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THE FORMATION OF CAPITAL MARKETS

Abstract: *All central banks have a stake in the health and efficiency of capital markets. Capital markets are key funding sources for the real economy; they facilitate risk allocation and encourage economic growth and financial stability. The research addresses the process of establishing effective capital markets. It emphasizes the crucial importance of a strong enabling environment, which is defined by macroeconomic stability, market autonomy, sound legal frameworks, and effective regulatory regimes. Additionally, market development is influenced by drivers that are more directly related to specific capital market functions – such as enhanced disclosure standards, increased investor diversity, internationalisation, and deep hedging and funding markets, as well as efficient and robust market infrastructures. The suggestions, which span six broad categories, outline feasible measures for policymakers to bolster these drivers, while noting that some are beyond the purview of central banks.*

Key words: *capital market, securities, Central Bank, market capitalization, bond market.*

Language: *English*

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Introduction

Development and depth of capital markets can be crucial in financing economic expansion, while also having an impact on financial stability and monetary policy transmission, among other things. The ability of the capital markets to service the real economy is contingent on regulatory frameworks that promote safety and operational effectiveness. Even though the private sector and securities market regulators are typically in the forefront of developing robust markets, central banks are significant players because the depth and liquidity of the financial markets have an impact on the central bank's policy objectives and duties.

Several central banks play an important role in the development of the capital market ecology in their respective countries. It is common for central banks to play an important role in government bond markets, usually in collaboration with the finance ministry; and, in emerging market economies (EMEs) with less developed domestic fixed income markets, central banks frequently oversee the development of trading and issuance venues. They frequently play a role in overseeing crucial sections of the payment infrastructure, such as the repo, fixed income, and currency derivatives markets, in part because of their authority over financial institutions such as banks. Additionally, central banks have historically played a considerable role in the formation and modification of capital and interest rate laws, in addition to other prudential policies affecting the growth of the capital market. Furthermore, as part of their responsibilities for macroeconomic and financial stability, they are responsible for periodically monitoring the operation of domestic capital markets. As a result, central banks can contribute knowledge to interagency capital market initiatives by drawing on their insights into domestic market functioning, their broad convening powers, and their interest in well-functioning and effective market transmission mechanisms. Central banks can contribute knowledge to interagency capital market initiatives in a variety of ways.

The operation of the capital market is complicated, and it is difficult to explain it in a single summary number. Market development was characterized by the Working Group in terms of four distinct dimensions. The first dimension is market size in relation to GDP, which reflects the ability of the market to meet the demands of the real sector in terms of investment. Secondly, market access refers to the

wide variety of companies that raise funds to fund the running of their businesses through capital markets. This, combined with the trading of various instruments that transmit risk among market players, constitutes the second dimension. Liquidity indicators are used to quantify the ease with which investors can realize the value embedded in securities, as well as the ease with which they can incur some of the associated transaction expenses. Finally, resilience measurements quantify the ability of the capital markets to perform their tasks in the face of adversity and uncertainty. The Working Group examined available data indicators as well as the results of the Group's market participant survey in order to assess progress along these dimensions. The conclusions of the analysis are detailed in the following sections, one for each of the four dimensions.

Literature review

Increased disclosure, according to empirical research, is associated with lower borrowing costs. Over the period 1987 to 1991, Sengupta (1998) conducted an analysis of data from 103 companies and discovered that higher disclosure was associated with lower issuance costs. A study conducted by La Porta et al. (2008) found that the size of a jurisdiction's capital markets is positively related to the presence of private enforcement mechanisms, such as disclosure, approval, and litigation rights, that govern and permit investors to sanction specific related-party or self-dealing transactions. According to La Porta et al. (2006), there is a strong association between the size of the equities market and public disclosure laws, as well as liability standards for noncompliance and an effective court for enforcing these rules.

A broad investment base contributes to liquidity, depth, and stability by increasing the amount of money available. As a result of their long investment horizons and low leverage, insurance firms and pension funds can offer long-term capital while reducing the likelihood that they will exacerbate volatility by selling into short-term falls. Aside from that, they are frequently vocal in their support for higher disclosure standards that remove information asymmetry and enhance market vibrancy. Collective investment funds, such as mutual funds, minimize the cost of risk diversification while also making professional fund management services easily accessible to normal investors, hence increasing the financialization of savings and retirement plans. Additionally, because of their shorter investment horizons, they can assist in the discovery of prices and the production of liquidity.

According to Niggemann and Rocholl (2010), there has been a large growth in the issue of stocks and bonds in the years after pension fund reform. Scharfstein (2018) finds that the choice between prefunded and pay-as-you-go pensions has a major impact on the size of an economy's capital market, with the latter's generosity restricting the expansion of a market's capital structure.

There are significant cross-country differences in how these assets are distributed among equities, corporate financial bonds, and non-financial bonds, despite the fact that the size of corporate capital markets is significantly correlated with the size of the institutional investor base Because of the large institutional investor base, this demonstrates that the evolution of a single market can be influenced by a variety of different factors such as rules and path dependence.

The relationship between institutional investors and the capital markets is bidirectional. The expansion of the capital market enables collective investment funds to gain higher economies of scale in their operations. As a result, asset management expenses are reduced, allowing for the financialization of extra savings through capital market investments, hence increasing overall savings. (Vittas, 1998; 1998)

Analysis and Results

Bond markets worldwide are expected to grow by 16.5 percent to $123.5 trillion in 2020, with global long-term bond issuance increasing by 19.9 percent to $27.3 trillion during the same period. 2020 will see a growth in global equity market capitalisation of 18.2 percent year on year to $105.8 trillion, while global equity issuance will decline by 52.9 percent to $826 billion. Purchasing and selling of foreign securities by the United States climbed to $46.1 trillion in 2020, a 24.7 percent rise over the previous year. Foreign gross activity in United States securities climbed by 19.6 percent in 2020, reaching $98.3 trillion.

A high-level overview of responses to the Working Group's poll on market functioning serves as an excellent preview of the messages from the subsequent sections' discussion. Market participants showed the least anxiety about government bond markets (left-hand panel) and slightly more concern about stock markets across all dimensions (centre panel). The primary source of concern was the operation of the corporate bond market (right-hand panel). Concerns regarding access were addressed primarily about smaller enterprises, particularly those in EMEs. Market players were more concerned with liquidity and resilience than with the provision of capital market credit for large issuers.

While the total market value of outstanding securities as a percentage of GDP continues to be a popular indicator of market size, it must be interpreted with the caveat that, in addition to cumulative net issuance, it also reflects valuation changes, which can be quite significant in the period following the GFC. With this in mind, the size of the equities market has stayed relatively stable on average, while the size of the fixed income market has expanded. Capital markets in EMEs have generally deepened, but they remain smaller than those in AEs.

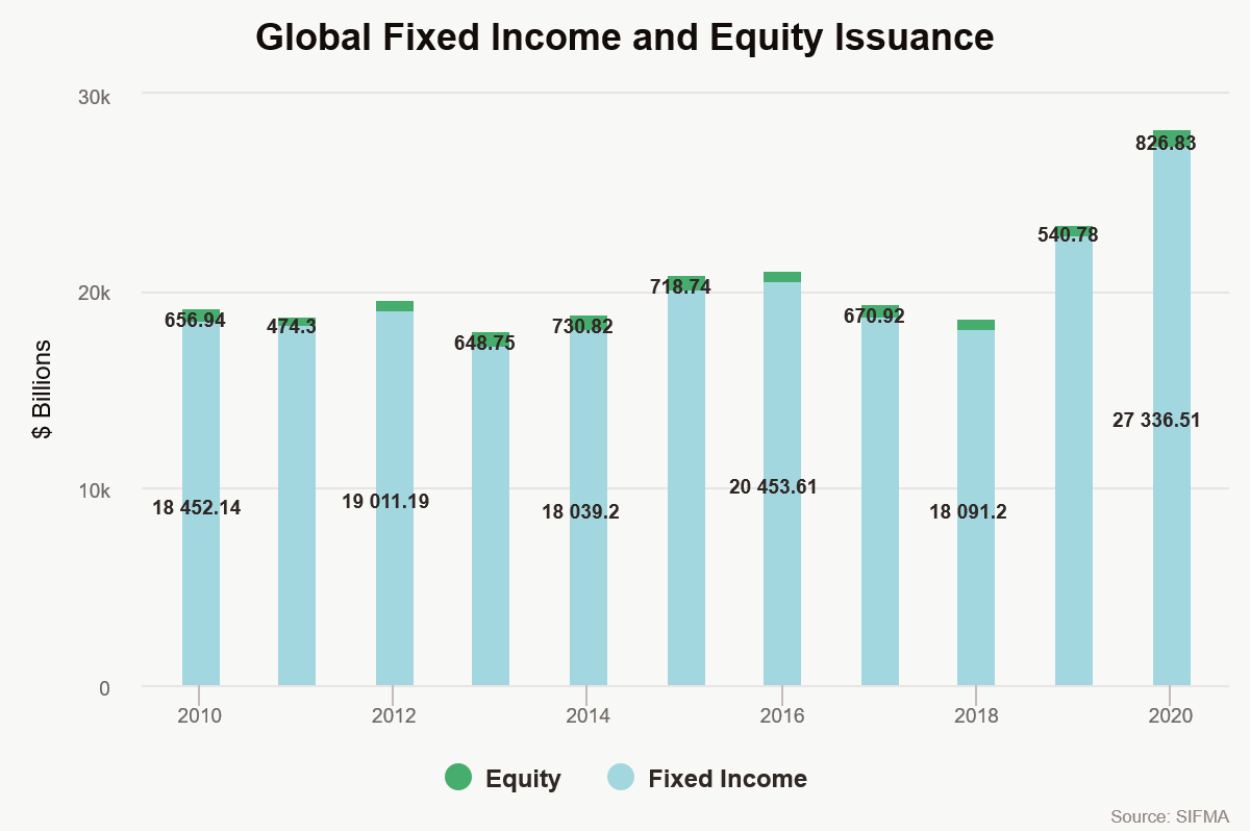

Figure 1. Global Fixed Income and Equity Issuance
Source: SIFMA

As evidenced by the unabated cross-sectional dispersion of the box charts in Figure 2, heterogeneity in capital market size remains significant. Indicatively, the AE equities and fixed income markets double in size as they progress from the smallest to the one at the 25th percentile (distance between the bottom of the line and the bottom of the box), from the 25th to the 75th percentile (box height), and finally from the 75th to the largest (the top of the line). The pattern holds true throughout EME markets, but with greater precision.

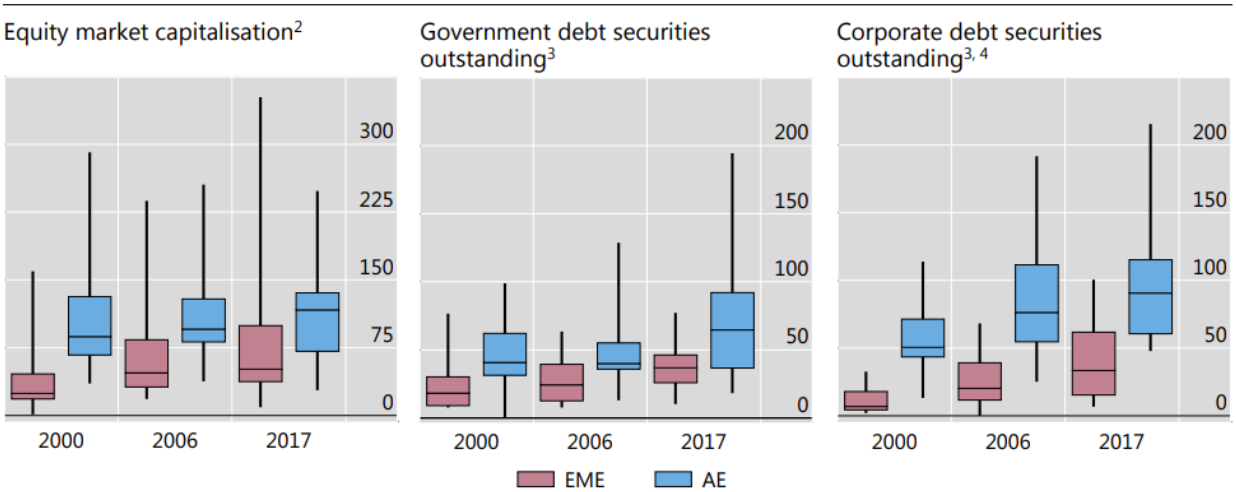

Figure 2. Market capitalization of securities
Sources: IMF, *World Economic Outlook*; World Bank; Datastream; national data; BIS debt securities statistics.

Between 2000 and 2017, the median AE equity market's capitalisation increased from roughly 85 percent to 115 percent of GDP, while the EME group's capitalisation more than doubled, from around 25 percent to almost 60 percent of GDP. When free float is considered (eg the value of shares excluding insider holdings such as management, controlling owners, or governments), the gap between AEs and EMEs is greater. In the median EME, the free-float percentage of total equity market capitalisation is roughly 50%, compared to 80% in AE equity markets. However, when measured by issuance, the EME and AE equity markets are more comparable. Since 2005, AEs have raised approximately 0.95 percent of GDP annually through equity issue. Annual equity issuance in EMEs averaged little under 0.75 percent of GDP in 2011–17, down from more than 1% in the previous five years.

Over the last two decades, bond markets have been catching up to equity markets (Figure 2, centre and right-hand panels). In AEs, robust finance bond issuance was followed by robust government issuance in the years preceding the GFC, whereas in EMEs, both non-financial corporate and government debt instruments outstanding have increased substantially over the last two decades.

In AEs, the median amount of outstanding government securities climbed from roughly 40% of GDP in 2000 to 50% in 2017. (Figure 2, centre panel). However, the size disparity within AEs has grown significantly, indicating the post-GFC surge in government bond issuance in certain jurisdictions. The median size of government securities markets in EMEs expanded from roughly 20% to 35% of GDP over the same time.

Reliable, publicly available information is critical to the operation of healthy capital markets. Prompt disclosure and well-developed accounting systems with a high degree of transparency reduce the cost of information acquisition for dispersed investors, economizing on what would otherwise be a duplicative, costly, and highly asymmetric process of information collection. Rules requiring prompt disclosure of material information, as well as the prospect of legal or regulatory fines for infractions, enable potential investors to determine the value of securities offered for sale in the primary and secondary markets, as well as to identify market abuse. Inadequate disclosure has a number of negative consequences for market functioning. To begin, inaccurate or misleading information supplied in advance of market difficulties can result in adverse selection. Second, delaying crucial information disclosure causes moral hazard by providing insiders time to profit from trading or prevent losses. Both of these factors contribute to investors' loss of confidence in the market. By contrast, increased disclosure enables minority investors to take action to prevent or sanction insider self-dealing.

Conclusions

Based on the findings identifying the primary drivers of capital market development, six broad areas have been highlighted as prospective enhancements to capital market functioning. These are as follows: In addition to promoting greater market autonomy, the government is working on strengthening the legal and judicial systems, increasing regulatory independence and effectiveness, expanding the domestic institutional investor base, pursuing bi-directional opening to international participation while preparing for spillovers, and deregulating the financial sector. The significance of these policy lessons varies from economy to economy, and many of them are not directly under the control of central bank policymakers. Nonetheless, they have an impact on the vitality of financial markets as well as the ability of central banks to achieve their goals. Furthermore, given the range of the factors discussed in the preceding section, comprehensive initiatives that take into account a variety of key qualities are more likely to be effective in establishing viable capital markets.

Financial repression, defined as measures that impede the development of capital markets while simultaneously weakening the economy's allocative efficiency, impedes the development of capital markets while simultaneously degrading allocative efficiency. The elimination of restrictive restrictions and the promotion of greater market autonomy are therefore crucial initial steps toward the establishment of sustainable capital markets.

When applied to merit-based frameworks, approvals can aid in the defense against some features of repression, such as the paternalistic substitution of market players' judgment in order to prevent losses and the influence of governments on issuance processes. Improved disclosure rules, as well as stricter regulation and a more supportive environment, may be required to encourage the creation of market capacity for screening and determining market access, among other things.

The recommendations presented below are intended to complement a broader push for increasing market autonomy by improving the effectiveness and efficiency of markets.

Increasing the strength of legal and judicial institutions can make a major difference in terms of the depth of the capital market. The ability to enforce contracts efficiently, timely, and predictably; the possibility of sanctions and legal remedies for corporate insider breaches of duty; changes to company law to strengthen minority shareholder rights; and efficient and predictable regimes for dealing with corporate distress and insolvency are all critical components of capital markets, according to past experience

Increasing the effectiveness of legal systems. The independence of the judiciary, which is staffed by qualified judges, lies at the heart of any properly

functioning legal and judicial system. Courts and judges can be held more accountable if their decisions are made public and subject to more judicial scrutiny. Additional benefits of specialized financial courts include increased technical expertise, efficiency, consistency, and fairness in financial legal proceedings. For example, the Financial Services and Markets Tribunal (now incorporated into the Upper Tribunal – Tax and Chancery) was established in the United Kingdom as an independent judicial body to hear financial cases; and China has just completed the construction of a financial tribunal in Shenzhen and a financial tribunal in Shanghai.

The scope for private contract and fiduciary obligation enforcement is broadened as a result of increased access to legal recourse and lower litigation costs. Where applicable, decreasing admissibility standards and shortening the judicial process for admitting cases can make a major difference in improving access to justice. Increasing the breadth of group litigation (e.g., through class action lawsuits) and developing new structures that permit cost pooling among or on behalf of dispersed investors can also help to bring down the cost of enforcement, which is particularly beneficial for small and medium-sized businesses. Moreover, the establishment of dispute-resolution procedures, such as arbitration and industry groups, that are subject to adequate regulation can be advantageous.

It is important to promote clearly defined property and contracting rights while also allowing for adaptation to changing circumstances. Property and contracting rights are essential for the protection of minority investors, and when clearly stated, they can help to safeguard enterprises from unnecessarily costly litigation. Aside from that, successful law requires mechanisms that are able to keep up with the ever-expanding nature of the financial markets. Because they draw on and adapt previous precedent in an environment where the spirit of contracts is often honored, common law legal systems frequently outperform civil law legal systems in both areas (La Porta et al. 2008). For example, in countries with a civil law tradition where laws are largely codified by legal scholars, enhanced protection and adaptability could be achieved by establishing mechanisms for systematic application of experience-based lessons, allowing for timely amendment of judicially based rules in places where such flexibility is lacking.

It is necessary to consolidate corporate legislation in order to strengthen the influence and access to information of minority shareholders. Improvements in corporate governance often result in more efficient capital allocation and usage, higher and more stable business valuations, and a reduction in the reliance on debt in most cases. As noted in the International Monetary Fund's Global Financial Stability Report (IMF (2016)), while emerging market economies (EMEs) have lately strengthened their corporate governance frameworks, adoption of the G20-OECD Principles of Corporate Governance may aid further progress. These standards include critical components such as revising company law in order to broaden board members' authority and ensure the separation of roles between chief executive and board chair, establishing mandatory and independent committees to audit the board on a regular basis, giving minority shareholders greater influence over board selection, establishing formal rules for shareholder meetings and strengthening rules governing controlling shareholders' changes, among other things (Allen F, 2017).

Finally, by improving the predictability and efficiency of insolvency and restructuring proceedings, capital market access can be expanded. This is especially true for smaller, riskier, and frequently more inventive businesses. A recent OECD research (Andrews et al. (2017) makes several valuable policy recommendations based on experience. Numerous insolvency regimes, in particular, can be enhanced by incorporating design aspects that facilitate the early identification and resolution of company issues and debt distress (eg preventive restructuring frameworks such as pre-insolvency regimes). This technique provides a viable debtor enduring transitory strains with an alternative to formal insolvency proceedings. Simultaneously, in circumstances when formal insolvency is warranted, streamlining procedures to minimize delays and costs can help limit deterioration of recovery values and promote the effective reallocation of assets and resources to more productive uses.

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