Comments on "Capital Market Developments in Emerging Markets: the Challenges Ahead"

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Accomplishments in financial development in developing countries/emerging markets

- Less bank-dominated systems
- Savings, especially pensions, more intermediated through capital markets
- More widespread access to finance
- Markets more integrated

But limitations/downsides to the progress

- Institutional investors apparently not maximizing returns
- Investors not “going long” very much
- Concentration of equity and bond issuance, narrow scope
- Negative effects of integration on domestic stock market development
- Far from “finance for all”

Asking some hard questions

- How to increase the availability of finance to harder to serve agents (small firms, poorer people)?
- How to get investors to “go long”?
- What kinds of financial structures and products are compatible with growth and stability (encouraging the “bright side” and not the “dark side”)

3 lines of comment

- The Croatian experience on financial development, mandatory pension funds and capital market development
- Some general skepticism on the pension fund-capital market development nexus
- How big a role does capital market development play vs credit market development in making progress on “finance for all”?

Lines of comment #1: The Croatian experience

- Bank-centric system, but less so over time (as measured by asset share)
- Long-term lending fairly strong
- Although banks face competition from bond market and international markets for large companies, these are still important customers
- Banks’ progression to consumer loans, mortgages, leasing occurred, but it seems SME lending also became interesting as competition increased in the 2000s. Big data problems in assessing SME credit situation.

Weak impact of mandatory pension funds

- Initiated in 2002
- Four funds, all part of bank groups
- Assets were 16.4% of GDP May 2013
- 66.2% of assets are domestic government bonds
- Foreign assets 11.99%
- Domestic corporate bonds 2.44% (0.4% of GDP)
- Note that increased contributions to pension funds mechanically increases size and share of these funds in financial markets, but does not substantively alter bank centered system

What has made finance more available?

- Overwhelmingly, a better capitalized and better regulated banking system
- This was based on improved legal framework, macroeconomic stability, and privatization
- Aside from extending credit availability (including leasing), not clear what would be promising
  – Issuance of debt and equity securities painfully limited
  – “grinding down frictions” will be a very drawn-out process
  – One hopes that EU accession process has helped, not clear where new direction comes from

Has stock market development helped?

- Croatia a typical case of the negative effects of stock market internationalization studied by Levine and Schmuckler (2007)
  - Good companies delist in Croatia and list internationally (also due to banking FDI)
  - Probably negative spillovers (lower turnover due to delisting, so less liquidity)
  - Trade diversion as shares of a firm with GDRs became very popular
- As an EU member state, difficult to see a big role for Croatian stock market when other, much stronger national stock markets are folding

Could Croatia do anything to encourage other kinds of institutional investors?

- Mutual funds?
- Venture capital?
- EU legal framework set, State Aids well-defined and limited

Lines of comment #2: general skepticism on mandatory pension funds

- Kotlikoff’s shell game: is there really any benefit for capital market development by allowing asset managers to get involved? (Kotlikoff 2007)
- Asset managers take fees but
  - Have little ability to add value
  - Do not face clear liabilities, so have weak incentives

The defined contribution mandatory pension fund "quasi-market"

- Impavido et al (2009) point out that a "quasi-market" has been set up
  - Savers cannot opt out of the market
  - Inflows are ensured by mandated contributions
  - Savers have a very hard time evaluating the performance of funds
  - Allocation of savings has been shown to be highly inelastic to changes in prices or performance
  - Supply is distorted by the fact that marketing effort is far more effective than good portfolio management for getting new business

Kotlikoff’s proposal for a cheaper, more effective state-run system

- Contributions
  - All workers required to contribute 7.15% to their Personal Savings System account
  - Government makes contributions for the unemployed and disabled
  - Below a certain earnings threshold, the Government would add contributions to workers’ accounts

Kotlikoff’s proposal

- Fund management
  - Social Security Administration (“Government”) invests in balanced global portfolios of stocks, bonds and real estate securities
- Guarantee
  - Government guarantees that amount in account at retirement is at least inflation-adjusted sum of contributions
- Annuitization
  - At age 57, contributions are sold off each day for inflation-protected annuities. These start paying out at age 62. By age 67, all contributions have been turned to annuities.

Is there any disadvantage to this?

- No fees for fund managers
- No distorted incentives due to quasi-market for dc funds
- Still investment of pension savings in capital markets
- Explicit but limited Government guarantee
- Highly transparent
- Not beyond the capabilities of emerging market Governments

Alternative: changing incentives in dc pensions

- Impavido et al (IMF and World Bank 2009) propose a series of reforms to avoid some of the quasi-market distortions
  - Require full annuitization and benchmark performance with this
  - This makes performance more transparent
  - And transforms pension funds from pure asset managers into something like asset-liability managers

Will changing incentives be enough?

- Concerns
  - Does this do enough to increase the impact of pension funds on capital market development and going long?
  - Is it transparent enough and simple enough to be robust in practice?
- Reality
  - Mandatory pension funds exist and a full reversion to a state system is probably unlikely

Line of comment #3: capital vs credit markets in FD going forward

- Hard to study empirically, but I suspect that access to credit swamps other financial development issues as a barrier to growth
- Didier and Schmukler (2013) show that, even among large firms in China and India, access to capital markets is limited to a very few. Access to capital markets has strong positive effects on growth, but is very narrowly distributed.

Maybe life is elsewhere…

- Aterido et al (2008) find that business environment issues, quality of infrastructure, and corruption, tend to be associated with greater persistence of micro firms. One way to read this is that when these problems are greater, more firms stay micro, limiting overall TFP and TFP growth
- Hsieh and Klenow (2008) show massive differences in manfacturing TFP in India and China due to policy distortions such as state ownership (China) and firm size restrictions (India). Probably this kind of low-hanging fruit has mainly been picked in Croatia and new EU member states (?)
- Do we still have more bang for the buck in these two areas than in capital market development?