Emerging Forces in the Capital Markets
New market centers share aspirations--and mutual support

By J.R. Magee

Globalization is an undeniable force in the capital markets, as it is in the world economy. Brazil, China and Dubai are just a few examples of less-mature markets that are literally emerging into the global investment spotlight--in each of those cases, with securities markets that have rapidly taken on characteristics capable of attracting funds from established institutional investors.

But even in the lower tiers of economic development, building blocks of financial infrastructure are clearly evident, ranging from microfinance programs that bring bank services to the poor, to South-South cooperation, a growing movement whereby emerging markets provide assistance to each other, with encouragement from higher authorities.

"The industrializing world is creating its own momentum and opportunity," said Yiping Zhou, director of the special unit for South-South cooperation at the United Nations Development Program (UNDP). "Emerging markets are doing so well, and it's still early in the game. There are some policy adjustments which need to be made."

As these countries and societies open up to the global economy, Zhou added, "they need to reform old ways, both inward and outward. When emerging markets are taken seriously as business partners, and not just an opportunity for exports, this is when emerging markets are successful. The infrastructure must be there for mature, industrialized nations to invest in and work with emerging markets."

South-South cooperation may be a new concept to international financiers who grew up amid the North-South dialogue of a generation ago. The notion was that the countries of the more-industrialized Northern Hemisphere needed to take steps to lift the South out of poverty and debt. That was a function, said Zhou, of the less-interdependent and -integrated world economy of the 20th century.

Although Zhou said that South-South cooperation has been on the international affairs agenda since 1978, "Once we entered the 21st century, globalization became a driver to emerging markets and South-South cooperation. This means that in the last ten years, globalization had enabled a large amount of development in emerging markets. The factors involved were both internal and external. Industrial countries and industrializing countries are looking for expansion into new markets. They are promoting free trade, free capital flow, free flow of technology and the free flow of people." He pointed to the rapid emergence of "new patterns of trade, investment and other economic linkages among the countries of the South."

In the South-South milieu, there is a shared sense that economic growth in an emerging economy raises the average rate of growth of the developing world, said Jomo K.S., assistant secretary general for economic development in the United Nations Department of Economic and Social Affairs (DESA). "There are new and significant investments from some developing countries into other developing countries, but the impact on growth is difficult to measure and may not yet be very significant, although this may change very quickly," he said. "A significant portion of investments from developing countries to other developing countries in recent years has been secure access to natural resources."

Cross-Border Capital Cooperation

In the capital markets, meanwhile, securities exchanges in countries such as India, Malaysia and Vietnam--each of those aspiring to play in the regional league with Hong Kong and Singapore, if not quite Tokyo and London--have entered into cooperation agreements among themselves and with leading industrial-nation exchanges, in much the same way that the Shanghai and Shenzhen stock exchanges in China have brought in advisers and technologies from the West. Indeed, technology itself could be a bootstrapping force: Stockholm's OMX, which recently signed a merger agreement with Nasdaq Stock Market, has sold exchange and clearing technologies in more than 50 countries. Technology arms of NYSE Euronext, Deutsche Borse and the London Stock Exchange are also major exporters, to developed and developing markets alike.

"Domestic capital markets in many emerging countries have been expanding as a consequence of worldwide liquidity supply," said Jomo K.S. "The newest area of growth is due to new interest by external funds in purchasing local currency bonds in markets such as Turkey. These markets are much smaller in comparison with developed-country markets, but can eventually provide a channel for access to foreign funding for domestic companies. Right now, the markets tend to be dominated by government borrowing."

Officially encouraged flows of foreign direct investments are stimulating economic and financial-market development. Foreign direct investment "plays a large part in the emerging-market boom," Zhou commented. "Many countries such as China, India and Malaysia offer incentives to interested foreign parties."

It's an element of policies and strategies aimed at creating knowledge-based economies capable of competing with the industrialized giants. "Emerging markets are figuring out how to become knowledge-based economies, and not just 'copy and paste' economies," said Zhou. "In China, the consumer base is huge, so they must tailor their strategies for competition in the world market. This is true of many emerging-market economies."

Vivek Chibber, professor of sociology and political economics at New York University, said: "Public investment has played a massive role in spurring growth rates in emerging markets. ... Emerging markets can offer an exorbitant amount of power and stability and attract investors."

How Microfinance Matters

Emerging-market development has also gotten a boost from microlending, which retains the reputation and image of a pure grassroots movement even as it gathers momentum as a more "institutional" infrastructure.

"When I started to try to convince my wealthy friends to invest in microfinance, they looked at me like I was a hippie, or a leftover from the '60s," said Alexandre de Lesseps, director of BlueOrchard Finance, a Geneva-based manager of microfinance investment products. "But markets can allow the transformation of a massive number of people."

He went on: "Why would I risk my money [in a business] banks have avoided like the plague since the beginning of time? We see more evidence that the world doesn't need big money--what it needs is small money." De Lesseps said that "small money is smart money." He wonders what would have happened if the $450 billion that flowed from Western nations to Africa over the past 40 years was channeled instead in the form of microloans, which are typically $1,000 or less, to small-scale entrepreneurs in developing countries.

But microlending--helped by the glow of the 2006 Nobel Peace Prize jointly awarded to the Bangladeshi pioneer of the concept, Muhammad Yunis, and the bank that he founded, Grameen Bank--is doing well enough to attract some big money. One example was the May 3 launch by Morgan Stanley and BlueOrchard of a $108 million bond issue backed by loans to microfinance institutions. It was billed as the first security of its kind to be rated by a major rating agency. Two rated classes of the bonds were pegged at AA and BBB by what agency? Standard Poor's?

"Funding individuals is the engine of emerging markets," said de Lesseps. "We must recreate a micro-revolution to bring money to as many as is realistic. In emerging markets, we must realize the entrepreneurial skills of the poor, no matter where they may be. I want people to be seen as consumers and not burdens of society; as business people, not charity cases." Perhaps paradoxically, as de Lesseps put it, "The more globalized the world is becoming, the more important role smaller communities play."

William Cline, the veteran capital markets industry consultant who recently co-founded, and is managing partner of, Acai Solutions in New York, said of microfinance, "The perception is that it works. It's a cost-effective way to stimulate growth."

Cline asserted that "in almost every case, very small amounts of capital had a surprisingly magnified effect on growth. This is a very

attractive and low-cost, conservative way to inject capital into a country that is otherwise challenged. If you don't have the robust capital infrastructure, if fixed income is immature, then microfinance is a good way to fund start-ups. These work to a certain point--the operative word being 'micro.' The capital needs of an entity will go beyond that, and that's where you need a robust financial infrastructure. But this is the most early stage of emerging markets."

Contrasting microlending opportunities to the politically difficult and logistically complicated renegotiations to "write off debt that could have never been paid by developing nations," de Lesseps said, "Isn't it high time that commercial banks join in? There is light at the end of the tunnel. .... More and more, access to credit is seen as the right of every human being."

He added: "We are pushing the limit of the frontiers for capital, and waiving the theories of risk as we know them. Today, microfinance [in emerging markets] is a $15 billion business. Over the next ten years, it is estimated to rise to $300 billion."

How Dubai Has Emerged

As emerging markets go, Dubai is a raging success. The Dubai International Financial Exchange (DIFX) can handle trades in equities, bonds, funds, Islamic finance products, index products and derivatives. The market opened in March 2000. Despite a significant market correction in late 2005 and early 2006, Dubai is showing signs of becoming the regional financial hub it set out to be. DIFX, headed by former OMX chief executive Per Larsson, was reportedly considering trying to top Nasdaq's bid for the Swedish exchange and technology company.

"The real challenge of emerging markets is how to increase transnational business," said UNDP's Zhou. "Dubai is doing this and is playing an important role."

Still, said DESA's Jomo K.S., speaking of both Dubai and Egypt, another regional aspirant, "The equity markets are not very large in these two countries. Like other emerging markets, they are growing mainly due to the plentiful supply of financial liquidity."

Acai's Cline said that "Dubai is going to be successful. They have both the capital and the business savvy to instill trading systems comparable to Frankfurt, London or New York. ... There is a lot of capital in the region, and they have the chance to have first-class infrastructure."

Cline, in common with others including NYSE Euronext CEO John Thain, believes that the elite, top rung of the global markets business will eventually consist of "three to five very large, very global, very

diversified exchanges." Beyond that, he anticipates "some niche players" in certain asset classes. "Then there will be some exchanges protected by regulations," said Cline. "Dubai is going to be able to take part in this global consolidation if they so desire. They will be attractive to the top three to five exchanges. Dubai will be seen as another India or China."

"The market matures as society progresses," said UNDP's Zhou. "If society isn't ready, even if you introduce modern mechanisms and a stock exchange, you should expect some backlash. ... There is always excitement in the beginning, but there may be a conflict of expectations. I would be very, very careful in these emerging markets. Dubai has the major financial infrastructure, and because of their openness to the world, they'll continue to be successful in the region. There is confidence in that market."

Futures in Brazil

On May 22, Manoel Felix Cintra Neto, chairman of the Brazilian Mercantile & Futures Exchange (BM&F), rang the opening bell at the Nasdaq market site in New York's Times Square. Jeff Singer, VP of Nasdaq, said, "Brazil has a bright future. It is the regional leader in various industrial sectors, including agriculture and energy. Agribusiness and energy hold enough weight to hedge risk. The new strides with ethanol are aimed at increasing liquidity. BM&F is now ranked as one of the top futures exchanges in the world."

Neto called Brazil's capital market "very developed. Of course, Brazil is the top economy in Latin America," and the ninth-biggest in the world, but according to the World Bank, socioeconomic problems and the rich-poor divide are stark. The poorest one-fifth of Brazil's 173 million people account for only a 2.2 percent share of the national income.

"For the future," said Neto, "it is important that our market and exchange be one center of liquidity for Latin America. This is a goal and a challenge. Global investors anticipate a profit with Brazil, and we have received a lot of investments for the short term. Now what we want are investments for the long term," which, he said, "will happen as infrastructure develops."

Neto noted that "Brazil's main investors to date are corporations," but added, "We are starting to work more on the micro level with smaller, individual investors, and there is a push to popularize investment in stocks in Brazil. We must develop strong relationships with other rising economies and markets, such as Dubai. We also have an agreement with the Chinese futures exchange in Shanghai and with the Indian Exchange which exchange is he referring to?," He said that BM&F has "very close ties" with the New York Mercantile Exchange and Chicago Mercantile Exchange.

"To rise beyond emerging-market status," said Cline, Brazil must

"grow their capabilities in knowledge work. Agriculture alone isn't going to do it." It has a social climate and political risk akin to that of Russia. "We were doing a big deal in Latin America outsourcing research," Cline recalled recently. "The client didn't want to go to Brazil, and found that the talent from the universities in Chile or Costa Rica was as good as in Brazil. But it would be a mistake to write Brazil off."

Key Ingredients

What may help carry Brazil forward is capital market infrastructure, which Cline considers "very, very important." He said that in China, "we've seen a very rapid transformation in exchanges and the infrastructure, and derivatives play a role in managing risk. This is fundamental in finding growth in emerging markets. It gives the ability to raise capital and consolidate, instead of stagnating. In some countries, lack of regulation can be inadequate, in terms of protecting investors. And nationalistic policies preclude the competition, mergers and acquisitions, and the exchange landscape [necessary to compete] in a rapidly consolidating world."

Cline noted that the 11 or 12 coexisting exchanges in India are "probably 10 or 11 too many," making India an example of an emerging market that "needs to undergo a consolidation from within. The capital market infrastructure is so interconnected. ... You don't want to be an island. It's like musical chairs--no one wants to be the last one standing. You can't wall yourself off; this is inconsistent with the structure of capital markets."

Emerging capital markets also must sustain their commitments to stability. "Russia was seen as a hot growth area," said Cline, "but now the general feeling is that it's begun to backtrack. The regulatory environment is too uncertain. It makes people reluctant to invest capital." The backlash has benefited Eastern Europe, he said. "Russia was seen as the new India" for outsourcing projects, Cline added. "Now it's much more Central and Eastern Europe."

Federal Reserve Board governor Randall Kroszner said in a recent speech: "First, the scale of gross capital flows throughout the world is expanding, reflecting financial innovation, lowered barriers to capital movements, and a decline in what economists refer to as home bias. Second, increased capital mobility is making it possible to finance ever-larger current account deficits, and, indeed, these deficits have grown in recent years relative to the size of the global economy. In the aggregate, we see that capital has been flowing, on net, from emerging-market economies to industrial countries in recent years, the reverse of the pattern in previous decades."

Cultural Factors

To UNDP's Zhou, emerging markets' maturity is not just a matter of money and shares and futures contracts. "Civil society is quite important," said Zhou. "Governments don't want to give too much credit to civil society, but the private sector and the media play a tremendous, positive role in the success of emerging markets. If you watch TV shows, whether in China, South Africa, Brazil or Thailand, there's less negativity. [Wealth] disparity and poverty are still major concerns, but the overall posture is positive."

To get to the level of transparency that is a prerequisite to a market being "embraced," said Zhou, "the learning curve can be very steep." Emerging markets must deal with the challenges, because many Southern [developing] multinationals have not been in business for long. ... Emerging markets must follow a more sustainable pattern. They must create the conditions for long-term development, not just reducing tariffs and making a quick profit, but having the openness to work with other developing countries and the readiness to appreciate different values and cultures."

Zhou said that emerging markets that have done relatively well, such as China and Dubai, "can offer enormous experience and opportunity to other developing markets." That's where South-South dialogue can be useful. At the same time, however, "China has not had the experience of a [market] crash," which would cause widespread concern because of "the interconnectivity of the world. ... There is a lot of enthusiasm running through the Chinese stock market. Money is being poured into the Shanghai Stock Exchange. If it crashes, the effect will be much more painful for the overseas Chinese."

Zhou believes institutional investors wouldn't suffer terribly through the worst-case scenario, but there would still be domestic economic pain and a natural level of uncertainty. "What's most important is for these emerging markets to be transparent and trustworthy--there is a credibility issue," said Zhou. In that light, there doesn't seem to be much of a divide between emerged and emerging markets, after all.