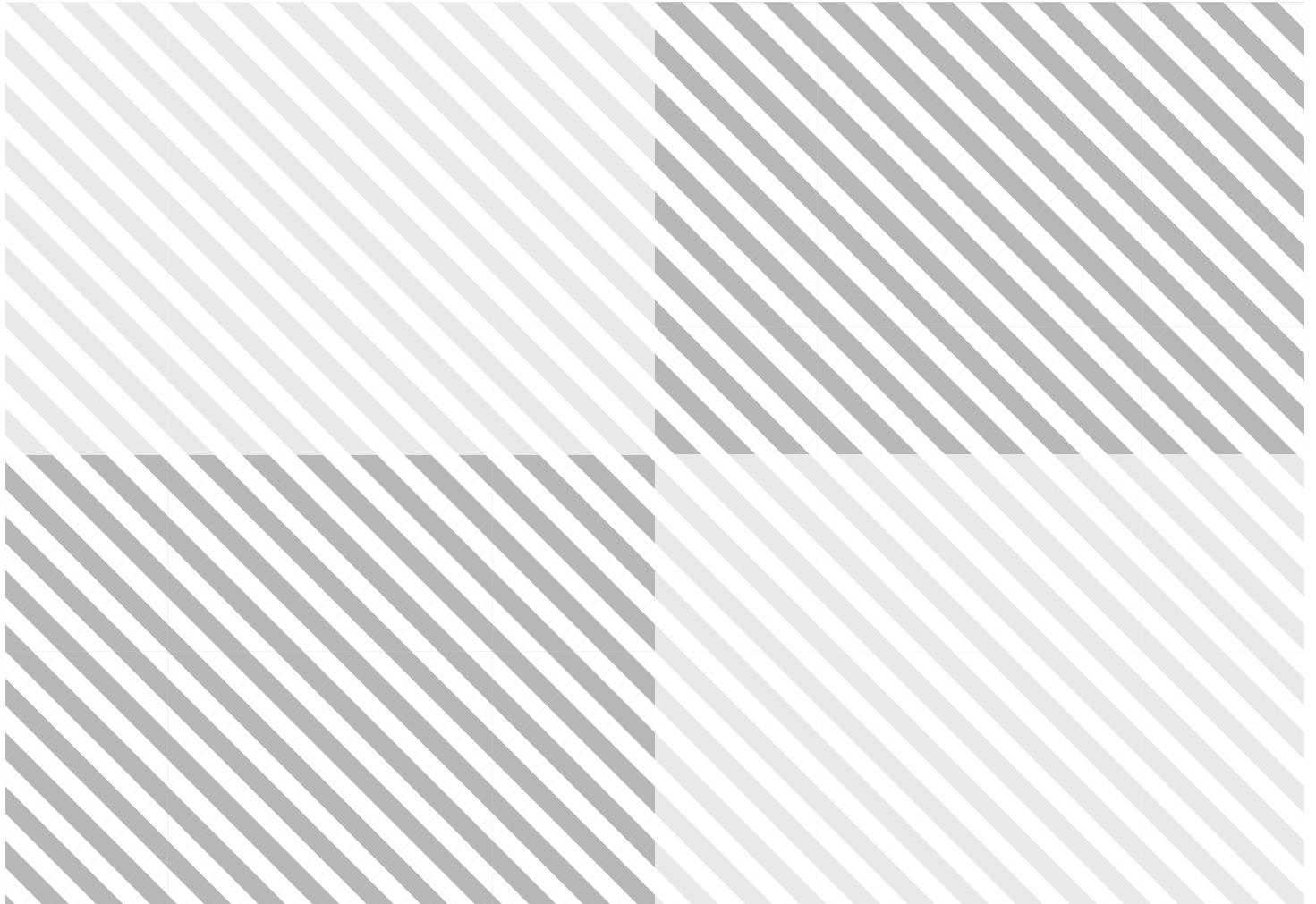


Accelerating Capital Markets Development in Emerging Economies

# How Global Can Power Local Harnessing International Investment to Develop Sustainable Local Capital Markets

Prepared in collaboration with Oliver Wyman

May 2017



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# Preface



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The World Economic Forum is pleased to release *How Global Can Power Local: Harnessing International Investment to Develop Sustainable Local Capital Markets*, the final report from the Accelerating Capital Markets Development in Emerging Economies initiative.

Launched in 2014, the initiative has worked to tackle the complex challenge of developing local capital markets in emerging economies. Despite their benefits to drive private-sector growth, finance public investments and enable local savers to access more mature and diverse investment products, capital markets remain relatively underdeveloped in emerging economies. This issue has become more relevant in recent years, as regulatory shifts have dampened banks' willingness to lend, a key source of financing in emerging markets. The initiative aims to identify best practices among policies that can promote capital market development and strengthen networks between policy-makers, investors and other market players.

In its first phase, the initiative focused on the development of corporate bond markets, recognizing the heightened need for emerging markets to build an alternative channel for debt financing outside the banking sector. By engaging a variety of stakeholders on this topic, the initiative curated practical recommendations for policy-makers to foster corporate bond market growth. This work culminated in the initiative's inaugural report, *Accelerating Emerging Capital Markets Development: Corporate Bond Markets*, released in 2015.

Following this, the Forum sought to apply some of the lessons learned to a country context, launching pilot initiatives in Colombia and Indonesia, and working directly with the respective ministries of finance on capital market development. Insights on each market's challenges and opportunities, identified through roundtables with policy-makers, regulators, domestic market participants and international investors, were captured in the initiative's 2016 White Paper, *Accelerating Capital Markets Development in Emerging Economies: Country Case Studies*.

The final phase of this initiative has considered the role that international investors can play in the development of sustainable local markets. Through a series of workshops held over the past year, the Forum has brought together international investors, policy-makers, regulators and local market participants to engage in dialogue on this topic.

In this White Paper, we present the key recommendations and insights developed through this work. Our findings are laid out across three topics: strategies for emerging markets to attract international investment, opportunities to harness international investment to build market sustainability, and a suggested reform roadmap for putting these ideas into practice. We acknowledge that all of the recommendations and examples here may not be applicable to each emerging market, but we hope they can spark ideas and dialogue to further progress towards local capital market development.

The initiative formally culminates with this White Paper's release. However, the Forum intends to continue applying the insights from this work through ongoing dialogue as part of the System Initiative on Shaping the Future of Long-Term Investing, Infrastructure and Development. In particular, the recommendations highlighted here for emerging markets to attract and manage international investment will link to the System Initiative's work in supporting infrastructure finance and development. Beyond the World Economic Forum, we hope that policy-makers and other market participants find this paper to be a valuable reference as they continue on the challenging path towards developing sustainable local capital markets.

# Key Insights

For an emerging economy, developing a sustainable local capital market can be an important contributor to financial deepening and growth. However, building this ecosystem can often be a complex and lengthy process. Over the past three years, the World Economic Forum’s initiative on Accelerating Capital Markets Development in Emerging Economies (also referred to as the "capital markets initiative") has shared ideas and best practices to support policy-makers in this endeavour. The work focuses on one lever for market development: international investment.

If deployed appropriately, international investment can catalyse market growth and contribute to greater sustainability in the local capital market ecosystem. Attracting international investment should not be viewed as a stand-alone strategy for market development; rather, cultivating a base of international investors, in tandem with other parts of the ecosystem (e.g. local investors, issuers, intermediaries), can best position the market for long-term success.

The following major themes emerged from the work on this topic:

- In the future, the quality of policy frameworks, rather than economic growth alone, is expected to increasingly influence international investment in emerging markets. This will increase the role policy-makers can play in differentiating their market and attracting international investment.
- Beyond the policy framework, investor perceptions of a market can also influence investment decisions. Policy-makers can address these “soft” factors through communication, consistency and predictability.
- International investment can not only serve as an added source of capital for an economy, but can also promote sustainability in the local capital market. Attracting and harnessing international investment should go hand in hand to fully realize the potential benefits for the market and economy.
- While implementing capital market reforms is a challenge, emerging market financing needs, local investor demand, connectivity between markets and access to information can serve as enabling forces for reform.

These findings are organized into four sections or topics (see also Figure 1). This section presents the key insights from each topic, and four annexes provide supplemental information on each.

Figure 1: Key Findings in Four Topics



## 1. The context of the capital markets initiative context

**Deep and efficient local capital markets can support economic growth and development in emerging economies.** From the issuer's perspective, capital markets serve as a source of financing for public- and private-sector investments. From the investor's view, capital markets allow citizens to translate short-term savings to longer-term, diversified portfolios. A local capital market, in which securities are denominated in the local currency rather than a hard currency (e.g. US dollar), allows domestic participants to raise and invest capital with minimal need to manage foreign exchange risk. Bank tightening, in response to regulation and shifting economic conditions (e.g. currency depreciation), underscores the need for local currency capital markets in emerging markets. However, despite their benefits, capital markets remain underdeveloped relative to the broader economy in many emerging markets.<sup>1</sup>

**International investment in capital markets can catalyse growth for emerging markets.** International investors can typically participate in emerging markets in two ways. Foreign direct investment involves establishing operations abroad or investing sufficiently in a company to give international investors influence over its operations. Foreign portfolio investment involves investing in equity, debt or other financial assets at levels that do not give international investors influence over the companies themselves. Here, the term "international investment" is used to refer to foreign portfolio investment, as it links most closely to capital markets. International investment can support capital market growth by expanding and diversifying the pool of capital available to local issuers, and by promoting increased transparency in the market. Though international investment has its risks – namely, the concern that sudden inflows and outflows of capital can lead to market volatility or economic instability – it can support economic growth if managed appropriately.

**In the current environment, emerging markets have both a greater opportunity and a greater challenge to attract and harness international investment for their local capital markets.** Total investable assets have grown substantially over the past few decades, increasing the opportunity for emerging markets to capture a share of this pool. However, the landscape has also become more competitive. More emerging and frontier markets are opening access to international investors, and investment needs are growing across markets.<sup>2, 3, 4, 5</sup> At the same time, differentials in gross domestic product (GDP) growth rates between developed and emerging markets are narrowing, and investors are reducing their allocations to emerging markets.<sup>6, 7</sup> This trend may continue as rates rise in developed countries.

In the future, policy frameworks, institutional quality and market conditions will differentiate emerging markets more than growth alone. As a result, policy-makers will likely play a critical role in building and communicating this value proposition to international investors.



**This phase of the World Economic Forum's initiative on Accelerating Capital Markets Development in Emerging Economies has developed recommendations for policy-makers in this context** by considering the following questions:

- What guides international investment decisions in emerging markets, and what policy actions can enable those markets to attract greater international investment?
- How can emerging markets harness international investment to build local market sustainability?

**Over the past year, the Forum has brought together stakeholders and generated insights on this topic** through:













- A global investor workshop aimed at identifying barriers to international investment and policy recommendations to remove those barriers
- A workshop focused on Asia, with investors, local market participants and regulators, to explore the relationship between international investment and local market sustainability
- A session at the World Economic Forum Annual Meeting 2017 with emerging market policy-makers, investors and other market participants to validate the high-level findings from the work
- Interviews with subject-matter experts and senior leaders
- A review of secondary research and literature

**This White Paper is a synthesis of the key themes emerging from this effort.** Throughout the paper, the findings are complemented by quotes from senior experts and case studies that showcase emerging market applications of many of the ideas laid out here. While these findings may not apply universally across markets, the frameworks and examples can hopefully serve as a guide for policy-makers as they continue tackling the complex challenge of developing local capital markets.

## 2A. Attracting international investment

When deciding how to allocate capital between emerging markets, international investors aim to balance the opportunity the investments provide – for example, to diversify portfolios or generate returns – with the cost and risk associated with these transactions. This calculus consists of 12 components (Figure 2):

Figure 2: Market Attractiveness Matrix

Investment Opportunity	Investment Ease/Cost	Investment Risk
 <b>Market size and growth</b> Scale of the local-currency capital market and prospects for future growth	 <b>Market access</b> Level of market liberalization, controls on capital and investor registration process	 <b>Macroeconomic stability</b> Sound monetary policy, fiscal policy, currency management and financial regulation
 <b>Issuer/product diversity</b> Range of issuers/financial instruments on the market (e.g. sectors, maturities)	 <b>Market liquidity</b> Ability of investors to enter and exit the market without major price fluctuations	 <b>Political stability</b> Minimal political disruption, rule of law, anti-corruption practices and judicial independence
 <b>Local investor activity</b> Active participation in the local capital market by a variety of local investors	 <b>Information transparency</b> Ease of access to reliable information (e.g. on issuers) to inform investment decisions	 <b>Policy and regulation</b> Sound, transparent and predictable policies governing the local market
 <b>Market performance</b> Return attractiveness and stability, and comparison against peers in benchmarks	 <b>Transaction execution costs</b> Ability/cost for intermediaries or infrastructure providers to support a transaction	 <b>Corporate governance</b> Oversight of issuer practices with sound protection for minority shareholders

Source: Authors

The relative importance of these factors to investors is expected to change. Rising financial liberalization means that access to emerging capital markets is likely no longer the primary constraint on international investment, while the policy environment is becoming more significant. In addition, each market will have different areas of strengths or gaps based on its conditions. For policy-makers, identifying intersections between the needs of investors and markets can help to focus policy agendas.

Once areas of focus have been identified, policy-makers can develop initiatives to attract international investment by increasing appeal along one or more of these factors; some strategies are outlined in Figure 3. While individual factors serve to organize these recommendations in the framework, they work as an ecosystem rather than in isolation. For example, increasing local investor activity is likely to also support greater market liquidity. Policy-makers can take such linkages into account when developing initiatives to attract international investment.

“In past decades, international investor interest in capital markets was influenced mostly by liberalization and free flow of capital. However, in the post-Brexit world, investors are more concerned about political and global economic stability.”

Figure 3: Policy Responses to Address Select Factors in the Market Attractiveness Matrix

Dimension	Potential policy response	Example
 <b>Market size and growth</b>	Link or integrate capital markets within a region to build scale	 <b>Mercado Integrado Latinoamericano (MILA):</b> Linked exchanges of four member countries in Latin America with the aim of further integration
 <b>Issuer/product diversity</b>	Introduce incentives or simplify processes for companies to list	 <b>Poland:</b> Launched an alternative market with a simple listing process for small to medium-sized enterprises, with over 400 listings since 2012
 <b>Local investor activity</b>	Encourage participation in pension funds or adjust portfolio requirements	 <b>Nigeria:</b> Increased contribution minimums and reduced portfolio caps on equity; pension funds are now the largest domestic equity investor
 <b>Market access</b>	Reduce length and/or complexity of the investor registration process	 <b>India:</b> Created a permanent registration process and common tax regime in 2014 for all international investors
 <b>Market liquidity</b>	Institute minimum free float requirements and enable market-making activities	 <b>Pakistan:</b> Integrated exchanges and enforced free float requirements to build liquidity and regain MSCI Emerging Market status
 <b>Information transparency</b>	Increase auditing/reporting requirements to meet international standards	 <b>Thailand:</b> Increased alignment to International Financial Reporting Standards and instituted additional reforms to ensure quality of reporting
 <b>Policy and regulation</b>	Develop a clear vision for market development and execute accordingly	 <b>Philippines:</b> Published two capital market development plans and shared progress on the objectives, improving quality of governance
 <b>Corporate governance</b>	Create voluntary standards for issuers to demonstrate commitment to governance	 <b>Brazil:</b> Created the Novo Mercado and two intermediate listing tiers for issuers that adhere to higher corporate governance standards

Source: Authors

These and other initiatives can help build a strong policy foundation for the local capital market. However, beyond the technical framework, expert interviews also emphasized the importance of softer elements that constitute the market's "look and feel" for international investors. The impact of subconscious perceptions of market openness, transparency and riskiness on an investor's evaluation of a given market may currently be underestimated. While addressing these factors does not replace sound policy design, doing so can build investor confidence and enhance capital market appeal. Suggested strategies to improve perceptions of the investment climate include instituting regular communication with investors, ensuring consistency of messaging and making the policy environment more predictable (Figure 4).

“  
Investors are simple animals. They invest based on confidence and conviction.  
”



Figure 4: How to Improve Investor Perceptions

Communication	Consistency	Predictability
<p>Markets will naturally be governed in different ways; providing a rationale for these policy choices and priorities can increase investor confidence in market oversight. Investors suggest that even when policies are unfavourable to them, clear communication on the policies can lessen their impact. On the other hand, a lack of communication may cause investors to assume the worst.</p> <p>“  <b>There is nothing to be lost by consistent engagement with international investors. Whatever their strategy, countries should explain why they chose it.</b>  ”</p>	<p>Messaging to international investors should be consistent across various oversight bodies (e.g. ministry of finance, securities commission) to reflect alignment of priorities. To demonstrate commitment to these stated objectives, policy-makers should implement reforms and enforce them consistently. By doing so, they can build additional confidence among the market's investors.</p> <p>“  <b>Many countries have the “advanced” regulations in place, but the difficulty lies in putting them into practice – enforcing and applying them consistently.</b>  ”</p>	<p>Even if policies surrounding international investment are complex, their predictability can build confidence. Conversely, markets with volatile treatment of international investors may be adversely impacted. For example, as international investors begin earning profits and withdrawing capital, sudden changes to the tax regime can reduce future investor interest.</p> <p>“  <b>Probably the best way to summarize what investors are looking for is ‘no drama’. Investors want a predictable framework they can work with.</b>  ”</p>

Source: Authors

## 2B. Harnessing international investment

Markets with active participation among international investors can consider opportunities to translate this activity into increased sustainability in their local capital market ecosystem. Four key pillars can define a sustainable local capital market (Figure 5).

Figure 5: Defining Capital Market Sustainability

<p><b>Depth</b> – The extent to which suppliers and consumers of capital join and use the capital market</p> <ul style="list-style-type: none"> <li>• <b>Issuers:</b> A large proportion of a country's firms raise financing through the capital market. The issuer base is diverse, and listed companies actively issue new securities.</li> <li>• <b>Investors:</b> A large proportion of the eligible population invests in the capital market. The investor base is varied, for example, in type (e.g. retail vs institutional), size, investment horizon and portfolio mix.</li> </ul>
<p><b>Efficiency</b> – The extent to which transactions can be completed with speed and ease</p> <ul style="list-style-type: none"> <li>• <b>Liquidity:</b> Though some investors may exhibit buy-and-hold behaviour (e.g. long-term investors), securities are actively traded, and investors can exit their positions as desired.</li> <li>• <b>Transaction execution:</b> Market infrastructure providers (e.g. exchanges, clearinghouses) enable transactions to be completed quickly and reliably.</li> </ul>
<p><b>Transparency</b> – The extent to which market activity is conducted with openness and accountability</p> <ul style="list-style-type: none"> <li>• <b>Information:</b> Reporting and disclosure requirements, along with the activity of third-party information providers (e.g. credit rating agencies), ensure that reliable information on issuers is readily available.</li> <li>• <b>Oversight:</b> Policy-makers clearly communicate priorities and rationales for regulatory changes.</li> </ul>
<p><b>Stability</b> – The extent to which the marketplace and associated institutions are trusted and predictable</p> <ul style="list-style-type: none"> <li>• <b>Market:</b> The investment environment is largely predictable, with rare periods of extreme volatility.</li> <li>• <b>Institutions and policies:</b> Oversight bodies are trusted and enforce regulation effectively. Capital market and macroeconomic policies are sound; the political climate is stable, and rule of law prevails.</li> </ul>

Source: Authors



Some of the policy actions that attract international investment may also inherently support market sustainability (Figure 6), as a more sustainable local market will also be more attractive to international investors. For example, developing an active local investor base promotes both depth and efficiency. In addition to this, effective management of international investment can also promote market sustainability. This relationship has been widely discussed from the perspective of capital controls, measures which constrain investor access to protect the market from volatility. However, the literature covers less about opportunities to build sustainability by harnessing the benefits of international investment. International investment can support each of the four pillars of sustainability.

**Figure 6: Benefits of International Investment on Market Sustainability**

<p><b>Depth</b></p> <p>International investors increase the supply of capital on the local market and encourage more firms to join the market.</p>	<p><b>Transparency</b></p> <p>International investors call for higher issuer reporting standards and policy transparency, which improve the investment climate for all investors.</p>
<p><b>Efficiency</b></p> <p>International investors complement the existing domestic investor base in terms of investment horizon and trading behaviour, increasing liquidity.</p>	<p><b>Stability</b></p> <p>International investors are a source of capital not affected by domestic slowdowns, mitigating the effects if local investors become less willing to invest.</p>

Source: Authors

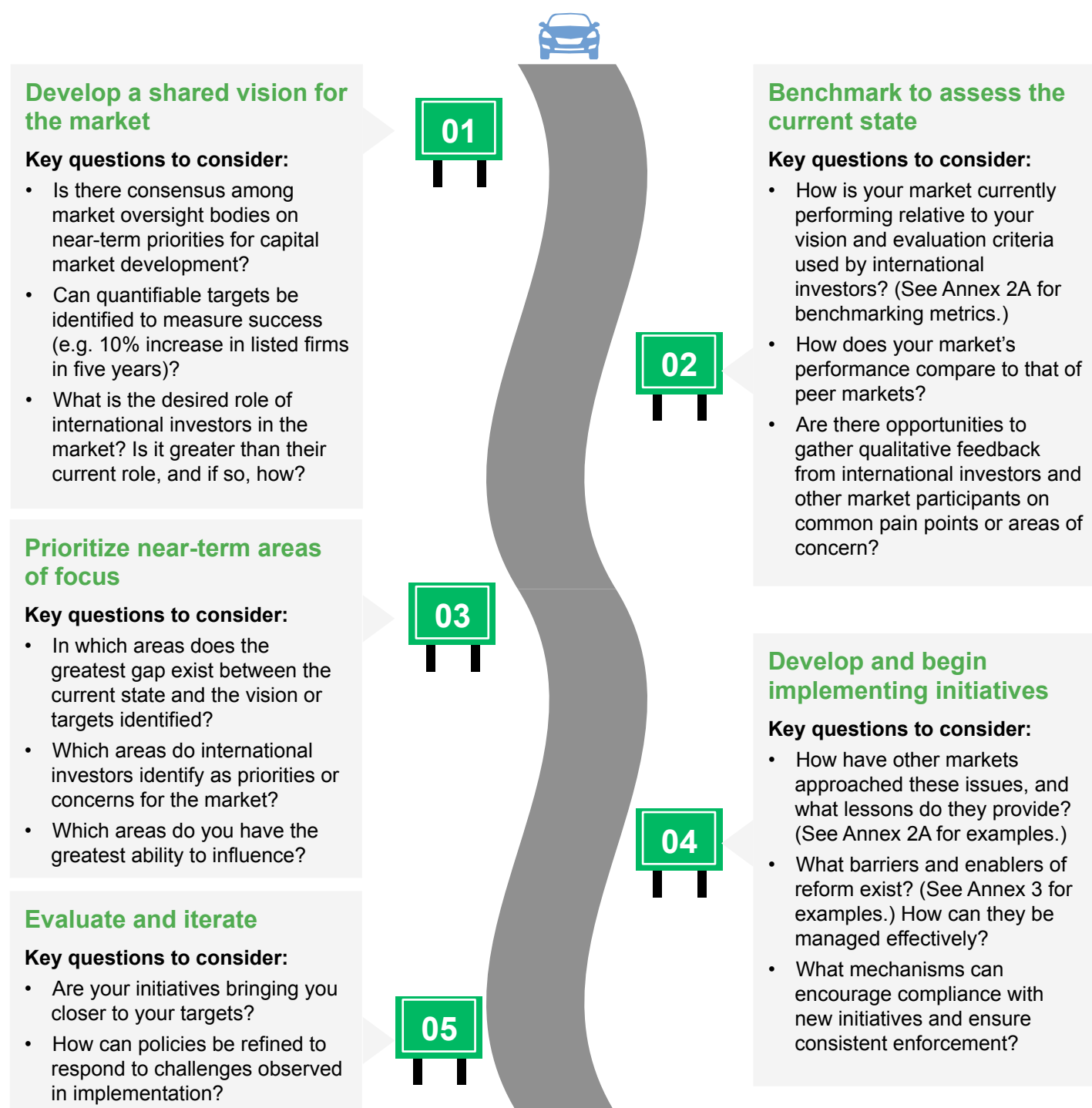
Policy-makers can consider various strategies to realize these benefits, but should be mindful of their potential downstream effects. For example, raising listing and reporting standards to meet the needs of international investors can promote increased transparency, but if requirements become too onerous, they may end up as barriers to local issuers to enter the market. Similarly, instituting capital controls may protect short-term market stability; however, they could also limit market development along the other three pillars if international investor interest is dampened as a result. As this is a relatively unexplored topic, readers are encouraged to continue advancing the thinking in this area.

### 3. A roadmap for reform

The capital market development process is complex, making it a challenge to implement some of these ideas. Policy-makers face various barriers (“headwinds”) to reform, but enabling forces (“tailwinds”) exist; see Annex 3 for examples. So, for policy-makers who feel that international investment can be better cultivated or managed, how can this be put into action? A few steps to get started are suggested in Figure 7, along with questions for policy-makers to consider in each stage.

Across these various stages, policy-makers are encouraged to communicate openly about their priorities and progress. But they need not go at it alone; global investors, advisers and other market participants are encouraged to support their efforts, using this White Paper as a reference where helpful. In this way, this work can enrich the tools for emerging markets seeking to build deeper local capital markets.

Figure 7: A Roadmap for Instituting Reforms to Better Attract and Manage International Investment



1
2A + 2B
3

# Annex 1. Initiative Context

Launched in 2014, the Accelerating Capital Markets Development in Emerging Economies initiative (also referred to as the "capital markets initiative") aims to bring together various public- and private-sector stakeholders to identify strategies that can promote capital market development. In this final phase of work, the focus is on international investment as one catalyst for market development. The first half of this section provides background on capital markets, their relationship to economic growth, and this initiative's efforts to enable market development. The second half includes a primer on international investment, discusses its relationship to growth and presents the current state.

## 1.1 A primer on capital markets

Capital markets connect suppliers of capital (investors) to consumers of capital (issuers) through the sale of equity and debt instruments. The capital market ecosystem consists of four key components (see also Figure 8):

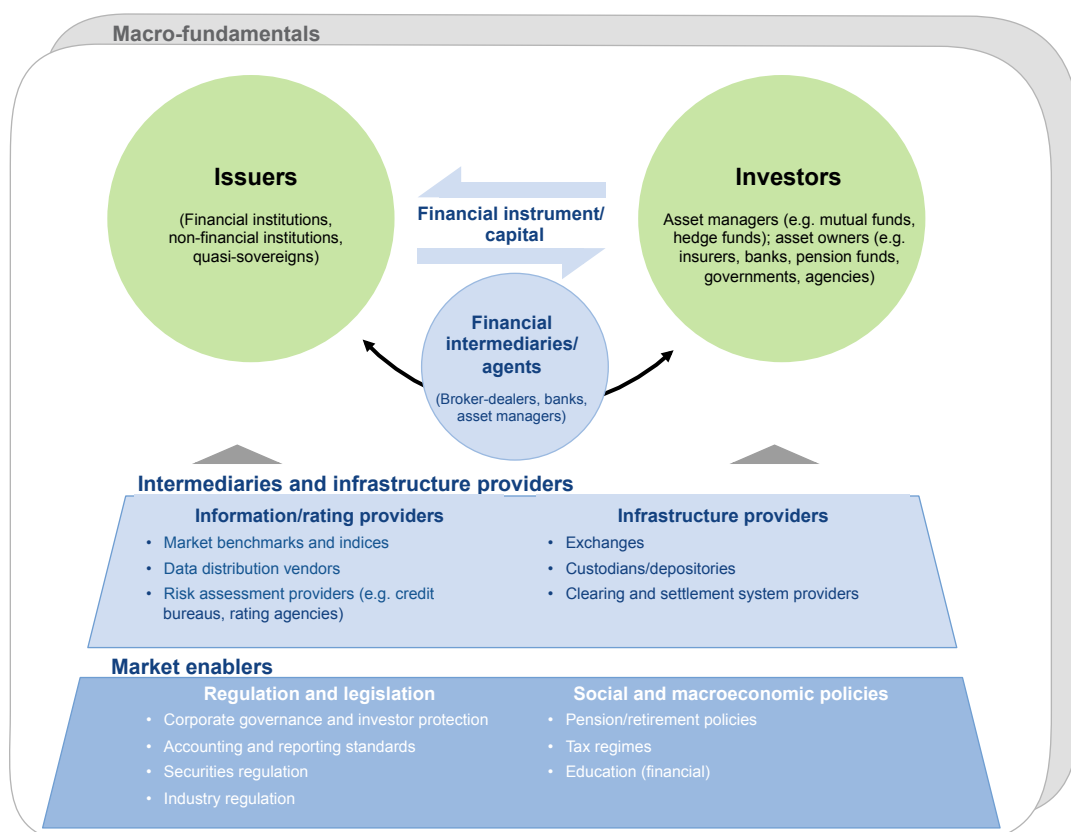
→ **Issuers (consumers of capital)** – Firms or governments looking to raise capital in order to finance investments. They do this either through a domestic or international issuance of debt or equity.

→ **Investors (suppliers of capital)** – Individuals or large institutions, based either domestically or internationally, that purchase financial instruments on the capital market in order to generate returns. Institutional investors can be classified into asset owners (e.g. pension funds, sovereign wealth funds, insurance companies), which invest their own capital, or asset managers (e.g. mutual funds), which invest pooled savings on behalf of others.

→ **Intermediaries and infrastructure providers** – A variety of service providers that enable transactions on the capital market. This includes market intermediaries, such as banks and asset managers that pool capital and invest on behalf of their contributors, and broker-dealers, who trade on behalf of their clients or themselves. A second subgroup is market infrastructure providers, such as stock exchanges, depositories and clearinghouses, which provide the platforms required to execute transactions. The third subgroup consists of information providers, such as rating agencies and benchmark index providers, which furnish third-party assessments of risk and opportunity in the marketplace.

→ **Market enablers** – The policy and regulatory framework that governs activity on the capital market. This can include legal requirements for issuers, such as corporate governance policies and financial reporting standards, as well as policies that influence investor participation, such as pension contribution policies.

Figure 8: The Capital Market Ecosystem



Source: Authors

Capital markets consist of the primary market, on which first-time issues of equity or debt are sold, and the secondary market, on which these securities can be retraded. Beyond equity and debt securities, financial derivatives, which are instruments based on equity, debt or other underlying asset classes, are also important for investors in international capital markets. For example, international investors may use currency futures as a way to hedge against foreign currency risk from their local-currency equity and debt investments. This White Paper focuses on equity and debt markets.

## 1.2 Local capital markets as a driver of economic development

The first-phase report, *Accelerating Emerging Capital Markets Development: Corporate Bond Markets*, highlighted four key mechanisms that allow capital markets to contribute positively to the domestic economy.

- **Supporting private-sector and economic growth:** Capital markets efficiently match savings to productive long-term investment opportunities, providing a source of financing for governments and corporate issuers looking to improve and/or expand their operations. Competition between the banking sector and the capital market can also help to lower the cost of financing for local issuers.
- **Encouraging domestic long-term and diversified investments:** As savings rates rise, local investors increasingly seek to shift their investments from bank-based products to more diversified portfolios in order to generate returns and hedge against risks. Capital markets provide access to a more mature and diverse set of investment products for local savers to build and manage wealth in the long term.
- **Diversifying sources of credit and associated risk:** Local capital markets enable domestic players to borrow or invest in the local currency, which eliminates the need to manage foreign exchange risk. Additionally, by providing an alternative source of financing to the banking sector, capital markets diversify credit risk away from banks, improving the financial system's overall stability.
- **Promoting greater market discipline and transparency:** Issuers who raise capital through the local capital market must adhere to listing and reporting standards, and are subject to supervision by various regulatory bodies. These mechanisms help to increase overall governance, transparency and oversight.

**Figure 9: In the Literature – The Relationship between Capital Markets and Economic Growth**

**The relationships between financial deepening, capital market development and economic development have been thoroughly examined in the literature.** Research from as early as Goldsmith (1969),<sup>8</sup> McKinnon (1973)<sup>9</sup> and Shaw (1973)<sup>10</sup> documents a positive correlation between financial deepening and economic growth, while King and Levine (1993)<sup>11</sup> find a causal relationship between financial development and real GDP growth rates. Though the specific effects of capital market development on economies has been debated, Bekaert and Harvey (1997),<sup>12</sup> Levine and Zervos (1998),<sup>13</sup> and Beck and Levine (2002)<sup>14</sup> find correlations between various indicators of stock market development (e.g. market capitalization, liquidity), banking development and economic growth. For debt markets, Pradhan et al. (2016)<sup>15</sup> report that bond market development, in combination with four other economic variables, shows a causal link to growth.

### 1.3 The focus of this initiative: capital markets in emerging economies

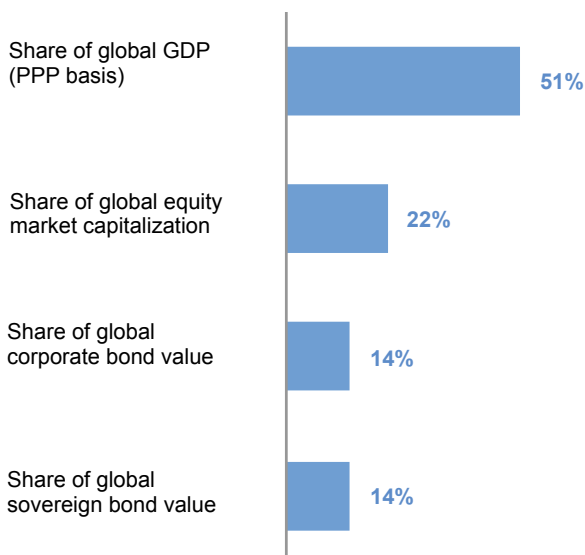
Emerging capital markets have grown rapidly in the past decades. Emerging equity market capitalization in 2014 was over seven times higher than in 1996. Corporate bond and sovereign debt markets in emerging economies grew at an average annual rate of 16.9% and 10.7%, respectively, between 2005 and 2014. However, further growth is still possible, as emerging markets comprise a lower share of global equity and bond value relative to their share of global GDP (Figure 10). Given this context, the World Economic Forum launched the capital markets initiative in 2014 to encourage dialogue between market participants and highlight policy best practices to facilitate market growth.

Over the past three years, the initiative has tackled various aspects of this challenge. In its first phase, it focused on local corporate bond markets, recognizing their increased importance as financial regulation impacts bank willingness to lend. The resulting report, cited above, provided a framework for evaluating capital market development and highlighted strategies to promote further growth.

Following the report's publication, the initiative launched two country-specific pilots, in Colombia and Indonesia, that focused on local equity and corporate bond markets, respectively. Learnings from roundtables held with policy-makers and other participants in these markets were captured in the White Paper, *Accelerating Capital Markets Development in Emerging Economies: Country Case Studies*.

Now in its third and final year, the initiative is exploring the role of international investors in catalysing the development of sustainable local capital markets. To this end, this White Paper identifies strategies for emerging markets to attract international investment and harness its benefits. This work can serve as a reference for emerging-market policy-makers as they consider the role of international investment in their local capital markets. To set the stage, the rest of this annex includes information on the components, history and current state of international investment in emerging markets.

**Figure 10: Emerging Market (EM) Share of Global GDP, Equity and Bond Value, 2014**



Note: PPP = purchasing power parity  
Source: Credit Suisse Research Institute, 2014. *Emerging capital markets: The road to 2030*

### 1.4 A primer on international investment in emerging markets

Emerging markets that are integrated into the international financial system are subject to two types of capital movements: inflows and outflows. Inflows are acquisitions of domestic financial assets by non-residents (international investors), while outflows are acquisitions of cross-border financial assets by residents (local investors). The focus here is on inflows, which can play an important role in emerging markets by helping to meet financing needs when domestic savings pools are insufficient, for example for infrastructure investment.

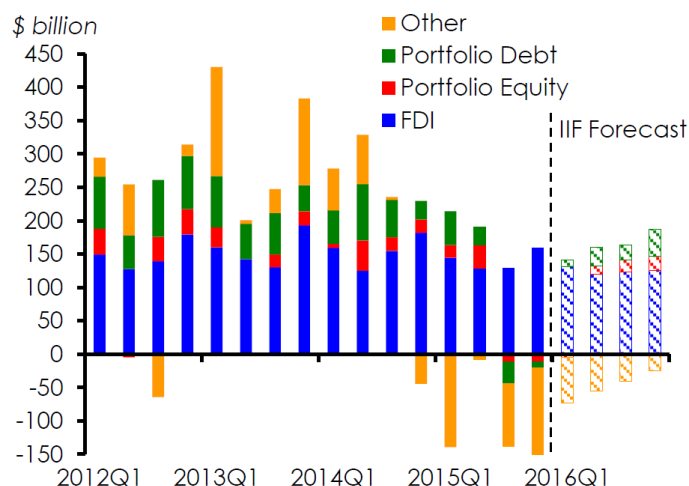
Emerging markets can receive capital inflows from private investors and public sources (e.g. international institutions or governments), with the focus on private investment and its two common types:

- **Foreign direct investment (FDI).** FDI consists of investments in which investors have influence or control over the relevant company's operations. FDI could take the form of a multinational firm establishing operations in a new market, or an international investor purchasing a controlling stake in a local firm. Typically, an investment is said to be FDI if the international investor holds at least 10% of the voting power in a company.<sup>17</sup>
- **Foreign portfolio investment (FPI).** In FPI, investors have no influence over the relevant company's operations. FPI is typically split into portfolio equity and portfolio debt (i.e. bond) flows. Considered to be a shorter-term flow than FDI, FPI involves relatively lower engagement in the operations of local companies than FDI.

Other types of non-resident private flows to emerging markets include cross-border lending, currency and deposits, and trade credits. Figure 11 shows the mix of private capital inflows to emerging markets in recent years.<sup>18</sup> FDI tends to be the primary component of inflows, though the contribution of portfolio debt and equity flows has increased over the past decades. Cross-border bank flows, on the other hand, experienced significant declines after the financial crisis.

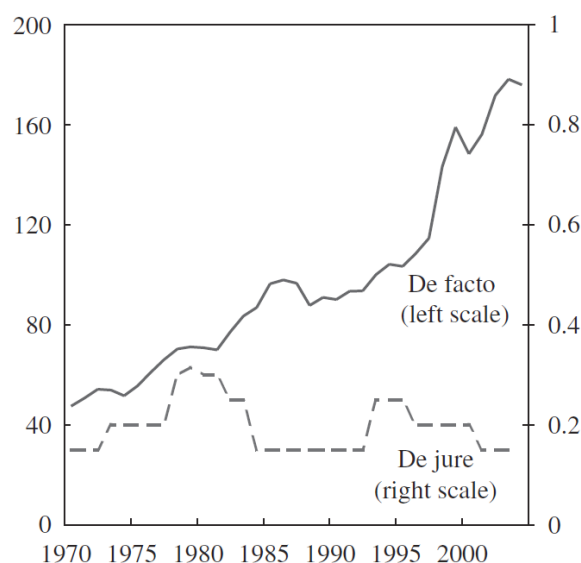
The various types of inflows to emerging markets complement each other and can serve different purposes for a market. However, as work on this initiative focuses on capital markets, "international investment" is used in this White Paper to refer primarily to FPI (i.e. portfolio debt and equity flows).

**Figure 11: Composition of Non-Resident Private Capital Inflows to Emerging Markets, 2012-2016, \$ Billion**



Source: Institute of International Finance (IIF), 2016. *Capital Flows To Emerging Markets*, 7 April 2016

**Figure 12: Level of Global Integration in Emerging Markets, 1970-2000**



Left axis: gross stocks of foreign assets and liabilities, % of GDP  
 Right axis: International Monetary Fund index of capital account restrictiveness (1 = fully open)

Source: Kose et al., 2009. "Financial Globalization: A Reappraisal", IMF Staff Paper, 56(1)  
 Graph shows unweighted averages

International investment has long been a fixture of emerging capital markets. In the late 1970s, low economic growth, corruption and increasing pressure to globalize in emerging markets ushered in a period of financial liberalization. During this time, many emerging markets relaxed capital controls and liberalized interest rates, though the pace and focus of liberalization varied considerably by market.<sup>19</sup> As a result, international financial markets became increasingly integrated (Figure 12).<sup>20</sup> However, financial crises in the 1980s and 1990s, most notably in Latin America and Asia, led some markets to slow their progress towards financial openness. During the Asian crisis, Malaysia instituted capital controls to prevent outflows of capital, for example by banning repatriation of foreign assets for one year.<sup>21</sup> Since that period, emerging markets have once more generally adopted policies towards financial liberalization.

From a de facto perspective, the overall trend has been towards increasing global financial integration. In fact, between 1980 and 2007, global capital flows grew 25-fold, compared to an eight-fold increase in trade.<sup>22</sup>

**Figure 13: In the Literature – Understanding Capital Controls and their Suggested Uses<sup>23</sup>**

**Capital controls, more formally known as capital flow management measures (CFMs), are policies that limit flows of international capital into or out of a country.** Countries typically impose CFMs in two ways: by limiting inflows (e.g. through foreign ownership limits) or by limiting outflows (e.g. through minimum holding periods). CFMs can be fixtures of the marketplace in economies that have not yet fully liberalized, or they can be temporarily imposed to respond to short-term capital flow volatility or crisis.

**The Liberalization and Management of Capital Flows: An Institutional View from the International Monetary Fund (IMF) covers the suggested uses of CFMs in detail.** The paper notes that liberalization offers the greatest benefits to economies that have reached a certain threshold of financial and institutional development. As a result, the optimal pace and sequencing of liberalization will vary for each market and, when designed, should be aligned with other economic reforms. However, the IMF recognizes that temporary CFMs can be part of a longer-term liberalization strategy, and are one of many tools for responding to surges in capital flows. In particular, the IMF notes that temporary CFMs cannot substitute for macroeconomic adjustments (e.g. lowering interest rates), but can be used if the ability to adjust policies is limited, or if the time lag for a macroeconomic change to occur would be too great.

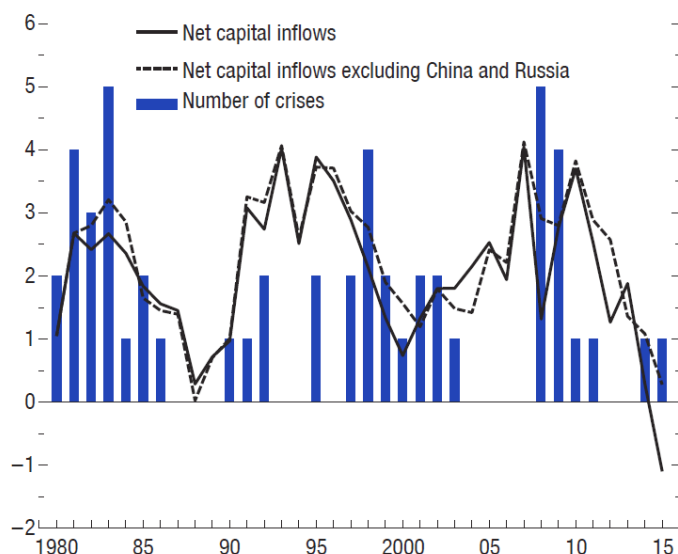


## 1.5 The role of international investment in market and economic growth

International investment can promote development of local capital markets by increasing the pool of capital available to local issuers and lowering the cost of financing. Additionally, international investors can call for greater market transparency, investor protection and oversight, improving market conditions overall.

However, financial openness also exposes markets to surges in capital inflows or outflows, though the impact of such flows on the overall economy has not been fully established. (For the relationship between financial openness and growth as covered in the literature, see Figure 15.) Slowdowns in capital inflows to emerging markets in the 1980s and 1990s coincided with the higher rates of debt crises, but a similar decline since 2010 has not yielded the same result (Figure 14).<sup>24</sup> This may be due to improved policy frameworks in emerging markets, highlighting policy-makers' critical role in managing international investment well.

**Figure 14: Net Capital Inflows to Emerging Markets (% of GDP) and Incidence of Debt Crises, 1980-2015Q3**



Note: Calculations are based on a sample of 45 emerging market economies. The observation for 2015 refers to the first three quarters of 2015. Data on the number of crises refer to the external crisis variable in Catão, L.A.V. and G.M. Milesi-Ferretti, 2014, "External Liabilities and Crises," *Journal of International Economics*, 94(1), updated to the third quarter of 2015.

Source: Figure as published in IMF, 2016. *World Economic Outlook: Too Slow for Too Long*, Chapter 2, "Understanding the Slowdown in Capital Flows to Emerging Markets"

**Figure 15: In the Literature – The Relationship between Financial Openness and Growth**

**Despite the growing body of work on the relationship between liberalization and growth, the research has led to a weak consensus at best.**

In their review of the literature, Kose et al. (2009)<sup>25</sup> reference a variety of studies that find positive, mixed or non-existent correlations between these two variables. One reason for the disparity in findings is the metric used to assess capital market liberalization: de jure (the legal openness of a market) or de facto (the actual level of financial integration). In general, studies that use a de facto measure find stronger correlations between liberalization and growth. Within asset classes, Bekaert, Harvey and Lundblad (2005)<sup>26</sup> found that equity market liberalization can increase GDP growth by one percentage point, noting that other reforms that could also promote growth accompany such liberalization. The analysis to date on the impact of portfolio debt flows on growth is largely inconclusive.

**Analysis suggests that the risks of financial liberalization may be overstated.**

Kose et al. argue that insufficient evidence exists supporting a causal link between liberalization and financial crises in emerging markets. For example, Edwards (2008)<sup>27</sup> found no link between financial openness and the costs of currency crises, while Glick and Hutchison (2001)<sup>28</sup> saw that the costs of banking crises may be lower for more open countries.

**However, the benefits of financial integration may be understated.**

Kose et al. suggest looking beyond growth as an outcome, pointing to numerous "collateral" benefits of financial liberalization. These benefits, such as the development of sound institutions, macroeconomic policy improvements and financial development, can themselves promote economic growth. The connection between financial openness and productivity have become a recent area of focus. Studies have found correlations between de jure and de facto openness and total factor productivity, a measure of how efficiently an economy translates inputs to outputs.



## 1.6 The current state: a greater opportunity, a greater challenge

The current financial landscape presents both a greater opportunity and a greater challenge for emerging markets to attract and harness international investment. Since the financial crisis, global assets under management have continued to rise, increasing the supply of capital available to emerging markets. But competition for capital in those markets has also grown, due in part to the following:

- **More markets accessible to international investors.** By 2007, the MSCI Emerging Markets index had risen to 25 members from its original 10.<sup>29</sup> In addition, MSCI launched its Frontier Markets index with 19 markets in late 2007, and has reached 30 markets as of 2017.<sup>30, 31</sup>
- **Greater demand for capital market financing in emerging markets.** More stringent bank regulation following the financial crisis has tightened credit in many historically bank-dominated economies, leading to increased reliance on capital markets. Since the crisis, the share of corporate debt raised through bonds has doubled in emerging markets, largely at the expense of domestic lending.<sup>32</sup> Capital markets are increasingly supporting infrastructure finance as well. In 1990-2000, bonds accounted for 18% of infrastructure finance. This proportion rose to 33% from 2001 to 2011, and is expected to climb above 50% by 2022.<sup>33</sup>
- **Weakening emerging market appeal relative to developed markets.** Research suggests that the GDP growth differential between emerging and developed markets is one of the most predictive determinants of capital flows to emerging markets. However, between 2010 and 2015, this spread narrowed by 0.75% on average per year.<sup>34</sup> The decline of portfolio allocations to emerging markets since 2011 is potentially linked to this trend (Figure 16).<sup>35</sup> Additionally, as rates rise in developed countries, the relative attractiveness of emerging market investments may also drop.
- **Post-crisis trend of “deglobalization”.** Since the financial crisis, capital flows across borders have dropped significantly. Global capital flows, accounting for 11.9% of GDP in 2007, fell to just 2.6% of GDP in 2015. This may indicate increased risk aversion among international investors.

In this environment, the quality of their policy frameworks and institutional environments will increasingly differentiate emerging markets looking to attract international investment.

Figure 16: Global Fund Portfolio Weights, 2008-2015 (% of Equity and Bond Allocations)



Note: dotted line = 2008-2015 year-to-date average; rhs = right hand side.

Sources: EPFR Global, IIF estimates; includes mutual funds and exchange-traded funds. Figure as published in IIF, 2015. *Trends in Investment Fund Portfolio Allocation*, 17 June 2015.

1
2A + 2B
3













# Annex 2A. Attracting International Investment

Given the positive impact international investors can have on local capital market development, the ability of emerging market policy-makers to attract those investors is valuable. To understand how to attract international investment, this annex first explores the factors investors seek out in emerging market investments. It then suggests strategies for policy-makers to prioritize those factors. Finally, policy recommendations are given for increasing market attractiveness along individual factors.

## 2A.1 How international investors evaluate emerging capital markets

Two broad types of investment decisions are made when investing in emerging markets: how much to invest overall (decided by asset owners through portfolio allocations to emerging markets), and how to allocate investments between countries (decided by asset managers to fulfill the investment mandate set by asset owners). The focus here is on the latter set of decisions. The Market Attractiveness Matrix (Figure 17) lays out the key factors international investors consider when making investment allocations between emerging markets. Specifically, international investors evaluate investment decisions by balancing an investment's opportunity with its costs and risks.

Figure 17: Market Attractiveness Matrix

Investment Opportunity	Investment Ease/Cost	Investment Risk
 <b>Market size and growth</b> Scale of the local-currency capital market and prospects for future growth	 <b>Market access</b> Level of market liberalization, controls on capital and investor registration process	 <b>Macroeconomic stability</b> Sound monetary policy, fiscal policy, currency management and financial regulation
 <b>Issuer/product diversity</b> Range of issuers/financial instruments on the market (e.g. sectors, maturities)	 <b>Market liquidity</b> Ability of investors to enter and exit the market without major price fluctuations	 <b>Political stability</b> Minimal political disruption, rule of law, anti-corruption practices and judicial independence
 <b>Local investor activity</b> Active participation in the local capital market by a variety of local investors	 <b>Information transparency</b> Ease of access to reliable information (e.g. on issuers) to inform investment decisions	 <b>Policy and regulation</b> Sound, transparent and predictable policies governing the local market
 <b>Market performance</b> Return attractiveness and stability, and comparison against peers in benchmarks	 <b>Transaction execution costs</b> Ability/cost for intermediaries or infrastructure providers to support a transaction	 <b>Corporate governance</b> Oversight of issuer practices with sound protection for minority shareholders

Source: Authors

The subsequent sections provide additional detail on this matrix's individual parts.

### Investment opportunity

This category of factors considers the ability of a given emerging capital market to meet the portfolio needs of international investors (Figure 18). It includes providing the types of products international investors seek, offering sufficient scale to justify the investment and generating attractive returns.

Figure 18: Breakdown of Investment Opportunity





Factor	Key questions	Sample benchmarking tools
 <b>Market size and growth</b>	<ul style="list-style-type: none"> <li>How large is the local-currency market?</li> <li>How fast is the market expected to grow, based on historical, economic or demographic trends?</li> </ul>	<ul style="list-style-type: none"> <li>Absolute market capitalization</li> <li>Market capitalization to GDP</li> <li>Number of listed companies</li> <li>Available free float</li> </ul>
 <b>Issuer/product diversity</b>	<ul style="list-style-type: none"> <li>Is a variety of products available across, for example, asset classes and maturities?</li> <li>Do the issuers on the market represent a variety of economic sectors?</li> </ul>	<ul style="list-style-type: none"> <li>Mix of issuers by sector</li> <li>Product mix by asset class (e.g. equity, debt, derivatives)</li> <li>Benchmark yield curve for bonds</li> </ul>
 <b>Local investor activity</b>	<ul style="list-style-type: none"> <li>How diverse is the pool of local investors?</li> <li>To what extent do local investors trade on the capital market?</li> </ul>	<ul style="list-style-type: none"> <li>Domestic savings rate</li> <li>Mutual fund, pension or insurance assets to GDP</li> <li>Local share of trading volume</li> </ul>
 <b>Market performance</b>	<ul style="list-style-type: none"> <li>How has the market performed in the past, and what is the projected performance?</li> <li>How volatile has the market's performance been?</li> </ul>	<ul style="list-style-type: none"> <li>Performance vs common benchmarks (e.g. MSCI indexes, J.P. Morgan Emerging Market Bond Index)</li> <li>Stock price volatility</li> </ul>

Source: Authors

### Investment ease/cost

This set of factors concerns the ease or cost to international investors of transacting on a given emerging capital market (Figure 19). It includes restrictions on or complexity of entering the market (e.g. an onerous investor registration process), the indirect cost associated with information gathering to research potential investments, and the ease of completing the transaction itself.

Figure 19: Breakdown of Investment Ease/Cost





Factor	Key questions	Sample benchmarking tools
 <b>Market access</b>	<ul style="list-style-type: none"> <li>Do capital controls restrict international investor behaviour (e.g. minimum holding periods, foreign ownership limits)?</li> <li>How complex is the international investor registration process?</li> <li>How burdensome is the tax regime?</li> </ul>	<ul style="list-style-type: none"> <li>IMF Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER)</li> <li>World Economic Forum Global Competitiveness Index rankings on effect of taxation on incentives to invest</li> </ul>
 <b>Market liquidity</b>	<ul style="list-style-type: none"> <li>Can international investors wishing to exit their positions do so with minimal delay and without significant fluctuations in price?</li> </ul>	<ul style="list-style-type: none"> <li>Stock market turnover ratio</li> <li>Annualized traded value ratio</li> </ul>
 <b>Information transparency</b>	<ul style="list-style-type: none"> <li>Is up-to-date information on issuers/ performance widely available to international investors?</li> <li>How reliable is this information?</li> </ul>	<ul style="list-style-type: none"> <li>Global Competitiveness Index rankings on strength of auditing and reporting standards</li> <li>Availability of credit ratings</li> </ul>
 <b>Transaction execution costs</b>	<ul style="list-style-type: none"> <li>How efficient is transaction processing?</li> <li>What is the cost for international investors to work with local market intermediaries and to hedge against exchange rate risk?</li> </ul>	<ul style="list-style-type: none"> <li>Average commissions charged by local brokerages</li> <li>Hedging costs</li> </ul>

Source: Authors

## Investment risk

This category assesses the riskiness of a potential investment, stemming from either macro variables affecting the country as a whole or from factors relating to the capital market (Figure 20).

Figure 20: Breakdown of Investment Risk

Factor	Key questions	Sample benchmarking tools
 <b>Macroeconomic stability</b>	<ul style="list-style-type: none"> <li>Are exchange rates well managed (e.g. commitment to free-floating regime)?</li> <li>Are fiscal and monetary policies sound?</li> <li>Is the financial system well regulated?</li> </ul>	<ul style="list-style-type: none"> <li>World Economic Forum Global Competitiveness Index pillar on macroeconomic environment</li> </ul>
 <b>Political stability</b>	<ul style="list-style-type: none"> <li>Do political transitions occur without risk of impact to the market?</li> <li>Are legal rights enforced effectively?</li> <li>Is corruption/low transparency a concern?</li> </ul>	<ul style="list-style-type: none"> <li>Global Competitiveness Index rankings on public institutions</li> </ul>
 <b>Policy and regulation</b>	<ul style="list-style-type: none"> <li>Are the appropriate policies and regulations in place to govern the capital market?</li> <li>How predictable and transparent are the policies and oversight bodies?</li> </ul>	<ul style="list-style-type: none"> <li>Global Competitiveness Index rankings on transparency of policy-making and regulation of securities exchange</li> </ul>
 <b>Corporate governance</b>	<ul style="list-style-type: none"> <li>Are policies for corporate transparency and investor conduct well enforced?</li> <li>How strong is the protection provided to minority shareholders?</li> <li>How efficiently are disputes resolved?</li> </ul>	<ul style="list-style-type: none"> <li>Global Competitiveness Index rankings on accountability</li> <li>World Bank Ease of Doing Business rankings on protecting minority investors</li> </ul>


Source: Authors


## 2A.2 Prioritizing between the evaluation factors

The relative importance of the 12 factors in the Market Attractiveness Matrix will likely vary for each market. Policy-makers looking to attract international investors should identify areas of priority for their local capital markets by considering the following dimensions:


→ **Level of policy-maker influence.** To what extent can an emerging market policy-maker or regulator (e.g. minister of finance, central bank governor) influence the given factor?

### Examples of factors over which policy-makers have limited influence

 **Political stability:** A single oversight body has limited ability to reduce corruption or regime changes in a broad-based way.

 **Market performance:** Returns are influenced by economic factors and company-specific performance that are outside policy-makers' control.


### Examples of factors over which policy-makers have significant influence


 **Market access:** Policy-makers determine the requirements for and limitations on international investors.

 **Policy and regulation:** Policy-makers manage the development of effective and fair policies for the capital market, and the communication of those policies to market participants.


→ **Relative priority for international investors.** To what extent do international investors value the given factor relative to the other parts of the matrix?

### Examples of factors with lower relative priority expected in the coming years

 **Market access:** After decades of liberalization in emerging markets, access is no longer the major constraint on international investors.

 **Market size and growth:** While capital market scale will remain important, the economy's underlying growth rates may become less of an investment driver, as growth rates between emerging and developed markets converge.

### Examples of factors with higher relative priority expected in the coming years

 **Market liquidity:** Now that market access is relatively widespread, market liquidity will have more influence on the effective ability for investors to enter and exit the market.

 **Policy and regulation:** As competition between markets grows, soundness and transparency of policies is likely to become a core differentiator between emerging markets.

→ **Relative priority for the market.** Is this factor a relative gap for the market?

A benchmarking exercise, potentially using the metrics (sample benchmarking tools) in the previous section, can help to identify relative strengths and gaps for an individual market. For example, a country with high rankings on the Global Competitiveness Index for strength of auditing and reporting may not need to emphasize improving information transparency as much as a country with lower scores.

Identifying areas of intersection among these three dimensions can help to isolate factors that are a high priority to address where emerging market policymakers can achieve maximal impact.

## 2A.3 Policy recommendations to increase market appeal to international investors

Once priority areas have been identified, policymakers can consider various initiatives to improve market attractiveness in those areas. Potential policy actions to address select factors in the framework are now provided here, along

with examples of current or past implementations. Though these recommendations are organized around individual factors, linkages often exist between them; increasing local investor activity, for example, will likely support market liquidity, and greater liquidity may draw more local investors to the market. Policy-makers are encouraged to consider this type of connectivity within the ecosystem when designing policy agendas. Additionally, the strategies outlined here are not exhaustive, and may not apply equally to all markets. Still, these examples can hopefully serve to spark ideas and dialogue among policy-makers looking to attract additional international investment to their capital markets.



### Market size and growth

International investors are likely to require a critical mass of investment opportunities before investing in a particular market. Emerging markets can grow their market size by encouraging greater issuance volumes and increasing the number of listed companies (see the Issuer/product diversity section below). For smaller economies, regional capital market integration (Figure 21) could be a strategy to build scale and increase visibility among international investors.



**Regional integration is a valid approach for countries that...are too small to build up a secondary market on their own and may not be very visible to international investors otherwise.**



Figure 21: Chile, Colombia, Peru and Mexico – Mercado Integrado Latinoamericano (MILA)<sup>36, 37, 38, 39</sup>

As part of the Pacific Alliance created in 2011, the Latin American Integrated Market (MILA) was formed to link the capital markets of Chile, Colombia, Peru and later Mexico. MILA enables investors to access stocks from all four exchanges through a local intermediary; the exchanges themselves remain independent and are subject to oversight by local regulatory authorities. However, policy-makers are working to harmonize regulation as much as possible across the four markets.

As of 2016, MILA had a combined market capitalization of over \$750 billion. But trading volumes and liquidity on the exchange have been lower than anticipated. While MILA is still in an early stage of development, it is one of the emerging markets furthest along in regional capital market integration. For a more established example outside the emerging world, Nasdaq Nordic, also known as Nasdaq OMX Group, has successfully linked the exchanges of multiple Nordic and Baltic countries.

MILA size (\$ billion) and issuer mix, 2016

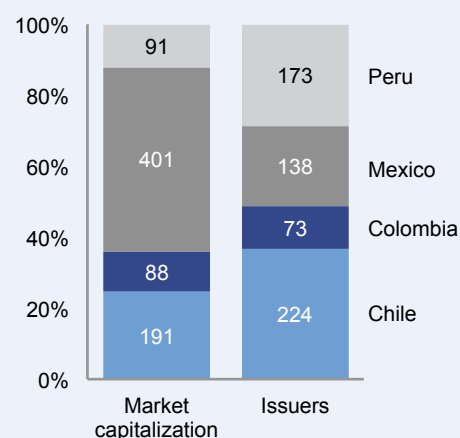


Chart source: MILA, <http://www.mercadomila.com/home/overview>, <http://www.mercadomila.com/home/resultados>



### Issuer/product diversity

Governments can increase issuer and product diversity either directly – through their own issuances, such as infrastructure bonds – or indirectly in a variety of ways. These include simplifying listing processes or incentivizing listing for new issuers; privatizing state-owned enterprises; increasing education for issuers with low representation on the market, such as issuers in rural areas; or enabling new products (e.g. hybrid bonds). Some markets are promoting debt market diversity through hybrid offer regimes, which reduce issuance requirements for bonds that are limited to qualified (often institutional) investors. Poland has increased equity market diversity with an alternative market for small to medium-sized enterprises (SMEs) (Figure 22).

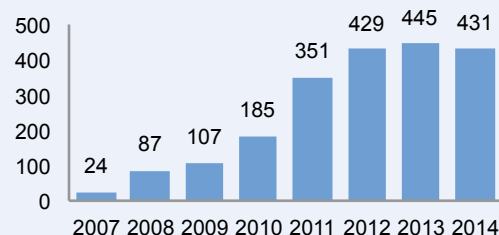
Figure 22: Poland – Launching a Market for Small to Medium-Sized Enterprises ,

In 2007, the Warsaw Stock Exchange (WSE) launched NewConnect, an alternative trading platform, to improve access to financing for SMEs, which make up over 90% of businesses in Poland.

NewConnect has reduced listing and reporting requirements for issuers to reduce the cost of capital for smaller firms; for example, independent audits are not required for semi-annual reports. Firms work with Authorized Advisors, who verify issuer compliance with relevant policies.

NewConnect has seen rapid growth in issuer volumes, with listed companies representing a variety of industry sectors. Both retail and institutional investors participate in the market. From 2007-2015, 35 NewConnect issuers moved up to the WSE's main board.

Number of companies listed on NewConnect



Sector mix of listed companies, 2014

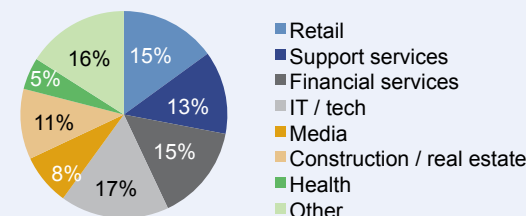


Chart source: NewConnect, NewConnect Report 2015: Summary of the Activities of Poland's First Alternative Trading Platform



### Local investor activity

A vibrant local investor base can signal a healthy capital market to international investors. To build an institutional investor base, policy-makers can increase the local savings rate (e.g. through pension fund reform) or stimulate the growth of the asset management and/or insurance sectors. For retail investors, educational campaigns are one strategy for encouraging participation. The growth and success of Chile's pension funds since the 1980s is well documented. More recently, Nigeria has embarked on a similar path (Figure 23).



**Market stability requires building local investor participation along with foreign participation. Local participation will really only come with the establishment of pensions, endowments and insurance products – items that encourage the personal investor to save for the future and to have those savings recycled and managed through institutional fund structures.**





Figure 23: Nigeria – Developing Pension Funds as an Institutional Investor Base <sup>43, 44, 45</sup>

Nigeria introduced a major pension reform law in 2004 that created a new defined contribution scheme, with minimum contribution amounts for both employers and employees. Subsequent amendments to the regulation have, for example, increased portfolio caps on equity and allowed investments in exchange-traded funds.

Pension funds have grown rapidly over this period, reaching about \$19 billion in 2016. As the largest source of domestic investment in the equity market, they have a roughly 14% average portfolio allocation.

However, there is still substantial room to grow: total assets of pension funds remain at about 3-4% of GDP, and estimates suggest just over 10% of employees participate in them.

Total assets under management of pension funds  
Nigerian naira, trillions

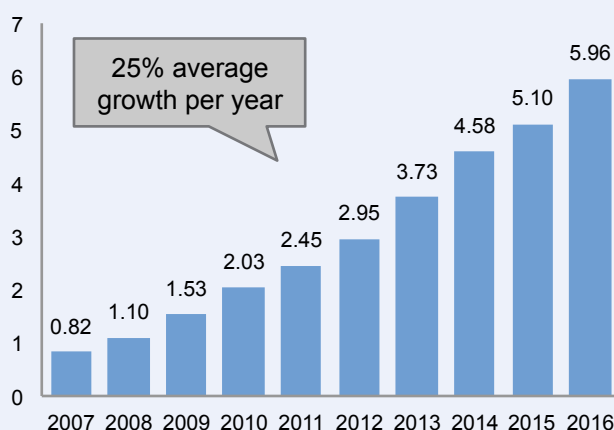


Chart source: Nigeria National Pension Commission annual and quarterly reports, <http://pencom.gov.ng/publications.php>

### Market access



Reduced capital controls is perhaps the most straightforward strategy to increase international investors' access to capital markets. Argentina has recently removed its 120-day minimum holding period for foreign capital, while Vietnam is gradually removing limits on foreign ownership in various sectors.<sup>46,47</sup> (For a more detailed discussion of capital controls, see Figure 13.) However, simplifying entry and exit processes, as recently tackled by India, can also improve market access for international investors (Figure 24).

Figure 24: India – Streamlining International Investor Registration and Tax Policies <sup>48, 49</sup>

Prior to 2014, international investors were subject to different registration processes and tax laws based on their profile (e.g. retail vs institutional). In 2014, the Securities and Exchange Board of India (SEBI) consolidated three common types of international investor into a single foreign portfolio investor (FPI) regime to simplify market access and clarity.

Under the new system, all FPIs will receive the tax rate previously used for institutional investors (lower than that for smaller retail investors). Whereas investor registrations expired after a few years, FPI registrations under the new regime will not expire. These steps have increased market access, even as ownership limits remain in place for international investors.

#### Changes to the FPI process

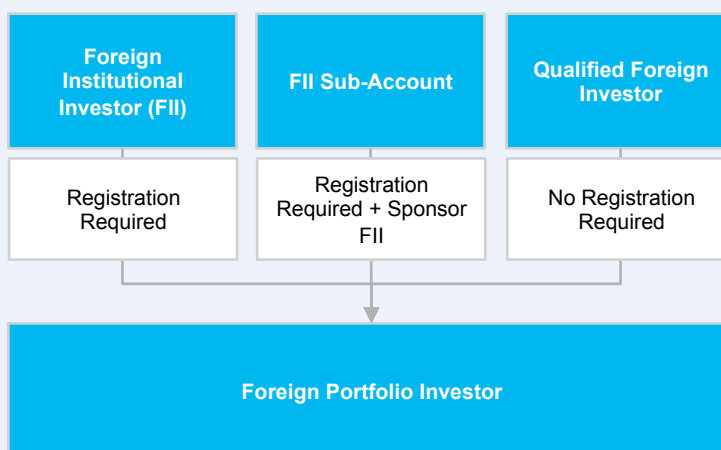


Figure adapted from: Citi Online Academy, 2013, "Recommendations of SEBI Foreign Investment Committee" [Securities and Exchange Board of India]





### Market liquidity

Liquidity emerges from a confluence of factors, including the activity of investors and issuers, the diversity of products available and the presence of market makers. A policy programme that addresses numerous such areas can help to build market liquidity. Pakistan's return to MSCI Emerging Market status reflects some of these actions (Figure 25).



**International investors entering the market need liquidity and exit strategies. They need a broad enough investor base to find pricing that is not skewed ... and the ability to exit their positions if conditions change.**



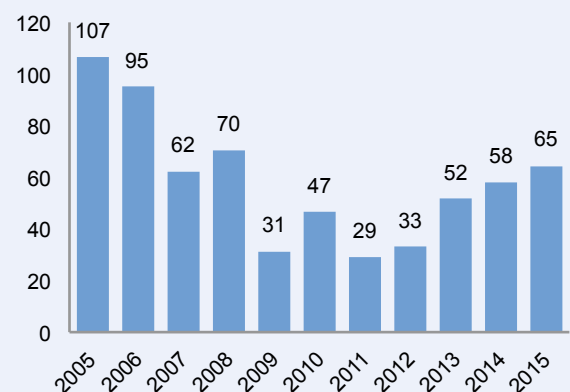
Figure 25: Pakistan – Regaining Status as an MSCI Emerging Market, 2005-2015<sup>50, 51, 52</sup>

Pakistan's equity market lost its place in the MSCI Emerging Market Index in 2008 after the market enforced a "floor" below which its plunging index value was not allowed to fall. Since then, Pakistan has undertaken reforms to reintroduce transparency and liquidity into the capital market.

These reforms have included improving disclosure and oversight of various market participants, integrating three exchanges into one, increasing enforcement of 25% minimum float requirements, and enabling market-making activities.

Investor confidence and participation has rebounded as a result. Though the daily traded value of \$94 million in 2015 has not reached its pre-2008 levels of \$450 million, improvement has been significant. In 2016, MSCI reclassified Pakistan as an Emerging Market, to take effect as of 2017.

Annual turnover of shares on Pakistan's stock exchanges (billions of shares)



Note: Data is from Q3 of the prior year to Q2 of the year indicated (e.g. 2009 shows Q3 2008-Q2 2009).

Chart source: Government of Pakistan, Ministry of Finance, "Pakistan Economic Surveys", <http://www.finance.gov.pk/>

### Information transparency

Policy-makers can influence the availability of information through the disclosure, accounting and reporting standards they set for listed firms. Raising these requirements to conform to international standards, as well as ensuring the reliability of third-party information providers (e.g. auditors, credit rating agencies), can increase transparency, as seen in Thailand (Figure 26).



**A market may have the most attractive opportunities in the world, but they will only be found if there is adequate information for an evaluation to be done. If the work and energy to conduct that due diligence is too high, then few will be interested.**



Figure 26: Thailand – Increasing Information Disclosure and Transparency <sup>53, 54, 55, 56, 57, 58</sup>

Over the past 10 years, Thailand has significantly improved its transparency on information. Thai Financial Reporting Standards now match the 2012 International Financial Reporting Standards (IFRS), and standards are being updated to match more recent IFRS iterations. A World Bank assessment in 2013 noted that annual reports in Thailand often provide more information than is available in other countries, such as risk management practices. Since 2010, Thailand's Securities and Exchange Commission has performed quality reviews of audit firms. Moreover, the country outscored peer markets in Disclosure and Transparency in 2014 as part of the Association of Southeast Asian Nations' Corporate Governance Scorecard.

This transparency has not come at the expense of capital market growth: corporate bond market capitalization grew 17% on average per year in 2005-2016, while equity market capitalization had average annual growth of 10%.

ASEAN Corporate Governance Scorecard, 2014  
Disclosure and transparency scores (max. 25)

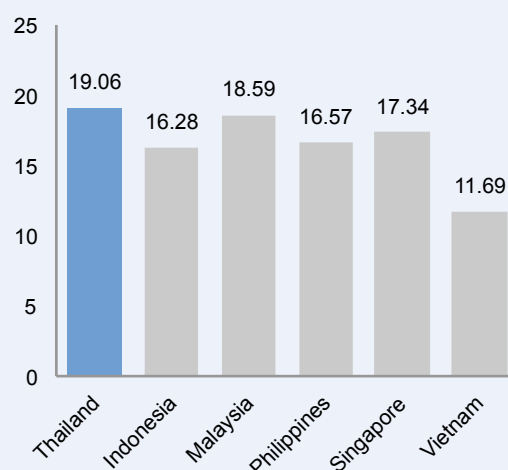


Chart source: Asian Development Bank, 2014, "ASEAN Corporate Governance Scorecard Country Reports and Assessments 2013-2014"

### Policy and regulation

A clearly-defined agenda for capital market oversight and development helps to demonstrate policy-maker commitment to improving the investment climate. Executing on that agenda through policy reforms or increased regulatory enforcement (see the Philippines, Figure 27) can increase confidence among international investors.

“

Investors will accept a higher degree of uncertainty and volatility when they are looking at less well-established markets – as long as there is a demonstrable consistency around the way laws are applied and the rule of contract law.

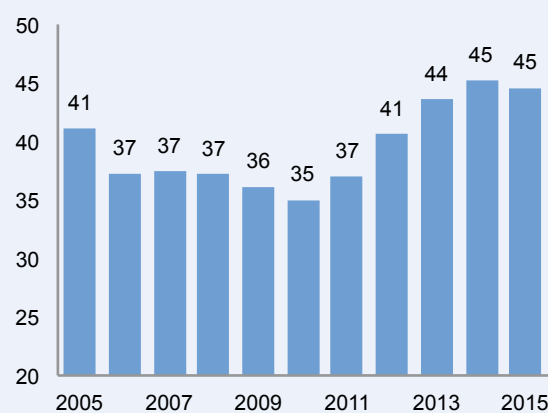
”

Figure 27: Philippines – Improving the Policy and Regulatory Environment <sup>59, 60, 61, 62, 63</sup>

The Philippines introduced its first Capital Market Development Plan in 2005 to assess the current state of capital markets development and lay out an agenda for reform. The government drove change along multiple avenues, including passing a law in 2008 to promote private pension fund growth, reorganizing the Philippine Stock Exchange (PSE) to increase oversight in 2011, and setting a minimum 10% free float requirement in 2012. The government has since released a second iteration of the Plan that sets out clear priorities and objectives through 2017.

These measures, along with other reforms, have contributed to the Philippines' improved overall governance scores. More specific to the capital markets, its score on regulation of securities exchanges in the World Economic Forum Global Competitiveness Index has climbed from 4.09 in 2010 to 5.0 (out of 7) in 2016.

Philippines: percentile rank of Worldwide Governance Indicators, 2005-2015



Note: Data reflects unweighted averages of the six Worldwide Governance Indicators

Chart source: World Bank Group, Worldwide Governance Indicators, averages of six indicators, <http://info.worldbank.org/governance/wgi/#home>



## Corporate governance

Markets looking to improve corporate governance can consider strengthening protections for minority shareholders, improving the efficiency of dispute resolution processes, or increasing issuer listing requirements. However, policy-makers should also consider the additional burden this may place on local issuers. Corporate governance became a major focus of capital market reform during the past decade, with Brazil's Novo Mercado as a well-regarded success story (Figure 28).

**Figure 28: Brazil – Implementing the Novo Mercado** <sup>64, 65, 66</sup>

Following an influx of capital into Brazil in the early 1990s, the São Paulo Stock Exchange (BOVESPA) stagnated. The market had only eight initial public offerings from 1995-2000, and traded value fell by almost half between 1997 and 2000. In addition, insufficient corporate oversight and protection for the market's minority shareholders worried investors.

In December 2000, BOVESPA introduced Novo Mercado, a new market segment that enabled listed companies to demonstrate compliance with higher corporate governance standards. BOVESPA also created two intermediate tiers to allow issuers to phase implementation of these requirements.

By 2010, the Novo Mercado tiers included 174 companies, accounting for 65% of market capitalization and 79% of trading volume. Other markets have since worked to replicate the model (e.g. the Bucharest Stock Exchange's "Transparency Plus" tier), though results have been mixed.

### Corporate governance requirements of BOVESPA market segments

	Basic	Level 1	Level 2	Novo Mercado
Common stock only			✓	✓
Translation of statements into English			✓	✓
>25% free float		✓	✓	✓
Size of the Board of Directors	>3	>3	>5	>5
Additional disclosures		✓	✓	✓

Chart source: BOVESPA, [http://www.bmfbovespa.com.br/en\\_us/index.htm](http://www.bmfbovespa.com.br/en_us/index.htm), [http://www.bmfbovespa.com.br/en\\_us/listing/equities/listing-segments/novo-mercado](http://www.bmfbovespa.com.br/en_us/listing/equities/listing-segments/novo-mercado)

Beyond the need for a sound policy framework, interviews also highlighted the importance of “soft factors” in international investment decisions. Such factors, including investor sentiment towards a market, are subjective rather than objective, and cannot be easily quantified by metrics or data. However, experts suggest they can materially impact investor evaluations of markets (Figure 29), and may therefore be worthwhile for policy-makers to consider.

**Figure 29: The Impact of Perception on Investor Evaluations**

Investor perceptions of an emerging market can be formed from a variety of sources. One is a country’s past policy actions regarding the capital market; in other words, to what extent have policy-makers maintained consistency and transparency in their historical treatment of international investors? However, investors’ perceptions of a market can also derive from their level of familiarity with the country, past experience investing or traveling there, coverage of the country in the media (e.g. news, movies, social media), accounts from friends and family, and other sources.

“  
**There are softer aspects of attraction – culture, chemistry between the investor and the country, how you feel when you land in the airport. These perception-based factors are often not included in standard indices that reflect attractiveness of markets.**

Investor perceptions can function as a filter over the Market Attractiveness Matrix shown in Figure 17. Positive perceptions of a country can amplify the appeal and promise of the capital market, while negative associations can detract from progress or strengths along various elements of the matrix. Improving investor perceptions is not a substitute for developing sound institutions and effective policies, but can be a valuable part of the broader tools for policy-makers to attract international investment. Interviewees pointed out a number of tactics that policy-makers can consider to improve investor perceptions:

“  
**Perception has a disproportionate weight on investors when it comes to investing in emerging markets.**

#### Improving perceptions of the capital market investment climate

Increase communication with global investors by:

- Holding regular press conferences and briefings to share policy decisions
- Organizing roadshows in major investor hubs and sharing stories of successful investment

Increase the predictability of the policy environment by:

- Aligning priorities and messaging between economic oversight bodies
- Notifying investors and providing rationale for upcoming policy changes

Increase consistency of messaging by:

- Creating a capital market development strategy that clearly articulates the role of international investors
- Delivering on promises through fair implementation and enforcement of laws

#### Improving perceptions of the country as a whole

Develop a unique brand for the country by:

- Incentivizing investment/growth in key sectors (e.g. Kenya as the “Silicon Valley of Africa”)
- Establishing a clear positioning to travellers (e.g. convention hub, leisure destination)

Improve the quality of infrastructure by:

- Investing in physical infrastructure (e.g. public transport, airports, roads)
- Incentivizing the development of tourist infrastructure (e.g. hotels)

Enhance the country’s profile in the media by:

- Monitoring ongoing media coverage
- Publicizing stories that highlight the country’s features (e.g. culture, history, people), either by disseminating stories directly or by working with external media outlets

Source: Authors

International investors evaluate potential investments in emerging capital markets based on their opportunity, cost and risk, each of which is defined by a few component factors. The relative significance of these factors to investors is changing: market liquidity may become a greater constraint on investment than market access, and investors may be increasingly influenced by a country’s policy environment rather than by its growth prospects alone. Policy-makers can identify high-priority factors to be

addressed for their markets based on investor and market needs, as well as through their own spheres of influence. They can consider the policy recommendations profiled above and other examples when formulating initiatives that meet their market needs. In addition, policy-makers should take into account the perceptions investors may have about their market, as these could also influence market appeal.

1
2A + 2B
3

# Annex 2B. Harnessing International Investment

International investment can help emerging markets address a financing gap that cannot be met by domestic savings pools alone. But such investment can promote sustainability in the local capital market system if managed appropriately. Policy-makers should consider the potential benefits when designing strategies to manage international investment. This section covers the components that define a sustainable local capital market, how international investment can support each of those factors, and policy actions that can help emerging markets realize some of those benefits. As this is a relatively unexplored topic in the current literature, these ideas are intended as a starting point for further discussion and development.

## 2B.1 Defining local capital market sustainability

A sustainable local capital market allows local issuers to access financing, and enables local investors to diversify risk and generate returns on their savings in an efficient and fair environment. Though international investors may participate actively, the market is resilient to inflows and outflows of capital. The sustainability of the capital market can be defined along four pillars (Figure 30).

Figure 30: Defining the Sustainability of a Capital Market

### Depth – The extent to which suppliers and consumers of capital join and use the capital market

- **Issuers:** A large proportion of a country's firms raise financing through the capital market. The issuer base is diverse, and listed companies actively issue new securities.
- **Investors:** A large proportion of the eligible population invests in the capital market. The investor base is varied, for example, in type (e.g. retail vs institutional), size, investment horizon and portfolio mix.

### Efficiency – The extent to which transactions can be completed with speed and ease

- **Liquidity:** Though some investors may exhibit buy-and-hold behaviour (e.g. long-term investors), securities are actively traded, and investors can exit their positions as desired.
- **Transaction execution:** Market infrastructure providers (e.g. exchanges, clearinghouses) enable transactions to be completed quickly and reliably.

### Transparency – The extent to which market activity is conducted with openness and accountability

- **Information:** Reporting and disclosure requirements, along with the activity of third-party information providers (e.g. credit rating agencies), ensure that reliable information on issuers is readily available.
- **Oversight:** Policy-makers clearly communicate priorities and rationales for regulatory changes.

### Stability – The extent to which the marketplace and associated institutions are trusted and predictable

- **Market:** The investment environment is largely predictable, with rare periods of extreme volatility.
- **Institutions and policies:** Oversight bodies are trusted and enforce regulation effectively. Capital market and macroeconomic policies are sound; the political climate is stable, and rule of law prevails.



Source: Authors

## 2B.2 The role of international investment in capital market sustainability

The relationship between openness to international investment and long-term market stability has been heavily analysed (see Annex 1 for key studies on the impact of international investment on emerging markets). The results, though still heavily debated, seem to suggest that international investment confers net benefits on emerging markets, but in some cases can contribute to adverse economic outcomes.

Thus, international investment can impact the sustainability of the local capital market either positively or negatively. Figure 31 outlines scenarios where international investment can support each pillar of sustainability, as well as caution points for policy-makers. This is not an exhaustive set of ways in which international investment can impact a local market, but is intended to showcase the possible variation. In many cases, decisions made by emerging-market policy-makers to improve market attractiveness to international investors and manage international investment can materially affect the outcome.

Figure 31: The Relationship between International Investment and Market Sustainability

Pillar	 Supporting market sustainability	 Points of caution
Depth	International investors increase the supply of capital on the local market and encourage more firms to join the market	Ensure that the local investor base is sufficiently deep and well developed to insulate the market from capital outflows
Efficiency	International investors complement the existing domestic investor base in terms of investment horizon and trading behaviour, increasing market liquidity	Ensure that complex market access rules or high transaction costs do not force investors to invest indirectly (e.g. via American depository receipts) at the expense of local market liquidity
Transparency	International investors call for higher issuer reporting standards and policy transparency, which improves the investment climate for all investors	Ensure that increased listing or disclosure requirements to attract international investors do not become a barrier for local firms to join the market
Stability	International investors provide a source of capital not affected by domestic slowdowns, mitigating the effects if local investors become less willing to invest	Ensure that the macro environment is well managed and sufficiently stable so that declining market performance does not prompt international investors to exit en masse

Source: Authors

## 2B.3 Harnessing international investment to build market sustainability

Given the various ways international investment can support overall market sustainability, what steps can policy-makers take to realize these benefits and protect against the caution points? Both indirect and direct strategies exist to do so; the following sections provide a few examples for consideration.

Case studies of countries that have achieved results from such policies are hard to isolate because of the difficulty in establishing a causal link between international investment and market sustainability. A correlation





between inflows and transparency, for example, could indicate that transparency attracts international investors, or that those investors promote increased transparency (or both). Anecdotal, interviews suggest that Singapore may be an example of how the presence of international investors accelerates improvements in the rule of law and transparency.

### Indirect measures

Policy-makers can start translating international investment to build local market sustainability even before international investors enter the market. Because international investors seek out active and vibrant local markets, many of their criteria for evaluating emerging capital markets are linked to local market sustainability. As a result, steps to attract international investment often inherently support one or more pillars of sustainability. Examples from policy actions described in Annex 2A are shown in Figure 32.



Figure 32: Indirect Measures to Support Local Market Sustainability

Area of focus	Policy action	Sustainability pillar(s) supported
 <b>Local investor activity</b>	Develop a pension fund industry with active local participation that invests in the local market	<b>+ Depth:</b> Expands the local investor base <b>+ Efficiency:</b> Promotes greater liquidity through a more diversified investor base
 <b>Market liquidity</b>	Set minimum free float levels and support market-making activity	<b>+ Efficiency:</b> Enables greater liquidity
 <b>Information transparency</b>	Increase disclosure and reporting requirements for listed firms	<b>+ Transparency:</b> Increases availability of information in the marketplace
 <b>Policy and regulation</b>	Establish clear policy objectives for market development and institute reforms accordingly	<b>+ Transparency:</b> Improves market oversight <b>+ Stability:</b> Increases the policy framework's predictability and consistency

Source: Authors

## Direct measures

Policy-makers can also take explicit steps to capture the benefits or reduce the risks of international investment in local capital markets. Examples of such policy actions, as well as their impact on the pillars of sustainability, follow below.

→ **Focus efforts to attract international investment on long-term, patient capital.** Some international investors seek returns from short-term currency or price fluctuations, while long-term investors focus more on the real returns of their assets and may be less prone to capital flight. One way to attract these long-term investors is to issue infrastructure project finance instruments. The Global Infrastructure Hub, founded in 2014 during Australia's G20 presidency, aims to establish quality standards and share data to improve investment conditions for infrastructure projects.<sup>68</sup>

“

An ideal marketplace will be able to accommodate both short-term and long-term investors, but markets can also cater to one or the other. The appropriate mix depends on where a company is in the economic journey, its political situation, and so on.

”

## Impact on market sustainability

- + Depth:** Increases the diversity of investment options available on the capital market
- + Stability:** Long-term investors may be less likely to exit as a result of short-term performance
- ⚠ Efficiency:** Long-term investors may be more likely to exhibit buy-and-hold behaviour than short-term investors; a healthy mix of investment horizons best promotes market liquidity

→ **Regulate market access by instituting capital controls.** Some emerging markets choose to restrict access for international investors through capital controls, either as long-standing policies or as a temporary response to capital flow volatility. (See Figure 13 for a discussion of capital controls and their suggested uses, based on the IMF's *The Liberalization and Management of Capital Flows: An Institutional View*.)

Policy-makers considering the implementation of capital controls, particularly as long-standing measures, should be aware of the potential negative effect they can have on international investor interest. Investors point out the importance of transparency in this process; for example, though China has liberalized its market very slowly, its policies have been predictable to international investors.



## Impact on market sustainability

- + Stability:** By limiting the participation of international investors in local markets, policy-makers can insulate those markets from sudden surges of capital into or out of the economy, thereby reducing the potential of a market crash
- ⚠ Depth:** Reduced interest from international investors as a result of capital controls can limit the supply of capital on local markets and impede market growth
- ⚠ Efficiency:** Reduced interest from international investors as a result of capital controls can prevent markets from realizing the liquidity benefits provided by these investors

→ **Understand and transfer corporate best practices.** Based on their experience in other markets, international investors will understand best practices in corporate governance across markets. Creating a formal process for these investors to share the practices directly with policy-makers or businesses can help to raise standards, particularly for markets with many family-run businesses.

## Impact on market sustainability

- + Transparency:** Improving reporting standards or other business practices can further increase market transparency
- ⚠ Depth:** If requirements for issuers become too onerous, local firms may be disincentivized from listing or issuing on the capital market

Each of the strategies outlined above has trade-offs that should be considered as part of managing international investment. The interviews with experts highlighted the importance of developing international investment alongside the rest of the capital market ecosystem to reduce potential adverse impacts. A market with a vibrant and active local investor base is likely to be more resilient to capital flow movements than one where international investors make up most of the activity. By positioning international investment as one part of a broader capital market development strategy, emerging markets can best realize its potential benefits in supporting the sustainability of the entire ecosystem.



# Annex 3. A Roadmap for Reform

For most emerging markets – where local savings pools are insufficient to meet domestic investment needs – international investment will continue to play a role in capital market growth. For investors, too, growing asset pools will continue to drive capital towards emerging countries. However, the dynamics of this investment may be changing. In the future, policy environments will likely influence international investors more than underlying economic growth.

But crafting the appropriate policy framework is no easy feat, particularly given the longstanding debate on the merits and risks of international investment. Policy-makers face the central challenge of balancing investors' desire for flexibility with markets' need for stability. In many cases, markets may need to enable short-term movement of capital to build the confidence required for longer-term investments.

“

**Global investors have allocations to meet, so the question is not ‘if’ they will invest in emerging markets, but ‘which’ markets they will chose.**

”

## The investor perspective:

“

**If emerging markets wish to attract quality investors that have confidence in the market, they have to allow them the flexibility to deploy their capital in accordance with their investment priorities, which could include withdrawing it from the country.**

”

## The policy-maker perspective:

“

**After many years of experience inviting and accepting international investors ... foreign capital is not a good substitute for domestic savings but works well as an addendum to the domestic economy. Cash is king, and in times of crisis, international investors will flee first.**

”

When designing reforms, policy-makers can balance such trade-offs to best suit their market. In doing so, they may face various barriers to reform (“headwinds”), but may also benefit from enablers (“tailwinds”) that build momentum for reform. The following is a non-exhaustive list for both:

## Headwinds

- ← **Shifting political priorities.** Capital market development is a long-term, complex process that requires sustained commitment from policy-makers to drive reform. However, changing short-term political priorities (e.g. resulting from elections or leadership transitions) can prevent steady implementation of a capital market reform agenda.
- ← **Misalignment between stakeholders.** Many recommendations to foster market development involve multiple stakeholders (e.g. ministry of finance, securities regulation body). Differences in incentives or priorities between these organizations can lead to disjointed efforts at reform.
- ← **Resistance to international involvement.** Certain markets, such as those with negative experiences in international investment, may show reluctance towards financial integration. Policy actions may be poorly received if they are seen to favour international investors over domestic priorities.
- ← **Costs of meeting investor standards.** Increasing issuer requirements to attract international investors may burden local firms.

## Tailwinds

- **Rising demand for financing.** Investment needs in emerging markets are rising rapidly. The gap for infrastructure financing in emerging markets alone is estimated at \$1.6 trillion per year. The need to finance such investments can support reforms to attract international investors.
- **Growing domestic investor bases.** As household incomes rise in emerging markets, local savers will increasingly go through capital markets to seek long-term investment opportunities. This can increase demand for better investor protection, reporting standards or other reforms.
- **Increased connectivity between markets.** Greater dialogue between markets means policy-makers can more easily share lessons learned, and best practices from one country can be adopted more broadly.
- **Greater access to information.** Technology and automation, as part of the Fourth Industrial Revolution (the digital revolution characterized by the fusion of technologies), have made data on emerging markets more widely available than ever before. As a result, markets can better assess their current performance and measure progress towards goals.

For those looking to drive change, the roadmap on page 9 offers suggestions to get started. That roadmap – along with the frameworks, ideas and examples in this White Paper – can enable emerging economies to better harness international investment towards more sustainable local capital markets.

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