General Characteristics of Developing Country Capital Markets and Asymmetry Related Allocation Problems

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Abstract. This paper examines *developing country capital markets*. In particular, the shortcomings of developing country capital markets relative to developed capital markets are discussed. These deficiencies include factors such as *illiquidity, lack of long term debt markets, crowding out* of the private sector from the publicly traded debt markets, *illiquidity derivatives markets* that hinder hedging of interest rate and exchange rate exposure of firms. It is argued that all these factors introduce *distortions* and *asymmetries* in the capital allocation mechanism by raising the cost of both debt and equity and resulting in an *underinvestment* problem for these markets. Additionally, the potential impact of the spread of *"equity culture"* for developing country capital markets and their economies is analyzed.

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1. Introduction

This paper discusses the general characteristics of developing country capital markets and compares the workings of developing countries' capital markets against the mature capital markets of developed countries. A partial list of developing country capital markets' deficiencies include factors such as the "crowding-out" of the private sector from public debt markets, lack of financial instruments with long-term maturities, inability of firms' to hedge their interest rate and foreign exchange rate exposure due to absence of liquid derivatives markets. Other developing country's specific capital market imperfections are caused by asymmetric factors that limit the deepness and broadness of these markets. Additionally, the high volatility displayed by the macro economies of these countries, and the fact that this high volatility is further magnified at the firm level due to heavy reliance on debt, represents an additional source of risk relative to developed country markets. These asymmetries will be discussed in detail. However, at the outset it can be said that, one way or another, from the investors' perspective all the capital market distortions in question create additional risk premiums that are typically not faced by the developing country investors. Thus, from firms' standpoint, the developing capital market imperfections discussed above translates into a higher cost of capital, which obviously adversely affects their investment decisions. Firm investment decisions that are made in high cost of capital environment, in turn, causes problems at the macro level, by creating a potential underinvestment (low growth rate) problem. It is to be expected that when cost of capital is contaminated by imperfections caused by risk premiums, there will be distortions in the allocation of capital in developing countries. In this paper, some of these developing country specific issues will be analyzed by using some stylized facts obtained from the Turkish capital markets. Additionally, this paper introduces a corporate finance perspective to understand macroeconomic implications of the "crowding-out" phenomena observed in many developing country capital markets.

This paper also employs a corporate finance perspective on another issue: The roots of the recent development of the "equity culture", its rapid global spread, and its potential implications in the arena of corporate governance related issues for firms in developing countries. The issue in question will be further discussed by examining the corporate finance implications of this development for the macro-economy.

Furthermore, this paper advocates the view that introduction of some complex financial products that are used in developed economies may prove to be attractive to both firms and investors in developing capital markets. If so, introduction of these financial instruments may have the potential of alleviating some of the asymmetries that cause capital allocation distortions in developing country capital markets. One such recent experiment appears to have been a success in Brazil. This country successfully introduced hybrid securities such as convertible bonds, and bonds with warrants. Given the positive Brazilian experience, the issue of whether or not securities that contain options may prove to be successful in other developing country capital markets needs to be examined.

Finally, this paper also addresses the issue of the structural reforms that are necessary for improved capital allocation process. It will be argued that governments, capital market ruling bodies, and firms that issue securities, can all take measures that will contribute towards a more efficient capital allocation mechanism.

2. Stylized Facts of Developing Country Capital Markets: Data from the Turkish Capital Markets

In this section data from the Turkish Capital Markets will be used to highlight some of the typical characteristics of developing country capital markets and the problems they face. Table 1 shows the distribution of financial products available for investors in Turkey during the recent past (2002-2004), as well as the market capitalization of the equity market.[2]

Some of the important facts that emerge from this table is that first, even though its share has shown some decline over the years (65 percent in 2002 versus