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WHITHER LATIN AMERICAN CAPITAL MARKETS?

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Back in the early 1990s, economists and policymakers had high expectations about the prospects for domestic capital market development in emerging economies and, particularly, in Latin America. Unfortunately, they are now faced with disheartening results. Equity and corporate bond markets are illiquid and access to them is segmented in most Latin American countries. Debt is concentrated in the short end of the maturity spectrum and has tended to be denominated in foreign currency in many countries, exposing them to maturity and currency risks. Moreover, government debt is crowding out corporate bond markets. The state of domestic capital markets looks particularly poor when considering the many efforts already undertaken to improve the macroeconomic environment and to reform the institutions believed to foster capital market development. This disappointing performance has left policymakers without clear guidance on how to revise the reform agenda and many of them do not envision a bright future for domestic capital markets, particularly in the case of smaller countries.



tantly, the study analyzes not just domestic market activity, but also global capital markets trends, the participation of developing countries in those markets, and interactions and feedback loops between local and international markets.

Evolution and Globalization of Capital Markets

The world's financial landscape has undergone significant changes during the last three decades. Financial depth and diversity increased sharply in the largest developed economies, starting in the early 1970s and booming during the 1990s. Financial intermediation expanded at a remarkable rate and the spectrum of financial services and instruments reached new dimensions. These developments were accompanied by increasing financial integration across nations.

While securities markets in the developing world also grew, most of the acceleration in capital market development

and globalization over the past 25 years or so has been concentrated in global financial centers and developed economies. Emerging markets, however, were brought into these global trends, attracting part of the capital that became available in international markets and implementing reforms to foster their domestic capital markets, albeit with mixed success and substantial contrasts across regions.

“Whither Latin American Capital Markets?” a study published by the Latin America and Caribbean Region of the World Bank in June 2004, analyzes the status and prospects for capital market development in Latin America. It reviews the evolution of securities markets in the region and related reforms and the factors driving their development. Import-

Overall, the 1990s surge in capital flows was characterized by a change in the composition of flows to emerging economies: the share of official flows more than halved and private capital flows became the major source of capital, especially in the form of foreign direct investment resulting from mergers and acquisitions and privatizations. This was accompanied by the internationalization of financial services, as developing country issuers and investors began to access international financial intermediaries, foreign financial institutions established physical presences in emerging markets, and investors in developed countries sought higher returns and global diversification.

Developing countries tried to attract international capital in different ways: by liberalizing their financial systems; privatizing state-owned firms; and improving the climate for capital flows through macroeconomic stabilization and better business environments. In particular, they undertook a barrage of reforms to foster domestic securities markets development, including new legislation, new or refurbished securities and exchange commissions, enhanced regulatory and supervisory frameworks; and improved infrastructures for trading, custody, clearing, and settlement of securities. In parallel, many countries implemented comprehensive pension system reforms that were expected to boost the availability of finance for the private sector.

Main Developments in Domestic Capital Markets

As noted, capital markets boomed in the developed world, but the picture is more mixed across developing countries, with pronounced regional differences. Domestic capital markets in East Asia have developed relatively well, but markets in Latin America have lagged behind.

Domestic bond markets grew significantly since the mid-1990s. But whereas in East Asia corporate bonds were a central part of this story, in Latin America, public sector bonds dominated. Moreover, the share of dollar denominated, floating-rate, and shorter maturities was much higher in Latin bond markets than in East Asia. Efforts to develop the market for domestic currency denominated corporate bonds in Latin America yielded little success, although Chile, with a relatively large stock of CPI-indexed bonds is an exception, and recent developments in the corporate bond side (again Chile, but also Mexico and Colombia) provide hopeful signs. Nonetheless, even where local currency corporate bond markets have reached a non-trivial size, the issuance is completely dominated by a few, large, high-grade companies.

The performance of stock markets in Latin America has also been disappointing. While Latin stock market capitalization relative to GDP doubled over the last decade, it is still very modest compared to other regions. Average stock market capitalization was 28 percent of GDP in the largest countries in Latin America at the end of 2002, compared to 72 percent in G-7 countries and 95 percent in East Asia. This lackluster performance is matched by low trading and liquidity levels.

Another feature of stock markets in the region is the high concentration of both trading and capitalization in a few stocks. Moreover, Latin American stock markets have been affected by a growing number of de-listings, with large companies migrating to international stock exchanges.

In contrast to the relatively poor state of their local capital markets, large Latin American firms and governments have actively participated in international securities markets. This participation has been significant not only relative to GDP, but also relative to domestic stock and bond market activity. In fact, for several countries, trading, equity capital raising, and bond issuance in international markets are much higher than in domestic markets. Furthermore, the extent of internationalization of Latin American securities markets in most cases exceeds that of the developed economies and East Asian countries.

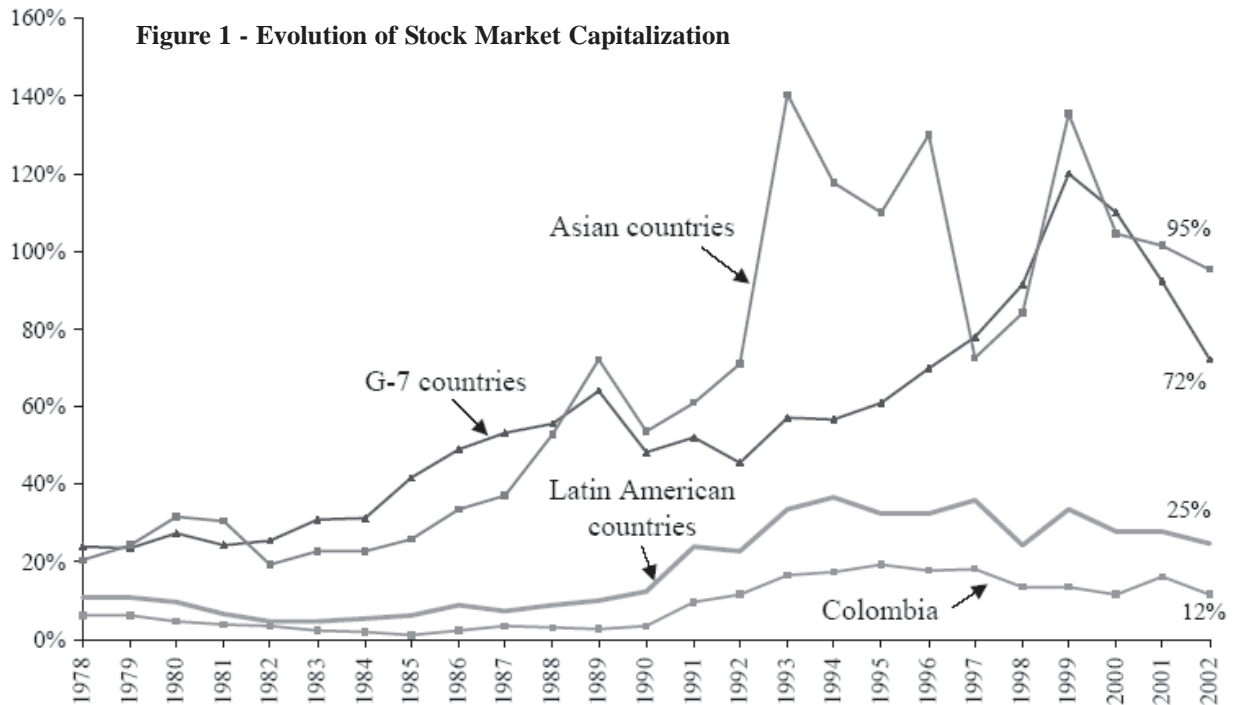
In all, the evolution of capital markets in Latin America in the last decade shows (see Figure 1) that the high expectations generated by the reforms have not been met. This is all the more troubling considering that the effort to reform capital markets in Latin America was as broad-based and intense, if not more, than in other regions, especially during the 1990s. Although local securities markets grew appreciably in Latin America, their growth pales in comparison to securities market growth in industrial and East Asian countries. A closer look reveals an even more disheartening picture. With a few exceptions (notably Chile), Latin American financial markets continue to be dominated by banks—with the added problem that the depth of bank credit to the private sector was, on average, stagnant throughout the 1990s in the region. Moreover, local markets for private securities (debt and equity) are rather illiquid, with private bond markets also tending to be highly dollarized and short-term. The contrast between the large number of policy initiatives and reforms and the lackluster performance of domestic capital markets raises basic questions, some of which the study tries to answer.

The Effects of Fundamentals and Reforms on Capital Market Development

The report analyzes the role of macroeconomic and institutional factors (e.g., monetary stability, overall economic development, economic size, rule of law) on the development of domestic capital markets and the participation of firms and governments in international financial markets. It also studies how capital markets have responded to the wide array of reforms that governments undertook during the past two decades.

The regression analysis of equity markets confirms that better macroeconomic and institutional fundamentals increase domestic stock market activity as well as participation in international markets (measured by the trading and issuance of emerging market securities in international financial centers). This result, which is mainly based on cross-country variations, is confirmed when the effects of reforms are tested

Percentage of GDP



over time, with emphasis on within-country effects. That is, reforms significantly influence local stock market development and its internationalization in the same direction as economic fundamentals. Perhaps more importantly, the study shows that both improved economic fundamentals and reforms accelerate the internationalization of stock markets proportionately more than the expansion of local stock market activity, and that these outcomes are not independent, as internationalization is found to adversely affect the liquidity of the local stock market.

Another key and robust finding is that Latin America is different in some important senses. Compared to other regions, Latin securities markets not only score poorly but also are significantly less developed (in terms of commonly used measures of size and liquidity) than predicted, controlling for per capita income, economic size, macroeconomic policies, and legal and institutional fundamentals. In addition, local capital markets in Latin America have responded much less favorably to reforms than markets in other regions. At the same time, stock market internationalization has been much greater than predicted in Latin America, controlling for the mentioned fundamentals, and much more responsive than expected to the introduction of reforms. In effect, in terms of internationalization of stock trading and issuance, Latin America is an extreme case, but it is not alone, as similar trends can be observed in Eastern Europe and even in the smaller Western European countries. The contrast with East Asia—where local stock market development has been well in excess of its internationalization—is, however, striking. The reasons behind these contrasts across regions is a key subject for future research.

Whither the Reform Agenda?

The shortfall in the development of Latin American local securities markets relative to initial expectations, despite the intense reform effort, raises the question of how to proceed with the capital market reform agenda.

There are at least two major views on what might explain the gap between expectations and outcomes in Latin America, each carrying their own prescriptions for what to do next. One view argues that the needed reforms are basically well known, that there is nothing wrong with them, and that the problem is with their implementation. This view ascribes the gap to impatience and imperfect and incomplete reform efforts, recommending that market discipline be given time to work, while forging ahead with further implementation, especially of second generation reforms. The other view claims that the problem lies with faulty reform sequencing, particularly with the fact that financial market liberalization and opening proceeded too soon and too fast. This view emphasizes the need to achieve a minimum institutional strength and development of local currency debt markets before fully embracing financial globalization. Each view captures important aspects of the problem, yielding considerable insights, but neither fully addresses some of the questions posed by the evidence.

The report offers a third, complementary view that is much less prescriptive. It contends that there are important deficiencies with respect to the expectations and design of past reforms, related to the failure to take appropriate account of the implications of certain basic issues. This third view

emphasizes the need to step back and reconsider basic issues with a fresh look, as a prior step to ensure more solid ground for reformulating the reform agenda.

The discussion of the different views and the analysis of basic issues invite eclecticism: a savvy reformer would combine elements from the three views, as appropriate to country circumstances. Key to designing country-specific reforms would be a determination of whether the country in question can realistically meet the size thresholds to sustain a liquid domestic secondary market for private sector securities. For countries that do, the suitable reform package would be easier to formulate, partly because developed capital markets experience would be more relevant. Reform expectations would still need to be significantly reshaped, however, particularly to accommodate the implications of financial globalization. Avoiding financial globalization is neither realistic nor desirable in the long run, not least because integration induces reform.

Elaborating suitable reform packages for securities markets in smaller countries is more daunting. Much more thought and analysis is needed to sketch a suitable “light” version of a domestic securities market for small countries, one that is not “over-engineered”, that does not need to rest on substantial liquidity, and that is complementary to international financial integration (rather than focusing on creating a “mini Wall Street” at home). Related issues and challenges also arise regarding the segmentation of access to capital markets proper, which systematically favors large firms, irrespective of country size. Moreover, the reform agenda for capital markets needs to be couched within a broader vision of financial development for emerging markets. Such a broader vision would emphasize access to high-quality and diverse financial services, regardless of whether they are provided at home or abroad, by securities markets or by other financial intermediaries.

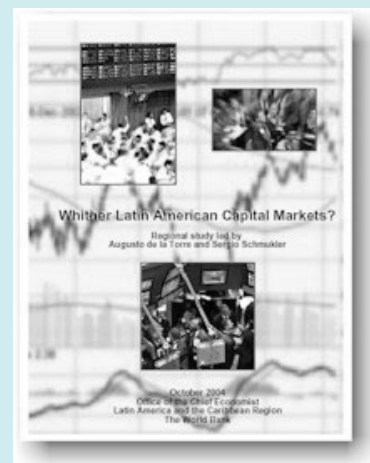
About the Authors

The source document for this piece (see right) was led by Augusto de la Torre and Sergio Schmukler. Norbert Fiess, Juan Carlos Gozzi Valdes, and Marina Halac are the leading authors of Chapters 2 and 3. Jurgen Janssens and Laonor Coutinho also participated in Chapters 2 and 3.

Many authors participated in writing the background papers. The peer reviewers of the project were Arturo Galindo (IDB), Thomas Glaessner, and Anjali Kumar.

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The goal of this study is to understand the state of securities markets in Latin America and discuss issues for the reform agenda. The study first describes the evolution of capital markets and capital market reforms in Latin America, over time and relative to other countries. Second, it analyzes the factors driving the development of capital markets, with particular interest on measuring the impact of reforms. Third, it discusses the question of whether and how to recast the capital markets reform agenda going forward. The study consists of a main report, divided into four chapters, a series of background papers, and presentations of the work-in-progress in various international forums (see below for all these documents).



This regional study was led by Augusto de la Torre and Sergio Schmukler.

Background papers available:

Accessing International Equity Markets, by Claessens, Klingebiel, and Schmukler

Corporate Governance in Latin America, by Capaul

Government Bonds in Domestic and Foreign Currency, by Claessens, Klingebiel, and Schmukler

Migration, Spillovers, and Trade Diversion: The Impact of Internationalization on Domestic Stock Market Activity, by Levine and Schmukler

Housekeeping and Plumbing: The Investability of Emerging Markets, by Ladekarl and Zervos

Stock Market Development and Internationalization: Do Economic Fundamentals Spur Both Similarly?, Claessens, Klingebiel, Schmukler

The Transaction Costs of Primary Market Issuance: The Case of Brazil, Chile, and Mexico, by Zervos

Why Do Emerging Economies Borrow Short Term?, by Broner, Lorenzoni and Schmukler

<http://www.worldbank.org/laceconomist>