

Capital Markets Development

A Primer for Policymakers



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1. See Carvajal, Ana and Ricardo Bebczuk. 2019. “Capital Markets Development: Causes, Effects and Sequencing.” A Literature Review.

2. See Demekas, Dimitri and Anica Nerlich. 2020. “Creating Domestic Capital Markets in Developing Countries: Perspectives from Market Participants.” EM Compass, Note 77.



Introduction

With a global size of USD 178 trillion,³ capital markets are one of the most powerful drivers of economic growth and wealth creation. A well-developed domestic capital market allows governments and companies to access long term finance in local currency, increases investments directed towards innovation, and promotes sustainable growth with greater employment opportunities for a growing middle-class. In the coming years, capital markets are likely to play an even bigger role by facilitating the mobilization of more private capital into key sectors such as infrastructure, housing, SME and climate action financing.

Unfortunately, many emerging markets and developing economies enjoy only a small portion of the benefits offered by capital markets. Excluding China, only about 11% of equity and debt issuances were placed by companies located in emerging markets in 2019. Therefore, it is essential for policymakers and other key capital markets stakeholders to understand the conditions in which well-functioning domestic capital markets flourish.

This Primer aims to provide policymakers and key capital market stakeholders in emerging markets and developing economies with insights and information on capital markets

development—with a focus on non-government markets. It reviews key preconditions for capital market development along with potential sequencing issues, discusses the role that governments and the private sector should play and relates the ways in which the World Bank Group (WBG) supports actions at the global and country level to develop resilient capital markets. It draws on (i) the real-world expertise of the WBG working with member countries to assist them in developing their capital markets, (ii) a review of the economic literature and empirical research on capital market development and WBG's own empirical research,⁴ and (iii) an extensive survey of the views of different market participants across five different continents on the preconditions for capital markets development.⁵

The COVID-19 pandemic adds further challenges to the development of capital markets. For many emerging markets and developing economies challenges have intensified as a result of (i) the deterioration in the macroeconomic environment, including the contraction of the economies, and larger fiscal deficits, (ii) reduced investor appetite due to uncertainty, and (iii) the nature and scale of the interventions used by governments to support the economy which, while necessary, might have limited the viability of different capital markets solutions, at least in the short to medium term. That said, this does not alter the fundamental premise

3. See SIFMA. 2019. Capital Markets Fact Book

4. See Carvajal, Ana and Ricardo Bebczuk. 2019.

5. As part of the J-CAP Initiative, 38 structured interviews were conducted during April-May 2019 with some 100 counterparts from 16 countries, representing domestic and foreign institutional investors, investment banks, finance companies, asset managers, debt issuers, market infrastructures, broker-dealers, regulators, and other capital market participants. The regional breakdown was as follows: 35% from Europe; 14% from Africa; 27% from the Americas and 24% from Asia. A summary of the results of such survey can be found at Demekas, Dimitri and Anica Nerlich. 2020.

that it is important to develop alternative finance mechanisms for key strategic sectors. Rather, if anything, the need for capital markets solutions is more critical than ever given the much more limited space that governments—and potentially also banks—will have going forward to support new financing.

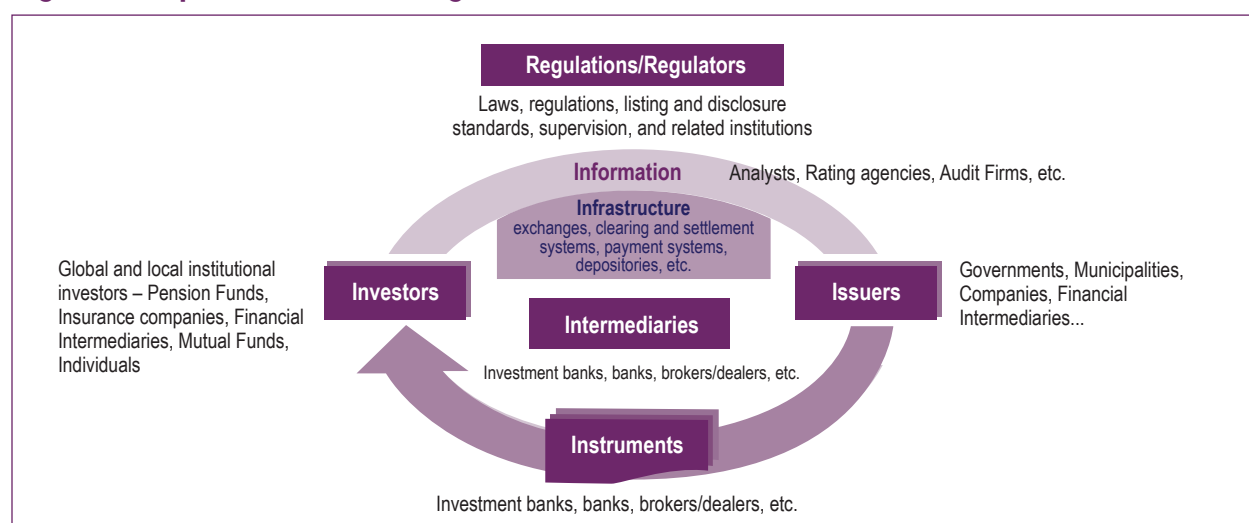
This Primer will be followed by a series of practitioner papers. As part of its knowledge management agenda, the WBG is working towards deepening the understanding of the use of capital markets to finance strategic sectors, from corporate to infrastructure, housing, SME and climate change financing. Along these lines, reports will be prepared—as appropriate—to help practitioners identify the key challenges that could prevent the mobilization of capital markets financing to these strategic sectors as well as key actions to address them.⁶

Working Definition

Capital markets refer to a segment of the financial system aimed at channeling the savings of an economy to those in need of capital. These transfers of capital are undertaken through financial

instruments and securities. These can include money market assets, sovereign and non-sovereign bonds, securitized assets such as mortgage-backed securities, participations in collective investment schemes such as mutual funds, and company equity. In contrast to deposits, investors bear the risk of such investments. Capital markets consist of a primary market, where the financial instruments described above are sold by their issuers (governments, companies, collective investment schemes, special purpose vehicles) to the investors, and a secondary market, where already-issued securities are traded between investors. Securities can be issued via private placements or public offerings. Overall private placements are restricted to institutional and other sophisticated investors and have limited price disclosure and trading activity. Securities issued under a public offering are accessible by all, including retail investors, and are traded on regulated markets with sufficient pre- and post-trade price transparency. Capital markets rely on professional intermediaries, and require a series of market infrastructures, including trading platforms, clearing houses and central securities depositories, and a capital markets-specific legal and regulatory framework backed by government supervision and enforcement (Figure 1).

Figure 1. Capital Markets Ecosystem



⁶ See Carvajal, Ana et al. 2020. “Capital Markets and SMEs in Emerging and Developing Economies: Can They Go the Distance?” World Bank Group

Why Capital Markets?

Well-developed capital markets are a driver of economic growth, and thereby yield positive effects on employment. The correlation between capital market development and economic growth has been well-established in the empirical literature. Capital markets mobilize additional savings into the economy, making more capital available to companies, which may then in turn create jobs and facilitate real-wage growth.⁷ At the same time, some evidence exists that capital markets are associated with higher productivity levels as the allocation of resources becomes more efficient—including through better information, mechanisms to control good governance, and the provision of capital to innovative projects.

On a microlevel, well-developed capital markets constitute an important source of financing for corporations. For businesses that already enjoy access to banking finance, capital markets can provide an attractive alternative as they can give companies access to larger volumes of funding, longer maturities and, potentially, better economic terms, thus reducing overall funding costs. This funding can be a crucial source for companies seeking to expand their business. In addition, capital markets allow companies to diversify their funding sources, which can become particularly critical in times of distress in the banking sector, as a retrenchment in banks' lending activities could leave companies without the financing needed to continue functioning. Capital markets can also fund riskier and more collateral-scarce businesses and activities that would not traditionally be

served by the banking sector as they bring to the table investors with higher risk profiles. Equity markets in particular have been found to be key to the financing of new businesses, particularly those relying on intangibles, R&D and human capital. In this way, capital markets can also support innovation. For governments, the capital markets are a crucial source to finance their fiscal deficits, including expenditures for social services and job creation. As government bond markets deepen, their funding costs are likely to decrease as well.

From the investors' perspective, capital markets offer investment opportunities and risk management tools. First, capital markets can offer more attractive investing opportunities in terms of their return than bank deposits, albeit with a higher risk. Further, if a wide range of instruments exist, then capital markets can provide investors with a diversified portfolio, which contributes to risk management. This is of particular importance to pension funds and insurance companies in countries that have young populations because higher rates of return are necessary to ensure an adequate payout in the future. Finally, well-developed capital markets also provide risk management tools through the derivatives markets.

Besides economic growth, well-regulated and supervised capital markets may enhance financial stability.⁸ Domestic capital markets provide access to long-term, local currency financing that helps companies, governments and investors to manage inflation, foreign exchange risks and maturity mismatches. This is especially important for middle and lower-income countries; as

7. Like all empirical research, this body of work also has limitations and blind spots. First, most empirical research focuses on the stock market, whereas the private fixed income market receives less attention. Second, while the correlation between capital market development and GDP growth is strong, causality does not run in a single direction: capital market development generates economic growth, but economic growth also contributes to further capital market deepening, and it is difficult to disentangle these two effects. Third, most studies have a macroeconomic angle but only a few focus on firm-level data that could explain how firms choose between different sources of finance or illuminate the precise mechanisms through which capital market development improves economic performance. Despite these limitations, the evidence overwhelmingly supports the conclusion that capital market development is associated with better economic outcomes. See Carvajal, Ana and Ricardo Beczkuk. 2019.

8. There seems to be a point beyond which continued financial deepening (also called "financialization") is associated with increasing risk of financial instability. This finding, however, is not immediately relevant for emerging and developing economies, given the state of capital market development that prevails in these countries.

several of their previous financial crises originated from a combination of large aggregate currency mismatches, small foreign exchange reserves and short-term debt liabilities. Further, there is empirical evidence that equity markets can reduce corporate leverage and curb insolvency risks, while bond markets can serve as a “spare tire” in times of banking distress. Given that financial crises adversely affect poverty rates—WBG estimates that the global financial crises increased the number of people living in absolute poverty by 52-64 million within two years—the prevention and mitigation of financial crises’ effects is one of the most important investments for development and shared prosperity.

Yet this is not to say that capital markets come without risk. For example, any new financial instrument carries risks that market participants will need to understand throughout boom and bust cycles to ensure that they provide suitable advice to investors and appropriately manage their own financial positions. Similarly, changes in the local and global macroeconomic conditions could trigger sudden stops and reversals in foreign flows that, if not well managed, could take a significant toll on economic growth. However, these challenges do not outweigh the benefits capital markets can have, rather these challenge are a call for good regulation and supervision.

The potential contribution of capital markets to economic growth in emerging and developing economies is even more relevant today, given the challenge of the Sustainable Development Goals (SDGs). There are huge financing gaps in key strategic sectors that are critical to achieve the SDGs. For example, in infrastructure alone it has been estimated that about US\$ 2 trillion in investment per year would be needed over the next 10 years. Similar gaps exist in sectors such as housing, SME financing, and climate change. Traditional funding sources, whether public

investment or bank lending, will be insufficient to close these gaps. Thus, the mobilization of private sector funding will be key. Capital markets could constitute an important channel to attract those private investments, in particular from institutional investors—foreign institutional investors alone manage an estimated USD 90 trillion of assets under management. In the past, and depending on the country, capital markets and institutional investors have helped in the financing of the corporate sector and the housing sector, the latter mainly via mortgage backed securities and covered bonds. The challenge now lies in designing capital markets solutions that could align the risk-return appetite of institutional investors with other strategic sectors, such as infrastructure, climate and SME financing. Different solutions are being tested globally to achieve this objective.

What is the State of Capital Markets Development in Emerging and Developing Economies?

In spite of the importance of capital markets, most emerging and developing economies continue to exhibit a very limited level of capital markets development. There is no universally accepted definition for what an advanced capital markets is; however, in general, there are four attributes associated with them: size, access, depth and efficiency. An analysis of the capital markets in emerging markets and developing economies against three of those four attributes shows that most of them are still at an early stage of development; although in many cases the markets—or some components of them—are growing (Figure 2). First, in most emerging markets and developing economies only a limited number of companies have used capital markets to fund themselves, either via equity or debt, with the majority still being financial institutions; the size of domestic capital markets

9. BCG. 2020. “Global Asset Management 2020: Protect, Adapt, and Innovate.”

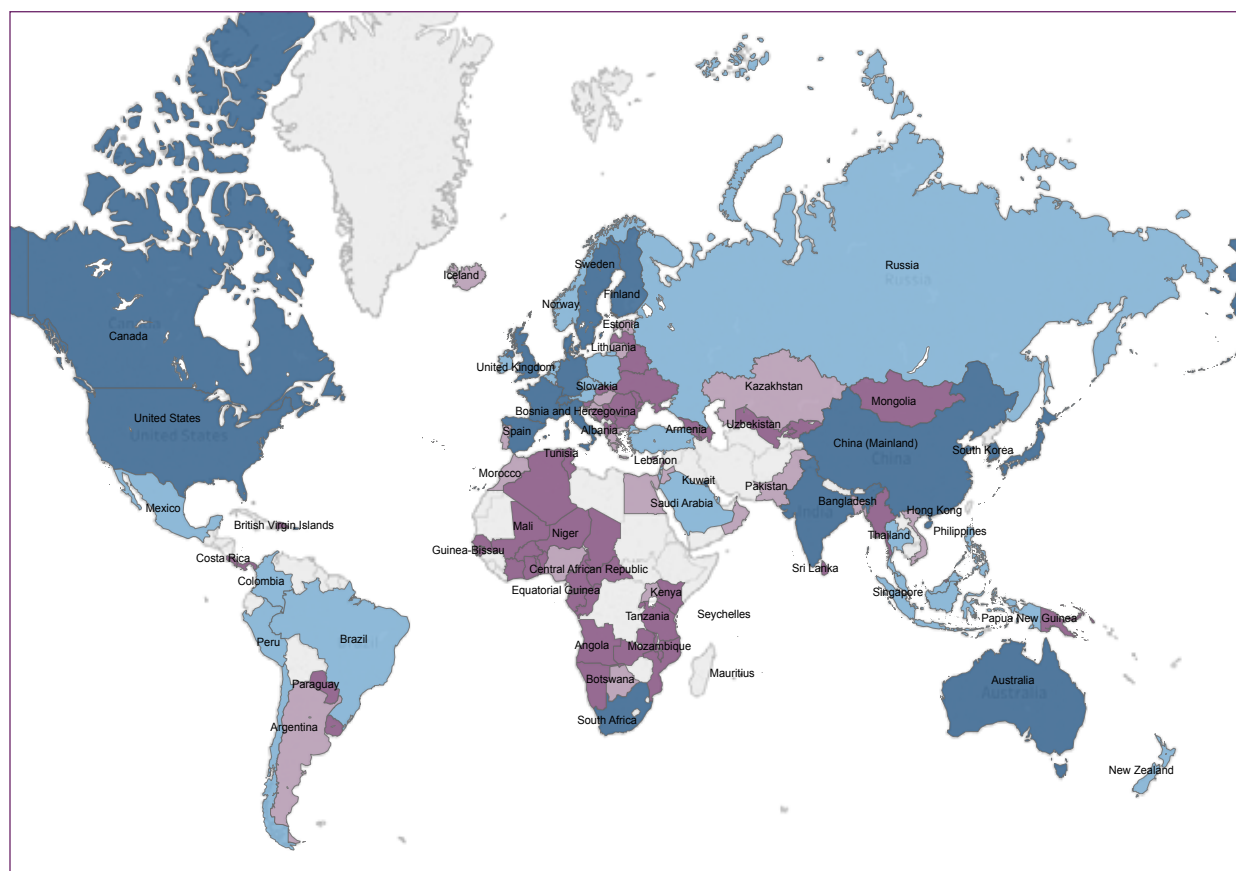
10. Due to data limitations the fourth attribute could not be assessed. Also, blank areas reflect countries for which data were not available.

are still small, and, especially for non-sovereign issuances, lack liquidity. From the investors' side, in many emerging and developing economies pension funds have already achieved significant growth, while other institutional investors are usually lagging. Retail investors' participation remains small as well although in many countries they are beginning to assume a larger role, mainly via mutual funds. As a result, in the majority of emerging markets and developing economies,

capital markets are only partially playing the role of channeling resources to the corporate sector and providing investment opportunities to investors, whereas their contribution to other strategic sectors is minimal.

In this context, it is critical to understand how capital markets develop, and in particular whether there is a set of conditions that is needed for this development to take off.

Figure 2: Index of Domestic Market Size, Access and Activity



Note: The Index is based on three sub-indices: the government bond market index, the corporate bond market index, and the equity market index. The index is biased towards larger economies, as its indicators (debt markets: amount issued, amount outstanding, number of issuers average issuance size) are based on absolute values to reflect the market's actual size and depth. The index only includes domestic issuances—that is, it does not include Eurobond issuances (a total market of 23 trillion USD during 2010-June 2019, as a result of which financial hubs and several European countries appear smaller in size and activity than they actually are. Data sources: Debt—Thomson Reuters, expected data coverage 60-70%, period: 2010-June 2019; equity—World Bank Group, expected data coverage 40-50%, period: 2010-2017.

What are the Key Preconditions for Capital Markets Development?

While rudimentary forms of capital markets can develop in any economy, a sustainable and well-functioning capital market has preconditions.

These preconditions can be grouped into three categories, encompassing i) macroeconomic stability; ii) a certain level of development of the financial sector; and iii) a robust legal and institutional environment.

There is no pre-determined threshold delimiting the extent to which each of these preconditions must be met for capital markets to develop.

What is clear from experience, and backed by WBG empirical research, is that these preconditions are interlinked and that the less developed those preconditions are, the less likely it is that specific actions taken to develop the capital markets on the supply, demand, and market infrastructure sides will have a material impact. Further, the line between preconditions and other factors that are considered drivers of capital markets development—such as liquidity, robust and efficient market infrastructure and specialized capital markets regulation — is often blurred.

Macroeconomic Stability

For investors to invest long-term, macroeconomic stability needs to be maintained over an extended period of time. The critical importance of macroeconomic stability for capital markets development is one of the key lessons arising from WBG work in the field. Indeed, the persistent high inflation prevailing in some emerging markets and developing economies dissuades investors from investing long term. Similarly, in many emerging and developing economies the need to finance large fiscal deficits has effectively led their governments to crowd-out the private sector, as the returns on government securities are too

high for private issuers to offer competition. The need for macroeconomic stability to provide confidence to investors, especially at an early stage of development of the capital markets, was also highlighted by market participants surveyed. Along these lines, empirical research confirms the correlation of a set of macroeconomic variables with capital market development, including low and stable inflation rates, economic growth and a certain level of savings, good fiscal governance and a strong current account balance.

The existence of a deep and liquid sovereign yield curve has an important role in capital markets development.

The main role of a sovereign yield curve is to provide a reference against which investors can benchmark other domestic securities. As government securities are considered risk-free within the domestic market, the returns paid serve as a reference for the valuation of other domestic securities, including corporate bonds and for investors to assess whether the potential returns offered by these securities are sufficient as relates to the added risk. In addition, the government yield curve also supports the implementation of fiscal and monetary policies with positive implications to a country's overall macroeconomic stability. The importance of a well-developed yield curve has been highlighted by private participants and it is in line with the WBG's field experience.¹¹

A relatively developed financial system

Capital markets development requires a certain level of financial sector development, in particular a sound and competitive banking system. Banks have a key role to play as the main providers of credit, sending signals to other market agents about the potential creditworthiness of companies. Further, banks also provide key market infrastructure, including payments and custody services; banks also act as an important issuer and investor, especially in the early stage of capital

11. Much of the empirical research on preconditions has focused on the size of the government bond markets; rather than on the existence of a deep and liquid yield curve. This approach to the topic, however, relies on a flawed proxy. For details, see Carvajal, Ana and Ricardo Bebcguk. 2019.

markets development. As a country's economic development deepens, other financial services are needed and capital markets therefore represent the next step for a maturing economy to further improve resource allocation and support continued growth. The importance of the banking system for capital markets development has been highlighted by empirical research, which shows that countries with well-developed capital markets tend also to have a well-developed banking system, and in particular a certain level of depth to their credit markets, which also brings a minimum level of information. According to several empirical studies, this effect of financial deepening is especially strong in countries with a competitive banking system, that is, one where monopolies and oligopolies are absent. That said, to some extent there is an inherent tension between capital markets and banks, as in practice they compete for companies in the credit market. Indeed, the global financial crisis has shown how the financial condition of banks can impact, both positively or negatively, the development of capital markets.¹² This situation, and in particular the challenge of ensuring complementarity rather than competition between capital markets and banks, has been highlighted by market participants as a key challenge faced by many countries as they develop their capital markets. There is no easy solution to this challenge—however, robust regulations (that take into account how each sector manages issues such as maturity and liquidity mismatches) are key to ensure a certain degree of complementarity.

The existence of a sufficiently large domestic institutional investor base is also key for capital markets development. In the WBG's view the development of a domestic institutional investor base is a critical anchor for a market, both because of their long-term investment horizon as well as their tendency to hold a relatively large amount of assets under management compared to the overall financial system. The existing research supports this observation, highlighting in particular the role

that pension funds have had in many emerging and developing economies in supporting capital markets development. Over time, however, a fully diversified investor base would be needed to deepen the markets and enhance liquidity (as different types of investors have different needs and risk tolerances), which in turn fosters the development of different financial instruments and potentially increases trading.

Financial liberalization, while important for capital markets development, must be appropriately sequenced. Overall, the empirical research has found a strong correlation between capital markets development and foreign access to the capital markets. However, cross-country experience indicates that while the participation of foreign investors brings benefits, it also adds risks and makes it more difficult for governments to manage changes in global and domestic macroeconomic conditions. As a result, it is necessary that certain preconditions are in place, ahead of financial liberalization. This issue will be explored further later in this Primer.

A Solid Legal and Institutional Environment

The existence of effective mechanisms to enforce investors' rights is a key component of the legal and institutional environment needed for capital markets development. For investors to participate in capital markets, mechanisms must be in place that ensure their rights, as creditors or shareholders in companies, or as clients of securities intermediaries, are adequately protected, and that in the event of breaches to such rights, there will be mechanisms to enforce remedies. This encompasses both private enforcement mechanisms—whereby investors themselves seek redress via different channels, for example, by bringing legal suits—and public enforcement mechanisms—via the securities market regulator.

12. For example, in Europe, bank deleveraging caused banks to reduce their lending activities. This, together with financial technology, has fostered the development of alternative lending mechanisms, such as lending platforms and credit funds that bring together companies in need of credit with capital markets investors.

The necessary cornerstone is respect for the rule of law, and political stability. Over and above the financial market-specific dimensions of institutional strength are the country's overall institutional foundations. In the end investors need to have confidence that they will not be expropriated. This confidence stems from the degree of respect paid by the public administration to the rule of law and the absence of political corruption. Certainty in policy-decision making, irrespective of the longevity or political orientation of a particular government, has also been highlighted by foreign investors who are seeking certainty in the entrance and exit of their flows.

Political commitment and political continuity are also critical for capital markets development. For many countries, capital markets development is a long-term endeavor that requires the implementation of actions by different public authorities that might impinge upon the status quo and entrenched interests or that could have an important fiscal impact. Thus, one of the key lessons from WBG work in the field is the need for a political champion who leads and coordinates public actions. Along similar lines, market participants highlighted the need for consistent policy and clear communications regarding the reform of financial markets. Finally, market participants also highlighted the need for a well-equipped and well-educated public administration that can respond to market needs in a timely and effective manner.

Market Potential

Finally, the size of the economy functions as a key determinant of market potential. Capital markets require a certain number of issuers, investors and transactions to achieve the economy of scale that not only permits their efficient function but also sustains the capital markets' infrastructure. The cost of setting up trading, clearing and settlement

systems are fixed and therefore a certain scale of business is required to render capital markets viable. This finding has ample support in the empirical research, which shows that, all other things being equal, larger economies tend to have larger capital markets. It was also confirmed by the market participants surveyed. In addition, certain microeconomic factors, which are likely associated with the size of the economy, seem to play a material role in capital markets development, in particular the structure of the corporate sector (for example, the number of large firms) and the level of diversification within an economy—although neither of these two factors has been covered by existing research. The WBG is therefore planning to conduct additional empirical research with a view to obtaining a better understanding of the impact of these two factors in capital markets development.

The impact of the size of the economy on capital market development requires authorities in small economies to hold realistic expectations. In particular, a clear prioritization of efforts and an alternative development strategy need to be considered depending on a given country's situation. First, if in addition to size, a country has problems meeting the preconditions of capital markets development then priority should be given to addressing such challenges. Second, a different development strategy could be considered, such as creating an easy but well-managed access to international markets for domestic companies and investors, or developing a competitive advantage that is strong enough to attract a large number of foreign market participants. However, on the latter point experience has shown that very few countries have a unique value added that enable them to become an international financial center.¹³ Finally, it is important to acknowledge that in theory regional integration could be a solution to the scale problem of small economies. However, regional integration initiatives entail complex and protracted

13. Further, this value added cannot longer be predicated in "transparency or disclosure arbitrages", given the movement towards greater transparency and disclosure of corporate and tax information by international organizations such as FATF and the OECD.

processes that require a significant level of political commitment, and in practice this complexity tends to cause such efforts to falter. Ensuring the necessary level of political commitment is even more difficult

in the absence of a formal political (and economic) union. Thus, regional initiatives must be assessed very carefully, with a view to ensuring alignment of domestic and regional priorities.

Box 1. Regional Integration

There is no universal definition of regional integration of capital markets although it is usually associated with the free flow of capital and investment services across a defined set of countries.

While some level of integration can be achieved without intervention at the policy level; as integration progresses such an intervention will be needed to address obstacles that prevent the free flow of capital and services. Theoretically, regional integration is an attractive proposition particularly for small countries whose domestic markets do not offer the necessary diversification of investment opportunities to investors or the funding advantages to companies, due to the lack of scale and the efficiencies that accompany it. The free flow of capital (and services) that is at the core of regional integration should translate in the possibility for existing companies in the region to appeal for funding from a wider base of investors, and for existing investors to choose among a broader set of investment opportunities, without additional costs, which should in turn translate into better price formation and portfolio allocation.

Despite its obvious appeal, very few projects of regional integration have achieved large scale “success”.

In addition to the European Union, there are projects of integration in all other regions, including Mercado Integrado Latinoamericano (MILA) initiatives in South America, the West African Economic and Monetary Union, the East Africa Community initiatives in Africa and the Association of Southeast Asian Nations (ASEAN) initiative in Asia. The European Union has achieved a relative degree of capital markets integration. Yet the capital markets union initiative has highlighted that more needs to be done to link investors and savers with companies efficiently and to unlock the potential of capital markets for long term investment. In all other regions, integration projects are at earlier stages, although some of them have already had impact. For example, the ASEAN initiative has helped the region's LCY corporate bond market grow by two orders of magnitude, from \$48 billion at year-end 2007 to over \$4 trillion at year-end 2017.

A review of these experiences shows that regional integration entails complex processes that require a significant amount of political support.

While theoretically appealing, in practice projects of integration give rise to a variety of concerns on the parts of both participants and the public authorities. From a private sector perspective, the key concern relates to the potential effects of competition on market participants. From a public sector perspective, a key concern relates to the potential for regulatory arbitrage and harm to investors and to financial stability. Irrespective of the merit of some of these concerns, it is difficult in practice to advance a project that is seen as a “losing proposition” by stakeholders who have strong political clout.

Some lessons can be drawn as to the potential for success of regional integration. There is no single model that can be predicated; rather any regional integration project needs to be adapted to the circumstances of the countries and the region where it would be implemented. However, the following overall issues need to be taken into consideration before any attempt at regional integration:

- **Basic preconditions:** The existence of strong economic ties between the countries seems to be a precondition for projects of integration in the financial sector. Ideally a single currency should be in place but the experience of capital markets in Europe show that the process of integration can start even with multiple currencies; however in that case, the availability of hedging mechanisms is critical. A similar legal tradition facilitates integration but is not a necessary precondition.

Box 1. Regional Integration (continued)

- **Level of development:** Integration projects might face fewer challenges when they involve countries that are at similar levels of development, so that in general all categories of stakeholders may perceive the benefits latent within integration.
- **The approach to the regulatory framework:** The regulatory framework that supports the offering and trading of securities and the provision of services in the region needs to provide comfort to the public authorities that the risk of regulatory arbitrage and harm to investor protection and financial stability are being minimized. Mutual recognition tends to work better when the legal and regulatory framework of the jurisdictions involved are perceived to provide a similar level of protection to investors (even if differences exist). If that perception does not exist, then regulatory harmonization might be needed.
- **The approach to supervision:** In principle integration requires the implementation of arrangements for the exchange of information, cooperation and coordination. However, experience shows that as integration deepens stronger supervisory arrangements are needed, including the creation of regional bodies, initially to better coordinate but over time to assume direct supervisory and enforcement functions.
- **The approach to market infrastructure:** Integration of market infrastructure is a complex subject. Integration does not necessarily require the existence of one single set of infrastructures (that is, just one exchange, one central securities depository, and so on). However, key to investors' ability to access all markets is the need for interoperability, particularly of the post-trading infrastructure to avoid undue costs.
- **The need to harmonize the enabling environment:** In the long run, full integration requires the harmonization of the enabling environment, including in sensitive areas such as the tax framework and the insolvency framework.

Increasing integration of capital markets can also bring increased risks. For example, domestic markets become more susceptible to global volatilities and operational and concentration risks may arise from the adoption of new, more interconnected and consolidated technologies and platforms. Prudent risk management should not be overlooked as emerging countries seek greater integration with regional and international markets.

Should Capital Markets Development be Sequenced?

Beyond these key preconditions, there is no blueprint for capital market development: each country is different. The pace of capital market development varies according to country-specific circumstances, also affected by domestic market shocks, exogenous events and global market conditions. Even if these events do not otherwise have a major or lasting economic impact, they can

in some cases have a significant adverse effect on the confidence of market participants and set back the market's development. Furthermore, attitudes towards transparency, governance, and control, as well as the broader corporate culture, play a major role in the development of capital markets. In the end, capital markets development is a matter of building trust between issuers, intermediaries and investors and so any factor that influences that relationship will ultimately shape the way a market develops. Hence, while examples from

other countries are useful, the actions to be taken in each country need to be tailored to its specific characteristics.

There is no rigid sequencing for developing markets for different asset classes. Overall government bond markets tend to develop earlier than other markets; however, as discussed earlier, in some economies where government debt markets grow too large, they can crowd out the private sector by disincentivizing investors from considering other types of assets.¹⁴ The experience of the WBG in the field suggests that in practice there is no rigid sequencing between equity and corporate bond markets; rather these two markets tend to develop in parallel (due to their complementarity) albeit at different speeds—depending on local context. The empirical research in this area is limited and shows contradictory results, which in the end reinforces WBG’s position concerning the absence of a rigid sequencing. Finally, experience indicates that derivatives markets tend to develop at a later stage, when the cash markets have achieved a certain level of liquidity.

There is no rigid sequencing regarding the development of the investor base; however based on its experience and cross-country lessons, WBG recommends focusing first on domestic investors. As indicated earlier, policy makers should focus on developing a diverse investor base. Considerable attention should be given to the creation of an institutional investor base in which to anchor the market. As indicated above, in some emerging markets and developing

economies pension funds have developed faster than other institutional investors, as a result of the implementation of government policies that mandate the creation of a retirement savings scheme. Their creation has had a material impact in capital markets development, as demonstrated by empirical research. In addition, a combination of economic growth and demographics is also prompting growth of the mutual fund industry, albeit in most cases at a slower pace than pension funds. Other institutional investors have lagged, in particular insurance companies, due to the low levels of penetration of life insurance. Thus, it is critical that governments have in place policies aimed fostering the development of all such investors.

The participation of foreign investors in domestic markets can offer substantial benefits but its timing should be carefully considered. The participation of foreign investors can deepen and diversify the pool of capital available to finance domestic investment, as well as lengthen maturities, increase competition, and spur improvements in transparency and governance of domestic companies. However, it also carries risks; foreign investors are more sensitive to global market conditions and may have different reaction compared to domestic investors, thus, potentially adding to market volatility. As a result, foreign flows should be subject to careful monitoring, robust safeguards (in the form of available capital flow measures), as well as accompanied by efforts to develop the domestic investor base to help governments manage potential stops and reversals of foreign flows.

14. That is likely the reason why the empirical studies have not found a clear correlation between government bond markets and bond markets.

Box 2. Foreign Investors in Domestic Capital Markets

Foreign investors' interest in emerging and developing countries' assets denominated in local currency remains largely limited to government debt. Overall, foreign investor participation is likely to depend on a continued strong track record of a country's local capital markets (sovereign and non-sovereign), including the following conditions:

- 1. Accessibility & Good Settlement Infrastructure**—the ability to open an onshore account easily and access to at least one bank that can service foreign investment flows and meet international standards. In addition, foreign investors require an easy way in and out and so prefer economies with either no capital controls or predictable capital control policies.
- 2. FX convertibility**—Confidence in a country's exchange rate regime, supported by a low and stable inflation environment overtime. A developed foreign exchange market that allows flows to be converted at any time.
- 3. Legal & Information Infrastructure**—the protection of property rights and contract enforcement.
- 4. Data**—quality data on a macro- (for example, economic growth, government debt forecast) and micro-level (for example, a firm's sales performance, equity return, and leverage) that are easily accessible.
- 5. Size**—a certain minimum investments size that allows large institutional investors to justify their credit analysis efforts and deploy their assets under management.
- 6. Liquidity**—an exit option (independent of its price) present at any time, a requirement that foreign investors value highly, especially after a financial crisis.
- 7. Tax**—a level playing field that ensures a fair treatment of foreign with respect to domestic investors.

Although the benefits of foreign investor participation on domestic capital markets can be large, the timing and conditions under which a country will liberalize should be carefully chosen. Foreign investors remain driven by high yield premia, and their investment decisions can therefore reverse quickly, creating market volatility. Thus, a successful liberalization of capital markets requires a certain degree of domestic market development first, including:

- 1. A large domestic investor base** that has the capacity to keep the liquidity center within the country, including in times of larger international liquidity outflows;
- 2. A very strong central bank** with well-functioning monetary policy and liquidity management tools to respond quickly to any larger investment in- and outflows.

What Role Should the Government Play?

The government—defined broadly to include the central bank, regulatory agencies, and all institutions with a public policy mandate—has a crucial role to play in the development of the local capital markets. As will be examined below, at a minimum this role includes the need to ensure that preconditions and appropriate regulation and supervision are in place. However, WBG experience in the field indicates that in many emerging markets and developing economies government authorities need to take a more active role at the strategic level, developing a plan for capital markets development, and also using different policy tools and interventions if they want to foster the development of the capital markets.

Building the Fundamentals

The first responsibility of the government is to ensure that the preconditions for capital markets development are in place. This includes maintaining prudent macroeconomic management, that can result in growth, low inflation, and low yields on government debt, which would in turn allow private companies to attract investors. It also encompasses establishing the basic legal and institutional framework. Regarding the financial sector, their role is mainly exercised through sound regulation and supervision to promote the development of a robust financial system. In addition, government policies in complementary areas can have a critical impact on capital markets development, such as have been the case with reforms implemented in different countries to create mandatory retirement savings vehicles. Hence a need to consider such impacts as part of the design of such policies. As many of these issues fall under the purview of different public authorities there is a need to ensure that all such authorities are involved and committed to the overall objective of developing sustainable capital markets—ranging from the financial authorities and the central bank to other public authorities, such as the ministry of finance, the legislative body and the judiciary. Thus,

active coordination and cooperation is critical to the success of capital markets development.

The second responsibility is to ensure that good regulation is in place. In defining the rules of the game governments should seek the right balance between market development and maintaining investor protection and financial stability. In this context, and to foster sustainable growth, it is critical that such regulations are proportionate to the level of development of the market, while still aligned with international standards. A problem found in many emerging markets and developing economies is a tendency to copy the regulations of more advanced economies, without a proper understanding of the differences in market structure, leading in some cases to overly restrictive requirements that could stifle development. Thus, it is critical that regulatory authorities have consultation processes to seek feedback from market stakeholders on key issues, including alignment of the draft regulations with a given country's context.

On the other hand, capital markets entail risks to both investor protection and financial stability that need to be adequately monitored and managed. With respect to consumers, these risks could entail misconduct like misselling, self-dealing, or even fraud, while, on the stability side excessive leverage, or maturity, liquidity or currency mismatches could lead to a buildup of vulnerabilities that could threaten financial stability. Thus, financial supervisors should adopt mechanisms to identify and monitor financial risks early on; further, they also need to supervise the markets with a view to ensuring that adequate measures are taking to prevent such risks from realizing, including changes to regulations if necessary. As capital markets grow and become more interconnected with other parts of the financial sector as well as with global markets, mechanisms to coordinate with other domestic authorities, including the central bank, and with foreign supervisors are crucial. Yet, supervisory capacity is a key challenge for many emerging markets and developing economies, triggered by the lack of skilled personnel, problems in funding and sometimes also challenges to the independence

of the supervisor. Thus, ensuring the capacity of domestic supervisors should remain a key priority for emerging markets and developing economies.

Finally, enforcement needs to be used proactively to build up and maintain investors' confidence in the markets. Similar to supervision, capacity issues greatly affect emerging markets' and developing economies' ability to ensure effective enforcement, compounded in some cases by gaps in the legal framework that do not provide financial supervisors

with strong enforcement tools, such as the ability to impose proportionate fines. In addition, in many emerging markets and developing economies there is a misapprehension that robust enforcement can choke a market; however, in many cases the problem lies in the regulations rather than their enforcement. Furthermore, a supervisor who is not willing to enforce their rules is bound to lose credibility; which in the long term will lead to a loss of investors' confidence in the fairness of the market.

Box 3. Risks Stemming from Capital Markets

In many emerging markets and developing economies the markets for non-governmental issuers are still at early stages; thus, many of the risks stemming from the capital markets are still tied to the government bond markets, and as a result, to the fiscal position of the Government.

The concentration of holdings in government securities can be a significant challenge for the respective government, as well as its investors. In the early phase of market development, those investors are often banks, which invest in government securities partly by choice and partly for regulatory reasons — for example, due to statutory reserve and liquid asset requirements. However, depending on the countries' debt trajectory, this can result in a sovereign bank nexus that poses a systemic risk, and discourages banks from lending to the real economy, as they prefer to invest in government bonds given their risk-reward profile. Further, high fiscal deficits that are financed through government securities can effectively crowd-out financing options for the private sector, as investors in general (not just banks) prefer to invest in what are perceived to be low risk securities with high return. This crowding-out effect can be seen in several emerging markets and developing economies. However, it is important to recognize that other factors also play a role, including the limited appetite of companies for diversifying their sources of funding.

Beyond this nexus and the crowding-out effect, other types of concerns and risks might arise from the placement of products that rely on government bonds to retail investors. For example, in 2004 Costa Rica suffered a "run" on its mutual fund industry, triggered by changes in US macroeconomic policies, which in turn caused a repricing of credit risk across emerging markets. At that time the mutual funds were heavily concentrated in government bonds, thus the repricing of such bonds caused losses in these funds for the first time. This, in turn, led to the run. To a large extent, the run was a result of a misperception by investors of the nature of the product, which was partly reinforced by poor selling practices, since many investors bought participations in the funds thinking that they were demand deposits yielding a higher interest rate. This situation did not trigger a systemic event, but it did affect investors' confidence in the Costa Rican mutual fund industry, with investment levels remaining below pre- "run" levels for an extended period of time. This example highlights the importance of having strong business conduct regulations, in particular suitability obligations, for the intermediaries that distribute securities products, including mutual funds—even if most of their investment is in government securities. In addition, the level of financial literacy within the financial system is an important consideration for policy makers and should be taken into account.

As capital markets develop, more corporate and non-government entities will explore options away from traditional bank financing, both equity and debt. As a result, risks associated with capital market development will also begin to shift to the private sector. In this context, robust disclosure and governance

Box 3. Risks Stemming from Capital Markets (continued)

requirements on companies that investors invest in become a key pillar for capital market development, along with robust business conduct obligations for the intermediaries through which investors participate in capital markets.

At an initial level of development, private capital markets are not likely to give rise to material financial stability concerns. However, they can (and do) give rise to investor protection issues from fraud, to faulty disclosure and misselling practices. Indeed, examples of fraud, and in particular of Pongzi schemes, can be seen across a wide range of countries, relying on different types of instruments. For example, in the case of Jamaica, Pongzi schemes proliferated around forex investments in 2006-2008, which resulted in significant losses for investors; more recently in China, Pongzi schemes have developed in connection with lending platforms; while currently several countries are experiencing frauds in connection with initial coin offerings (ICOs). It is important to mention that mitigating the risks of fraud, faulty disclosure and misselling constitute a key concern for securities regulators of capital markets at all levels of development.

Financial stability concerns become a more important issue for capital markets as they deepen. For example, as mutual funds become a key source of funding for banks, and to the corporate sector, so issues of interconnectedness may become more important—as demonstrated by the 2008 run in the US money market fund industry. Likewise, the more companies access the markets for debt financing, the greater the need to monitor the build-up of leverage. In this context, authorities should focus attention on creating mechanisms that allow for the identification of risks across all segments of the financial sector in order to coordinate actions. In many countries, financial stability committees have been created to identify and manage emerging and systemic risks. The WBG-IMF Financial Sector Assessment Program (FSAP) is a key tool to assist countries in identifying vulnerabilities in their financial sectors, along with actions to mitigate them.

Finally, in most emerging markets and developing economies, foreign investors focus their investment on sovereign securities. However, in certain larger markets, foreign investors do invest in corporates and other securities issued by private entities. As they do, then the interconnection with global capital markets becomes deeper. In this context, the need for further mechanisms of coordination and cooperation at the global level becomes critical. The IOSCO Multilateral Memorandum of Understanding (MMoU) is a key mechanism to exchange information that focuses on enforcement. Other mechanisms are being created to enhance coordination in supervisory activities, such as colleges of supervisors. Finally the FSB plays a key role in the identification of global vulnerabilities.

Active Promotion of Market Development

For most emerging and developing economies, the challenges of developing capital markets are manifold and require the articulation of policy actions by different public authorities. Governments should develop a strategy anchored in detailed action plans and communicate this strategy clearly. The management of expectations is vital throughout the entire process. A good action plan should be:

- **Holistic and comprehensive with anchors in sector-specific assessments**—Especially if

capital markets are to serve the fulfillment of the SDGs, sectorial analyses of the supply side, demand side and market infrastructure are key because the requirements and potential actions needed are often very specific. For example, many solutions to mobilize investors to infrastructure financing require a strong PPP framework to be in place.

- **Tailored to market structure and appropriately sequenced**—Actions should respond to the needs of the economy and be aligned with the level of sophistication of the market. As discussed above, the complexity of instruments and products

should be increased gradually and respond to the capacity of market participants to evaluate and manage the risk imbedded within them.

- **Take into consideration non-traditional solutions**—Increasingly non-traditional solutions are being leveraged to mobilize capital markets investors, including solutions brought by fintech. Thus, it is key that action plans consider efforts to promote the consideration and development of such solutions, starting with a legal and regulatory environment that promotes innovation, while ensuring appropriate investor protection and management of systemic risk.
- **Time bound**—in order to strengthen accountability.

To this end, broad engagement with the private sector is necessary. In some countries this objective has been achieved through the use of committees for capital markets development with representation from public and private stakeholders. In others there are white papers circulated and follow-on workshops organized to discuss the action plans and the subsequent laws and regulations.

This process of strategizing and prioritization should not be seen as a one-time exercise. Experience shows that the process of capital market development is neither smooth nor uniform but rather highly idiosyncratic, different in each country, and subject to stops and possibly reversals. This requires constant vigilance and preparedness to intervene, if necessary, to “unblock” the process of market deepening. That is why it is critical the authorities keep the pulse on the implementation of the action plans and periodically assess the impact of the policies and measures taken, with a view to identifying whether additional and/or different actions are needed.

In addition, other types of intervention may be needed. WBG experience and survey results suggest that there might also be the need for the government to create additional incentives for market development beyond proper regulation

and supervision, including the use of tax policies or other tools to de-risk instruments and further align stakeholders’ interest with the goal of capital markets development. This may particularly be the case for newer asset classes involving risks not been traditionally taken by investors. That said, these types of action need to be assessed within broader discussions of fiscal sustainability. Actions to consider involve the use of:

- **Tax benefits**—such as tax benefits given to venture capital investors to expand SME financing.
- **Guarantees**—such as partial credit risk guarantees in the context of project bonds or SME securitization to align the risk return appetite of institutional investors with infrastructure and SME financing.
- **Co-investments** — such as co-investment by the government in infrastructure funds or in venture capital funds and other alternative lending solutions such as lending platforms, which are being used to expand private sector funding to infrastructure and SME financing.

What Role Can the Private Sector Participants Play?

It is key that private sector participants are committed to the development of resilient capital markets. This requires a high level of professionalism from private sector participants. Investors rely on financial intermediaries to advise them on their investments, manage their investment portfolios and custody their assets, as well as to provide them with a series of information services, ranging from research analysis, to pricing of securities. In addition, some financial intermediaries hold proprietary positions. All of these activities give rise to different legal duties for intermediaries with respect to investors, as well as the need for them to have robust risk management arrangements. Thus, it is the reputational capital of financial intermediaries that adds to the efficiencies of a capital markets—a loss of trust and confidence

in financial intermediaries significantly increases transactional costs, the cost of capital, and systemic risk. Promoting professionalism across the financial services industry (including via industry associations that set common standards) could be an active way for private sector actors to complement the efforts undertaken by public authorities, and in particular those undertaken by financial regulators.

How is the World Bank Supporting Capital Markets Development?

Capital markets development constitutes a core program of the WBG. The WBG reviewed its strategic approach towards capital markets development in 2019 to anchor it in the mobilization of capital markets to five strategic sectors (corporate, infrastructure, housing, SME and climate change), in line with the SDGs and WBG's twin goals. The implementation of this strategy requires work at both the national and global levels.

At the Global Level

The World Bank Group remains committed to supporting the development of resilient markets, via its contribution to global standard setting. The WBG is member of the International Organization of Securities Commissions (IOSCO), and in particular of the Assessment Committee, which is in charge of the periodic reviews of the IOSCO Principles and Methodology. In the course of these reviews, the WBG provides feedback intended to ensure that while current, the Principles retain sufficient flexibility to allow implementation in markets with different structures and at different levels of development.

The WBG also remains committed to the Financial Sector Assistance Program (FSAP) program, conducted jointly with the IMF. The FSAP was designed in the late 1990s to assist countries in identifying potential vulnerabilities

in their financial systems along with actions that could mitigate these. As part of the exercises, capital markets development diagnostics are prepared, as well as assessments of the robustness of the regulatory framework for capital markets are conducted based on the IOSCO Principles and Methodology. Periodic reviews are conducted of this program to ensure that it remains valuable to the countries it is intended to assist. The current review focusses on the incorporation of financial technology developments into the FSAP exercise.

Finally, the WBG remains committed to a deeper understanding of the role of capital markets. To this end, it has strengthened its knowledge management activities with a view to releasing both foundational pieces, such as this Primer,¹⁵ as well as more in-depth analyses of the role of capital markets in mobilizing private sector funding to key strategic sectors.¹⁶

At the National Level

The WBG is well positioned to assist individual countries in developing their capital markets through a combination of interventions on the advisory and the transaction sides. The WBG has more than 40 years of experience in developing capital markets. This history enables it to develop tailor-made solutions that adequately respond to a country's development opportunities and challenges. Depending on the development status of a country, those services can range from an activity-specific to a programmatic, multi-year approach and can comprise one or more of the following engagements:

- **Advisory services**—The WBG advises government authorities and private sector stakeholders on the development of the capital market fundamentals, including policy advice to strengthen the legal and regulatory framework for capital markets or to strengthen key market

15. See Carvajal, Ana and Ricardo Bebczuk. 2019.

16. See for example, Carvajal, Ana et al. 2020.

infrastructure, as well as advice in the design of specific instruments, such as infrastructure debt funds or green bonds. Advisory support can be complemented with development policy financing, whereby the WBG provides financing to the government tied to the accomplishment of policy goals, which can be linked to capital markets development.

- **Transactions**—Transaction interventions can encompass investments (equity and debt), guarantees (for example, partial credit guarantees) or local currency funding solutions (including cross-currency swaps) for specific private sector projects that have a catalytic market development impact.

Through the Joint Capital Markets Program (J-CAP), the WBG is providing a “one-stop shop” solution to countries as they embark on capital markets development efforts. The distinctive feature of this Initiative is precisely the joint use of advisory and transaction support to mobilize private sector financing via capital markets to key strategic sectors agreed with the government authorities, be it corporate, infrastructure, housing, SMEs or climate change financing. The combined use of advisory and transaction work creates a virtuous cycle where

one reinforces the other, maximizing impact. This in turn requires the deployment of staff across the whole WBG, operating as a one-stop window for countries. This approach is being piloted in seven jurisdictions: Bangladesh, Indonesia, Kenya, Morocco, Peru, Vietnam, and the West African Economic and Monetary Union.

The WBG is currently developing a framework to prioritize its capital markets work. The framework relies on a broad set of internal WBG criteria to support country selection, including an index of capital markets potential that the WBG developed based on a robust empirical exercise. The index scores countries against a set of preconditions, providing a starting point for assessing how well or poorly prepared a country is to take the leap into more vibrant capital markets, and to identify areas where policy reforms could improve the probability of success. In addition, as part of its knowledge management agenda the WBG is working towards deepening the understanding of the use of capital markets to finance key strategic sectors from corporates to infrastructure, housing, SME and climate change financing. The overall goal is to maximize the impact of WBG engagements.

Box 4. The JCAP approach to mobilizing institutional investors to strategic sectors: the case of Colombia

Starting in 2013, the World Bank Group (WBG) has sought to strengthen its impact in capital markets by providing an integrated solution (a “one stop shop”) to countries as they seek to address the challenges preventing mobilization of capital markets to strategic sectors. This means, using jointly advisory and transaction support in a way that they reinforce each other.

The first time such an approach found use was a project to support the Colombian authorities in mobilizing institutional investors to support infrastructure financing. This approach was different from previous attempts in that the WBG assembled an interdisciplinary team on the advisory side who assisted the authorities in identifying, evaluating and implementing the wide range of policy reforms needed to support this effort. As these reforms were implemented, staff from the investment/transactions side were brought in to identify key capital markets solutions that could help achieve the desired objective. Below is a summary of the project and its impact.

Context

- A stable macroeconomic environment, and a solid legal and institutional environment;
- A solid banking system but with insufficient absorption capacity to finance a US\$26 billion pipeline of toll roads;
- A shallow corporate bond market (5.6 % of GDP); but a large but very concentrated pension fund industry (USD 80 billion (20 % of GDP), with 4 pension funds of which 2 held 80% of the assets);
- Highly risk-averse institutional demand below AA+.

Key policy reforms implemented by the Government with support from the WBG

- Changes to the fiscal support given to the toll road program (from 15% to 30% availability payments in USD, with more frequent payments to compensate for traffic shortfalls);
- Creation of a development bank, Financiera de Desarrollo Nacional (FDN), to support market-based financing solutions with emphasis on capital markets;
- Changes to pension fund regulations, in particular to the minimum return rules and the investment regulations, to address misalignment of incentives in pension fund regulation;
- Support to the financial supervisory agency, Superintendencia Financiera de Colombia (SFC) and the Ministry of Finance to make changes in capital markets regulations, in particular the offering regime regulations, the regulations for mutual funds and project finance regulations.

Key transactions supported by the WBG

- Support to the infrastructure agency, Agencia Nacional de Infraestructura (ANI), in contract standardization and in quality control of project structuring;
- Support to FDN in the design of guarantees, and standardized project bonds;
- IFC equity investment in FDN;
- IFC investment in an infrastructure debt fund that was created to mobilize pension funds to infrastructure financing.

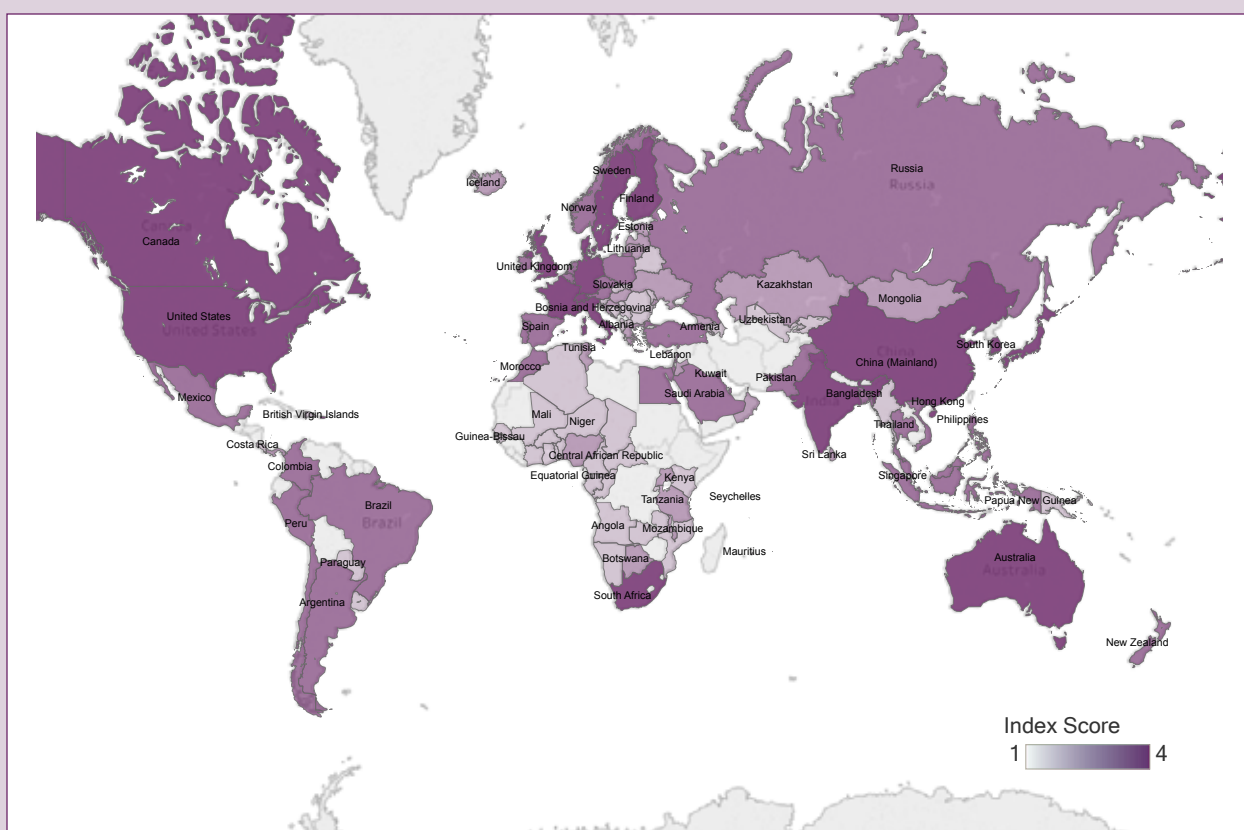
Direct development impact

- 800 km of highway were built;
- Through the infrastructure fund the Government of Colombia raised USD 400 million from capital markets investors—of which IFC invested USD 70 million.



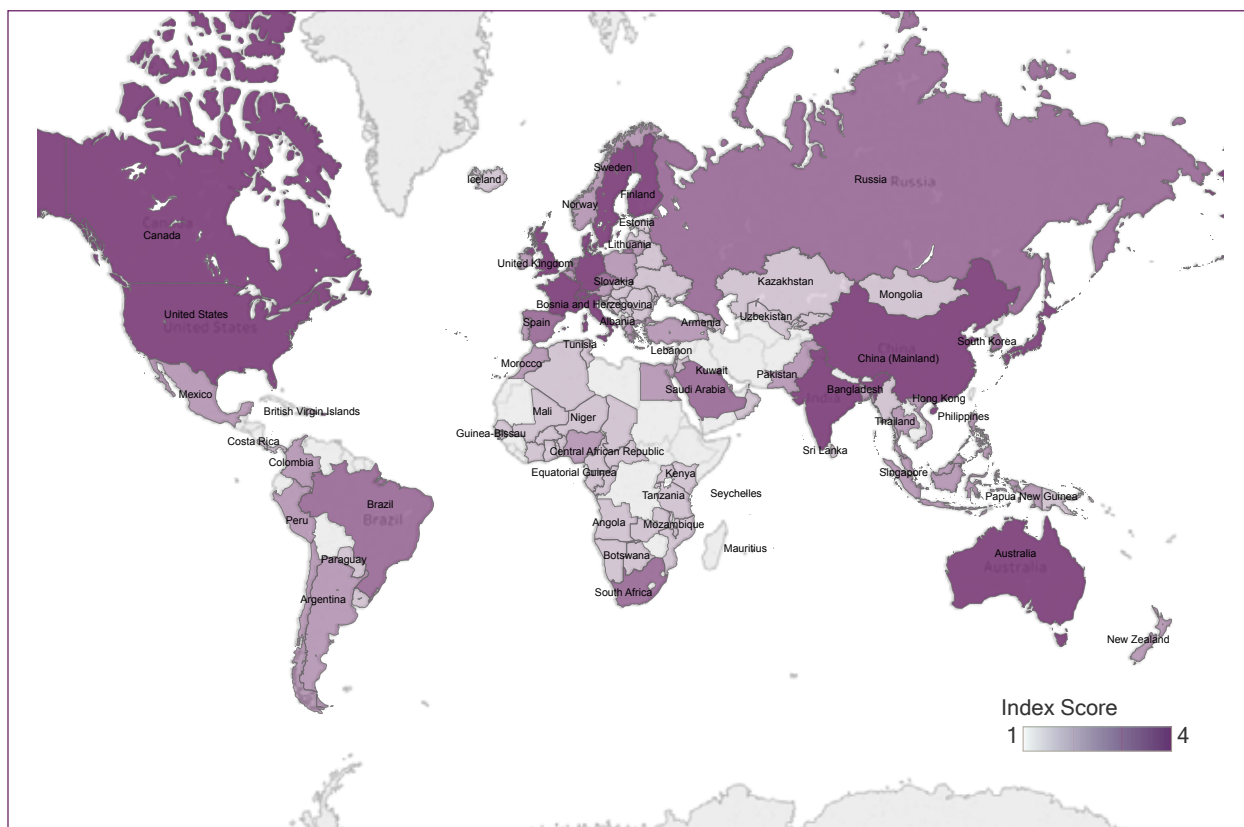
Domestic Capital Markets Size, Access and Activity Index

Sub-index Government Bond Markets



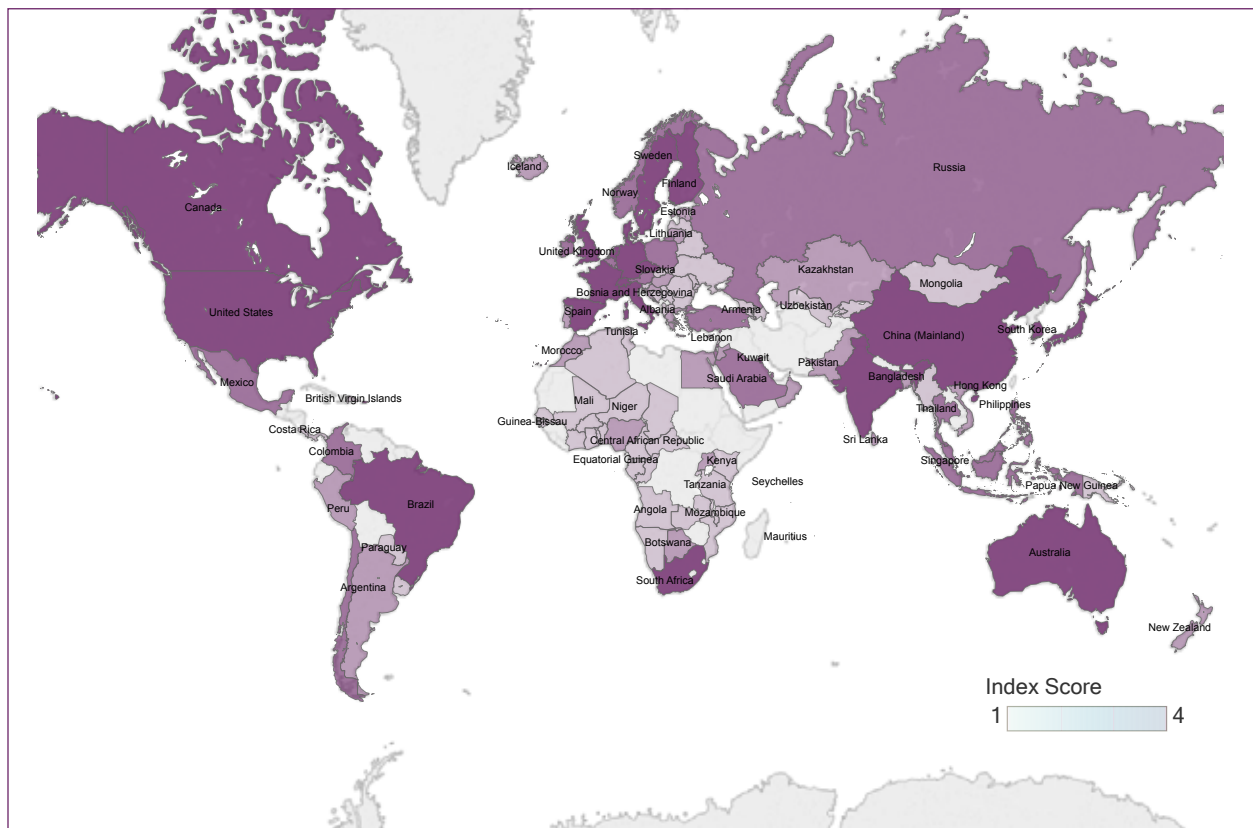
Data source: Thomson Reuters, expected coverage 60-70%; excludes Eurobonds due to the lack of information on their geographical location (total market of USD 23 trillion during 2010-June 2019); index is biased towards larger economies due to the use of absolute values as underlying datapoints so as to reflect the actual market size and activity; time period: 2010-June 2019

Sub-index Corporate Bond Markets



Data source: Thomson Reuters, expected coverage 60-70%; excludes Eurobonds due to the lack of information on their geographical location (total market of USD 23 trillion during 2010-June 2019); index is biased towards larger economies due to the use of absolute values as underlying datapoints so as to reflect the actual market size and activity; time period: 2010-June 2019

Sub-index Equity Markets



Data source: Thomson Reuters, expected coverage 60-70%; excludes Eurobonds due to the lack of information on their geographical location (total market of USD 23 trillion during 2010-June 2019); index is biased towards larger economies due to the use of absolute values as underlying datapoints so as to reflect the actual market size and activity; time period: 2010-June 2019

