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Developing a strategy for reform of capital markets in Latin America and the Caribbean

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Capital market reform

In the last decade, increasing attention has been directed at the role that capital markets play in stimulating or supporting economic development. During this time many countries have adopted policies aimed at creating domestic capital markets to realize some of these specific benefits. Domestic capital markets direct national savings to productive assets while attracting foreign funds and investors. This process provides access to capital at lower cost and facilitates the growth of companies and the economy as a whole. Also, capital markets could be more advantageous than other sources of financing (such as bank financing), as it provides companies with alternative funding mechanisms to support rapid growth relative to those that depend solely on internal sources of funds.

Capital markets have other functions. They reduce the dependence on bank financing, particularly during a credit crunch; provide a more "democratic" access to capital and financial support to innovators and entrepreneurs; and reduce contagion risk based on problems within one firm or industry that could spread to the overall economy. Equity and debt markets, in particular, also serve to enhance corporate governance through increased monitoring of management performance, reduction of agency cost, and increase in the efficiency of investments and management decisions.

On the demand side, as investors are provided with viable alternatives for investment, a saving incentive is created, which has other macroeconomic impacts relating to currency stability. Also, through the development of specific instruments, capital markets facilitate risk management and portfolio diversification.

The focus on domestic capital market development in emerging countries can be divided into two generations. In the first generation, the focus was on creating a good foundation for market activity. Thus, the main preoccupation was the introduction of an appropriate legal and regulatory framework for the operation of stock and debt markets. During the first stage, attention was directed at the delicate balance between creating a legal/regulatory environment that stimulates capital market activity on one hand and emphasizes safety, discipline and soundness on the other. Another component of the first generation of reforms was the development of market institutions to expand trading. Some of the visible elements of this first phase include the enactment of capital markets regulation, introduction of trading mechanisms, creation of a securities regulatory body, and emphasis on investor education.

The second generation of reforms for capital market development has adopted a different focus. It presumes that the foundation has been laid or is well underway, and that the focus has shifted to increasing market activity and liquidity, broadening investor participation, and expanding the types of instruments traded. The elements of the second-generation reform are also driven by vast development in technology and increasing investor sophistication.

This article explores the impact of these second-generation reforms on the development of capital markets in Latin America and the Caribbean and presents some of the critical ingredients required to develop a strategy to increase capital market activity in emerging countries. The next section examines the decline of local capital markets in Latin America and the Caribbean, and the factors that prompted it. The final section provides the elements of a strategy to promote the development of capital markets.

Capital markets in Latin America and the Caribbean

In reviewing the development of domestic capital markets in Latin America during the last decade, it is necessary to first review the macroeconomic situation during that same period. With some exceptions, during the last decade, sound macroeconomic policies, market liberalization and the privatization of state enterprises have restored economic growth in Latin American and Caribbean countries. However, the improving macroeconomic situation has not always been reflected in the region's capital markets, which have been marked by numerous market crises, weaknesses and volatility.

Decline in local capital markets

There is evidence of an improving macroeconomic climate in Latin America and the Caribbean. Net equity investments in the largest Latin American countries increased from USD7.3bn in 1989 to over USD77bn in 1999. During the same period, external borrowing increased from USD417bn to USD76bn, but it declined as a percentage both of GDP and of exports of goods and service compared to 1989. Public sector borrowing has declined from 40 percent to 4 percent, reflecting the impact of privatization on fiscal policy. However, the countries in the region still rely on external financing to sustain growth. The structural current account deficit (almost USD48bn in 1999 with the same gap expected for 2000) is nearly exclusively financed through direct investments with only a small portion of the financing stemming from portfolio investment. Also, savings in 1998 represented 17 percent of GDP compared with 34 percent in Asia.

Relative to other countries, domestic capital markets in Latin America and the Caribbean are underdeveloped with respect to market depth, quality and ability to attract domestic and external resources. Box 1 presents comparisons of trade activity between selected countries in Latin America and countries with more advanced capital markets. Most recently these problems have tended to worsen rather than improve.

The decline of local markets in Latin America has been caused by a number of factors. The cost of operating in the stock markets (measured by fee levels, time for liquidation, etc.) is proportionately far higher in Latin America and the Caribbean than in other regions. The region's stock exchanges do not penalize large companies that are able to raise funds abroad. However, small and medium-sized start-up companies, which

BOX 1

The statistics on Latin American stock exchanges present a picture of steady decline. Over the last ten years, the number of listed companies on Brazil's São Paulo Stock Exchange declined by about 18 percent from 581 to 478. Argentina's stock exchange has experienced an even greater decline, falling by 30 percent from 179 to 129 listings. In the period 1995-99, the average daily volume on the Argentina Bolsa went from USD652m to USD17m.

Comparing the capitalization of the stock market as a percentage of GDP, we find that, on average, stock market capitalization in Latin America is about 25 percent of GDP. In the United States that percentage is almost 200 percent, while it is well above 60 percent in Europe. Liquidity, measured as turnover of the capital of companies listed over GDP, is about ten percent in the major Latin American exchanges, over 200 percent in USA, around 70 percent in Europe as a whole, and more than 130 percent in Spain.

generate new employment, are not able to obtain any financing. Even when money is available locally, taking a company public in Latin America is often not considered to be worth the effort, because local exchanges lack the capital, the liquidity and the risk-tolerant investors (especially for "new economy", or Internet companies, which do not become profitable for several years). These factors have also led a growing number of Latin American blue chip firms to de-list their shares on local stock exchanges.

During the 1990s these shortcomings were largely offset by international portfolio investments. Fund managers in developed countries invested heavily in emerging countries (through equities, bonds and project finance) based on expectations that economic growth (and market returns) in those economies would exceed growth in the United States and Europe. Furthermore, it was hoped that international portfolio investments would provide diversification due to the low cross-correlation. Unfortunately, those expectations have not been realized. The US stock market outperformed other markets over the period 1987-1999, as has the US bond market.

Factors affecting market development

There are several factors that explain the performance of capital markets in Latin America. Within the past decade there have been severe financial crises in emerging economies (most notably, the devaluations of the Mexican peso in 1995, the Thai baht in 1997, and the Brazilian crisis of 1998) that have highlighted the risks of investing in emerging markets. Also, the expectations of low correlation in investing internationally do not fully apply for many securities in emerging countries. These two factors have made investors very wary of investing in international, and particularly in emerging capital markets.

The demand for securities from emerging markets is dependent on the stage of development of the market infrastructure, particularly the legal and regulatory framework and the level of transparency under which listing firms operate. In Latin America, the securities that have successfully attracted international investors have been characterized by international activity, application of international standards in accounting and auditing, and simultaneous listings in the United States or Europe. The reality, though, is that only a few Latin American companies, typically in the telecommunication and media sectors, are able to reach that level and are truly integrated and capable of raising resources through ADRs and GDRs.

Under these circumstances, the recently created "Comisiones de Valores" (Securities and Exchange Commissions) are financially strapped because their revenues depend on stock market activity that has been steadily declining. This phenomenon erodes the commissions' independence and threatens their long-term survival.

Another contributor to the state of capital markets in Latin America and the Caribbean has been the impact of privatizations and mergers and acquisitions during the 1990s. In the telecommunications sector in particular the trend has been the acquisition of Latin companies by foreign firms such as AES, Telefónica, Repsol, Endesa, and BSCH. These acquisitions have led to the removal of local companies from national exchanges, as listings were consolidated with those of the parent companies in exchanges outside of Latin America. A similar process of consolidation has swept through the banking sector in Latin America, but with a more limited impact on the development of local capital markets. Many of the acquiring firms are based outside of Latin America and the Caribbean and bank consolidation across Latin American countries is very limited. Although Latin America and the Caribbean economies have grown during the last decade, investors have not been directed toward the region's capital markets. Investors need good liquidity and shareholder protection. They also evaluate a company on its own merits, the liquidity of its stock and the environment in which the stock is traded. This implies that fund managers view favorably those emerging companies that apply international financial standards in their statements and represent global growth companies in well-identified sectors.

BOX 2: Impact of the Internet on capital market activities in Latin America

Recently, the Internet and Initial Public Offering (IPOs) have become part of the Latin American landscape. The following are some noteworthy examples.

- Starmedia, one of the most successful Latin American Internet companies, raised USD330m in two public offerings on Wall Street. Its shares, listed in the Nasdaq, initially sold at USD5 and traded for as much as USD60, though they have recently lost much of their value as a result of a generalized cooling of the Internet sector. Starmedia is not listed on any exchange in Latin America.
- El Sitio, an Internet portal and service provider based in Buenos Aires, also raised millions of dollars through an IPO on Nasdaq.
- Yupi Internet Inc., another portal company, raised start-up money in the United States with the goal of serving Latin American countries. It intended to sell shares to the public in the United States, not in Latin America.
- Ibolsa, an Internet company, sells and buys shares over the Internet. Its costumer is the Latin American community living in the USA. Ibolsa represents a vehicle through which Latin American investors can finance North American companies. Ibolsa is under the jurisdiction of the US SEC and is also listed on Nasdaq.

Furthermore, the emerging market stocks that fund managers consider are from those companies that are fully integrated into the global economy, which receive attention and investments regardless of the fact that they are emerging market companies. Investors are attracted to securities with the best returns, the easiest access, and the highest quality in terms of standards and services (i.e., corporate governance, disclosure, and market regulation). For similar reasons, local companies do not regard their capital markets as the answer to their funding needs because of high cost of capital, short tenure, adversity to risk and lack of liquidity. Issuers go where they get the lowest cost of capital, which is tied to investors' demand.

Structural changes are occurring and some Latin American governments are taking encouraging steps toward building a solid financial system and stronger capital markets. Despite the shortcomings indicated previously, capital market flows have assumed an increasingly important role compared to international bank flows. These kinds of financial flows, primarily in the form of international bonds, portfolio equity and direct investments, quadrupled during the last decade, reaching around USD70bn in 2000. This shift reflects the diversification of banks into financial services and the increased role institutional and multinational investors play. For the change to be sustainable, however, local capital markets will need to become even more attractive to these kinds of investments. Ideally, domestic markets must also be seen as one of the most effective ways of protection against market turbulence and contagion.

Although we have established the relevance of capital markets during the last decade, current circumstances raise several critical questions: What should be the role of the public sector in market development? What is an appropriate sequence leading to capital market development? What areas should be targeted as crucial second-generation reforms? While the private sector plays a pivotal role in the development of capital markets, in this difficult environment Latin American governments must take bold and unequivocal steps to ensure that local markets can survive. The next section addresses some of these issues.

A strategy to promote the development of capital markets in Latin America and the Caribbean

As suggested at the outset, second generation reforms for capital markets assume that the foundation and fundamentals for capital market activity are in place. The goal of these reforms is to create mechanisms to increase market activity, liquidity, broaden market participation and increase the variety of instruments traded. We propose that a suitable capital market strategy should include three basic structural pillars: (1) an enhanced regulatory framework; (2) modernization of market institutions and actors; and (3) supporting regional efforts and activities.

Enhanced regulatory framework

For many countries in the region it is necessary to restructure the regulatory framework to ensure market viability. The legal regulatory structures currently in place seek to increase security and investor protection, and, to a lesser extent, to encourage internal competition between market institutions. A new focus is necessary to support external competition and also ensure that the regulatory framework meets international standards. The regulatory framework should address three important and related issues: (1) reliable legal and judicial system, (2) good corporate governance, and (3) transparency and disclosure. It is widely recognized that a reliable legal and judicial system is essential to the development of a sustainable capital market, as it encourages appropriate market incentives and allows equitable and reasonably affordable access to the enforcement of legal remedies for dispute mechanism. Good corporate governance ensures the protection of the rights of shareholders (particularly minority shareholders), equitable treatment of shareholders and stakeholders' participation in decisions relating to management compensation, mergers and acquisitions, dividend policy and other significant corporate actions. Good governance also emphasizes the role boards of directors are expected to play, ensuring they are selected fairly and autonomously, acquire training commensurate with their responsibilities, and are sufficiently motivated to create value for shareholders. A key area for reform is also the principles and practices for transparency and disclosure that allow comparability in relation to international best practices, which would also set the foundation for regional integration and harmonization.

An approach to reform could include the utilization of the International Organization of Securities Commissions' (IOSCO) Principles for Securities Regulation. These principles, developed through global consensus, are essential to ensure that international standards for market activity are maintained. The Principles have specific applications and guidelines for all the market actors, from regulators and enforcement agencies to markets participants. Regulatory reform should also seek to create an environment that encourages the participation of new potential issuers of securities. The Association of the Securities and Exchange Commissions of the Americas (COSRA) is encouraging its members to adopt the IOSCO's core principles for securities supervision, international accounting standards issued by the newly revamped International Accounting Standards Board (IASB), and the corporate governance principles of the Organization for Economic Corporation and Development (OECD).

As indicated earlier, a key problem many domestic capital markets face is the need to increase market liquidity. In this regard, regulations that focus on improving liquidity should be designed to ensure: (1) increased efficiency for securities trading; (2) a greater role for organized markets and the concentration of operations in those markets; (3) fostering internal markets in relation to external ones and, also, allowing remote members free entry to markets; (4) establishing a strong market maker; and, (5) instituting a comprehensive market perspective that includes sub-markets that currently exist in each country. It is also crucial to eliminate dispersed regulations (established with other goals) that can hamper market competitiveness. With respect to the activity of the regulator, improving market competitiveness depends on the quality of regulation and, above all, on the enforcement capacity. International institutional investors consider enforcement one of the main elements when deciding where to invest.

There is encouraging evidence that Latin American countries are moving towards regulatory regimes for their markets that meet the standards of foreign investors. Brazil is at the forefront in defining and implementing a strategy for local capital market development and is acting on several fronts. The "Commissión de Valores Mobiliares" (CVM) wants to make it difficult for controlling shareholders to coerce minority shareholders into selling their stakes in public tender offers. By increasing the minimum level of approval for such decisions (from 50 percent to 67 percent), CVM is signaling that Brazil intends to protect shareholders' rights and evolve into a modern financial centre.

The legislation to that effect is now in Congress. The Government is taking action to shape the local government bond market and increase its liquidity, lengthen the tenor of corporate issuers. The accounting profession is also taking decisive steps towards introducing accounting and auditing standards aligned to international best practices. Brazil is also working on the other end of capital market development: the access of small and medium size companies to capital market. The Sao Paulo Stock Exchange (Bovespa) has launched the "Novo Mercado", a trading environment which is intended to attract companies with the highest standards and hungry for capital (e.g. technology companies like Microsiga Software constitute one of the target of "Novo Mercado"). A similar initiative is underway for Chile.

The government of Mexico has proposed legislation for allowing swift action on insider trading and greater protection for minority shareholders based on the assumption that greater shareholder's protection could double market capitalization and attract five time the companies currently listed. At the same time, the local bond market is being revitalized. Chile is also expected to increase dramatically corporate issuance of Inflation Indexed Units. Another encouraging sign is the growing amount of funds managed by institutional investors, mostly pension funds, (e.g., USD28bn in Argentina, USD15bn in Mexico). Brazil, which has not yet privatized its social security system, holds mutual fund assets beyond USD15bn; Chilean institutional investors and insurance companies hold beyond USD4bn . These funds, presently mostly invested in Government bonds, are seeking diversified investment opportunities within the local markets.

The situation for the smaller countries in the region is very different where the focus is on increasing cross-border intra-regional activity. Countries in the sub-regions of Central America and the Caribbean have launched regional capital market development programs, which include collaboration on market infrastructure, coordination of the legal regulatory framework for trading and market activity, and cross-listing agreements. More work is needed in this arena along the lines described in the section on regional integration below.

Broadening the role of market institutions

To increase market competitiveness, there should be a focus on enhancing primary market and secondary market institutions. For the primary market, a main requirement is the need for good transparency and disclosure. Efforts should be made to implement standards that subscribe to international best practice and allow for wider dissemination among the public. It is also important to explore other types of instruments that could be introduced in the marketplace using venture funds, securitization, and products that help small and medium enterprises gain access to capital markets.

For secondary market activity, market institutions must play a central role in increasing liquidity. In an ideal regulatory framework, with the "holding" structure or the equivalent tailored to the country's needs, market institutions should act as "champions of the security industry". But these institutions must also graduate from being merely "the meeting point of supply and demand" to being "the meeting point of potential demand and supply." This can be achieved through (1) their transformation into "venture capital leaders," (2) the creation of virtual meeting points between possible suppliers and demanders, and (3) massive education of investors.

Market institutions include private sector members, but they perform very important public sector goals. They can play a central role in advancing the reforms to enhance liquidity, as has been the case in several European countries. Isolated interventions by the public sector are neither meaningful nor sustainable —market innovation has to come from within the markets themselves. Market institutions are the only ones, as intermediary associations, able to combine interests that have the necessary amount of leverage and are able to sustain a competitive drive. They boost the integration processes without which it is very difficult to find the critical mass needed for the survival of these markets. Hence, public sector support for organized markets should never be seen as a subsidy for a private project, but as a measure that intends to provide the financial systems of the region with a relevant development instrument.

Simultaneously, market institutions have to ensure wide access for broker-dealers by providing incentives for their activities while ensuring that self-regulating structures are created to monitoring these activities. However, the present situation is far from perfect, as in many cases there are important structural deficits (particularly in small, concentrated markets) that lead to development of fragmented markets and "club-structures". These structures reduce market integrity and hinder market competitiveness. The trend in many countries is toward the creation of "holdings" that bring markets together, as well as clearance and settlement agencies to avoid insufficient internal competition mentioned above. These "holdings" also allow markets to dispose of redundant structures by sharing systems and professional management.

It is also essential that market institutions offer instruments that meet the needs of investors. Institutional investors are still the dominant investors in many emerging economies. These investors demand instruments that offer good quality with respect to risk, sufficient liquidity, appropriate tenure and good returns. This is a daunting task for many domestic markets, as they cannot compete with the international products offered to institutional investors. However, with increasing innovation and commitment to develop products such as pooled instruments, project financing vehicles, bonds (government, municipal, asset-backed and corporate), it should eventually be possible to attract more institutional investors to Latin America's domestic markets. Brazil and Mexico have been making efforts to build and lengthen government bond yield curves, for example.

The next challenge is to create liquid secondary markets and develop corporate debt. Given the increasing importance of small and medium enterprises to economic activity, efforts must be directed to support their growth and development by creating suitable market structures to help small and medium enterprises to access capital. Some of these developments could include programs for specific types of IPOs for these entities, specialized trading facilities (similar to the Nuovo Mercato of Italy and Neuer Markt of Germany), and government supported finance programs.

Regional capital market integration

Regional integration is a crosscutting issue that is critical for development of many sectors in Latin America and the Caribbean. Given the lack of depth and critical mass in most of the capital markets in Latin American and the Caribbean, regional capital market integration is an important policy consideration. Generally, discussions on this issue focus on the importance of common "trading" systems. While this is an important dimension of the issue, it can sideline more critical issues that have greater implementation potential. These include:

- Trading systems that could operate in the different interested markets. The market members, "remote" members, would have access only to their respective market, but with the possibility of seeing the activity of each and every one of the markets that are part of that single trading system;
- Media systems in which the agencies (Reuters, Bloomberg, etc) spread the information about various markets jointly, in the different currencies;
- "Routing orders" that would allow crossing connections; and,
- Clearance and settlement procedures that would also allow accounts to cross borders.

A capital markets integration strategy based on these elements could facilitate increased liquidity without the need to: (1) harmonize the different individual legal systems; (2) consolidate the relevant regulatory frameworks and agencies; and, (3) create a single currency and a unified monetary policy. In such a setting, the market actors are responsible for boosting the performance in the different markets. Over time, this structure could motivate market members to progressively increase the degree of co-operation and integration. On the more optimistic agenda of creating a unified market, it is necessary to develop a more holistic process that gives consideration to macroeconomic and fiscal concerns, financial sector policy, and cross-border issues. In developing this executable strategy, it is necessary to address specific consideration relating to the benefits of integration, the region or regions to which the strategy should apply, the barriers to integration, and the methods to remove them.

Conclusion

Although emerging economies have implemented programs and policies to foster development of capital markets over the last decade, the evidence demonstrates that many of the markets are still very fragile and lack depth and liquidity. The article examines some of the issues that can explain the current situation and suggests a strategy to more fully develop capital markets in the emerging Latin American and Caribbean economies. The article supports an approach that encourages increased market activity and liquidity while, at the same, advancing a second generation of legal and regulatory reforms. These reforms should emphasize the adoption of internationally accepted accounting standards, developing good corporate governance, and increasing transparency and disclosure.

The article also points out that the roots of the encouraging movements towards capital market development, undertaken by the largest countries of the region, are driven by governments' recognition that local capital market development constitutes a public good and needs to be pursued. Political will constitutes the crucial ingredient for success.

Implicit in the strategy is the potential role for international financial institutions (IFIs) to support the development of capital markets in Latin America and the Caribbean. These institutions can foster and facilitate the articulation of a vision of the role of capital markets as an appropriate component of public policy. Once the political consensus within each country is reached, and the role of capital markets clarified, further support could be directed to the development of the regulatory environment described above. At the same time, IFIs can provide support to the goal of moving towards regional capital market integration and the initiatives that seek to harmonize practices in sub-regions.

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