

## Creating Domestic Capital Markets in Developing Countries: Perspectives from Market Participants

By **Dimitri G. Demekas** and **Anica Nerlich**

Domestic capital markets that are deep, efficient, and well-regulated can create access to long-term, local-currency finance. Interviews with market participants reveal four important findings. First, there are two distinct phases of capital market development, an embryonic phase in which the government is predominant and a mature phase in which the capital market starts to serve the private sector. Each phase has distinct preconditions and drivers that determine the success of capital market development. Second, capital market development requires continuous monitoring and policy interventions due to changing market stages, some of them stable but suboptimal. Third, while capital markets are a crucial source of large volume, long-term local currency finance, they often fail smaller countries and companies. Finally, as the capital market develops, intangible or “soft” factors become more important, including financial sophistication, a culture of trading and risk-taking, the quality of human capital, and an appreciation of transparency.

What is a “developed” capital market? In the absence of a precise and universally accepted definition, for the purposes of these interviews—and therefore for this note—a “developed” capital market is understood to be one in which participants buy and sell freely a wide range of financial assets, including fixed income and equity, with reasonable regularity and price transparency, and where liquidity is sufficient to make the prices of these assets reflect underlying market conditions.

Anything short of this admittedly loose standard is considered an underdeveloped capital market, one with room to grow and mature. Note that this definition does not incorporate minimum market capitalization, volume of transactions, or market liquidity as criteria of “development” (there are no such broadly accepted quantitative thresholds in the literature), nor does it require a certain contribution of the capital market to investment and growth. It simply requires that a market exists for a broad range of domestic financial assets and that prices clear this market at least most of the time.

But how do countries reach this state of “development”? Are there any rules that need to be followed, any preconditions that must be in place? The international development community and various policymakers in developing and emerging markets have asked themselves these questions over many years. The answers, however, remain vague and unsatisfactory. While this note does not claim to provide the remedy, it hopes to shed light from a different perspective.

Within the World Bank Group’s Joint Capital Markets Program (see Box 1 below for details), 38 structured interviews were conducted during April-May 2019 with about 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 Joint Capital Markets Program (J-CAP) interviews focused on the conditions and policies necessary for the development of domestic capital markets in emerging markets. The real-world

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insights from the interviews complement the theoretical and empirical literature and, in some cases, challenge the received wisdom, particularly with regard to the ability of market forces to deliver optimal outcomes and the role of the government.

### A “Rule of Thumb” for Capital Markets Development

The market participant interviews highlighted a wide diversity of country experiences. Each country is different, so the pace of capital markets development varies considerably with country specific circumstances, global market conditions, and exogenous events. Such events could include market shocks or defaults of domestic companies. Even if these do not otherwise have a major or lasting economic impact, they could have a significant adverse effect on the confidence of market participants and slow the development of the market. In other cases, historical factors such as a legacy of public ownership of companies play a key role in shaping the future development of the domestic capital markets.

This diversity notwithstanding, on the basis of the experience of market participants, the development of the capital markets seems in most cases to follow a general pattern with distinct stages. This general pattern should be treated more like a rule of thumb rather than a general law for capital markets development. There are exceptions to the rule, and the length and specific characteristics of each stage can vary from country to country. But at least at a high level, there are sufficient similarities to allow some useful generalizations.

We can distinguish two phases in the development of a domestic capital market. There is an **early phase**, in which the market is still embryonic. In almost all countries in this phase of development, the government is the predominant—and in some cases the only—issuer of debt in the market, in order to finance the fiscal deficit. The issuance is typically in domestic currency. The government may also be issuing foreign currency debt, typically in offshore markets. There is little secondary trading and few if any other financial instruments. An organized exchange may exist but is likely to be limited in reach. The

domestic investor base is likely to be dominated by banks. Foreign investors may be present in this market—in smaller markets they may indeed have a substantial presence—but are typically focused on yield, with a relatively short-term horizon.

And there is a **late phase**, in which domestic companies start tapping the capital markets more frequently, issuing equity and/or fixed income instruments. While this phase sees a large spectrum of development ranging from small and infant capital markets that consist of only a few non-sovereign issuers (such as Kenya), to markets that are already fairly advanced and large (such as India), there are three common characteristics. First, a domestic non-sovereign issuer base is emerging. In many countries, the market for equity appears first and the market for corporate debt develops later.

There are some notable exceptions where corporate debt markets emerge early, many of them in Latin America. Second, domestic non-bank institutional investors (such as insurance companies and pension funds) emerge and begin to play a central role. Retail investors also start to participate, either directly or indirectly through mutual funds. Foreign investors may be present—in some cases they may even start becoming long-term or strategic partners for governments and listed companies. And third, there is a fairly sophisticated legal and regulatory framework as well as a functioning market infrastructure, including an organized exchange or trading platform, a clearing house, and a depository. There may be some secondary trading, at least for government debt. Overall, a capital market in this phase of development may not yet play an important role in the overall allocation of savings; it may not be a major source of capital or funding for private companies; and it may be illiquid. But it has started serving the private sector, albeit in a limited way, and has acquired a degree of breadth and sophistication that distinguishes it from more primitive markets in the first phase.

To be sure, the distinction between these phases is somewhat arbitrary, and not all capital markets fall neatly into either.

#### Box 1 Joint Capital Markets Program

The World Bank and IFC launched the Joint Capital Markets Program (“J-CAP”) in mid-2017 to support the development of local capital markets. J-CAP mobilizes experts across the World Bank Group to advance deep, efficient, and well-regulated local capital markets that create access to long-term, local-currency finance. Such domestic capital markets are the foundation of a thriving private sector and the key driver for employment and sustainable growth. J-CAP initially focuses on six target countries—Bangladesh, Kenya, Morocco, Peru, Vietnam, and Indonesia — and one target region, the West African Economic & Monetary Union. Under J-CAP, World Bank and IFC experts work with investors to mobilize local and global savings, to prepare for market transactions through advisory services, and to develop institutional investors (i.e., pension funds and mutual funds) and new instruments for investment capital (i.e., SME securitization, mortgage securities, infra funds, and green bonds). For more information, see: [https://www.ifc.org/wps/wcm/connect/Industry\\_EXT\\_Content/IFC\\_External\\_Corporate\\_Site/Financial+Institutions/Priorities/Capital-Markets/](https://www.ifc.org/wps/wcm/connect/Industry_EXT_Content/IFC_External_Corporate_Site/Financial+Institutions/Priorities/Capital-Markets/)

Nevertheless, the two categories provide a basis for a structured discussion of the key factors behind capital market development.

## Key Factors Behind Capital Market Development

There were several factors that interview participants highlighted as important for the development of capital markets. Some of these were seen as fundamental: They are necessary even at the earliest stages of market development. Other factors become more important as the capital market grows, and they are needed for the market to continue maturing and move to the next phase of development.

### Early Phase Factors

There was near universal agreement among interview participants on the indispensable **preconditions** for the emergence of functioning capital markets.

**A basic legal and operational infrastructure.** This comprises a legal and institutional framework that ensures the clarity and enforceability of property rights for capital market instruments and collateral; the transparency of the regulatory treatment of trading activity; and a reasonably effective dispute resolution mechanism. (In the case of India, for example, the multiplicity of laws and regulatory agencies involved in various aspects of capital market activity, as well as the ease with which civil disputes could be turned into criminal disputes, were mentioned as factors that had held back market development in the past.) It also includes the ability to open accounts and execute transactions efficiently, as this is a major hurdle in certain jurisdictions, especially for foreign investors. Also needed is the presence of custodians (typically local banks) with clear separation between clients' assets and their own.

**Policy coherence and continuity.** Most participants mentioned that at least up to a point, economic and political instability were expected in frontier markets and did not deter investors—including foreign investors. However, all agreed that regardless of the stability or political orientation of the government, a certain degree of continuity in the fundamental approach vis-à-vis the capital market was necessary. This was especially crucial in the early stages of market development, when several institutional and legal reforms may be necessary to establish a functioning market—reforms that often take years to prepare and sustained effort to implement.

**The quality of the regulator and public administration.** Many participants stressed that this factor was critical for early-phase market development. Since most initiatives and innovations at this stage are top-down and typically driven by the regulator, the quality of the regulatory agency and, more broadly, of the public administration was essential for effective planning and delivery. In the case of Argentina, for example,

even though a modern capital market law had been passed by parliament, extended delays in preparing implementing regulations and in regulatory approval of new plain-vanilla mutual funds—which in other Latin American countries took at most a few days—were seen as major obstacles for the establishment of a viable market. Technical assistance or knowledge transfer from abroad could help in these areas but were not sufficient.

Once these essential preconditions are in place and a functioning domestic capital market is established—usually, at this early phase of development, just for government debt—a number of additional **growth drivers** were identified by interview participants as beneficial for the gradual deepening of the market. These drivers would, over time, allow the capital market to mature into the next phase of its development.

**Consolidating and standardizing the issuance of government debt** on a regular schedule for a range of maturities would help create an orderly and predictable market. This would encourage the entry of new investors, including foreign investors, and increase liquidity. Regular issuance of a few benchmark maturities (say, one, two, five, and ten years) would also establish a meaningful yield curve, which is critical to the pricing of other domestic currency instruments.

**Being included in an internationally recognized index**, such as the J.P. Morgan Government Bond Index (GBI) (for local currency EM sovereign debt), **provided that a strong central bank and a large domestic investor base are in place.** Once a country is included in the index, global index-tracking funds would have to invest in the country's debt and large institutional investors would also tend to make discretionary allocations. At the same time, interview participants acknowledged that not all countries could take this step: Smaller emerging markets, in particular, would find it difficult to meet the requirements for inclusion in such indices, especially those for minimum outstanding amount and trading liquidity. Further, market participants pointed out that, if not managed well, foreign flows can increase volatility and financial risk. A strong central bank is required as well as a sufficiently large domestic investor base that can counterbalance potential sudden stops. Nonetheless, all interview participants agreed that policymakers in emerging markets should strive to have their country included in an index, if at all possible.

**Access to an International Central Securities Depository (ICSD)**, such as Euroclear or Clearstream, is another step that could allow local issuers to diversify their investor base and access international investors. “Euroclearability” (the term is used here for both ICSDs) is defined as an environment where international investors are able to access the domestic capital market easily, with efficient processes for asset ownership and

transfer. A number of emerging markets including *Russia, Peru, Chile, and Poland* have established these conditions and are now Euroclearable. It has been estimated that Euroclearability is associated with a reduction in sovereign borrowing costs of 28 basis points in primary bond issues.<sup>1</sup> Some interview participants noted, however, that while the reforms required to prepare the country for Euroclearability were beneficial, Euroclearability itself was not necessary: A number of emerging markets with relatively developed capital markets in which foreign investors had a sizeable presence, such as Brazil and India, did not have Euroclearable debt. In any case, participants saw Euroclearability as the “end game” for early-phase capital markets: A country that had implemented the reforms required to achieve Euroclearability already had a relatively mature capital market.

### *Late Phase Factors*

One of the **key preconditions** for a market to transition from the early to the late phase was a **low and stable risk-free rate**. This was universally seen as a necessary condition for the private sector to be able to tap the domestic capital market in a significant way. This was crucial for corporate fixed income issuance but also important for equity. In countries where sovereign yields are persistently high, the government dominates debt issuance and crowds out demand for other instruments, especially longer-term instruments. For example, in the case of Argentina, as well as elsewhere, participants noted that there is currently little or no investor appetite for private long-term domestic currency fixed income instruments, even if they are inflation-indexed: The real returns on government debt are simply too high for private issuers to compete with.

A low and stable risk-free rate is usually associated with a **stable macroeconomic environment**. High yields on government debt are often driven by a history of macroeconomic instability—high inflation and large fiscal deficits—but could also reflect default risk. Macroeconomic stability seems to be especially important in the early phase of a markets’ development. Once market participants have developed a certain level of trust, it seems to become less important and more a matter of risk and price.

A **critical mass of domestic savings and large local investors** was another factor underscored by most interview participants. While a rudimentary market concentrated in government debt can be sustained with a few domestic investors—typically banks, which are required by regulation to invest part of their portfolios in government paper—and some foreign investors, it cannot start serving the private sector without a broader set of domestic investors with a long-term commitment to the market. Domestic insurance companies and pension funds are the natural candidates to play this role: They need to match

the long maturities of their domestic currency liabilities and, in many cases, are required to invest the bulk of their assets at home. Retail investors also have a role to play but they typically come into the market later and through mutual funds. They also have a shorter time horizon than institutional investors and tend to be less sophisticated and more sensitive to political and economic uncertainty. As regards foreign investors, most interview participants felt their presence has several benefits: It increases liquidity, opens up the market, and engenders improvements in transparency and corporate governance, etc. But as mentioned earlier, foreign investors play at best a supporting role: They can’t be the main driving force behind domestic capital market deepening. This requires large, committed, and reasonably sophisticated domestic investors.

Once the capital market has matured into the late phase of development and the private sector has begun to access it, interview participants identified a number of additional drivers that would help the market deepen further and broaden its reach. The discussions, however, also highlighted two important caveats. These challenge the neoclassical economics canon and underscore the importance of real-world insights.

First, **as markets mature, idiosyncratic and intangible factors play an increasingly important role**. Such factors include the degree of financial sophistication, a tradition of public ownership, a culture of trading, as well as the interaction between the market and the broader economic and social context. These factors are not typically covered in empirical investigations into capital market development in the economic literature.

Second, **the process of capital market deepening is not necessarily continuous and self-sustaining**. Even after the market has reached the late phase of development and appears well established, continued deepening is not guaranteed: Stalls and even reversals are possible. In a number of countries discussed in the interviews, such as *Morocco, Colombia, and the Dominican Republic*, the market had reached a certain level of capitalization and then stopped developing or, in some cases, started shrinking. Although there were no major institutional or regulatory obstacles to further deepening, the market seemed to have reached a stable, if suboptimal, equilibrium.

**With these caveats in mind, we turn to the discussion of the growth drivers** that a majority of interview participants identified as important for capital markets in the late phase of development.

The **role of domestic banks** was discussed at length. Most participants felt that domestic banks play a crucial role in the early phase of market development: They act as primary dealers for government debt, as investors, and as a bridge for foreign investors trying to enter the market. As the market

develops, however, their role becomes more ambiguous. On one hand, banks continue to be major players in the market and, in some cases, significant issuers of bonds. On the other hand, their dominant position in credit provision becomes a hurdle for the budding corporate debt market: In several of the countries discussed in the interviews, domestic companies have little appetite to issue debt in the market—with the attendant disclosure requirements and increased market scrutiny—since their credit needs are covered by banks. Moreover, some interview participants speculated that in countries where domestic commercial banks own the largest broker-dealers and investment bank outfits—for example in the Dominican Republic—the latter may have limited incentives to encourage corporate debt issuance. Thus, it is important for regulators to clearly define the rules and functions of different financial sector players and reinforce those by adequate regulation.

**Corporate attitudes toward transparency, governance, and control and the broader corporate culture** play a major role in the development of the capital market. In interviews spanning countries in *Latin America, Africa, and Asia*, participants mentioned that for many companies—especially smaller, family-owned companies—an unwillingness to disclose

information and submit to market scrutiny, fear of potential tax consequences, and reluctance to share control with other shareholders were major obstacles to market deepening. These factors, partly reflecting deep-seated cultural attitudes, were difficult to overcome. In a number of countries, including *India and Brazil*, interview participants mentioned that the stock exchange was playing a key role in addressing these concerns by educating and altering company owners’ attitudes and preparing companies for issuance. All stressed, however, that this process takes years and can sometimes go into reverse.

**Efficient market functioning** was seen as an important factor by all participants. Most mentioned **liquidity** in this connection: A shallow market with a small free float (for equities), infrequent issuance (for corporate fixed income paper), and a preponderance of buy-and-hold investors is unlikely to become a significant source of capital or funding for the private sector. Market liquidity is also a major consideration for foreign investor entry. As with size, there was no consensus on a threshold that defines a liquid market: Some global investors even said they often invest in illiquid markets if the premium is right. Instead of a certain minimum amount of trading volume, bid-ask spread, or other commonly used quantitative liquidity

**TABLE 1** Development of Domestic Capital Markets – Early and Late Phases

EARLY PHASE	LATE PHASE
<p><b>A basic legal and operational infrastructure</b></p> <ul style="list-style-type: none"> <li>· Ensures/enforces property rights</li> <li>· Provides dispute resolution</li> <li>· Enables efficient transaction execution</li> </ul> <p><b>Policy coherence and continuity</b></p> <ul style="list-style-type: none"> <li>· Provides predictability of regulation and oversight</li> </ul> <p><b>The quality of the regulator and public administration</b></p> <ul style="list-style-type: none"> <li>· Quality of human capital at the regulator is essential to effective planning and deliverability</li> </ul> <p><b>Consolidating and standardizing the issuance of government debt</b></p> <ul style="list-style-type: none"> <li>· Helps create an orderly and predictable market</li> <li>· Encourages entry of new investors, including foreign investors</li> <li>· Increases liquidity and creates a meaningful yield curve</li> </ul> <p><b>Inclusion in an index</b></p> <ul style="list-style-type: none"> <li>· Critical to attracting large foreign institutional investors</li> <li>· Forces many global index funds to allocate funds to the market</li> </ul>	<p><b>Two important caveats:</b> <i>Idiosyncratic and intangible factors play an increasingly important role, including financial sophistication level, culture of trading, interaction between market and economy, and</i></p> <p><i>The process of capital market deepening is not necessarily continuous and self-sustaining, and stalls and reversals are possible.</i></p> <p><b>Low and stable risk-free rate</b></p> <ul style="list-style-type: none"> <li>· Government yields need to fall to allow the capital market to grow</li> </ul> <p><b>Size of individual transactions</b></p> <ul style="list-style-type: none"> <li>· A minimum feasible transaction size is needed to attract buyers</li> </ul> <p><b>Total Size of the Market</b></p> <ul style="list-style-type: none"> <li>· A threshold of \$100M to \$200M of government debt outstanding is needed for sufficient liquidity</li> </ul> <p><b>Size of the Economy</b></p> <ul style="list-style-type: none"> <li>· Stock market development is difficult in economies with GDP under \$20B</li> <li>· A critical mass of domestic savings and large local investors is needed</li> </ul> <p><b>Critical role of domestic banks</b></p> <ul style="list-style-type: none"> <li>· Act as primary dealers for gov’t debt, as investors and a bridge for foreign investors</li> </ul> <p><b>Other factors needed</b></p> <ul style="list-style-type: none"> <li>· Efficient market functioning and liquidity</li> <li>· Visibility of price formation</li> <li>· Hedging instruments and derivatives</li> <li>· Ratings agencies</li> <li>· Corporate acceptance of transparency, governance, and control</li> </ul>

Source: IFC

metric, what foreign investors seemed to care most about was a diversified and uniform investor pool and a level-playing field that doesn't segregate foreign and domestic investors. This provides some assurance that "there would be someone on the other side of the trade if we decide to get out."

A related aspect of market efficiency underscored by both foreign and domestic investors was **visibility of price formation**. Absent that, it is difficult to price risk and there are concerns about market integrity. Visibility of price formation requires a certain amount of transparency and access to data, as well as enforcement of mark-to-market rules. Postponing marking-to-market because the market price is below book means that funds will not sell (or buy) and liquidity will dry up.

Lastly, efficient market functioning was a necessary condition for the emergence of more sophisticated financial products such as hedging instruments and derivatives. These products are particularly important for foreign investors. Based on the country experiences discussed in the interviews, foreign exchange hedging instruments tend to appear first and interest rate hedging instruments—also important for domestic investors—come later.

### The Role of Foreign Investors

The role of opening the domestic capital market to foreign investors was a recurring theme in the interviews. As discussed earlier, most participants stressed that foreign investors alone are not sufficient for the domestic market to develop in a sustainable way: A critical mass of savings managed by domestic long-term investors is necessary. The approach of foreign investors to developing and emerging markets remains largely motivated by yield premia. Thus, their investments are often short-term and more volatile in nature, and a sensitivity for liquidity in particular has been noticed following the financial crisis of 2007-2008.

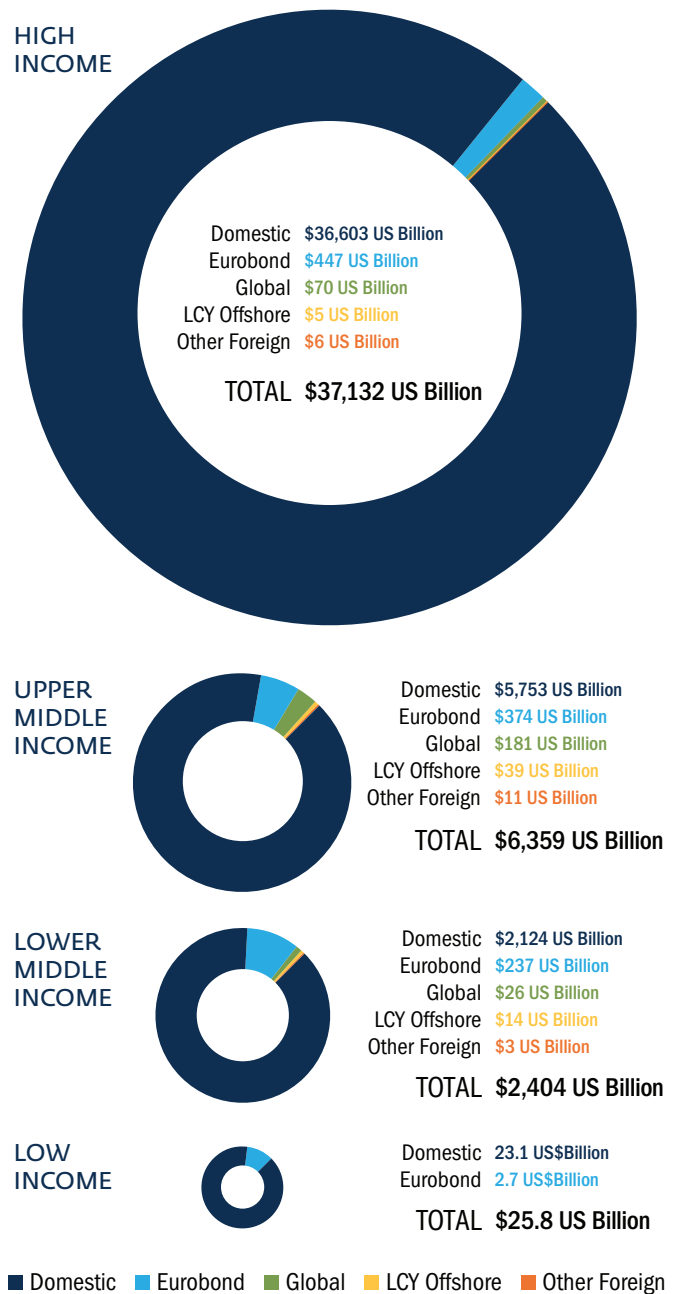
However, for a few large markets, a shift in strategy has become visible: Interview participants mentioned the case of India, where the first wave of foreign entry into the domestic equity market in the 1990s and early 2000s took the form of passive minority stakes in domestic companies, mainly to "ride the macro wave." This did not generate substantial benefits either for the companies or for the market as a whole. More recently, however, foreign investors have become more selective, acquiring larger stakes and backing specific technologies, companies, and management teams, and this approach seems to be much more beneficial. Unfortunately, the motivation and strategy of foreign investors is something over which country authorities have little information or control.

Still, nearly all participants thought that foreign entry into the market brings substantial benefits: deepening and diversifying

the pool of capital available to finance domestic investment; lengthening maturities; increasing competition to the benefit of domestic issuers; and spurring improvements in transparency and governance of domestic companies.

Needless to say, these benefits materialize only if the intention to open the market to foreign capital is sincere, sustained, and supported by a consistent legal, tax, and regulatory framework.

However, interview participants stressed that the decision to open the domestic market to foreign capital is, for practical



**FIGURE 1** Government Bond Markets—Domestic versus International Issuance (US\$ Billions)

Source: Thomson Reuters. Note: LCY = Local Currency.

purposes, irreversible: Reversing it would generate so much financial and reputational damage that most country authorities avoid it at all costs. It is therefore critical to time and sequence this decision appropriately, taking into account the country's balance of payments and, more broadly, macroeconomic stability, in order to minimize the risk of sudden stops or reversals to capital flow.

### **Market Failure: Small Economies and Enterprises**

There was a broad agreement among interview participants that size matters for the development of capital markets. Although there is no widely-accepted specific threshold, small economies may not be able to develop sustainable domestic capital markets, as some empirical estimates suggest that stock markets do not seem to develop in countries with a GDP below \$20 billion.<sup>2</sup> Interestingly, interview participants did not seem to think that regional markets such as the African Exchanges Linkage Project<sup>3</sup> could be the solution to this problem. While these have benefits for investors and could in principle improve liquidity, companies and issuers that are too small for a single national market would be even smaller in a regional one. This is not to say that small economies cannot develop or benefit from capital markets. It just requires a different approach; for example, Luxembourg and Singapore have developed certain competitive advantages to attract foreign issuers and investors.

The total size of the market is also an important element, as it correlates with market liquidity. Empirical estimates by the Bank for International Settlements suggest that there is a threshold of \$100 million to \$200 million of government debt outstanding, below which sustaining a liquid government bond market may be difficult.<sup>4</sup> A total outstanding amount equivalent to \$500 million was also one condition for inclusion of a country in the J.P. Morgan Emerging Markets Bond Index (EMBI) (for dollar-denominated EM bonds).

Finally, the size of individual transactions was mentioned repeatedly by investors. For fixed income instruments in particular, there was broad agreement that issuance below a certain size could not attract buyers: The fixed costs would make it uneconomical, especially for foreign investors, since they generally face higher transaction costs and rarely, if ever, cover the entire issuance. However, there was a wide variance of views regarding the minimum feasible transaction size: Representatives of large global asset managers and investment banks felt that tickets less than the equivalent of \$50 million to \$60 million would be uneconomical; other investors, including hedge funds, suggested that much lower ticket sizes were feasible, depending on other aspects of the transaction (Armenia and Georgia were cited as examples here).

While not the only reason, the need for size is one of the reasons that the benefits of capital markets do not spread equally to the small business sector. Other reasons can be tax implications that deter smaller companies from moving to the formal economy, or the unwillingness to give up control, and this applies in particular to smaller and less sophisticated personal or family-owned businesses.

The topic of finance for small and medium enterprises (SMEs) is extensively studied—it has been a G20 priority for some years—and lies outside the scope of this note. Nevertheless, it came up repeatedly during the discussions, underscoring the sobering fact that even in a developed capital market, the SME sector is likely to remain underserved. And market forces alone are unlikely to close this gap. Thus, sustained effort and policy interventions are needed to help SMEs share in some of the benefits of capital market development.

### **An Expansive Role for the Government**

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 domestic capital market. The experience of market participants, however, suggests that this role is broader and more complex than what is usually reflected in the standard neoclassical economic literature. To be sure, the primary responsibility of the government is to ensure the preconditions for the capital market to function: Establish the basic legal and institutional framework; protect property rights; furnish the regulator with adequate independence and budgetary and human resources to do its work, including enforcement of regulations; and stay the course, avoiding arbitrary and capricious policy shifts.

In addition, the government can help the capital market to deepen and better serve the private sector by maintaining a prudent fiscal position and sound macroeconomic management. Doing so should over time result in low yields on government debt, which would in turn allow private companies to attract investors. Regular issuance of government paper on a range of maturities would also contribute to this goal by facilitating the pricing of risk and the lengthening of maturities. Yet experience shows that the government may need to play a much more expansive role.

In most cases discussed in the interviews, the government (or the regulator) led market reforms or innovations and the market followed. To be sure, many of these reforms involved reducing the footprint of the government, for example through privatizations and market liberalization. It was also understood that constant interference with market functioning can lead

to distortions. But other cases involved targeted market interventions or changing the incentives of private market participants. It appears that simple laissez faire may not be sufficient for capital market development and, moreover, that there is no single recipe for the balance between laissez faire and policy intervention that applies in all instances.

The government is uniquely placed to address country-specific issues that, according to interview participants, become increasingly important in the later stages of market development. This cannot happen by decree but requires “smart” and imaginative policies. These may involve funding financial education, sponsoring initiatives by exchanges or associations, or using state-owned entities or development banks to promote changes in corporate culture. For example, Brazil’s national development bank BNDS played a key role as strategic investor in private companies during the 1990s, helping them modernize management and bring corporate governance to international standards (although it was also criticized for growing “too big” and is now in the process of reducing its balance sheet).

Finally, the government has a key role to play in addressing the market failures that deprive SMEs the benefits of the capital market.

## Concluding Observations

There is no general law of capital market development. Every country is unique, and the speed of capital market deepening in each country reflects a host of factors, including country-specific circumstances, global market conditions, and exogenous events such as market shocks or defaults that can shake confidence and inhibit market development. Since several of these factors are outside the control of policymakers, there is no uniform script for policymakers to follow in all countries and under all circumstances.

The process of capital market development is characterized by multiple equilibria, some of them stable but suboptimal, requiring continuous monitoring and policy interventions. After an initial growth spurt, countries sometimes find themselves “stuck” with a capital market that does not function to its full potential. Although all the obvious institutional and regulatory impediments may have been removed, the private incentives of market participants do not stimulate further deepening, leaving the market at a stable but suboptimal equilibrium. At that point, only policy intervention can catalyze the next level of

market deepening. Even if the “right” initial conditions are set and market forces are allowed to operate, policy interventions may still be necessary along the way.

As the capital market develops, intangible factors become more important. These include “soft” elements such as financial sophistication, a culture of trading and risk-taking, the quality of human capital, attitudes toward transparency, and the willingness to transition from direct ownership and control of a business to indirect control through shareholding. This stands in sharp contrast to the theoretical and empirical literature on capital markets that focuses on “hard” facts such as size, macroeconomic performance, and compliance with international standards. All these elements were also mentioned by interview participants, but rarely as the most critical.

Lastly, opening the domestic capital market to foreigners has a positive impact but is not sufficient to generate a sustained process of market deepening. Foreign entry in the domestic market has benefits and costs. It can increase competition, provide a crucial additional savings pool, and spur innovation and improvements in market functioning and transparency. Yet foreign capital can also be fickle and subject to herd behavior, increasing volatility. Nevertheless, almost all respondents—including domestic respondents—said the net impact of foreign capital in their markets had been positive. All stressed, however, that a domestic capital market cannot develop through the inflow of foreign savings alone, and instead requires domestic savings.

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<sup>1</sup> Euroclear. 2019. “Impact of Euroclearability.”

<sup>2</sup> Quoted in De le Torre, Augusto and Sergio L. Schmukler. 2007. “Emerging Capital Markets and Globalization: the Latin American Experience.” World Bank and Stanford University Press.

<sup>3</sup> The African Exchanges Linkage Project is an initiative to link trading on the stock exchanges of South Africa, Morocco, Egypt, Kenya, Nigeria, Mauritius, and the West African Economic and Monetary Union (WAEMU).

<sup>4</sup> McCauley, R. and E. Remolona. 2000. “Size and Liquidity of Government Bond Markets.” *BIS Quarterly Review*, November, pp. 52-60 (available at [https://www.bis.org/publ/r\\_qt0011f.pdf](https://www.bis.org/publ/r_qt0011f.pdf)).