarizes the results of the day's discussion and captures both the consensus and the divergent views of roundtable participants on key issues for strengthening capital markets.[2]

The summary is divided into five sections, each concludes with a number of policy research questions generated at the roundtable.

I. **Capital Market Development Globally: A Progress Report –** reviews the progress in capital-market deepening globally in developing countries.
II. **The Financial Market Context: Banking and Institutional Investors –** places capital markets in the context of other key financial market sectors namely the banking sector and the public buy-side (pension funds and other institutional investors).
III. **Capital Market Development –** discusses in more detail the nuts-and-bolts of capital-market development – the regulatory environment, equity markets, and bond markets.
IV. **International and Regional Integration of Capital Markets –** outlines the potential for and risks of international and regional integration.
V. **The Role of International Financial Institutions and Development Agencies –** offers recommendations for IFIs and other development organizations that want to help.

[1] CFM hosted the roundtable as part of its ongoing policy research initiative, Capital Markets for Development (CM4D). The CM4D program hopes to address pressing issues of capital-market development and to identify practical solutions.
[2] This roundtable was held under the Chatham House rules.

I. Capital Market Development Globally: A Progress Report

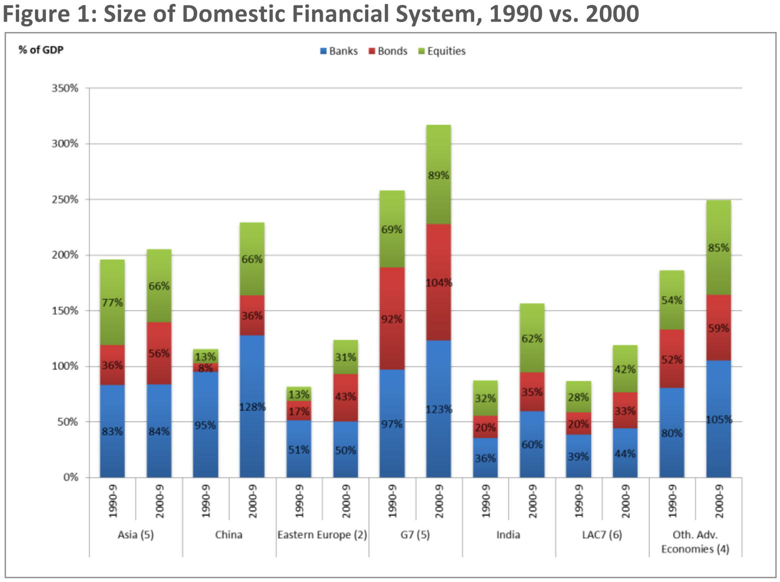
Over the past two decades, capital markets most everywhere have become deeper and more sophisticated. Domestic financial systems have undergone a dramatic change across developing regions and emerging markets, especially in China and India. China, for example, saw four-fold growth in both equities and bonds and five-fold growth in bank assets from 1990 to 2000.

In general, Southeast Asian markets have experienced strong, steady growth. In the Philippines and Thailand, for example, market capitalization, at less than a third of GDP in 2000, has risen to over 100 percent of GDP[3]. Vietrillionam did not have an exchange in 2000, but today the Ho Chi Minh Stock Exchange lists over 300 companies. In addition, during the period from 1990 to 2013, international debt securities outstanding rose from $9 billion to $147 billion in Southeast Asia. Government and corporate local-currency issues have grown from $165 billion in 2000 to just shy of $1 trillion at the end of 2013.

Latin America's capital markets have both increased in size and deepened over the past decade. Market capitalization there saw four-fold growth in a decade, from $560 billion in 2000 to $2.4 trillion ten years later. While equity markets are larger in Chile and Colombia, bond markets are larger in Mexico, Brazil and Costa Rica. According to statistics from the Bank for International Settlements (BIS), Latin American debt outstanding in international currencies from all issuers, both sovereign and corporate, has risen from $40 billion in 1990 to $600 billion in 2013. Local currency debt markets are also growing. As recently as 2001, local currency bonds outstanding from all issuers, government and corporate, in Latin America stood at less than $30 billion. By the end of 2013, they had grown nearly a hundredfold to $2.8 trillion.

In Sub-Saharan Africa, markets are still at a nascent stage of development, but have started to attract foreign investors searching for higher risk-adjusted returns. While few countries report reliable statistics, markets appear to be deepening. Since 1990, sixteen new stock exchanges have appeared and the market capitalization now approaches $1 trillion.

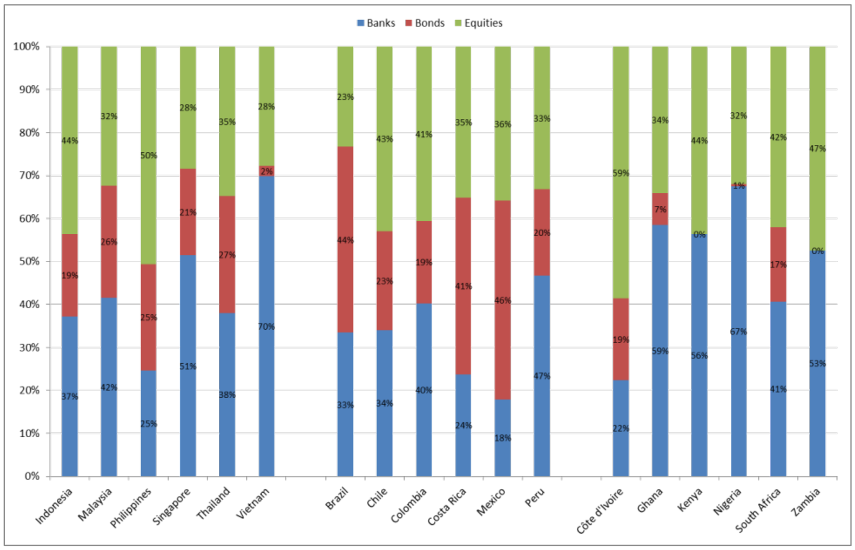
Figure 1: Size of Domestic Financial System, 1990 vs. 2000



Source: Presentation by Sergio Schmukler, World Bank at Milken Institute Strengthening Capital Markets in Developing Countries, March 14, 2014

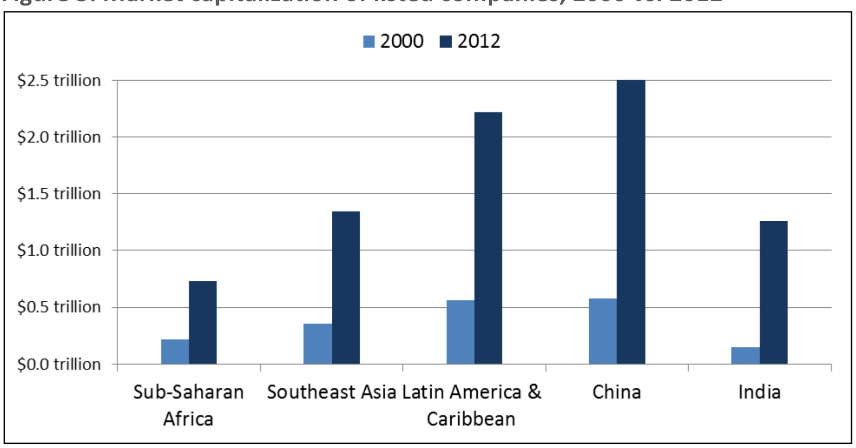
Figure 2: Size of Domestic Financial System, 2012

[3] In 2012 market capitalization as a percentage of GDP had reached 106 percent in the Philippines and 105 percent in Thailand, according to the World Bank's World Development Indicators.



Sources: Bank for International Settlements, Bloomberg, Bankscope, Milken Institute

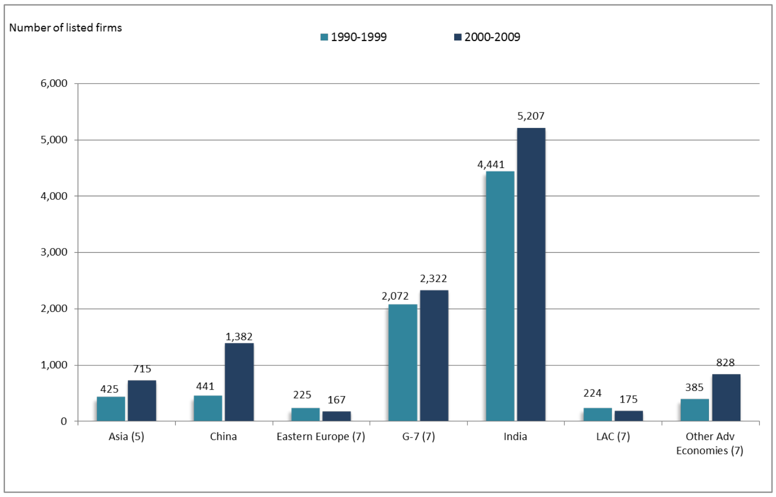
Figure 3: Market capitalization of listed companies, 2000 vs. 2012



Source: World Bank–World Development Indicators

Despite this growth story, only a small number of firms in developing countries access capital markets. For equity markets, presented in Figure 4, the number of firms raising capital is relatively few compared with the total number of firms in these countries, and only in China and India has the number of firms raising capital increased by a notable amount. The number of firms has in fact declined in Latin America, from 224 in the 1990s to 175 in the 2000s. These figures indicate the concentration of markets among a few top issuers in many countries, not the diffusion of capital access to a wider range of participants.

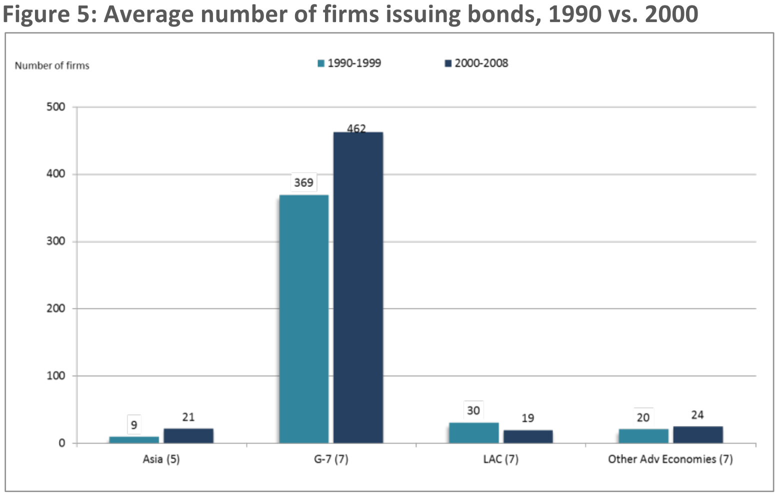
Figure 4: Number of listed firms in equity markets, 1990 vs. 2000



Source: Tatiana Didier and Sergio L. Schmukler, "Financial Development in Asia: Beyond Aggregate Indicators," Policy Research Working Paper No. 6761, World Bank, January 2014

Likewise, only a small number of firms in developing countries access bond markets. For instance, as shown in Figure 5, an average of just 21 firms per year issued bonds in Asia for the period between 2000 and 2008. The number of firms issuing bonds decreased in Latin America, from 30 firms in the 1990s to 19 firms in the 2000s.

Figure 5: Average number of firms issuing bonds, 1990 vs. 2000



Source: Tatiana Didier and Sergio L. Schmukler, "Financial Development in Asia: Beyond Aggregate Indicators," Policy Research Working Paper No. 6761, World Bank, January 2014

II. The Financial Market Context: Banking and Institutional Investors

Participants began by recognizing that a strong banking sector has historically preceded the development of capital markets, and that in many developing countries, banking sector stability has made enormous strides in the past decade, despite the global financial crisis. Likewise, the past two decades of sustained economic growth have led to larger pools of organized savings in the form of both public pension funds and sovereign wealth funds. These two sectors are important for the discussion of capital market development. Banks serve both as an important foundation for, but also competitor to capital markets, and institutions of domestic savings benefit from and contribute to the development of deep, liquid markets.

The banking sector: Complement and competitor

It makes sense that the banking sector develops first in most countries. In a weak information environment, the relationship between banker and borrower may be the only way to assess the credit-worthiness of firms. Furthermore, several participants agreed, the banking sector lays an essential foundation for capital-market development, as "money markets are the cornerstone of capital markets." Through credit lines, banks provide the liquidity to capital markets, and bank deposits provide an "exit door" to investors. Last, and perhaps most importantly, banks are active participants in capital markets on both the asset and liability sides of their balance sheets. In many frontier markets, large banks are often among the first to issue domestic bonds or to list on local stock exchanges.

Beyond helping banks meet their own financing needs, capital markets reveal financial market information that is useful to banks. "The importance of capital markets is not necessarily the amount of funding that is raised in the markets," said one participant, "it is the information revealed. Capital markets reveal information for the banks, and the banks reciprocate in renewing loans or not renewing loans for the capital markets." As such, the development of capital markets is also essential for the sustained health of the banking sector.

The dominance of the banking sector, however, can often stifle the development of a country's capital markets. In many developing countries, the government and the largest firms are the only economic actors with access to bank financing. As one participant noted, "Banks dominate as the source of capital, and governments dominate as users of capital." As a result, developing countries "can have a very stable banking system, which consists of banks just buying treasury bills and being very profitable and very stable—but not really doing their job as financial intermediaries." In the private sector, which is often highly concentrated, banks prioritize only the largest firms, with neither side being incentivized then to develop capital markets that could (1) compete with banks and (2) finance the large firms' smaller, perhaps more innovative competitors. This situation harms small and medium-sized enterprises (SMEs) that often face collateral demands that are, as one participant described them, "really ridiculous—nothing short of ridiculous." Yet these businesses have no other way of raising capital.

Participants agreed that government policy, is for the most part, "severely biased in favor of banks." For example, in times of economic crisis, in both advanced and developing economies, governments are more likely to save systemically important banks from collapse, even as, for instance, corporate bond markets dry up. In most cases, "just getting out of the way is often one of the most efficient strategies that governments can take to develop capital markets," remarked one participant. Policies such as subsidized bank-deposit insurance and the double-taxation of dividends, in particular, cause market participants to favor bank financing over using capital markets. Instead, the public policy goal "should be to create a level playing field for the development of all types of financial products."

Mobilizing domestic savings: The role and requirements of local pension funds

Public institutional investors play an important role in capital-market development, not just because of their size, but also because they do not face excessive liquidity requirements, given their long-term mandate and (thus) investment horizon. In particular, roundtable participants emphasized the potential of long-term institutional money to help catalyze domestic capital-market development through investing in infrastructure projects and the corporate sector. "Countries that have had really big pools of organized savings have had an easier time building capital markets," explained one participant. "Look at Chile, Colombia, Malaysia, and Thailand as examples of developing countries that have achieved a good balance in this regard."

While there was some disagreement among participants on the question of the optimal asset allocation for pension funds in developing countries, participants did agree that those pension portfolios are overwhelmingly concentrated in domestic, low-risk, low-yield securities. “It’s scary that so much money is invested in bank deposits and short-term government bonds,” said a roundtable participant, “because they’re very low yield.” While pension funds have a fiduciary duty to an economically dependent and vulnerable segment of the population—which naturally drives conservatism in asset allocation—it is also true that pension funds must generate positive real rates of return in order to meet these long-term liabilities.

In some respects, a limited investment opportunity set with a bias toward short-term government securities increases concentration risk, and as a result heightens the risk of negative tail events from macroeconomic shocks. Diversification, of course, requires the existence of a range of investment opportunities as well as deep, liquid capital markets that enable institutional investors to access – and exit – those opportunities.

One participant summed it thus: “Pension funds need long-term local currency investments, and they need yields from a range of asset classes in order to meet the payout obligations to policyholders.” This can also mean internationalizing investment guidelines. Domestic institutional savers could improve both yields and hedge local exposure through diversification into other geographies. As one participant noted, Chinese citizens “saving for retirement would optimally like to have some of their exposure outside China. Certainly, Chilean residents do not want to have to depend on a pension that’s vulnerable when copper prices are down.” Participants cautioned, however, that because governments often see pension savings as an important source of budgetary finance, any moves toward international diversification can be a hard sell.

Participants agreed that a lack of capacity and regulatory burdens drive what may be excessive conservatism in pension fund investment decisions. “In many of these countries,” said a participant, “pension funds are just very new to investing, and so by nature they’re very conservative.” Another noted that “while the capacity of investment managers and senior leadership has continued to improve dramatically in recent years, the boards of directors have in many cases suffered from a lack of financial literacy and the ability to assess the risk-versus-return profile of pension fund asset allocation strategies.” Regulatory regimes, recognizing the lack of capacity in many cases, are often excessively conservative, and this—together with the negative publicity that can arise from investment losses—adds to the risk aversion of pension boards.

While much of the discussion focused on pension funds, roundtable participants agreed that a public policy goal for developing countries should also be to diversify the domestic investor base. One participant cited the experience of Colombia, where pension funds “kidnapped and destroyed” the liquidity of the nascent corporate bond market. Participants agreed that developing countries would do well to put more focus on commercial savings vehicles for retail investors, such as mutual funds and other vehicles. Domestic savers suffer from financial repression in many developing countries, and households would benefit from pooled, diversified vehicles that give them an option beyond local bank accounts. Further, as one participant argued, “if pension funds come to understand that they dominate local financing, they charge too much.”

To develop the institutional investor sector more broadly, participants discussed the importance of establishing government saving vehicles, such as sovereign wealth funds, to manage natural resources wealth. In Nigeria, for example, the Nigerian Sovereign Investment Authority is increasing the amount of capital available for domestic infrastructure projects. “Even Senegal, which has no natural resources,” noted a participant, “has started a sovereign wealth fund by selling public assets, and is trying to kick-start private investment.” Finally, governments can make better use of capital markets by becoming investors themselves. Another participant pointed to the importance of public institutional investors in

France, Italy, and Canada as models that could be used by developing countries. Here, public money, pooled in the *caisse de dépôt*, seeks market returns, and becomes an additional source of finance for domestic borrowers.

Policy Research Question

- How can pension mandates be reformed to encourage diversification both within the domestic economy and internationally in ways that both benefits pensioners and deepens capital markets?

III. Capital Market Development

For domestic governments, capital market development begins with a "first pillar," macroeconomic stability, and a strong legal and regulatory framework.[4] The government's role begins with promoting the rule of law, protecting the physical security of citizens and visitors, and establishing a sound, independent judicial system. "One should not expect to have developed capital markets in a country where the expected profitability of long-term projects will likely be negatively impacted by volatility in the macroeconomic environment," explained one of the roundtable members. Nominal interest rates, in particular, must come down to reasonable, stable levels before firms can issue long-term debt. "If interest rates in a given country are 20 percent," this participant added, "there are just not many companies that have a business model where they can borrow at those rates and invest attractively."

Second, as discussed, a healthy banking sector is likely needed before capital markets can develop. Third, capital markets need good market rules and regulations. But, having good laws is, in itself, not sufficient; a fourth pillar is strong institutional capacity to implement existing laws and create reforms when needed. As one participant said, "if countries have weak judicial systems, even if they have the perfectly designed bankruptcy law, [the existence of that] law will not allow for the orderly restructuring of a firm in distress, or a change in management." Another said, "it's not just about having regulation, but having the expertise to enforce it."

This section looks in more detail at the problems and policy ideas for improving the regulatory environment in general and for developing equity and bond markets in particular.

Regulatory environment: Overbearing and overly vague

Regulation that creates an enabling environment can have an important impact on the pace of market development. As an example, one participant pointed to the contrasting approach of two regulators in India. The Stock Exchange Board of India, which regulates the public equity market, has adapted more readily to the needs and incentives of market participants, spurring an expansion of listings and rapid growth in market capitalization. Meanwhile, the country's central bank, the Reserve Bank of India, has more rigidly regulated the corporate bond market, likely slowing its development. Unfortunately, in many developing countries, regulatory regimes are costly, time-consuming, uncertain, and ineffective and/or corrupt. Roundtable participants discussed each of these concerns.

First, regulatory compliance can be expensive for companies, especially those seeking to raise capital; to market intermediaries; and to investors. Registration, licensure, and underwriting and legal fees,

[4] For a full treatment of all pillars, see roundtable participant Liliana Rojas-Suarez, "Toward strong and stable capital markets in emerging market economies," BIS Paper No. 75, January 2014, available at http://www.bis.org/publ/bppdf/bispap75c.pdf (accessed October 22, 2014).

especially when paired with policies that subsidize commercial bank financing, inhibit the development of capital markets. Though anecdotal evidence abounds, participants noted that there is a lack of systematic, cross-country empirical data on the financial costs for capital market participants in developing countries. One participant suggested that the collection and publication of data on these costs would be a worthwhile research effort.

In addition to financial costs, burdensome regulatory compliance means lost time for companies. Long approval processes mean that they often cannot access capital when they need it to expand and invest. Tedious and time-consuming paperwork can also delay market activity or, due to strained capacity, prevent some companies from participating in capital markets at all. Participants agreed that reducing the complexity and length of approval processes ought to be a policy priority. A participant pointed to Kenya as a positive example; there the securities commission has reduced the number of days needed for approval for a corporate bond issuance from 240 to 70.

Ironically, while regulatory regimes can be are overly complex and demanding in some aspects, in developing countries, they are also too uncertain, lacking clear “rules of the game” and a history of case precedent. Developing countries can often lack a bankruptcy code, property rights protections, or clear rights for minority shareholders, all of which deter investors from entering the market. And regulators often have no standards for alternative financial products, including commodities derivatives or securitization. A country’s speed in adopting clear and concise regulations can be an important aspect of attracting foreign direct investment (FDI). Two private-sector participants noted their own experience in East Africa, where they needed regulators to write new public policy before the foreigners could make investments. “You’re waiting for them to come up to speed, which is really quite a challenge,” explained one of them, “because you’re burning capital while they’re trying to figure out whether they’re going to license you, or how they’re going to deal with you.” In this case, Rwanda acted more quickly than Kenya, so the firm based its operations there.

Finally, the regulatory environment can be ineffective due to a lack of capacity and/or corruption. Policymakers may design rules that favor elites or other domestic actors, and bureaucrats often arbitrarily impose fees. Roundtable participants discussed various solutions to the problems of capacity and effectiveness. For instance, an international authority or regional body could assume the responsibility to design and enforce regulatory standards, or there could be a role for international consultants in regulating markets, whereby governments could maintain their own sovereignty while hiring independent regulators. Most participants, however, were skeptical that policymakers would adopt an arrangement that cedes traditional mechanisms of sovereign authority to external actors.

In improving the regulatory environment more generally, participants saw promise in the possibility of self-regulation through the adoption of international best practices. They pointed to the positive influence of the International Organization of Securities Commissions (IOSCO) in increasing financial literacy and regulatory capacity in developing countries. According to several participants, a valuable pursuit would be strengthening IOSCO and working to ensure that its global benchmarks take into account the limited resources of developing countries, and their vulnerability to external shocks.

Building equity and bond markets

For developing countries, equity-market development is far ahead of that of corporate bond markets. This is due in large part to the difficulty in acquiring the credit skills and establishing the credit culture necessary to participate as investors in bond markets. But at least one participant noted some irony in this: “I find it somewhat illogical that you could have an extremely robust equity market, which is absolutely the most subordinated layer of the capital structure, but then have a complete absence of a high-yield market, which offers better investor protection."

In any event, the roundtable discussion of these markets reflected this dynamic. The more optimistic discussion on building equity markets focused on the need for attracting more issuers, the demutualization of exchanges, and the role of SME exchanges. In discussing corporate bond markets, participants focused mostly on constraints.

Equity markets

Public equity markets in developing countries have expanded in recent years, but in many countries the markets remain shallow and are made up of only a few sectors, particularly banks and telecoms. Moreover, family firms, which represent a large proportion of the private economy in many countries, are often uninterested or unable to raise equity finance through public markets. These firms may not want to dilute control or undergo the scrutiny that comes with the disclosures required of public companies.

How can more issuers be drawn to these markets? Participants discussed several ideas. Perhaps most important, governments can give momentum to public markets by listing, or partially listing, state-owned enterprises (SOEs). This could provide much needed capitalization in many cases, but participants noted that policymakers are often reluctant to list SOEs for reasons similar to those of family firms: They do not want to cede control. And as is often pointed out, SOEs are often run to maximize political value, rather than financial value. Participants pointed to the UK and Poland, however, as good examples of privatization that did catalyze the development of equity markets.

In addition to a lack of issuers, nascent markets suffer from a lack of qualified, interested intermediaries. In some countries, regulatory requirements (such as multi-year commitments) deter banks from playing a facilitating role as market makers. Intermediaries are critical for SME listings in particular. SMEs "really need somebody like a market maker or nomad or sponsor. Whatever you want to call them, you need somebody to do the due diligence and to provide some more PR for smaller companies."

If the right intermediaries were in place, what should an SME exchange look like? First, one participant argued, the SME exchange must be connected to the main stock market. Otherwise, "the companies that do well will graduate and move on to the main exchange, leaving the SME exchange with a large proportion of poor performers, to the detriment of the exchange's reputation as a desirable platform for visibility and marketing. If, on the other hand, the SME and the main exchange are linked, there will be incentives to make each platform work."

Second, according to the same participant, "in the case of SMEs, the job of an exchange is not simply to list and trade. They need to do a lot more in terms of providing other services to SMEs." These services should include financial market education and assistance with investor relations. By offering these services collectively to listed SMEs, exchanges could improve market efficiency by (1) removing the need for every SME to spend financial and human capital on these services, and (2) presenting more standardized investment opportunities to investors.

Private markets can also play a crucial role in financing private enterprise directly, as well as in developing public markets. Several participants suggested that promoting a vibrant private equity market that feeds into the development of public equity markets ought to be a policy priority. In this scenario, private equity firms would identify high-growth companies in a developing country, perform due diligence, and invest in improving management and operations, thus helping the firms develop to the point where they are ready for public offerings. Then, when firms are more established, the stock exchange can offer an exit for these investors. One participant drew attention to the example of NASDAQ Dubai as a cautionary tale, however. Liquidity is low and private equity firms are having trouble selling shares, even after listing companies. Such stories discourage future participation in these markets, because "exchanges need success stories for markets to get going."

Last, participants agreed that the exchanges themselves should become public companies. That is, exchanges should move toward demutualization. The demutualization process may be slow, as markets are nascent and sometimes depend on the government to continue operations, but in the longer term, demutualization will have positive benefits, in that it strengthens corporate governance of the exchange (by removing conflicts of interest among leadership) and makes the exchange more responsive to market forces. Demutualized exchanges are also more likely to offer new products, such as exchange traded funds (ETFs) that can draw retail investment to the exchange. Moreover, through an initial public offering (IPO) and subsequent offerings, demutualized exchanges are better able to raise capital to make important investments in new technology and market infrastructure. Vested interests, however, can make demutualization politically difficult.

Bond markets

Many of the themes discussed for building equity markets also pertain to building bond markets. Again, participants agreed that the legal and regulatory environment is fundamental. Unlike in equity markets, bond market development is primarily about developing primary issuance markets. As one participant argued, in developing countries, "corporate bond markets do not need a lot of liquidity, as most institutional investors … are longer-term investors." While the lack of liquidity in secondary markets is obviously in part what drives buy-and-hold strategies, for the most part, participants felt that targeting the development of primary bond markets is the sensible policy priority.

For bond market development, participants spent much time discussing the necessity—and difficulty—of building the capacity to conduct credit analysis. They agreed that the most glaring needs were in credit assessment and developing a credit assessment capability beyond the banking sector. "Typically investors lack the skills required to do a credit assessment in these countries," said one participant, "because they've never had to." Companies can lack the financial literacy to understand the issuance process and the advantages of participating in capital markets. This lack of knowledge pushes market participants toward the more familiar option of bank financing.

Participants agreed that governments, as economic actors, have a crucial role to play in bond market development through their treasury function as primary issuers. Governments can often borrow more cheaply abroad than in local currency, but they do so at the expense of the local corporate and banking sectors in many instances. Local currency-denominated sovereign paper is essential to market development as it serves as a benchmark for bank and corporate coupon rates. To build a local currency yield curve, governments must raise money on a regular basis, and at a range of maturities. Opportunistic financing might be more efficient, but regular issuance, that the market can rely on, is required for building a yield curve and for yield compression for private-sector borrowers. As a result, participants agreed, regular issuance on the part of government finance ministries, augmented by SOE issuance, is a critical building block for enabling broader commercial issuance. One participant pointed to Singapore as an example of this strategy, where Singapore Airlines and DBS Bank, both subsidiaries of the government-owned Temasek Holdings, have issued bonds in local markets.

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One of the important points raised during the roundtable was that all four pillars mentioned above are likely required before capital markets can deepen significantly. They reinforce one another, and weakness in one undermines the strength of the others. In light of this interconnectedness, capital-market development requires a sense of common purpose throughout the whole of government, driven by political will from the top levels of national leadership. Political will, and a clear roadmap that outlines the sequencing of reforms, enables a coordinated effort across agencies. Several participants pointed to the Malaysian capital-market planning process as a successful example of combining political leadership with a clear, practical roadmap.

Participants also pointed to Poland as an example of implementing many of the most important features of a capital-markets development strategy. In particular, Poland embraced the concept of building out its own treasury issuance in order to lengthen the local yield curve. The Ministry of Finance also established a primary dealer system for government securities auctions, made early investments in creating a sound market infrastructure, and built a well-functioning stock exchange. Poland used privatizations to "build an equity culture," following the example of the United Kingdom. In parallel, Poland invited foreign banks into the economy. While the participation of foreign banks in developing economies can be contentious, one participant argued that in Poland foreign banks have had a positive impact. They brought strong balance sheets, better financial products, better risk management, and deep financial knowledge – all of which immediately strengthened the domestic financial system, leading to sustained growth over the last two decades. Last, the Polish Government took active steps to court foreign capital, including conducting roadshows where "they would go out to prominent financial centers and sell the Polish story as it developed over the years."

Policy Research Questions

- What are the characteristics of those countries (and/or their policy environments), that have been successful in developing capital markets? Are these characteristics consistent across developing regions? If not, what accounts for variations?

- What is the right level of financial sector development for the economic size and development of a particular country? What other country assets (human, cultural, legal, geographic etc.) are the most important determinants of potential for, and right strategies for pursuing, capital market development?

- What is the right sequencing of capital market innovations? What kind of planning process should be undertaken? What are the right benchmarks? Are there political economy models that best enable execution?

- What are the costs associated with issuing bonds and/or listing on equity exchanges in developing countries? How can we make cross-country comparisons and deliver them in a way to be helpful to governments to make improvements.

- What is the relationship between a robust private equity market and the development of public stock exchanges? What are the best policies to create feeder markets to broad public ownership?

IV. International and Regional Integration of Capital Markets

One of the most serious challenges facing the development of long-term financing options in many developing countries is the size of their economies. Even when countries like Rwanda make impressive gains in improving regulations and the ease of doing business, they still must attain a certain minimum economic size before they can attract investment, particularly from institutional investors. As a corollary, developing countries have very limited, if any, ability to issue “safe assets,” those securities that offer reasonable price stability and liquidity.

As a result, during downturns, investors tend to run from assets in emerging and frontier markets, and invest in the securities issued by the world’s advanced and stable economies. This exacerbates the problem for developing countries. As capital leaves, price volatility increases in the short term; and in the longer term, firms face greater difficulty in financing their growth and operational activities, slowing the real economy. Slower growth, of course, makes it more difficult to attract global investment flows, and the downward spiral continues. Discussion was wide-ranging, but there was general agreement that deep, liquid capital markets are a fundamental requirement of a “safe asset” environment.

The discussion on international integration asked fundamental questions about the benefits and requirements for attracting investment and financial intermediary services from abroad. One participant emphasized the difference between the provision of financial services per se and the delivery of those services by a local provider. Technology increasingly enables local actors to access financial services internationally, mitigating capacity constraints to market development, as well as potentially enabling developing countries to “leapfrog different stages of financial-sector development through importing an array of banking and capital market services.” Thus, importing financial services might be the right policy choice for resource and capacity-strapped governments.

On the other hand, policymakers will be motivated by the desire to maintain sovereignty and to avoid dependence on foreign counterparts to deliver services to citizens. “One of the negatives [of importing financial services] is that if governments rely on commercial institutions from countries from abroad, they are really at the mercy of specific interests,” explained a participant. “We would have to figure out how to ensure that continuity if a market player in another country decides that it is no longer worth their while to continue servicing a given market.” Recommendations to import financial services from abroad must recognize these considerations, the group agreed; yet despite these concerns over sovereignty issues, participants concurred that it worth thinking more carefully about the relative benefits of opening domestic markets to international participation.

A fundamental question for globally integrated capital markets is the advisability (and ability) of meeting global standards or benchmarks for regulation, operational practices, and other areas. Several participants argued that developing countries should aspire to global benchmarks. “Investors prefer international standards,” said one, “and countries that come up to speed with global best practices could achieve an advantage over their peers in attracting FDI.” However, international standards may be an inappropriate goal for developing countries, given that these require high levels of technological and regulatory capacity. Moreover, they are designed for much larger, faster, more liquid markets.

Some participants asked whether developing countries might be better served to expend their limited financial and human capital on other priorities. More fundamentally, several participants suggested that developing countries may wish to reserve the right to maintain some level of protectionist policies in order to develop local markets without the disruptive stops and starts of foreign portfolio flows. Participants agreed that the global standard-setting process should be democratized so as to better address the needs and constraints of the more limited capital markets in developing countries.

Roundtable participants discussed a number of more granular, technical ideas by which developing countries could take advantage of international capital markets. First, developing governments could provide better and more readily accessible data to international investors. As one participant noted, only a handful of countries in Africa and Latin America report to the Bank for International Settlements (BIS), so it is very difficult to understand particular monetary environments. Second, these governments should consider issuing sovereign debt in large enough size to be included in international fixed-income indexes, such as Citi's World Government Bond Index (WGBI) or JPMorgan's Emerging Market Bond Index (EMBI). "Whether a particular country's instruments are in certain indexes historically has been extremely important in terms of both the perception and the liquidity of those instruments," said one participant, noting that "there is more than $2 trillion in passive funds that follow certain indexes." Finally, governments in developing countries should consider the benefits of making their currencies euro-clearable. Being clearable in global currencies reduces costs and risk for large, global investors. "Mexico has performed well relative to its peers," observed a participant, "in part because the Mexican peso is the only Latin American currency that is Euroclearable."

Regional capital markets integration

Participants discussed the potential for regional integration of capital markets, and the associated risks. Regional integration can take the form of full monetary union, such as the West African Economic and Monetary Union (WAEMU), or a looser system based on harmonization and mutual acceptance of local standards within a region, as has been attempted in East Asia. The harmonization of standards is, of course, an important first step and prerequisite for further financial-market integration.

The benefits of regional integration include a larger market and better diversification of opportunities for investors; greater access to savings for borrowers; and cost savings for regulators, market institutions, and market intermediaries. These efficiencies come with economies of scale. In addition, a well-integrated region can do more to attract international long-term investment, including for much-needed regional infrastructure projects. The WAEMU, in particular, is a successful example of developing liquid markets in government securities, with regional institutions. "WAEMU has eight countries with the same currency and one central bank," noted one of the participants, "and they have built a booming regional treasury bill market. Any bank or other investor in one of the eight countries can purchase securities issued by any other government, and it has been working well." Yet despite this success, the WAEMU has made little progress in developing a corporate bond market.

In particular, public-sector pensions might benefit from regional integration. A Nigerian fund might be more willing to invest in Kenyan infrastructure, for example, than in an equivalent type of asset in Europe. Regional institutional fund managers would likely have better knowledge of and/or might more easily do due diligence on investments in their own region. In addition, those investments would have a potentially greater direct and indirect positive economic spillover to the home country.

But participants also raised concerns about the merits of integration efforts in light of the heavy costs of both financial and political capital. First, as one participant remarked, for both large firms and SMEs, "it is not clear that integration among equals will achieve much more on top of what countries already have." Large firms usually have adequate financing domestically, and the few large firms that do wish to raise capital internationally are likely to do so through international financial centers. SMEs, on the other hand, are likely to face the same barriers to bank financing and the same, limited access to capital that they experience in their own country. Second, participants noted that there can be asymmetric benefits and risks associated with regional integration. Regional integration can benefit one country at the expense of the others, and the largest beneficiary is likely to be the most advanced economy in the region. “Where is the money really going to flow, given that liquidity begets liquidity?” asked one of the roundtable participants.

In part for these reasons, participants were also quick to highlight the political difficulties of regional integration. Although not every country needs to build its own stock market, for example, one participant noted that “politically, politicians in every country seem to *want* a stock market.” Elected officials enjoy the prestige that comes from launching large-scale national projects. Like national airlines or large dams, a stock exchange can be perceived as a symbol of national progress.

One participant also noted that those countries that have pursued a regional approach have often had to internationalize. “In Asia they established a regional clearing platform, as well as a regional ratings system, but they moved to an international clearing platform shortly thereafter and saw regional ratings agencies acquired by international firms.” Another person argued that “regional integration almost seems like last century. We’re in a world of the cloud and the Internet. Why does it matter that the countries are next to each other?”

One benefit of pursuing an agenda of regional integration may simply be what occurs in the process of doing so: the benefits of knowledge transfer and peer pressure. As one participant argued, “one of the most important benefits of regional financial integration is not necessarily to have more firms listed in the market, but the fact that regional initiatives create a venue for knowledge transfer and momentum for domestic reform efforts.” In other words, the competition and positive peer pressure of integration efforts pushes countries to reform more quickly than they might otherwise. Pointing to the Pacific Alliance of Chile, Colombia, Peru, and Mexico, the same participant argued that regional efforts have also produced a larger, more readily accessible set of data on market activities in these countries, both bringing to light inefficiencies and alerting investors to opportunities.

Policy Research Questions

- What are the opportunities and risks for developing countries to import or otherwise access financial services from abroad as opposed to developing local institutional providers for those services? What are the risks? What should be the decision criteria? How can technology facilitate wider access to such services when local providers are not available?

- Are there ‘shortcuts’ to improving regulatory capacity, through the creative access of outside experts. Is there a role for regional regulatory bodies? Could a ‘good seal of approval’ approach be used to help improve regulatory decision-making, as well as cover’ when making difficult decisions.

- Under what conditions should developing countries seek financial integration with regional peers? Are regional integration efforts worth the cost or would it be better for many developing countries to seek to integrate internationally instead of regionally?

V. The Role of IFIs and Development Agencies

International financial institutions (IFIs) and bilateral development agencies can have a profound influence on capital-market development, both because of their mandates and because they are, themselves, important economic actors. Participants discussed their importance in building capacity, providing credit enhancements, and crowding in private investment.

Not surprisingly, the importance of financial literacy among companies, investors, retail savers, and regulators arose repeatedly during the roundtable, and participants agreed that the IFIs could play an important role in building broad capacity through training and related activities. As an example, participants referred to a recent program launched by the U.K.'s Department for International Development (DFID), which established an educational exchange between policymakers in Tanzania and the London Stock Exchange. As part of the program, Tanzanian officials traveled to London to visit the exchange and attend educational seminars, with similar plans for British officials to travel to Tanzania to offer on-the-ground technical assistance.

More directly, IFIs can and do facilitate deeper markets by providing credit enhancements to local borrowers. To establish the importance of credit enhancements, one participant explained that bond-market development begins with sovereign issuance, followed in most cases by the largest companies in the country which "are well known in the country and are deemed by investors to be equal if not better than the sovereign" in terms of credit risk. Further down the curve, the IFIs can sometimes "pave the way" by issuing domestic currency bonds for specific projects. However, none of these products requires a credit assessment from investors, and, according to one participant, "markets typically stall at this point because investors do not have experience in credit analysis or with credit products."

But the IFIs can help introduce investors to credit products by participating in the deal and assuming some of the credit risk. "Coming in at the mezzanine or quasi-equity level and taking a second-loss position after the originator, the IFC will absorb most of the risk of default, thereby improving the credit rating of an issuance," explained a participant. "Investors then are more likely to invest, sometimes at lower rates and longer maturities than companies could otherwise expect." India, Russia, and Thailand are successful examples of this approach. Another way for the IFIs to provide broad credit support, one participant suggested, is to play a constructive role by creating "liquidity backstops" or "safe-assets backstops" for countries that meet certain good governance standards and other requirements.

The IFIs can also play a role in capital-market development by crowding-in private capital through initiatives that target particular sectors and through sharing reputational risk with international investors. USAID's Power Africa initiative, for example, has worked to channel private capital into African energy production by identifying attractive projects, promoting those projects to domestic and international investors, and clearing barriers that keep investment on the sidelines. Through the Commonwealth Development Corporation, DFID has directly invested in mission-driven funds to promote impact investing in the venture capital and private equity space in Africa. The African Development Bank (AfDB), through the Africa50 Fund, has also sought to crowd-in private investment and fill the region's infrastructure financing gap. The US Agency for International Development (USAID) also provides credit guarantees to local banks in order to encourage lending to SMEs that might be overlooked for financing, such as companies owned by women.

One participant suggested that the African Development Bank and the other IFIs heavily invested in Africa should consider selling down their own balance sheets in order to draw in private equity and other investment. "First-time investors, such as pension funds and other entities, may have interest in infrastructure projects that have now moved to the 'operational' stage," noted the participant. In this way, the IFIs have an opportunity to bundle their loans and then sell on smaller equity stakes ($5 million or $10 million) in the resulting portfolios. These investment opportunities could be attractive to smaller public and private pension funds both in Africa and abroad that seek diversification, a streamlined investment process, and impact.

Last, participants observed that the financial engagement of the IFIs and bilateral development agencies is important not just to mitigate financial risk, but also to curtail reputational risk. First, other investors can outsource in large part the environmental and good governance due diligence to the IFIs. Second, the presence of these organizations arguably adds heft to enforcement efforts. "Governments don't like to default or otherwise have issues with the IFIs," one participant observed.

What counts as good policy advice?

Participants identified several important concepts that should inform policy recommendations for strengthening capital markets in a developing country context.

First, policy recommendations must be practical and tailored to the specific conditions in each of these economies. Broad admonishments to policymakers that do not include prescriptive policy ideas (e.g., a recommendation simply to expand the domestic investor base, without articulating the steps to do so) are not useful. As one participant phrased it, "policy recommendations must identify and then address the 'sticky pieces' that hold back development."

Second, participants agreed that policy recommendations must take into account the incentive structures of private-sector borrowers, investors, and intermediaries. As one participant remarked, capital-market development can never be sustainable unless investors and intermediaries are making money. Policy recommendations that do not take into account the profit motive of the private sector will not lead to capital-market development, because "it's just not going to continue."

Third, in designing policy recommendations, one must keep in mind that reform does not always have to be about starting a new initiative. As one participant said, "governments are constantly under pressure to start on the next project, when they are often better served to concentrate on improving existing initiatives." And, as mentioned, recommendations should acknowledge that there is a distinction between creating domestic market institutions and providing market services to domestic market participants, and that policy makers have a choice there.

Last, policy recommendations must distinguish between "what is truly a constraint and what makes countries 'developing' or 'frontier' by definition." Participants agreed that policy ideas that do not explicitly account for the low income levels, the limited human capital, and the small economic size of most developing countries will be of little value to domestic policymakers.

Policy Research Questions

- What financial products would be most useful to the private sector in developing countries and how can the IFIs help expand access to those products? What is the right incentive structure?

- What is required to issue internationally recognized "safe assets"? Given small economic size and other problems, are there ways for countries to issue "safer" assets. What role can the IFIs play in these situations? Would it be possible, for example, for IFIs to create a "liquidity backstop" for developing countries that meet certain standards?

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Acknowledgments

The Milken Institute is grateful to all participants for their time and their insights during the roundtable, and we look forward to continued collaboration on these topics in the future. Thanks to John Schellhase for significant contributions to this summary paper and to Moutusi Sau for data compilation and research assistance.

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A working roundtable hosted by the Milken Institute Center for Financial Markets
March 14, 2014

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