

# Local Capital Market Development The Latin American Experience

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## **2006 CENTRAL BANKING SEMINAR**

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Office of the Chief Economist  
Latin America & the Caribbean Region  
The World Bank

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# Structure of Presentation

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- ✚ Latin American capital markets have underperformed
- ✚ Is underperformance due to weak fundamentals and lack of reform or to wrong reform sequencing?
- ✚ Back to basics
  - ✚ Financial globalization
  - ✚ Size
  - ✚ Segmentation of access
- ✚ Conclusion: salient challenges for the reform agenda and some recent promising developments

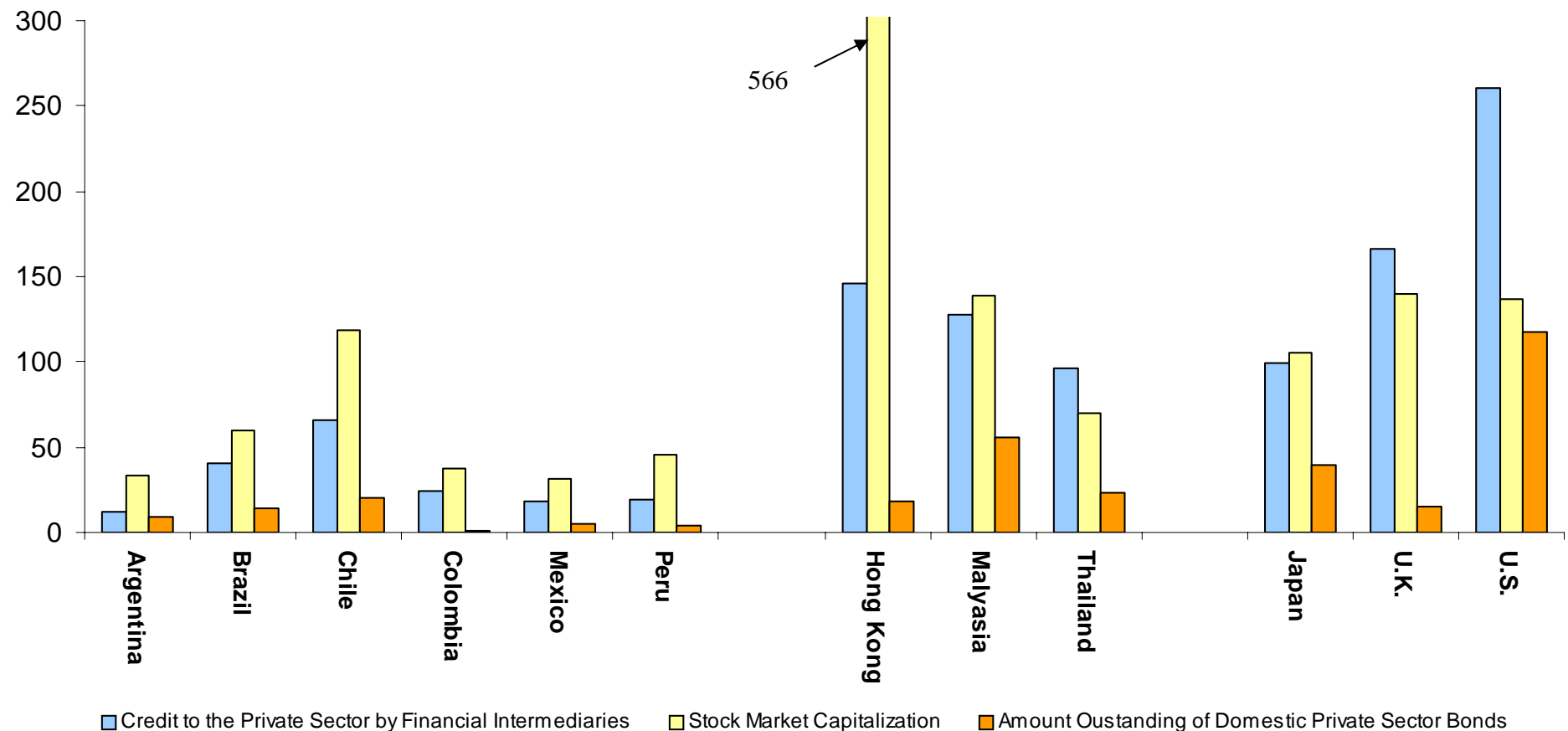
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# Latin Financial Systems Have Underperformed

# Latin Financial Systems are Small and Underdeveloped

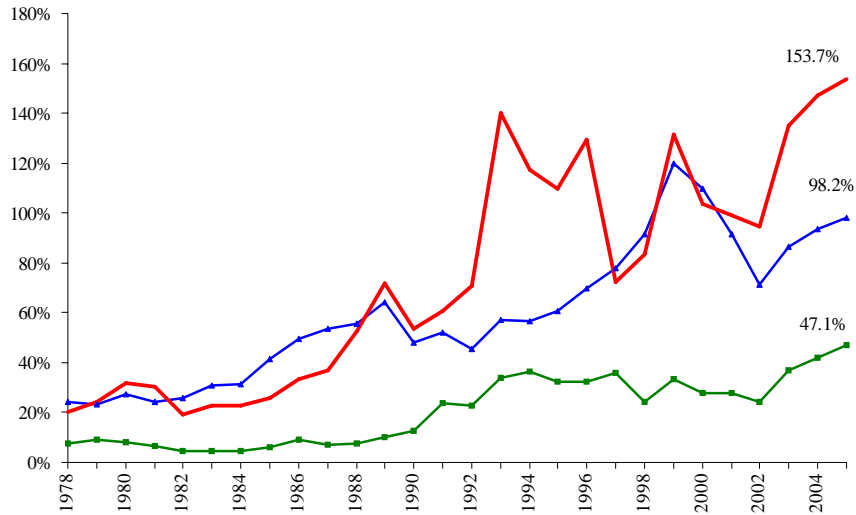
## Financial Sector Size Across Countries

Percent of GDP, 2005

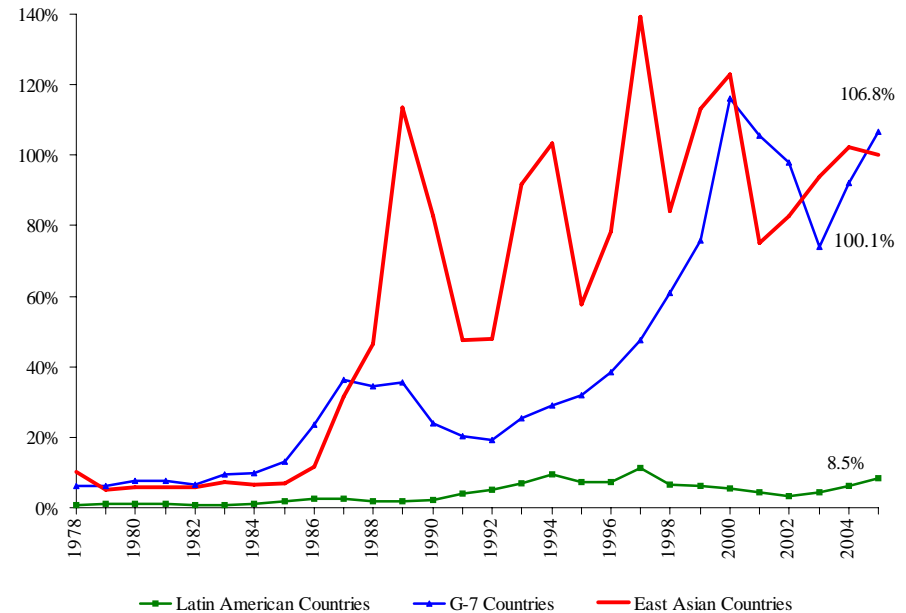


# Latin Stock Markets Are Not Converging

Market Capitalization / GDP



Value Traded Domestically / GDP

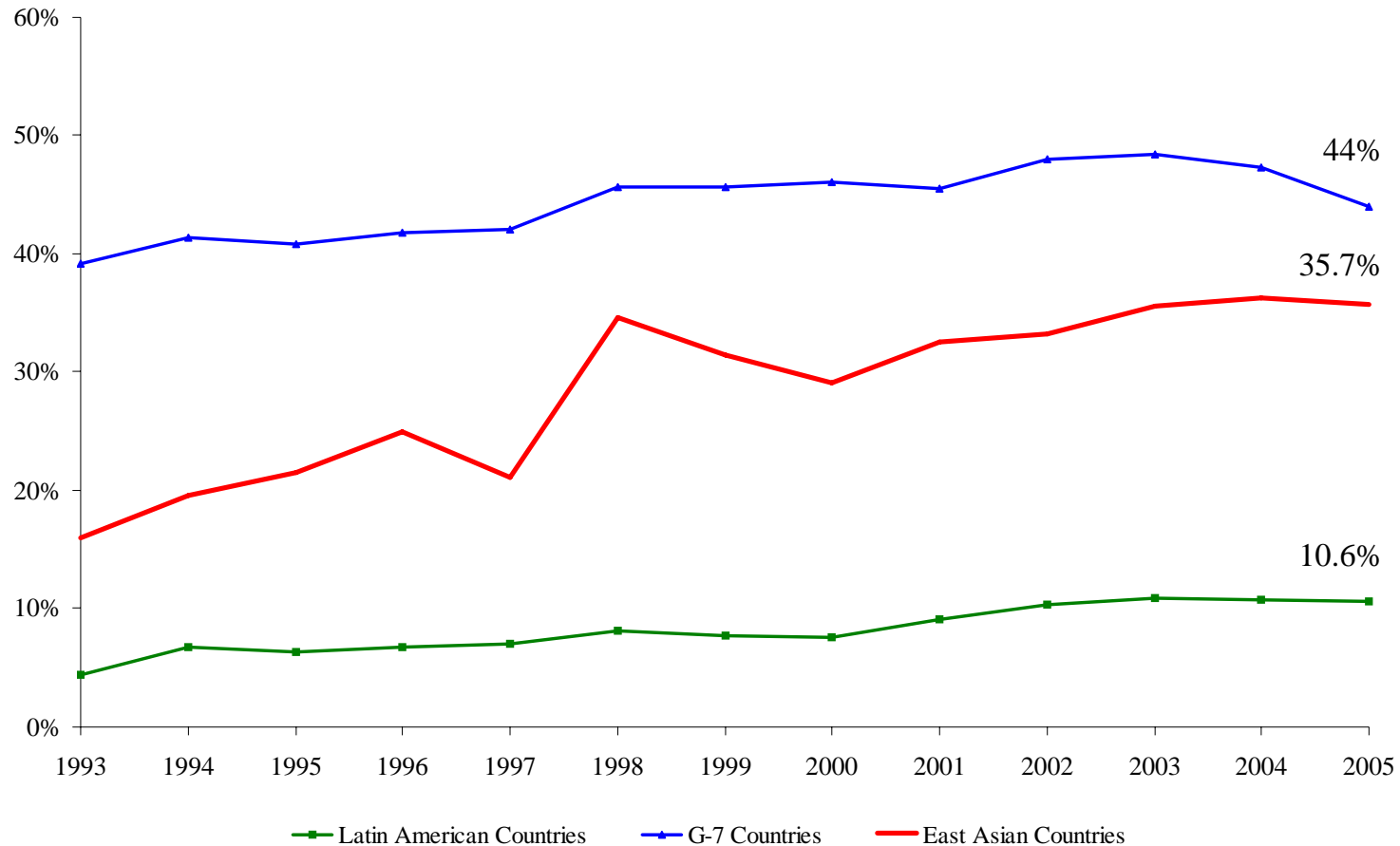


Source: Whither Latin American Capital Markets?, 2004.

# Corporate Bond Markets Also Trailing Behind

## Domestic Private Sector Bonds Outstanding

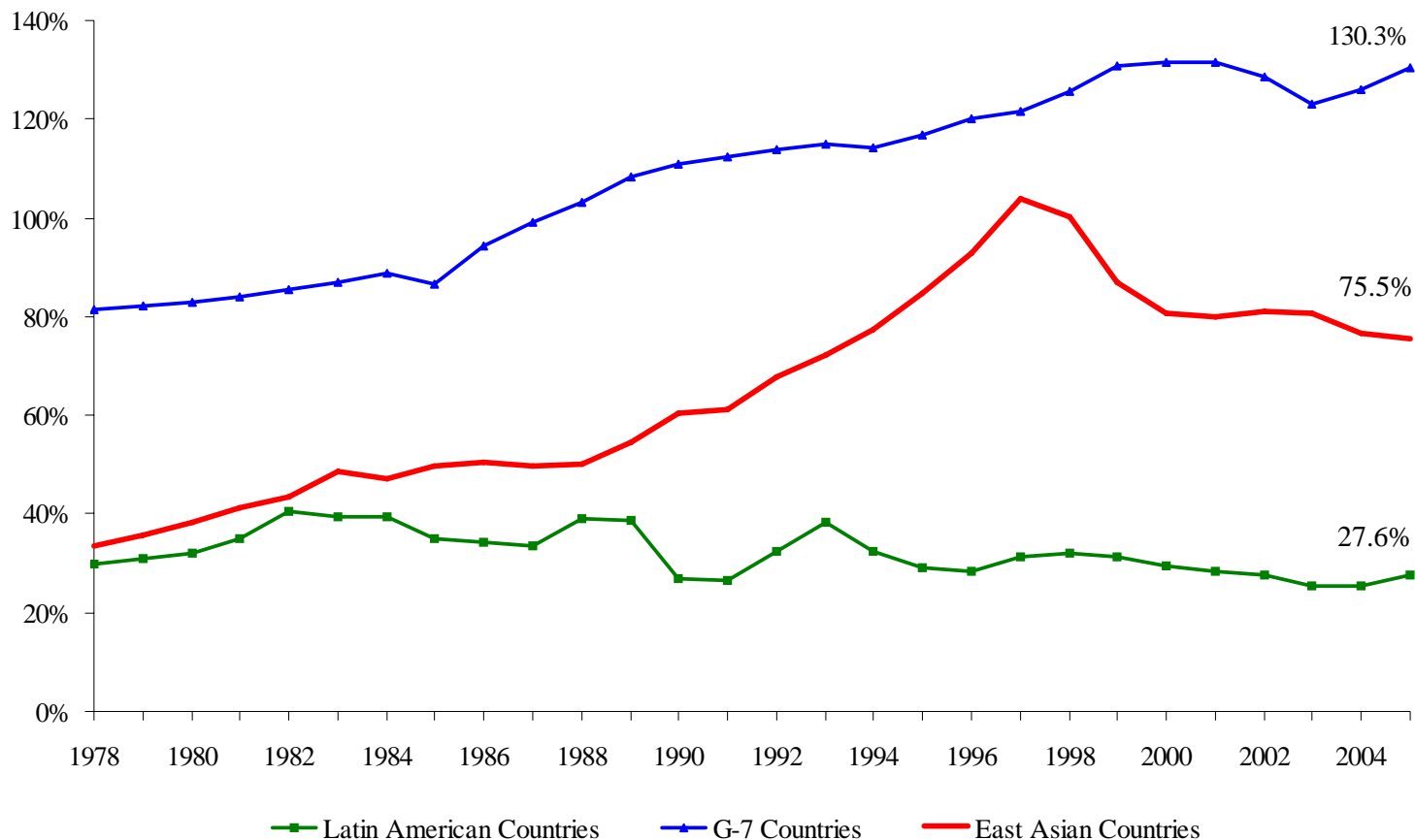
Percent of GDP



# Bank Credit Has Not Compensated

## Credit to the Private Sector by Deposit-Taking Institutions

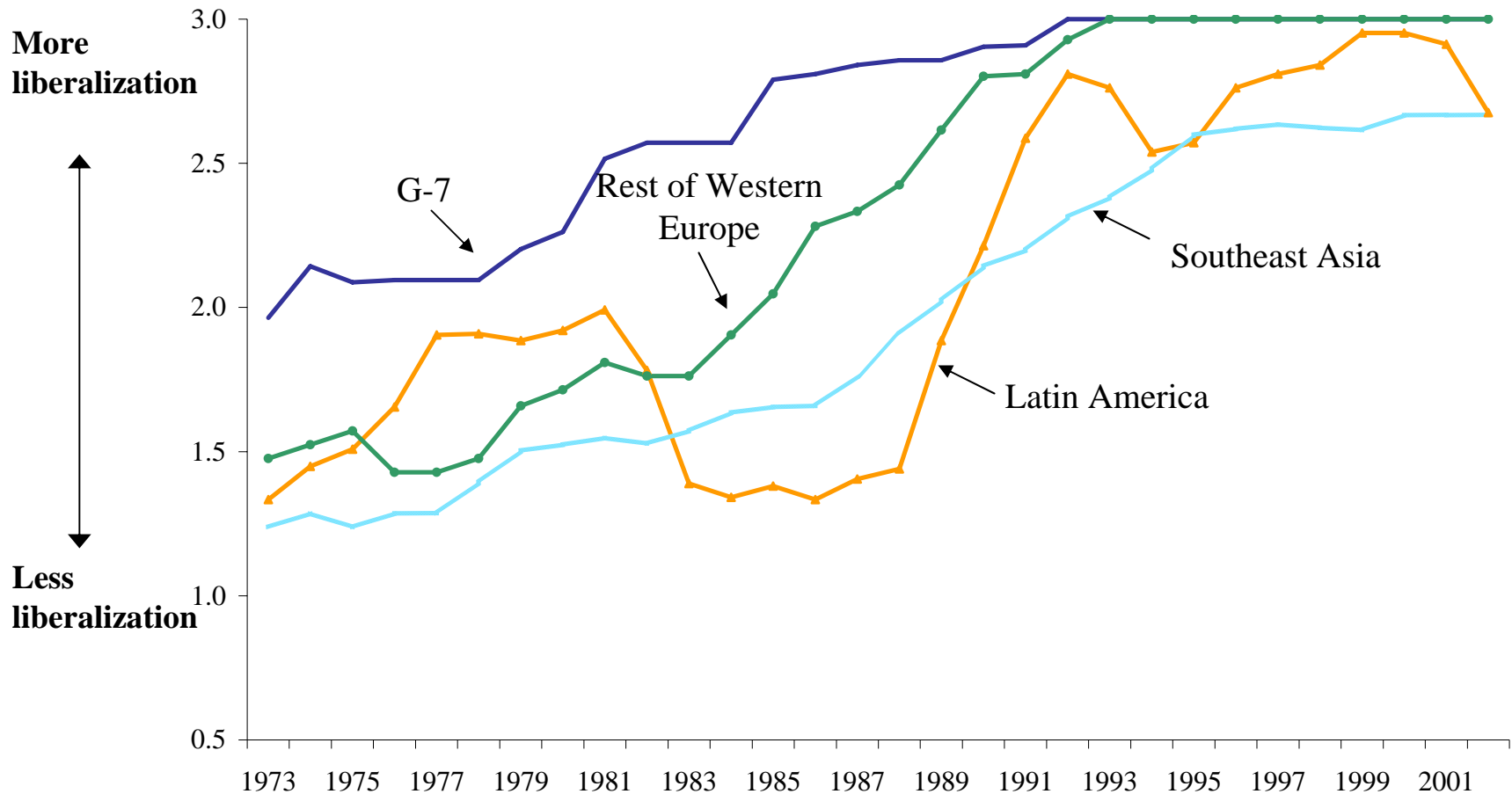
Percent of GDP



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Is Underperformance Due to  
Weak Fundamentals and Lack of Reform or  
Wrong Sequencing?

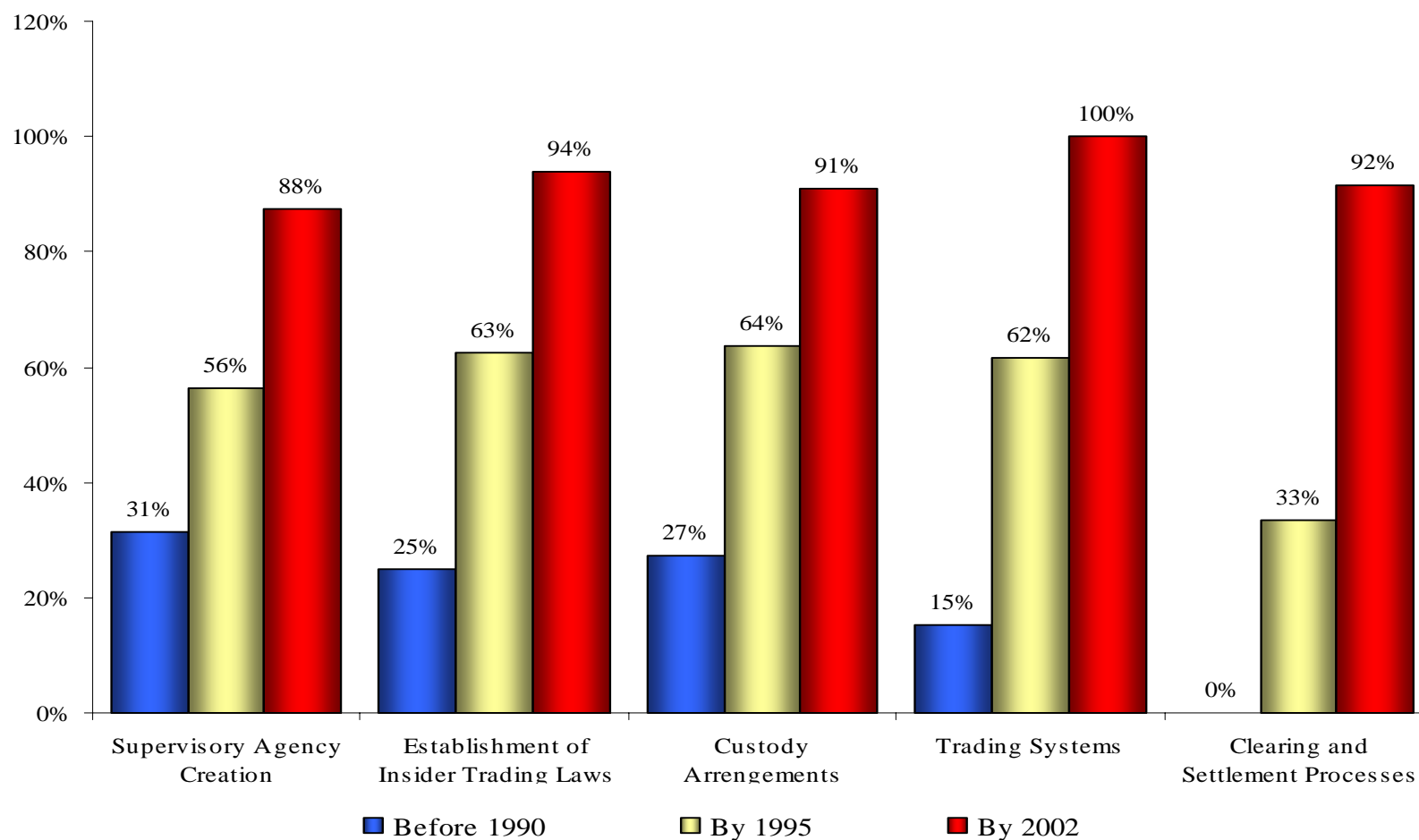
# Latin America – Aggressive in Financial Liberalization



The liberalization index is calculated as the simple average of three indices (liberalization of the capital account, domestic financial sector, and stock market) that range between 1 and 3, where 1 means no liberalization and 3 means full liberalization. These data are then aggregated as the simple average between countries of each region.

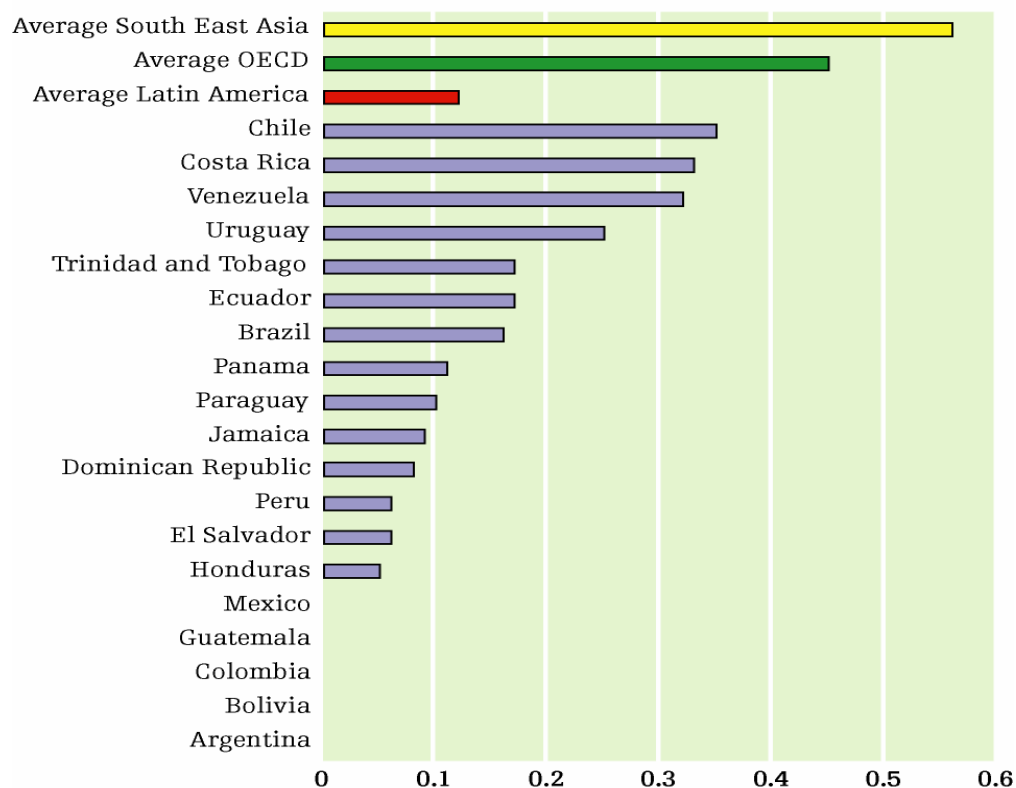
# LatAm – Intense Capital Mkts Reform Effort in the 90s

Percentage of Latin American Countries Having Implemented Reforms



# But Latin Contractual Environment Remains Weak

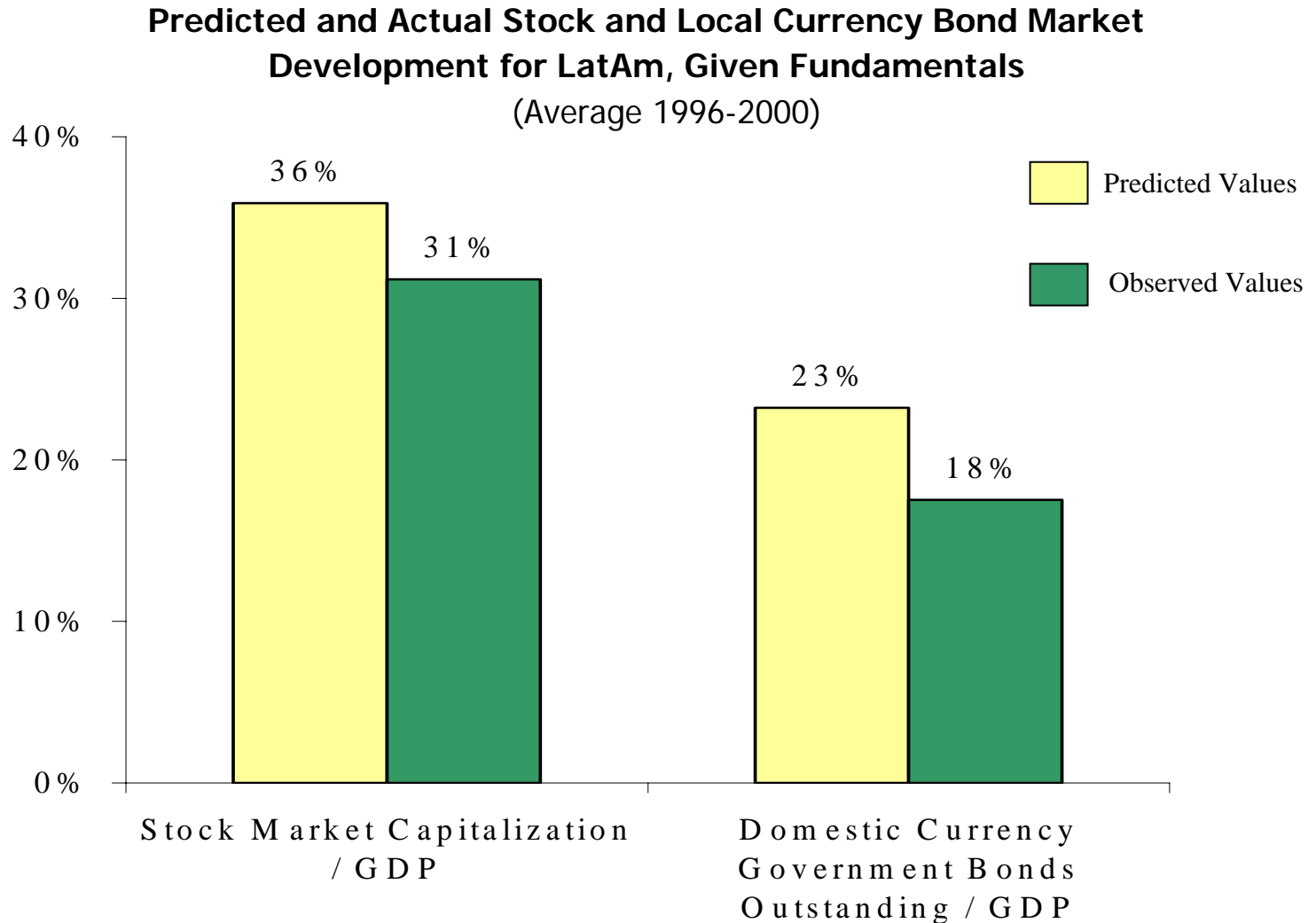
**FIGURE 2.6** Effective Creditor Rights  
(Index, 0-1)



*Note:* The effective creditor rights index measures legal protection for creditors and the degree of law enforcement. The index ranges from 0 to 1. Higher values measure greater creditor protection.

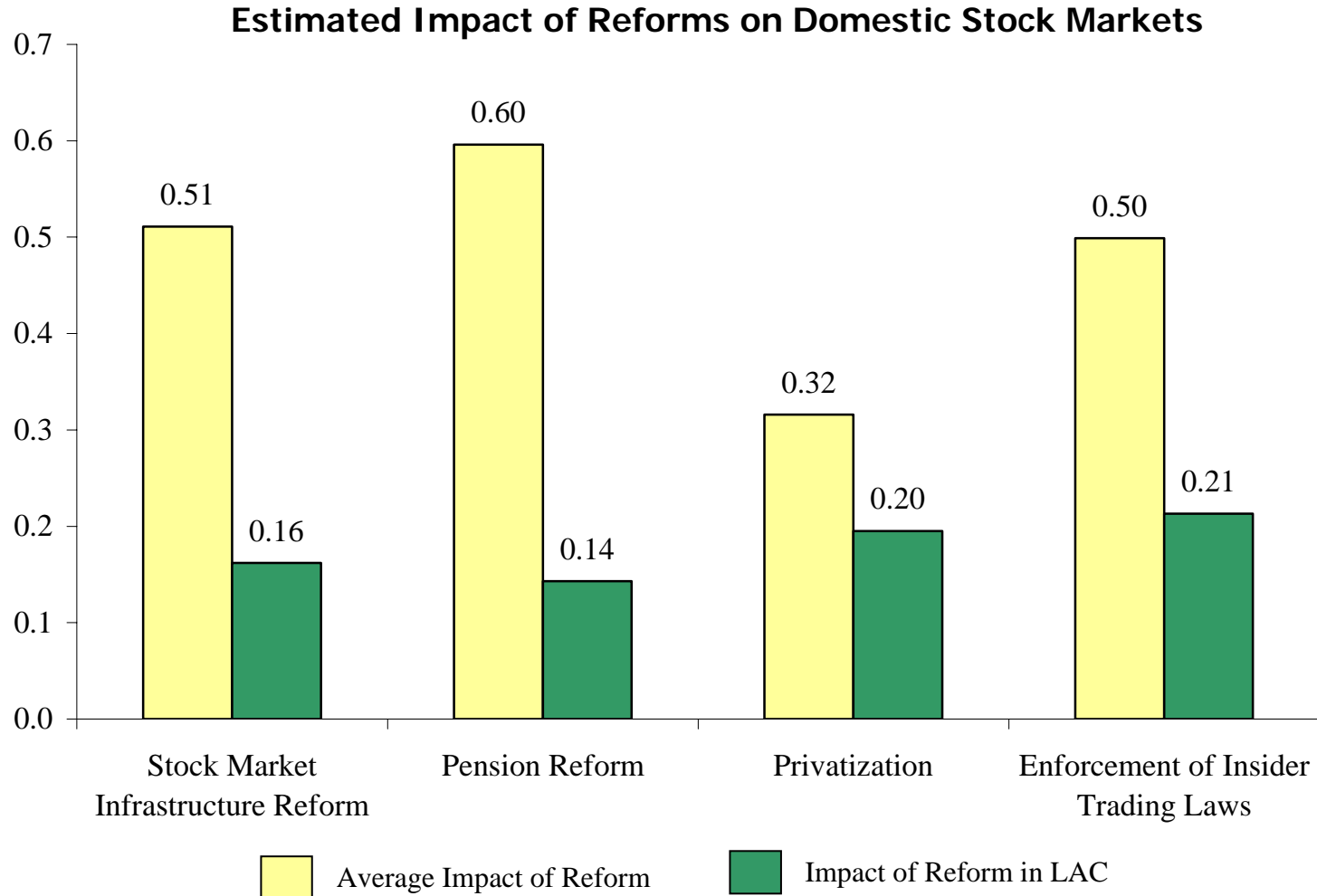
*Source:* La Porta and others (1998); World Bank (2003); Chapter 12 of this Report.

# Latin “Shortfall” in Local Markets, Given Fundamentals



# “Shortfall” in Reform Impact on Latin Local Stock Mkts

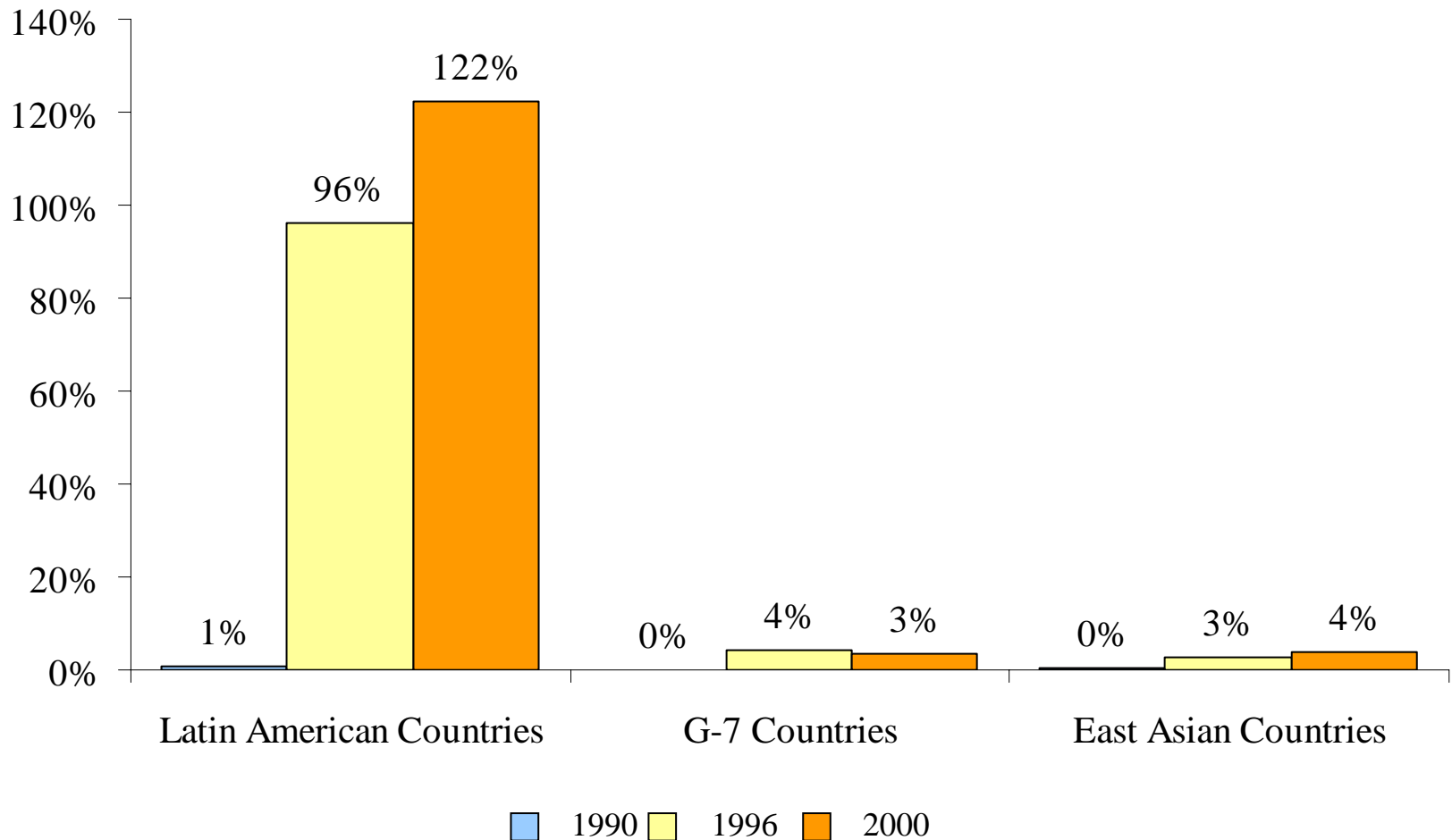
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# Latin "Excess" in Stock Market Internationalization

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## Ratio of Value Traded Abroad to Value Traded Domestically



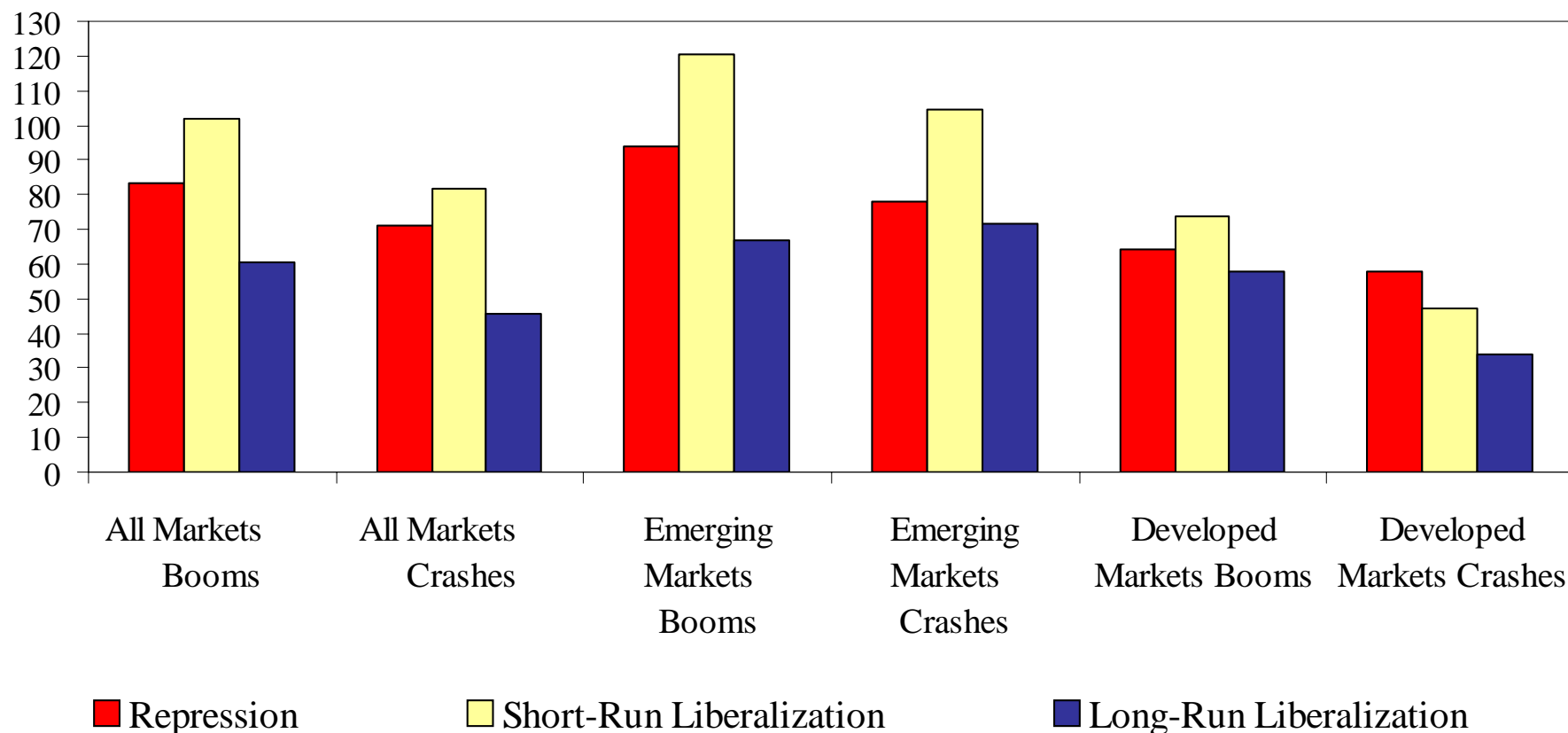
# Reform Sequencing Can Make a Difference

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- ✚ Premature domestic financial market liberalization
  - ✚ Liberalization before institutional & regulatory strengthening...
  - ✚ ... can magnify boom-bust cycles?
- ✚ Premature international financial integration
  - ✚ Integration before development of local currency debt markets...
  - ✚ ... can accentuate currency mismatches and systemic vulnerability?

# Liberalization Has Raised Instability in SR, Not in LR...

## Boom-Bust Cycles and Financial Liberalization

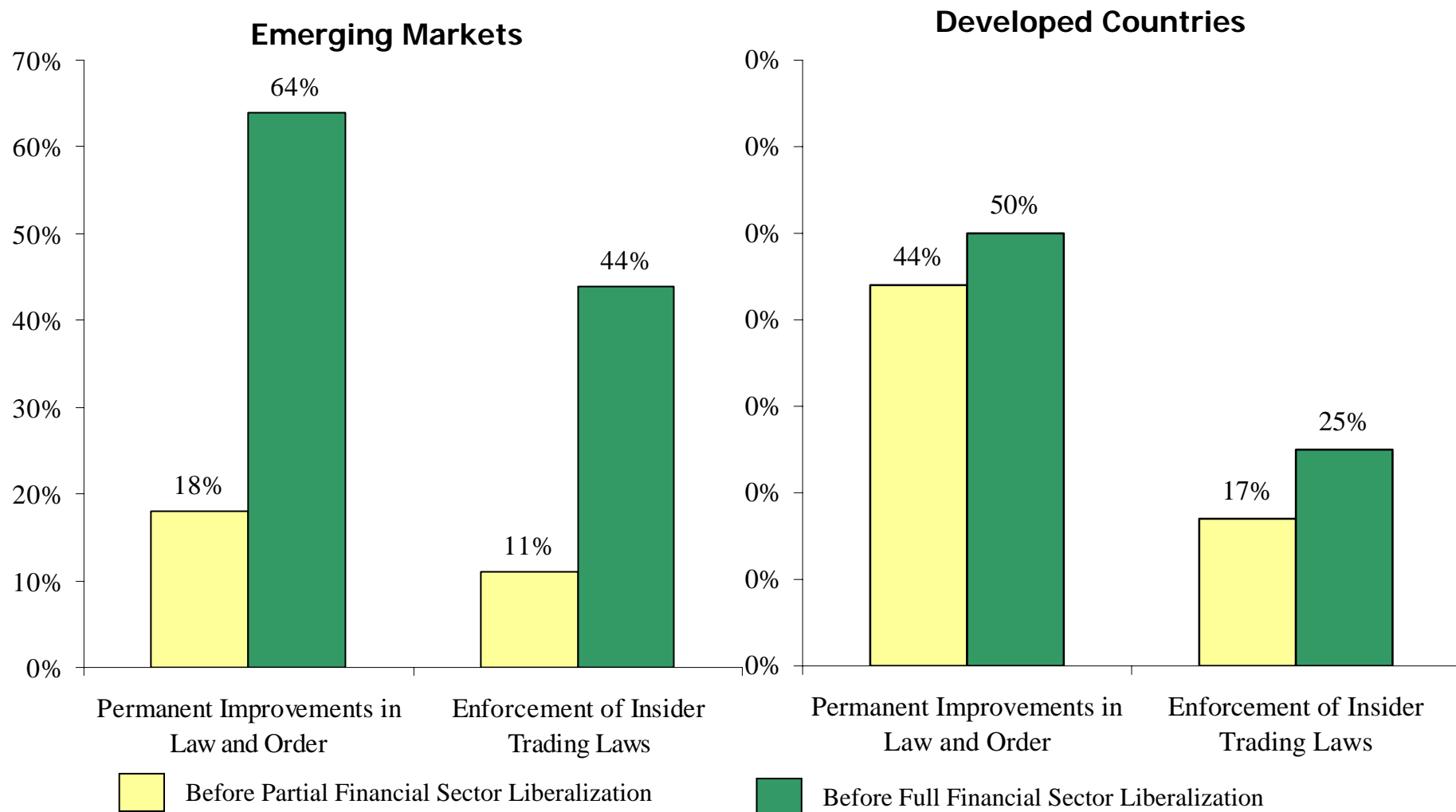


The figure shows the average amplitude of booms and crashes in the different periods and markets.

Source: Kaminsky and Schmukler (2001)

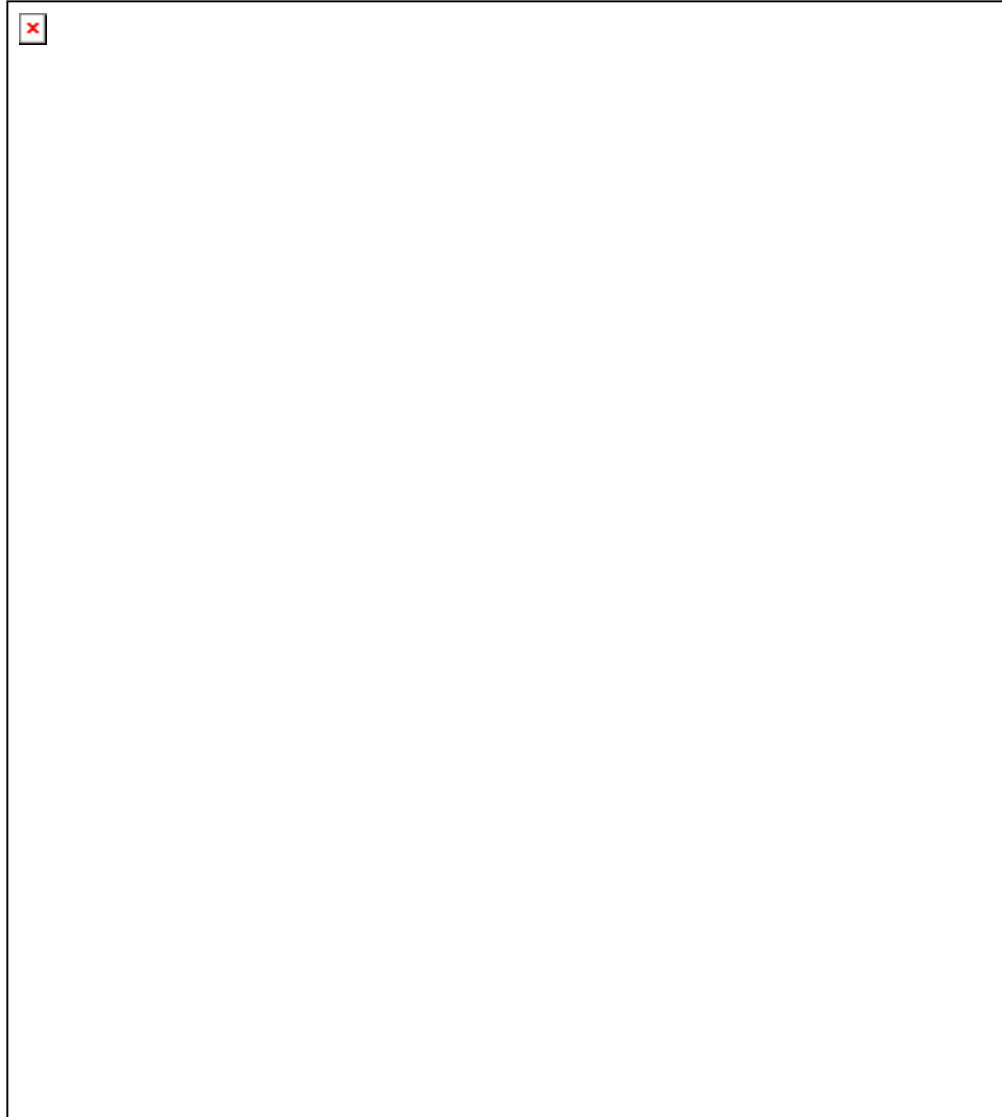
# ... Arguably Because Liberalization Stimulates Reforms

Percentage of Countries Having Implemented Reforms



# Currency Mismatches Reflect History of Financial Dollarization

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# Back to Basics

1. Financial Globalization
  2. Size
3. Segmentation of Access

# Financial Globalization

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- ✚ Measuring financial development by domestic variables alone is misguided – what matters is access to financial services
- ✚ However, it can magnify weak-currency problems in debt markets
- ✚ And it can undercut development of local stock markets
  - ✚ Stock market internationalization can have negative spillovers on the local market but does not result in balance sheet vulnerabilities

# Size

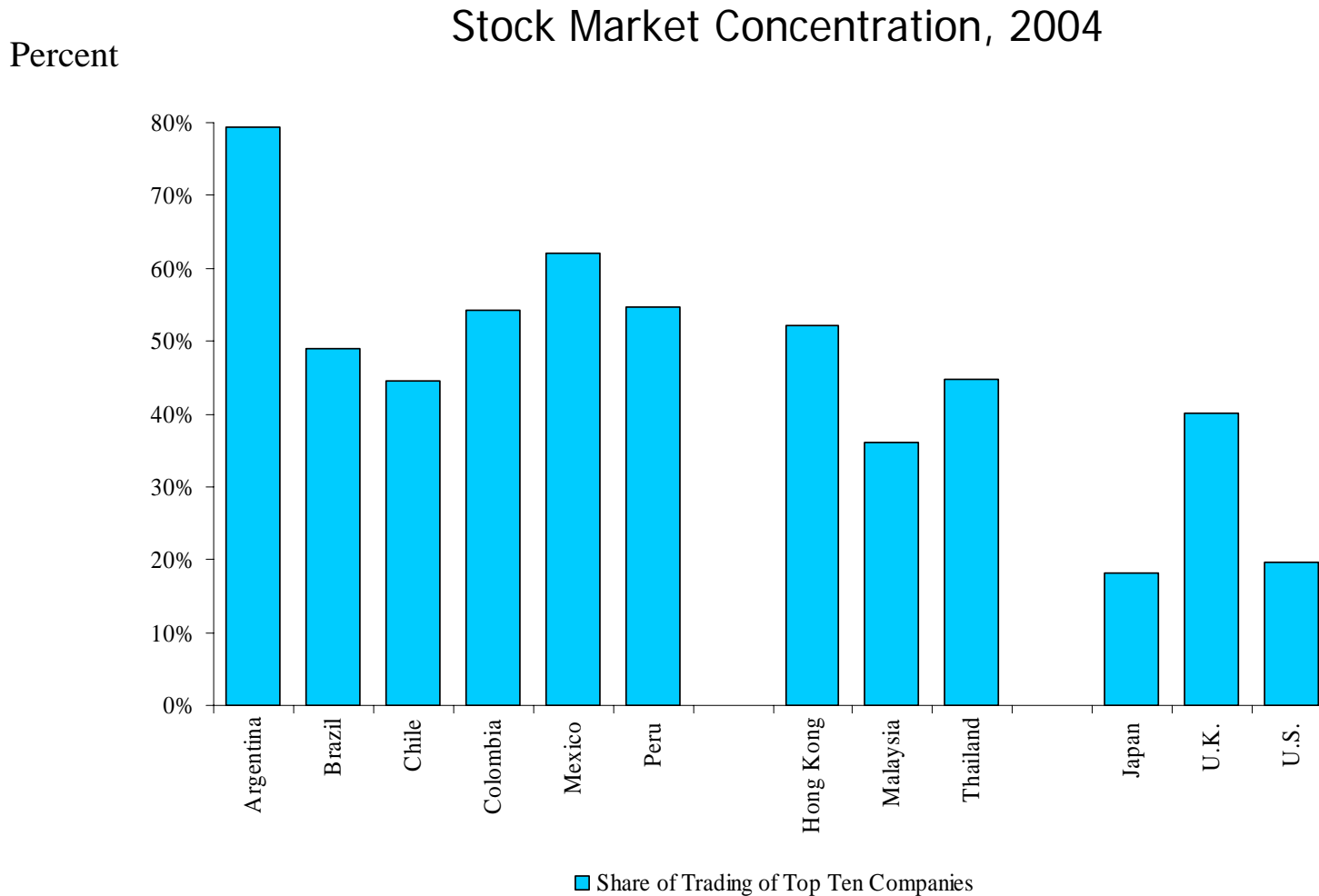
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- ✚ Liquidity is a positive function of size of market and issues
  - ✚ Ongoing clustering of world-wide liquidity in few int'l centers
  - ✚ Illiquidity begets illiquidity
  - ✚ Illiquidity hampers “price revelation” – core function of capital markets
- ✚ Larger economies and larger financial markets facilitate the development of local currency debt markets
- ✚ Size of issues matter for risk diversification
  - ✚ Small issues are too marginal or redundant in risk diversification strategies of local and foreign institutional investors
  - ✚ Small issuers/issues are not included in portfolios of pension funds when their investment regulations are relaxed (the case of Chile)

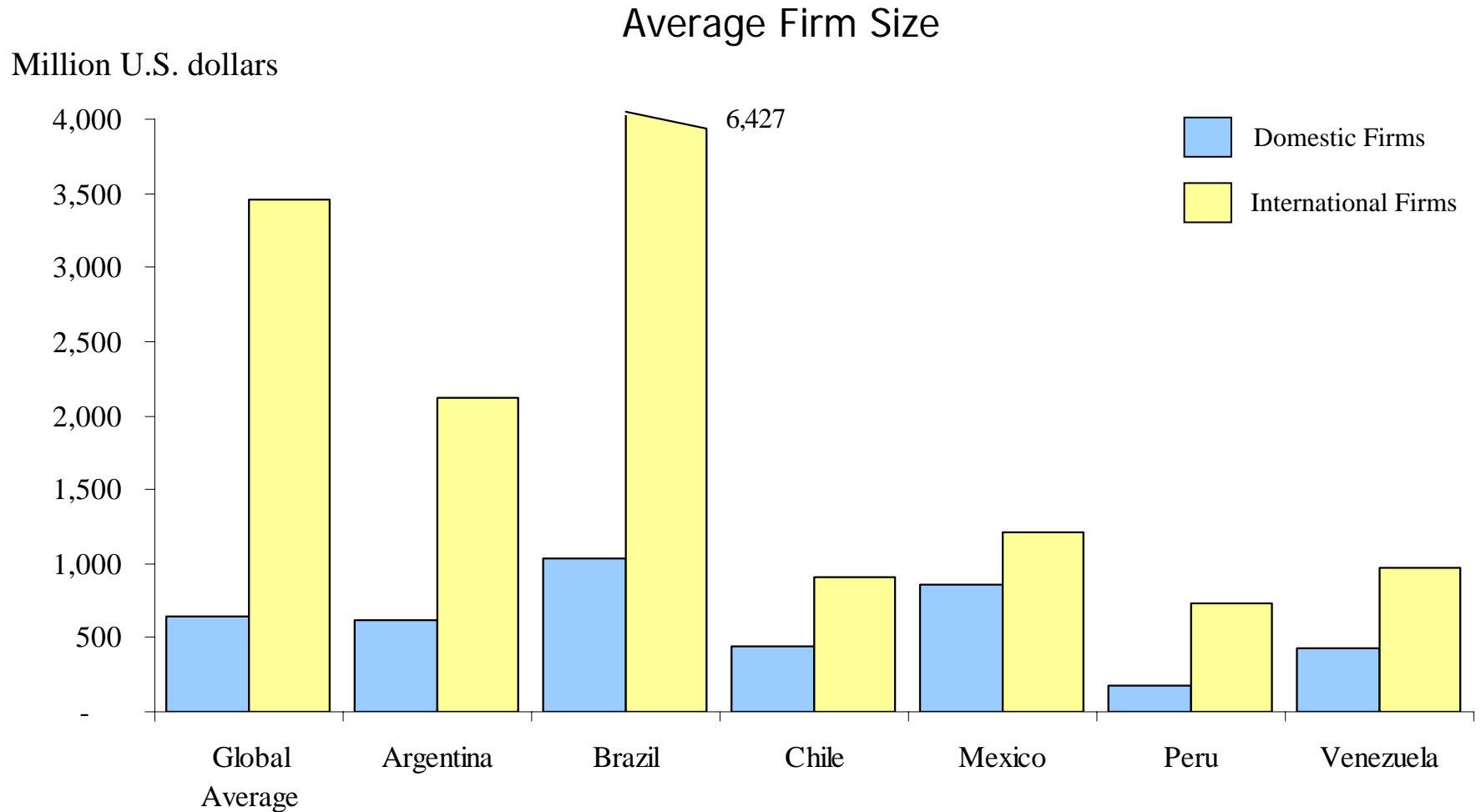
# Segmentation of Access

## A Few Large Companies Dominate Latin Stock Markets

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# Segmentation in Access to Finance – International Equity Markets



Domestic firms are firms listed in domestic stock markets which do not access international equity markets. International firms are those identified as having at least one active depositary receipt program, or having raised equity capital in international markets, or trading in the London Stock Exchange, NYSE, or NASDAQ. The data for international firms correspond to their size on the internationalization year.

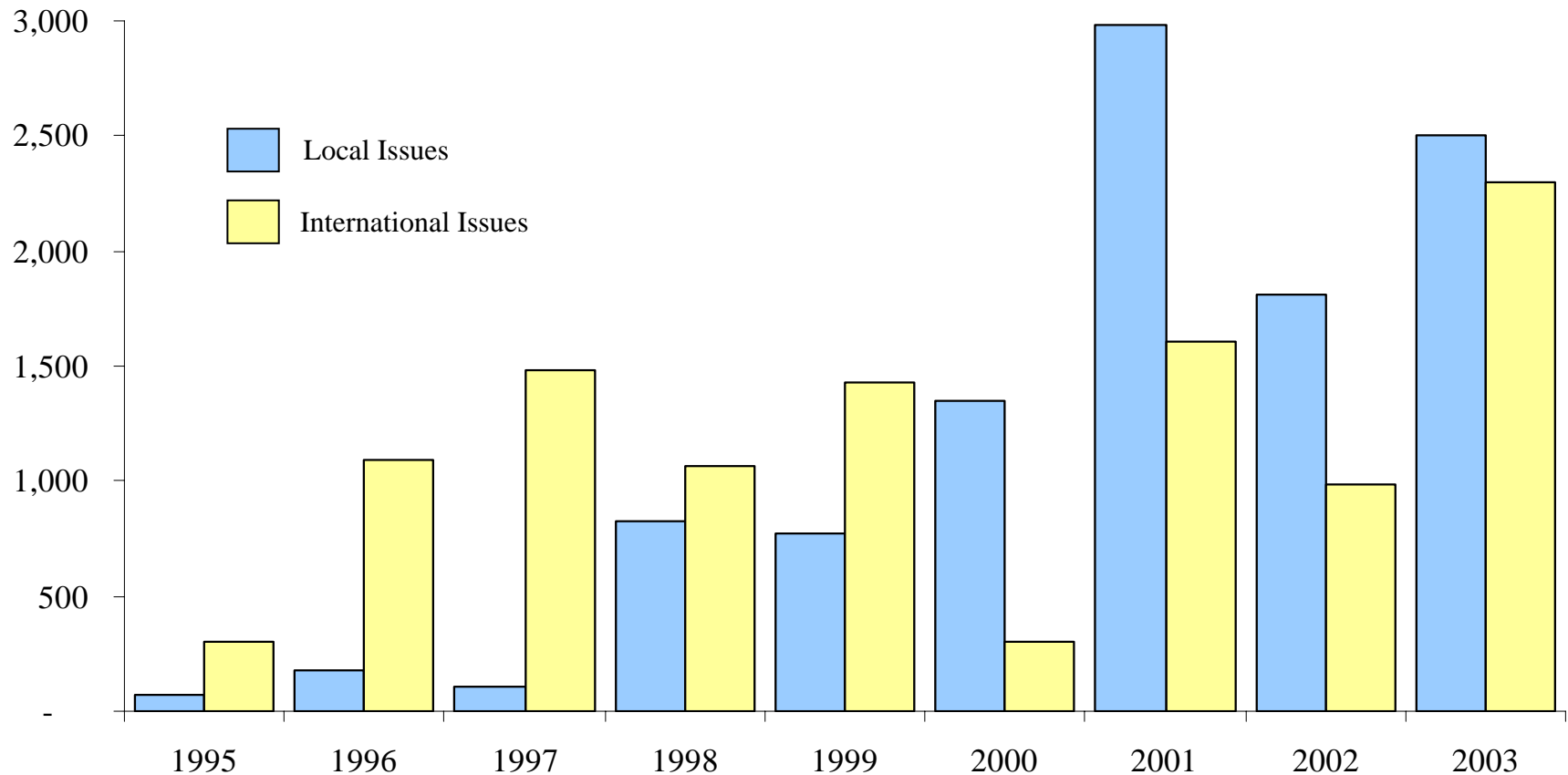
# Segmentation of Access

## Even in Successful Corporate Bond Mkts, Like Chile's...

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Chile - Corporate Bonds Issues in Domestic and International Markets

Million U.S. dollars

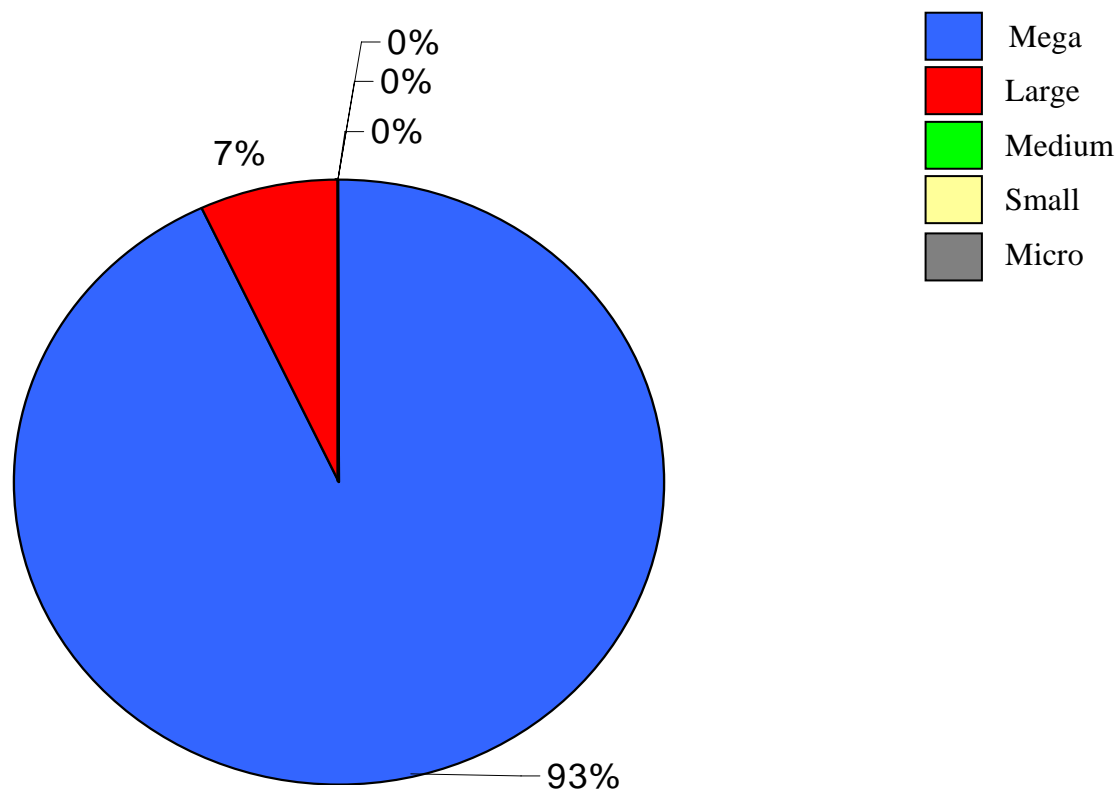


# Segmentation of Access

## ... Only A Few Large Companies Have Access

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Chile – Corporate Bond Issues in the Local Market by Firm Size  
(Cumulative Issues for 2000-2003)



Mega firms are defined as those with annual sales net of VAT above UF600,000 (US\$17.2 million); large firms have sales between UF100,000 (US\$2.8 million) and UF600,000; medium firms have sales between UF25,000 (US\$0.7 million) and UF100,000; small firms have sales between UF2,400 (US\$68,688) and UF25,000 and micro firms have sales below UF2,400. Micro firms represent around 82 percent of all firms, while small firms are 15 percent and medium firms two percent. Large and mega firms combined account for only one percent of all firms. *Source: World Bank (2004)*

# Conclusion

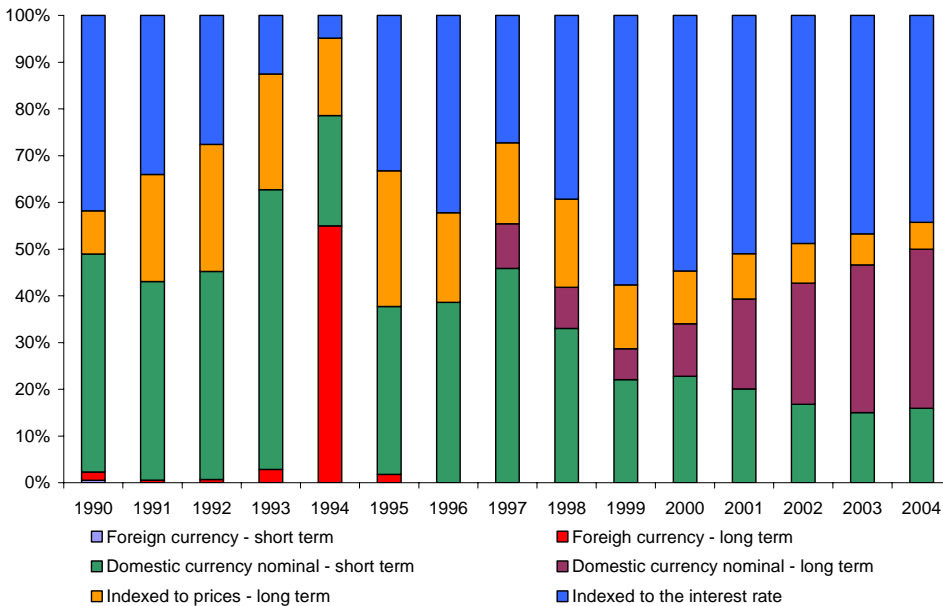
## Salient Challenges for the Reform Agenda

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- ✚ Overcome the Latin “shortfall” in local currency debt markets without barriers to international integration
  - ✚ Exchange rate flexibility cum inflation targeting
  - ✚ CPI-indexed financial contracts
  - ✚ Potential role for multilateral development banks, specially in dollarized economies
  
- ✚ Generate a suitable version of local stock market for small economies
  - ✚ Abandon hope of creating “mini Wall Streets”
  - ✚ Accept structural illiquidity and pro-internationalization bias of reforms
  - ✚ Reassess global integration versus regional integration
  
- ✚ Access of SME’s remain the key unsolved problem:
  - ✚ Financial structures & hybrid products linking multiple actors
  - ✚ *Direct* access to securities markets for small issuers may not be feasible: key role of pooling
  - ✚ Role of non banking financial intermediaries

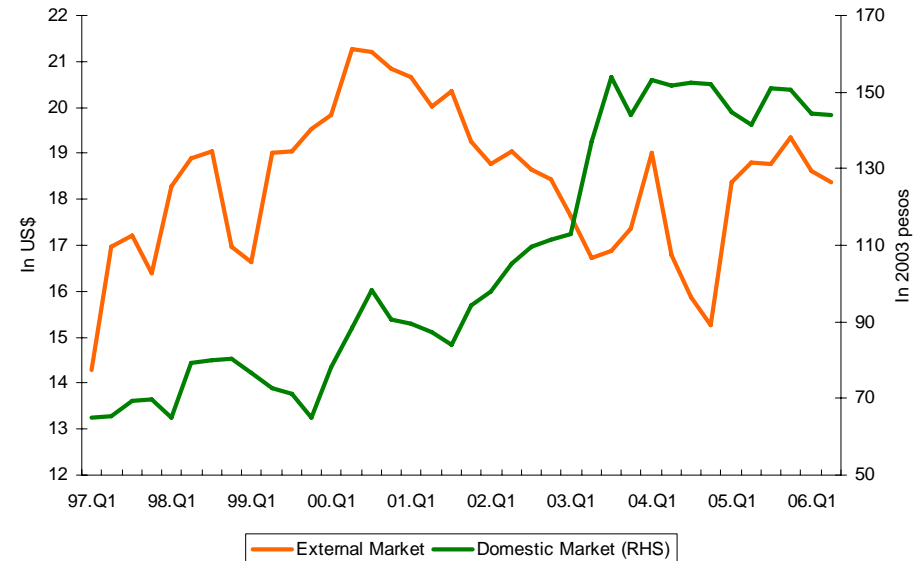
# Some Promising Recent Developments: the case of Mexico

Composition of Central Government bonded debt



Private Bond Issuance

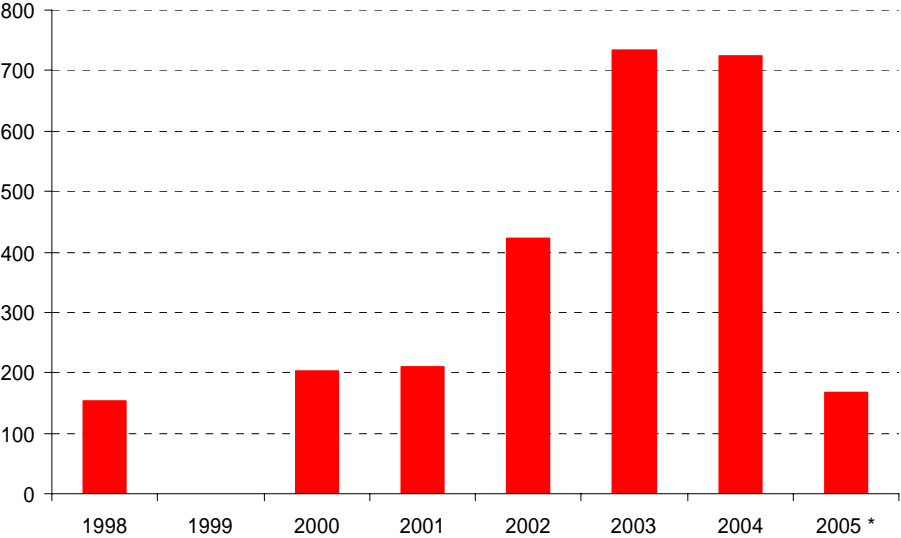
(in billions)



Source: Cowan et. Al. 2006 and Bank of Mexico

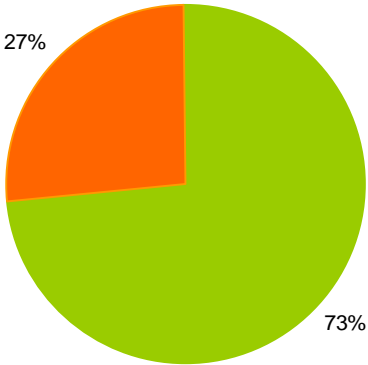
# Some Promising Recent Developments: Infrastructure Bonds in Chile

**Chile: Infrastructure Bond Issuance**  
(millions of US dollars)



\* Includes information of bond issuance up to June 2005

**Chile: Infrastructure Project Financing  
Road Concessions**



■ Infrastructure Bonds ■ Bank Loans

Source: Ministry of Public Works, SVS, Central Bank

# Some Promising Recent Developments: a new role for second-tier Public Development Banks?

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- Factoring:
  - NAFIN (México): internet-based system to provide reverse factoring services to SMEs (since 2001)
- Structured Finance: FIRA (México): Pooling and securitization of credit rights
  - ✚ Working Capital Financing: Shrimp Producers/Ocean Garden
  - ✚ Inventory Financing: Sugar Producers/Cargill
- Partial Credit Guarantee Systems
  - ✚ FOGAPE (Chile): SME's

Source: De la Torre, A., J.C. Gozzi Valdez, and S. Schmukler, 2006. Innovative Experiences in Access to Finance: Market Friendly Roles for the Visible Hand? World Bank Latin America and Caribbean Regional Study

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