Towards Strong and Stable Capital Markets in Emerging Market Economies

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Abstract

This paper identifies and discusses the conditions needed for achieving strong and stable capital markets in emerging market economies, which at present remain illiquid and underdeveloped. These conditions can be grouped into four pillars: macroeconomic stability, sound banking systems, high institutional quality, and an adequate regulatory and supervisory framework. A central message is that these pillars are interdependent: failure to strengthen any of these pillars will weaken the others; all pillars are complementary and equally important. The paper also emphasizes that the inability of emerging markets to issue safe assets imposes a major constraint on the resilience of their local capital markets to external shocks.

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I. Introduction

The benefits of deep capital markets in emerging market economies are well known. In addition to supporting efficient allocation of resources by complementing banks' financial intermediation role, they can increase economic agents' capacity to manage financial risks and their resilience in the face of unexpected shocks. Moreover, deep capital markets foster firms' financial integrity through market discipline and the need to comply with internationally accepted standards on accounting practices, transparency and governance, among others. In spite of these benefits, however, capital markets in most emerging economies remain thin and underdeveloped. Developing these markets is not an easy task, as it involves a large number of players and institutions, as well as complex building blocks, to ensure the efficiency and safety of their operations.

This paper focuses on the necessary conditions for the development of strong and stable capital markets in emerging market economies. The paper argues that such conditions can be grouped into four pillars: *macroeconomic stability*, *sound banking systems*, *high institutional quality* and an *adequate regulatory and supervisory framework*. The main message of the paper is that the four pillars are interrelated and complementary: the eruption of fragilities in any one of them weakens the effectiveness of the others. This implies that all four pillars are equally important. A section presenting several examples supports this claim. The paper ends with a reflection about a long-term constraint to the resilience of emerging economies' local capital markets to external shocks: these countries' limitations with regard to issuing *safe assets*.

II. The Four Pillars for Capital Markets Development

The first pillar: sustained macroeconomic stability

It is amply acknowledged that capital markets cannot develop in unstable economies. Indeed, in a large number of economic/financial crisis episodes in emerging market economies, capital market activity contracted dramatically and, in some cases, practically disappeared. Macroeconomic weaknesses are reflected in asset prices and, if serious enough, can result in the drying-up of a number of asset markets. The Latin American debt crisis of the 1980s is a good example. More recently, the Argentinean on-going macroeconomic difficulties—first originated in the crisis of 2001-- have severely impacted the depth and liquidity of that country's local capital markets.

While volatility of financial variables, such as interest rates and exchange rates, encourages the development of a number of financial products, a problem emerges when the volatility of these variables is so large that it creates uncertainty about the *direction of the rules of the game*. For example, excessively high and volatile real interest rates are perceived by investors as unsustainable and, therefore, induce uncertainty about possible changes in the rules of the game, such as government interventions to modify the exchange rate *regime* or to impose new forms of taxation and controls. In turn, this uncertainty reduces incentives to invest in local capital markets, since it adversely affects the expected profitability of long-term projects.

Moreover, significant macroeconomic instability, reflected in excessive asset price volatility, generates incentives to use derivatives for speculative, rather than hedging, purposes.

The problem of excessive volatility is particularly important for institutional investors, especially pension funds. Managers of well-run pension funds would not be interested in maintaining in their portfolios a significant proportion of assets with highly volatile prices, since these assets are associated with a higher probability of default.

Finally, macroeconomic stability is the foundation for sustainable economic growth and, therefore, for increases in private saving ratios.[1] This, in turn, raises the potential domestic demand for capital market instruments.

Sound banking systems: the second pillar for the development of capital markets

In spite of its central importance, this is perhaps the least understood pillar of capital market development in emerging market economies. In particular, there are some misconceptions regarding the capacity of local corporate bond markets to substitute for bank lending to meet firms' financing needs in periods of financial stress. My view is that *deep capital markets and sound banking systems are complements, and cannot be substitutes*. At times of banking difficulties, when credit contracts sharply, capital markets, including corporate bond markets, will most likely also shrink significantly.

There are a number of reasons explaining the complementarity between sound banking systems and deep capital markets:

First, sound banks provide the sources of liquidity needed by capital markets. For example, broker-dealers play an active role in dynamic capital markets by trading securities for their own account, or on behalf of their customers. To undertake their activities, brokers hold securities in inventories, which at times may be quite large. These inventories are financed through banks' credit lines. Therefore, if banks' credit dries up following financial disturbances, the provision of liquidity needed for the adequate functioning of capital markets would be disrupted.

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[1] While the debate regarding the causality relationship between savings and growth is still open, most experts favor a causality running from economic growth to savings. A seminal paper in this area is Carroll and Weil (1994).

Second, consider the development of local corporate bond markets. In a nascent market, in order for investors to trust their long-term funds to local bond issuers, they need to be confident that these borrowers are already able to meet the repayment standards established by sound banks and their supervisors. In other words, because it is the business of sound banks to assess borrowers' repayment capabilities by, for example, adequate monitoring of their cash flows, firms' credit performance sends a signal to potential investors interested in bonds issued by these companies. If, however, the banking system is not strong, this signal is worthless.

Third, during the process of capital market development, bank deposits are an important investment option for institutional investors, such as incipient private pension funds. This would not be a sensible choice in the context of a highly fragile banking system.

Fourth, after cash, bank deposits are the most liquid assets in many emerging market and developing economies. Thus, given their high liquidity, bank deposits can provide an *exit* option to investors interested in *entering* into local capital markets, where riskier and less liquid assets are traded.

It is interesting to note that the complementarity between sound banking systems and deep capital markets has implications for banking regulation. The need for strong banks in order to develop capital markets underlines the desirability to implement adequate banking regulations and supervisory practices. This includes the adoption (and, when necessary, adaptation to local conditions) of capital requirement recommendations advanced by the Basel Committee on Banking Supervision (BCBS). In turn, deep capital markets can guide banking supervisors to assess the *true* value of reported capital. This is particularly important under the new BCBS capital recommendations, given the emphasis on common equity as a central component of Tier 1 capital.[2]

The third pillar: a solid institutional framework

Evidence shows that robust institutions complement the role of regulations aimed to promote capital market development (see below). Indeed, *regulations cannot be effective if they lack the support of a solid institutional framework that protects the rights of investors and creditors*. In equity markets, this means shareholders' voting rights to exert control over boards. In bond markets, bondholders have the right to claim their collateral in case of firms' failures.

A strong institutional framework that protects investors' and creditors' rights includes adequate mechanisms to enforce contracts and the rule of law.[3] In turn, this requires: (i) a capable and independent judicial system, free of political pressures; (ii) legal processes that support the prompt implementation of regulations; (iii) transparency in government policies;

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[2] See, Basel Committee on Banking Supervision (2011)

[3] In particular, weak contract enforcement increases counterparty risk of default and limits participation in bond markets.

and (iv) an adequate bankruptcy law. Unfortunately, the quality of institutions in most emerging markets lags significantly that of advanced economies.

To the extent that creditors' rights are inappropriate, lack transparency or are not credible, investors, domestic and foreign, will be discouraged from investing in local corporate liabilities. As stated in the *Doing Business* report by the World Bank, South Asia, the Middle East and North Africa, and Latin America are the regions that have undertaken the least number of reforms to make it easier to resolve firms' insolvencies. Not surprisingly, capital markets in these regions remain thin and underdeveloped.

Adequate regulation and supervision: the fourth pillar of capital market development

There is significant consensus in a number of areas defining what constitutes adequate regulation for efficient and sound capital markets (but there are also controversial issues – see below). A first area of consensus is that capital market regulations should enhance and complement the role of market discipline, to minimise systemic risks, ensure competition and efficiency of markets, and protect investors. The challenge is for the regulatory framework to generate the right incentives among market players to achieve these goals. These are precisely the main objectives of the International Organization of Securities Commission's (IOSCO) principles. Some of the key IOSCO principles call for: (i) comprehensive enforcement powers and independence of regulators and supervisors (from political pressures); (ii) the implementation of information-sharing mechanisms that would allow regulators to share relevant information with their domestic and foreign counterparts on a timely basis; (iii) the requirement for transparency of information by securities issuers and institutional investors; (iv) the absence of discrimination among classes of investors, including minority stockholders and foreign investors; (v) the establishment of minimum capital requirements and other prudential regulations for financial intermediaries in accordance with the risks they take; and (vi) adequate supervisory oversight for hedge funds and their managers.

There is also a consensus that the foundation for an effective regulatory framework lies in the development and strengthening of appropriate corporate governance. Although advanced economies are by no means free from corporate governance deficiencies (as demonstrated by events during the recent global financial crisis), this problem is widespread among emerging market economies, and difficulties at the firm level quickly turn into a systemic problem. Broadly speaking, the provision and transparency of information is at the core of the recommendations for adequate corporate governance, especially when dealing with the responsibilities of members of boards of directors. That is why some of the key OECD principles to guide regulatory improvements in this area include recommendations for the dissemination of key corporate information, such as financial statements, property and governance structure. Explicit responsibilities for members of boards of directors are also part of these recommendations.

A third area of consensus is the need to improve regulations and supervision of derivatives contracts. On the regulatory side, there is agreement on the implementation of the Financial Stability Board's recommendations to improve the safety and transparency of OTC derivatives markets, by promoting standardisation of OTC derivatives contracts, central clearing of standardised derivative products, and increased trading on exchanges or electronic platforms. Evidence from the global financial crisis supports this recommendation. During that period, many OTC derivatives markets in emerging economies dried up, but exchange-traded products proved more resilient.

But improved regulations are insufficient without accompanying enhancements in oversight of derivatives contracts. The examples of Brazil and Mexico during the global financial crisis are cases in point. On expectations of continuous appreciation of their local currencies, during the pre-crisis period some corporations in these countries expanded their off-balance sheet foreign exchange exposures through derivatives contracts arranged with international banks (selling foreign exchange options in the offshore market). The sharp currency depreciation observed in Brazil and Mexico after the collapse of Lehman Brothers resulted in huge derivatives losses (around $4 billion in Mexico and over $20 billion in Brazil).[4] To a large extent, these developments surprised local authorities, who since then have strengthened their supervisory practices.[5]

A discussion on the regulation of derivatives begs the question: should the development of derivative products *at the local level* be promoted in all emerging markets? As is well known, derivatives require the existence of a liquid market in their underlying products, but they also enhance the liquidity and price discovery in those underlying markets. However, derivatives themselves raise other forms of risks, and dealing with these risks requires additional infrastructure (such as adequate settlement systems for derivatives exchanges) and adequate capabilities to understand more complex risks (such as accounting practices for derivatives products on and off banks' balance sheets). Also, as the examples above illustrate, although derivatives markets are not the cause of financial crises, some derivative products can play an amplifier role in the presence of vulnerabilities in the financial system and/or the macro-economy. These considerations imply that the promotion of derivatives markets in emerging markets should depend on the degree of readiness of a country's institutions and players. In my view, in addition to the pillars for developing capital markets discussed above, pre-conditions for promoting derivative products include: (i) strong capacities for risk management, both by regulators and supervisors and by the private sector; and (ii) adequate

[4] For more details, see Jara et al (2009)

[5] International coordination among supervisors and harmonization of derivatives market regulations are essential if efforts by regulators from emerging markets are to yield the expected results. For example, Mexican regulators are concerned that the implementation of strict rules governing derivatives trading in Mexico might push local transactions to the United States, where regulators are not yet applying clearing requirements to peso-denominated interest rate swaps (so far, US regulators have put in place clearing rules for interest rate swaps in only four currencies: the US dollar, pound sterling, yen and euro, which account for the large majority of transactions).

technical capacity to monitor the linkages and risk transmission mechanisms across market segments. *Adequate surveillance systems and technical expertise to understand and oversee the transmission of risks across market segments are a major challenge in a large number of emerging markets and developing economies.* Technical cooperation from multilateral organisations, as well as bilateral arrangements with supervisory authorities from advanced economies is greatly needed in this area.

In spite of international consensus on many issues concerning regulatory practices for developing capital markets, there is still controversy with regard to a significant number of topics. For example: Should the government introduce or promote some form of indexation in order to foster the development of local currency bonds? Should regulation create incentives for the *local* offering of *all* types of capital market products and institutions? Moreover, should there be tax incentives for promoting investments in local capital markets? And what is the most appropriate structure of regulatory agencies? Should there be a single regulatory and supervisory agency overseeing banking and capital markets institutions? Or would *specialised* agencies be more effective? Or, should regulatory agencies specialise in *functions* rather than institutions? These and other questions await further debate and analysis.

III. The Four Pillars are Interdependent: Some Examples

As mentioned in the introduction, a central point advanced in this paper is that none of the pillars *on its own* is sufficient to do the job of promoting capital markets development: the four pillars are interdependent and complementary. While an adequate regulatory/supervisory framework is essential, it would most likely fall short of expectations in the presence of fragilities in the other three pillars. To be more precise, regulations, even if appropriately designed (pillar 4) lose their effectiveness if there are weaknesses in any of the three other pillars of capital market development. For example, regulations cannot create incentives for investors to place their funds in local capital markets in the context of a highly unstable economy (pillar 1). Likewise, regulations cannot be credible if the institutions that determine their implementation are weak (pillar 3). Finally, no capital market regulation can ensure the availability of liquidity provided by sound banks (pillar 2).

The following three specific examples illustrate the interdependence of the pillars.

First, consider the implementation of an appropriate bankruptcy law; an essential regulatory requirement for the development of corporate bond markets (pillar 4). *In countries with economic instabilities* (pillar 1)*, weak judicial systems* (pillar 3) *and/or fragile banking systems* (pillar 2)*,* even the most comprehensive and up-to-date bankruptcy law will not allow for the orderly restructuring of a firm in distress, nor a change in management that can enable the firm to continue operating as a going concern. Instead, in many emerging market and developing economies, when a company is facing severe financial difficulties creditors' preferred option is to liquidate the firm, even at fire sale prices, and distribute the proceeds, often under the advice of external auditors. The reason for this choice is that creditors assign a very low probability to the recovery of their investment, even in the long run, be it because they do not trust the macroeconomic management of the country or the rulings of the courts, or because they fear a sudden change in the institutional *rules of the game*. That is, failure to strengthen the four pillars presented here can result in an abrupt liquidation of firms in distress, without an adequate assessment of the present value of the firms' assets.

Second, consider the need to develop a benchmark yield curve for government bonds, for the purpose of developing liquid corporate bond markets (since it supports price discovery). The experiences of some Asian countries, like Korea and Malaysia, back up this recommendation. Once more, however, the linkages between the pillars for developing sound capital markets need to be taken into account. The strategy of implementing rules and regulations for developing a government yield curve (pillar 4) seems highly appropriate for countries with strong fiscal accounts, like most of the East Asian economies, (pillar 1). In contrast, in countries experiencing fiscal problems, this strategy might be the source of two forms of risks. The first is that, by reflecting a country's high credit risk associated with large fiscal deficits, the resulting high yields on government bonds will translate into high yields on corporate bonds. That is, the danger is that increased government risk will be reflected in the prices of private sector liabilities. The second risk is that governments facing fiscal difficulties will be unable to successfully place long-maturity bonds and that government issuances will instead remain at the shorter end of the curve. This would constrain, rather than support, the development of long-term corporate bonds. A third risk is that, lacking a market to place long-term bonds, governments in fiscal trouble will implement policies to induce banks and institutional investors, especially pension funds, to purchase the bonds. This would reduce the soundness of both banks and capital markets (pillar 2). If investors' perceptions of a government's credit risk were to deteriorate, so would the quality of assets held by local banks and pension funds.

Third, there is no general agreement among policymakers about the desirability of allowing pension fund investments in foreign securities. Policymakers' concerns in some emerging markets are understandable. For instance, liberalising the investment rules of private pension funds (pillar 4) in countries that have not reached macro stability (pillar 1) and financial soundness (pillar 2) might exacerbate capital outflows if an adverse shock hit the economy. In my view, the sequence of liberalisation of pension fund investments followed by Chile is recommended. In that country, controls on investments in foreign securities were gradually lifted as the economic, regulatory and institutional environments gained strength.

IV. An important constraint limiting the resilience of capital markets in emerging economies to external shocks

I cannot end this paper without stressing the importance of a long-term constraint to capital markets' resilience that affects *all* emerging market economies: these countries' inability to issue internationally recognised *safe assets*. Even if all the pillars discussed here are in place, in the presence of large uncertainties in international capital markets, investors (foreign and local) will attempt to flee to what they consider to be *safe assets;* namely, assets that maintain their liquidity in bad times. In the current international financial architecture, there are only few *safe assets* and, besides gold and silver, they are all government securities issued by countries that also issue *hard currencies* (highly liquid, internationally traded currencies). Currently, US Treasuries can be said to be the most liquid securities in the world. The experience during the global financial crisis showed that equity and bond instruments in emerging markets lost liquidity and prices collapsed. When deep external shocks occur, corporates will find themselves with fewer and more expensive sources of funding *even if local capital markets appeared to be highly liquid before the shock*.[6, 7]

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[6] The experience of Israel during the global financial crisis is a case in point. The corporate bond market practically dried up for about six months following the eruption of the crisis: new issuance stopped, and the number of firms entering debt restructuring proceedings increased significantly. For more details, see OECD (2011).

[7] While pension funds can potentially provide a stable source of local funding, in the presence of an adverse external shock capital market losses would be transferred to savers if local pension funds were not allowed to invest in foreign safe assets.