

THE IMPORTANCE OF LOCAL CAPITAL MARKETS FOR FINANCING DEVELOPMENT

Rudimentary markets for capital—for raising money and investing—exist in even the remotest places around the world. However, prudent macroeconomic management, regulation, investor protection, and innovation are necessary to transition these nascent markets, which are often speculative ventures prone to fraud, into modern, efficient, and well-functioning markets capable of serving the needs of investors and entrepreneurs, borrowers and lenders alike.

A growing economy in need of new forms of financial intermediation to finance investments that are either too long-term or too risky for commercial banks is one of the most important drivers of capital markets growth. It is also now well understood that fostering the development of capital markets can itself be a strong spur to innovation and economic growth. The role of capital markets in development has been the focus of considerable research over the years.¹

In the simplest terms, a marketplace where buyers and sellers can engage in the trade of financial securities broadly defines the market for capital, or capital markets. Financial markets comprise both capital and money markets. Capital markets refer to markets that trade financial instruments with maturities longer than one year. Money markets trade debt securities or instruments of maturities of a year or less.

Markets are further segregated by the type of instrument—debt or equity—used to raise capital, and the derivatives market, which is used to manage risk. Capital markets are also distinguished as either primary or secondary. Users of funds raise them in primary markets via primary issuances of stocks or bonds. Once these instruments are issued, they can be traded in secondary markets.

Intermediation between lenders (or savers) and borrowers (or users of funds) is a fundamental function of the financial system in an economy and is performed primarily by commercial banks and primary capital markets. The key distinction is that capital markets provide direct funding from saver to user via the issuance of securities, while bank intermediation involves indirect funding with banks as the go-between connecting the saver and user.

The Value of Capital Markets

Capital markets have several beneficial features for different participants in the economy. For a company or entity in need of funding, domestic capital markets provide an alternative source of funding that can complement bank financing. Capital markets can offer better pricing and longer maturities, as well as access to a wider investor base. They can also offer funding for riskier activities that would traditionally not be served by the banking sector, and by doing so contribute significantly to innovation in an economy.

While some governments can access international capital markets, the development of local capital markets can increase access to local currency financing and thereby help manage foreign exchange risk and inflation better. For governments, this is a valuable benefit since it can allow them to finance fiscal deficits by borrowing from local markets without exchange rate risk. Government borrowing has been done in international markets in local currency and/or indexed to the exchange rate, but local markets have the benefit of more easily tapping local investors, and often local banks. The creation of local capital markets is enormously beneficial to governments attempting to finance development internally.

For investors and savers, capital markets can offer more attractive investing opportunities—with better returns—than bank deposits, depending on risk profile, liquidity needs, and other factors. Further, with a wider range of securities and instruments offered, capital markets can help investors diversify their portfolios and manage risk.

This is particularly important for institutional investors, including pension funds and insurance companies. In this way, capital markets have a deeper impact on society. Through the

use of derivatives, well-developed markets provide risk management tools not only to market participants, but also to end users as diverse as companies and agriculture producers.

Well-developed capital markets also provide benefits at the macroeconomic level by supporting monetary policy transmission, which is facilitated through liquid securities markets. Further, they can serve as a “spare tire” for the financial sector, enhancing financial stability and reducing vulnerabilities to exchange rate shocks and sudden interruptions of capital flows. World Bank Group research has shown that emerging market countries with robust government bond markets were better able to manage the 2008 global financial crisis, averting major economic dislocations and helping firms and citizens maintain financial solvency and liquidity.²

Moreover, in most countries, as a result of rapid economic growth, population growth, and urbanization, the financing needs of infrastructure, housing, and climate adaptation and mitigation are staggering.

On infrastructure alone it is estimated that an additional \$1 trillion to \$1.5 trillion in annual investment will be needed in low-income and middle-income countries through 2020 in order to meet the demand from industry and households.

The housing gap in these countries poses similar challenges. Globally, one billion people in urban areas lack access to adequate housing. By 2030, three billion people, or 40 percent of the global population, will need new houses. That translates into some 565 million new housing units. Yet mortgage penetration remains between 1 and 2 percent in most low-income countries. Neither the government nor the banking sector can provide the investment funding needed in such key strategic sectors. The only real alternative is greater use of primary capital markets—both local and international—to help close the gap.

For emerging markets, the benefits enumerated above render more extensive use of capital markets for investment financing both desirable and beneficial.

Varying role of Capital markets

The map below illustrates the relative size of each country or territory’s free-float stock market, via relative land area. The stock market capitalization of emerging market countries, including those in Asia, remains significantly smaller than that of advanced economies.

Figure 1: Global Free-Float Stock-Market Capitalization by Country, in \$ Billions



Source: Bank of America Merrill Lynch, *Transforming World Atlas*, August 4, 2015

There is also a wide variation among emerging market countries in terms of the development of capital markets, ranging from

countries where capital markets currently play no role (usually in smaller and low-income countries) to countries where they already

This publication may be reused for noncommercial purposes if the source is cited as IFC, a member of the World Bank Group.

play a role in providing financing for the government and larger firms in the corporate sector (including the banking sector). In some of the larger emerging market countries, capital markets are beginning to play a role in the housing sector and infrastructure financing. But in the majority of emerging markets, the use of capital markets for investment financing still has a long way to go to help countries enhance the availability of long-term funding.

Challenges in Developing Capital Markets

While the benefits are clear, the potential for and timing of capital market development are to a large extent dependent on the level of economic and structural development of a country. That is, a country's starting point heavily dictates the recipe for timing, sequencing, and even the feasibility of what can be done in terms of developing local capital markets.

There is a high correlation between fundamentals—in particular the size of the economy in terms of aggregate gross domestic product and per capita income—and the level of development of the local capital markets. This explains in large part why, in general, capital markets are at an embryonic stage in smaller and low-income countries. For larger and middle-income countries, significant differences across countries are explained more by institutional development, the size of the institutional investor base, the level of contractual savings such as pension funds, and macroeconomic stability.

An essential condition for a well-functioning financial system—with both banks and capital markets—is the existence of sound macroeconomic and policy frameworks.³ The institutional framework is also critical, as markets depend on investor confidence and strong institutions provide the basis for investor and creditor protection.^{4 5}

As with any economic activity, capital markets are not without risks. These include the potential for asymmetric information between savers and users, non-transparency and lack of adequate regulation and monitoring of issuers, lack of adequate and efficient market infrastructure for issuing, trading, clearing and settlement, and the potential for increased volatility due to liquidity, interest rate and rollover risks.

At their best, capital markets enable tailored matching of cash flow profiles and risk appetites between investors and issuers, enhancing economic welfare for all parties. To reliably extract the benefits of well-functioning markets, adequate regulation for issuers, investors, and intermediaries in addition to robust supervisory arrangements to protect investors, promote deep and liquid markets, and manage systemic risk are critical.

Such a framework in turn needs to be anchored in a good investment climate that includes a sound taxation and accounting framework, reliable and quality accountancy, creditor rights, property rights, and bankruptcy and competition law. Finally, markets need an infrastructure—exchanges and trading platforms, clearing houses, and custodians—to develop.

Capital Markets as formalized Security Markets

Capital markets have existed in some shape or form for hundreds of years, often with fascinating and colorful histories. In Europe, the roots of modern, highly sophisticated stock exchanges such as the London Stock Exchange can be traced to the 17th century. The London Stock Exchange played a key role in the Industrial Revolution, when many new ventures were launched that needed financing.

In the United States, the New York Stock Exchange (NYSE)—a powerhouse of transactions, technology and innovation—evolved from humble beginnings on a Manhattan street corner where intrepid, all-weather street traders, once called curbstome brokers, plied their trade. The NYSE was formed by brokers under the Buttonwood Agreement of 1792, so called because it was signed under a buttonwood tree.

The Bombay Stock Exchange was established in 1830 and is one of the oldest exchanges in Asia. The Hong Kong securities market can be traced back to 1866 but the stock market was formally set up in 1891 when the Association of Stockbrokers in Hong Kong was established.

In larger and middle-income countries, near-term improvements can more easily be achieved through policy reform and institutional development. However, in almost all middle-income countries, development of bond markets for all but the largest non-financial corporations remains quite low and is the most important challenge for further local market development.

Typically, capital market offerings of debt securities start with the highest credit quality issuers that are able to attract investors in a nascent market.⁶ The highest quality issuer, particularly in local currency, is typically the government, and government bond markets—beginning with short term money market instruments and extending to longer tenor bonds—form a basis for further market development by establishing price points along a yield curve and providing instruments for liquidity management.

They also provide a critical mass of securities to support market infrastructure development. Banks are often the next issuers able to come to market. While banks may benefit from including capital market instruments in the funding mix to better match liabilities to assets, they tend to have a ready source of liquidity from deposits available to service their obligations. As regulated institutions, there is often more transparency about banks' cash flows and the capital necessary to support meeting a debt obligation.

Thus, in many markets banks are the first corporates to issue bonds, and in some markets the types of funding extend to covered bonds or other securitization structures that are more closely linked to the banks' underlying loan books. Eventually other sectors may follow as the investor base builds familiarity with the market and instruments. Utilities, which typically have long-term capital investment needs but steady and predictable cash flows, may follow, and then other corporates. In parallel, it is critical that

efforts be focused on developing the investor base. Some countries may be able to tap international investors, but this will require adequate macro stability to make the country attractive to external investors, in addition to investor protections and transparency to make the capital market instruments attractive.

For most countries, however, the most reliable and stable investor base will be local. Nurturing domestic investible asset pools via pensions, insurance, and savings vehicles for individuals to deploy into capital markets is critical for local sustainable capital market development. Pension reform, development of the local insurance industry, and an increase in household savings are often part of a comprehensive capital market development program.

For countries that lack the scale or size for rapid and efficient development of local markets, capital markets linkages—these include safely accessing international capital markets, promoting foreign listings, and regional exchanges—could also be considered, although World Bank Group experience shows these to have mixed outcomes.

While greater reliance on international markets and investors is not a perfect substitute for local markets in every respect, their use may be a feasible option for the foreseeable future for many small countries (including poorer and fragile and conflict countries), to have a more direct form of access to foreign savings other than official flows and interbank transfers for lending to their private sectors.

For many emerging economies where domestic savings rates are low, attracting greater portfolio inflows into private sector securities could be an attractive option. This requires proper safeguard rules, however, to handle risks such as currency mismatches and “sudden stops”, or abrupt reductions in net capital flows into the economy. International institutional investors have hundreds of billions of dollars that can be put to work in emerging markets. At present, however, the investible universe is almost exclusively government bonds and bonds of the largest corporates. At the same time, international investors have an increasing appetite for local currency bonds or bonds indexed to the exchange rate. Even after emerging market economies began to slow in 2015, there remains an appetite for the higher yields available in the developed world.

Achieving these objectives will be challenging. Given the small size and relative non-transparency of most emerging market corporates, bank loans are likely to remain the preferred form of funding over bond issues. One approach to capital market development might likely involve new forms of packaging loans into securities and involvement of International Financial Institutions to assist with structuring and credit enhancements.

Supporting Resilient Capital Markets

Since its founding, the World Bank Group has been helping countries develop capital markets and access international markets for investment financing. This includes both transactions

and advisory support, including a broad range of activities aimed at developing both government and non-government bond markets.

In the government bond market, the Bank Group assists governments in improving their debt management, building more liquid yield curves to serve as a benchmark for private bond markets, and enhancing market infrastructure. In the non-government bond market, the Bank Group actively works with local regulators to improve regulation and supervision of the markets (including issuers, market infrastructure, intermediaries, and institutional investors), to improve market infrastructure, and, depending on the country, to promote an enabling environment, especially in terms of taxation and accounting issues.

Case Study: Local Currency Issue of Umuganda Bond

Issued in May 2014, this bond marked IFC’s inaugural issuance under the Pan-African Domestic Medium Term Note Programme in East Africa. It was also the first international AAA-rated Rwandan Franc bond issuance in Rwanda and the first non-sovereign issuance since 2010. The bond was intended to increase access to long-term local-currency finance for local businesses while strengthening the country’s domestic capital markets.

The bond is listed on the Rwanda Stock Exchange. The issuance attracted strong participation from both local and international investors and was more than twice oversubscribed. Issuance managers were Standard Bank/Stanbic Kenya, and Bank of Kigali, Rwanda.

Bond characteristics: Senior Unsecured Notes with a 5-year tenor and a bullet repayment due 2019; a semi-annual fixed rate coupon (12.25%); and no 5-year government benchmark yield. Its regulatory status features include 0% risk weighting for computing capital adequacy; liquid asset status; repo eligibility; and 100% admissibility as an asset for insurance company solvency ratios.

Source: *IFC Debt Capital Markets Solutions, IFC 2016*

Bank Group programs have been implemented in countries as diverse as Costa Rica, Egypt, Kenya, Lebanon, Morocco, Nigeria, Romania, and Turkey. In a few larger emerging economies—including Brazil, Colombia, Indonesia, Peru, and South Africa—the Bank Group through its advisory services supports the mobilization of institutional investors in the funding of strategic sectors such as infrastructure financing. A key component of such support is the development of instruments and guarantees to align the risk-return appetite of institutional investors.

The Bank Group also promotes the development of innovative global products to further catalyze local market development. In Brazil, an issuer-driven exchange-traded fund structure aimed at enhancing market-making and consolidating local currency indices is being implemented for government bonds. In Kenya, the Treasury Mobile Direct project is focused on improving retail

This publication may be reused for noncommercial purposes if the source is cited as IFC, a member of the World Bank Group.

access to government instruments by distributing these instruments through mobile phones.

IFC plays an important role in catalyzing capital market development by investing in private sector transactions either as a sole investor or as an anchor investor in bonds, structured securities (securitizations across different asset classes), as a credit enhancer or anchor investor, and in new products, instruments and investment funds aimed at bringing new asset classes to the market or supporting strategic sectors with private financing. IFC also provides local currency solutions and credit enhancements to facilitate access to capital markets for its clients. And IFC has a robust local currency bond issuance program and has issued bonds in 17 countries.

As one of the world's largest financiers of climate-smart projects for emerging markets, IFC was one of the earliest issuers of green bonds. It launched a green bond program in 2010 to help catalyze and unlock investment for private sector projects that support renewable energy and energy efficiency.

Conclusion

Capital markets development rarely follows a linear path. Developing local capital markets and making greater use of them to fund private investment and strategic economic needs tends to

happen in stages. Therefore some sequencing of policies is essential.

This is particularly true for debt markets, which require well-functioning money markets to create government bond markets, and they in turn are essential for corporate bond markets. Understanding the linkages between different segments of the market and their building blocks is critical to ensuring a proper sequencing of policy and regulatory reforms.

The experiences of countries across the globe shows that capital markets development is a gradual process requiring strong leadership from government authorities as well as a significant commitment of time and resources. If done correctly, the payoffs can be substantial and long-term. The strategic imperative, however, is to develop strategies that fit the particular country circumstances. ■

Meera Narayanaswamy, Senior Investment Officer – Financial Institutions Group, IFC (mnarayanaswamy@ifc.org)

Charles Blitzer, Senior Advisor – Financial Institutions Group, IFC (cblitzer@ifc.org)

Ana Carvajal, Lead Financial Sector Specialist, Finance & Markets, World Bank (acarvajal2@worldbank.org)

References

¹ Laeven, Luc, *The Development of Local Capital Markets: Rationale and Challenges*, IMF Working Paper No 14/234; see also: Black, Bernard, 2001, *The Legal and Institutional Preconditions for Strong Securities Markets*, UCLA Law Review, Vol. 48, pp. 781–858; Borensztein, Eduardo - Cowan, Kevin - Eichengreen, Barry – Panizza, Ugo, *Building Bond Markets in Latin America*, in Borensztein, Eduardo - Cowan, Kevin - Eichengreen, Barry – Panizza, Ugo, *Bond Markets in Latin America: On the Verge of a Big Bank?*, MIT Press, Cambridge, Massachusetts, 2008, pp. 1-28; Eichengreen, Barry - Borensztein, Eduardo - Panizza, Ugo, *A Tale of Two Markets: Bond Market Development in East Asia and Latin America*, Hong Kong Institute for Monetary Research, Occasional Paper No. 3, 2006; Burger, John D. - Warnock, Francis E. - Warnock, Veronica, *Emerging Local Currency Bond Markets*, Financial Analysts Journal, Vol. 68, 2012, No. 4, pp. 73-93; De Fiore, Fiorella - Uhlig, Harald, *Bank Finance Versus Bond Finance: What Explains the Differences Between US and Europe*, European Central Bank, Working Paper No. 547, 2005; De la Torre - Augusto, Gozzi, Juan Carlos - Schmukler, Sergio L., *Stock Market Development Under Globalization: Whither the Gains From Reforms?*, Journal of Banking & Finance, Vol. 31, 2007, pp. 1731–1754; De la Torre, Augusto - Gozzi, Juan Carlos - Schmukler, Sergio L., *Capital Market Development: Whither Latin America?*, in Edwards, Sebastian – Garcia, Marcio G. P. (eds.), *Financial Markets Volatility and Performance in Emerging Markets*, 2008, pp. 121-153; Dittmar, Robert F. - Yuan, Kathy, *Do Sovereign Bonds Benefit Corporate Bonds in Emerging Markets?*, The Review of Financial Studies, Vol. 21, 2008, No. 5, pp. 1983-2014; Eichengreen, Barry - Luengnaruemitchai, Pipat, *Why Doesn't Asia have Bigger Bond Markets?* National Bureau of Economic Research Working Paper No. 10576, 2004; Harwood, Alison, *Building Local Bond Markets: Some Issues and Actions*, in Harwood, Alison (ed.), *Building Local Bond*

Markets: An Asian Perspective, 2000, pp. 1-37; IMF, 2002, *Emerging Equity Markets*, in *Global Financial Stability Report*, Chapter 4, International Monetary Fund, Washington, DC; Laeven, Luc - Perotti, Enrico C., *Confidence Building in Emerging Stock Markets*, CEPR Discussion Paper No. 3055, 2001; Milesi-Ferretti, Gian-Maria - Tille, Cedric, *The Great Retrenchment: International Capital Flows During the Global Financial Crisis*, Economic Policy, Vol. 26, 2011, pp. 285-342; Shleifer, Andrei - Wolfenzon, Daniel, *Investor Protection and Equity Markets*, Journal of Financial Economics, Vol. 66, 2002, pp. 3–27; Turner, Philip, *Bond Markets in Emerging Economies: An Overview of Policy Issues*, Bank for International Settlements, Paper No. 11, 2002, pp. 1-12..

² Anderson, Phillip R. D. - Silva, Anderson Caputo - Velandia-Rubiano, Antonio, *Public Debt Management in Emerging Market Economies: Has This Time Been Different?*, World Bank, Policy Research Working Paper No. 5399, 2010; see also Herring, Richard – Chatusripitak, Nathporn, *The Case of the Missing Market: The Bond Market and Why It Matters for Financial Development*, Paper prepared for The Asian Development Bank Institute / Wharton Seminar on Financial Structure for Sustainable Development in Post-Crisis Asia, Tokyo, May 26, 2000.

³ Rajan, Raghuram G. – Zingales, Luigi, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, Journal of Financial Economics, Vol 69, 2003, pp. 5–50.

⁴ Ibid.

⁵ Andritzky, Jochen R., *Capital Market Development in a Small Country: The case of Slovenia*. IMF, Working Paper No. 07/229, 2007.

⁶ Karacadag, Cem – Sundararajan.V – Elliott, Jennifer, *Managing Risks in Financial Market Development: The role of sequencing*. IMF, Working Paper No. WP/03/116, 2003.

This publication may be reused for noncommercial purposes if the source is cited as IFC, a member of the World Bank Group.