GLOBAL TRENDS IN EMERGING SECURITIES MARKET INSTITUTIONAL INVESTMENT: IMPLICATIONS FOR COLOMBIAN REFORM

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Executive Summary

Foreign institutional investment (FII) in emerging securities markets, both debt and equity, has been a growing phenomenon particularly in the past five years. Emerging market investing has become mainstream across the broad spectrum of industrial country-based institutions. The range of allocation possibilities once confined to a few country funds has extended geographically worldwide, and by instrument to include private placements, derivatives, and international depository receipts in addition to more traditional instruments. Latin American and Asian markets continue to lead in attracting FII activity and have dramatically revamped their FII frameworks in accordance with their success.

Informal surveys show that from 1990-1992, spurred by the signature of Brady plans, structural economic reforms, and initial global depository receipt offerings, institutional emerging market participation as a percentage of total international portfolios tripled to around 7.5 percent, not withstanding limited entry and poor company reporting, regulation, and custody and settlement. In 1993, a record year of double and triple digit gains among most stock markets, FII allocation to emerging markets nearly doubled again as stellar performance combined with notable market openings and supervisory and infrastructure improvements. In 1994-95, this progress has been sustained despite the wholesale correction in the markets exacerbated by Mexico's peso crisis. In turn, institutional

exposure to both emerging markets generally and Latin America in particular has held steady, suggesting a stable core of "buy and hold" investors.

In assessing markets, foreign institutions assume basic economic and financial system stability, and increasingly focus on institutional, legal, and regulatory factors such as ease of entry, the existence and enforcement of prudential norms, the extent of automation and broker sophistication, and the level of taxation and market depth (i.e., market capitalization and liquidity compared to economic activity). The main Latin American and Asian markets, recognizing the funding and ancillary benefits brought by FIIs, have shown marked improvements in these areas as measured by IFC rankings and the sweep of government-directed modernization and internationalization programs.

In Latin America, markets like Argentina, Mexico, Chile, and Peru propelled by free trade pacts, privatization programs, and low domestic savings apart from Chile have launched policy and operating initiatives to bolster the FII climate. Overall the region has advanced further on market liberalization, regulation, and infrastructure than Asia which both for cultural and economic reasons -- including high domestic savings and foreign direct investment rates -- has tended to be less hospitable to outsiders. Nonetheless the experience of markets like Indonesia and Thailand demonstrates important strides across the board on market access, oversight, computerization and market deepening.

Against this background of FII facilitation, Colombia arguably lags behind other emerging markets, limited by the strict authorization and operating criteria for funds-only entry and the lack of technical depth and advanced regulation on the three exchanges. Among priority steps needed to ensure that the country reaches FII compatibility with other emerging markets, are the relaxation and simplification of fund requirements to also permit greater

participation in fixed income instruments and additional sectors such as real estate, elaboration and enforcement of public disclosure norms and fair trading rules, professional upgrading for brokers and auditors through tighter licensing and training standards, greater equality in the tax treatment of stocks and bonds, and fuller automation and overhaul of the exchanges including the promotion of formal market makers.

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Introduction

Foreign institutional investment (FII) in emerging securities markets[1] has been a growing phenomenon the past decade and particularly pronounced since the early 1990s. Multilateral agency and privates sector sources document the dramatic rise in these flows. The World Bank's Debt Tables reference shows that portfolio equity ownership soared more than twenty-fold from less than $2 billion in 1988 when dedicated emerging market funds began to spread to a record $47 billion in 1993 and almost $40 billion in 1994. (see Annex 3) In 1995 the Institute of International Finance, a Washington-based group of global banks and securities firms, projects a range of $30-40 billion. Leading emerging markets house ING/Barings believes that emerging market exchanges' portion of cross-border share activity has quadrupled since the late 1980s and FIIs now control an estimated $200 billion or 10 percent of combined market capitalization as of end-1994.[2] As for bonds, participation has evolved beyond overseas-directed Brady and Euro-issues into

[1] As defined by the World Bank/IFC: Low and middle income countries with per capita GNP of less than US$8,626 in 1993.
[2] "The Financial Silk Road -- A Fifth Wave of Global Money." Cross Border Equity Flows, Vol. 1, Barings Securities, London, September, 1995.

local currency government and corporate paper whose total outstanding is put at $1 trillion as of end-June 1995.[3] Clearly both debt and equity commitment, propelled by sweeping changes in global portfolio diversification, corporate/economic competitiveness, and financial sector status continue to expand in these high-risk high reward regions despite periodic reversals most recently evident in the wake of Mexico's peso crisis.

In the past five years emerging market investing has become mainstream across a broad spectrum of industrial country-based institutions including brokerage firms, pension funds, and insurance companies. The once narrow menu of allocation possibilities has similarly extended geographically into Eastern Europe, South Asia, and the Middle East/Africa, and by instrument to encompass private placements as well as public listings, asset-backed and convertible securities, and derivatives, both on- and off-exchange. Prior to 1990 only a few pioneering institutions were active through a handful of open and closed-end mutual funds, many markets were closed or severely restricted, and local dealing costs and infrastructure were often prohibitive. With subsequent liberalization and operating improvements in emerging markets hundreds of these country funds have been launched, increasingly geared toward retail investors seeking expertly-aided diversified exposure. For their own account and big customers, FIIs now prefer to access stock markets directly or via international depository receipt programs. The year by year summaries below, based on informal surveys of 40-50 leading money managers, pension fund advisers, and traders in the field from the US, Europe, and Japan describe how emerging markets have gone from fringe to accepted asset class at even the most traditionally conservative institutions.[4] (Annex 1) The brief chronology also illustrates how recipients worldwide -- particularly in

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[3]Emerging Bond and Money Market Guide: 1995 Edition. Kleiman International Consultants, Inc., Washington, August 1995.
[4]"Emerging Securities Markets Investment: Annual Surveys 1989-1995." Kleiman International Consultants, Inc., 1989-95.

Latin America and the Pacific Rim where a dozen bourses continue to dominate activity -- have moved in parallel to construct FII-friendly logistical and policy frameworks to facilitate channeling of their multi-trillion dollar pool of assets.

The Last Five Years: Institutional Perspectives and Shifts

As reflected in World Bank data, in 1989 only a tiny fraction of institutions' international assets were devoted to developing regions, exclusively the "Tiger economies" of East Asia. Latin America with its high inflation, low growth, and heavy unserviceable external debt discouraging capital inflows and credit commitment was unexplored. Investors criticized the lack of company information, steep transaction fees, and official entry barriers. In Korea and Taiwan access was limited to specially approved offshore funds.

A year later allocation tripled (Chart 1) as Latin America, following the success of the Brady debt reduction initiative in Mexico and the onset of free-market reforms in the region, returned to world debt and equity markets to raise US$1 billion for sovereign and corporate issuers. Chile, which led in implementing stabilization and structural adjustment policies and tackling its commercial bank debt through equity swaps which simultaneously galvanized securities market development, had the continent's first ADR placement when its privatizing phone company listed on the NYSE. To avoid the hefty management charges of the country funds and extend their global investment presence locally, FIIs increasingly targeted markets firsthand. Initially they uniformly employed a top-down approach emphasizing overall macro-economic fundamentals over individual stock selection as balance sheet and corporate reporting were rarely available.

1991 was a breakthrough period for Latin securities despite the early dampening effect of the Persian Gulf War. Mexico's highly-publicized US$2 billion Telmex international privatization share offering coincided with openings to foreign capital in Argentina, Brazil, Colombia and Peru to more than double regional trading volume and market capitalization. FII portfolios were diverted from Asia to Latin America, which had the top five performing bourses globally as tracked by standardized separate indices supplied by the IFC and Morgan Stanley-Capital International. The emerging market segment of foreign securities holdings reached 10 percent, but practical impediments continued to deter the vast majority of institutional investors. Poor company research in the absence of adequate accounting and public disclosure practices, non-functioning custody and settlement, and lax regulatory oversight were regularly cited. Among Latin exchanges, only Mexico was seen as approaching acceptability in these categories prodded by Telmex holders.

In 1992 the institutional base widened to include conventional pension funds. Typically restricted to safe investments abroad, their initial participation averaged about one percent of international commitments. In turn the emerging markets departments at already active financial institutions greatly expanded to service this new clientele, and worked with local brokerage counterparts to upgrade research quality. In Asia and Latin America analysts probed specific industries and sectors, and devised balance sheet models to attempt valuation comparisons even when underlying numbers were suspect without agreed standards. Mexico was the top pension plan holding, and it was praised for advance in supervision and settlement. In contrast, Brazil and Venezuela were viewed as most deficient in the region in these areas. Multinational custodian banks were refused permission from home country authorities to handle the local share record keeping and safekeeping needs of publicly-listed investment funds due to the shortfalls in local markets, delaying allocation until adequate investment protections were met.

1993 marked a watershed in the five-year old emerging market trend. Portfolio equity inflow hit a record, nearing US$50 billion according to the World Bank. They were in part performance-driven, as most exchanges posted double and triple-digit gains, but also reflected geographic diversification as Eastern Europe launched markets and those in South Asia and the Middle East/Africa, notably India, opened to FII. The main markets in Latin America and Asia meanwhile drew money with new listings, investor protection and disclosure criteria, and transaction efficiencies expressly promoted through government action. With these strides managers experimented with bottom-up styles of stock picking and quantitative techniques routine in industrial country allocation, such as capital asset pricing and passive indexing tied to one or a combination of the investible performance benchmarks calculated by the IFC, MSCI, and Barings, the latest entry.

Local fixed income -- particularly short term money market instruments and convertible bonds -- also began to attract attention as investors sought alternatives to equities and Brady and Euro-issues that dominated the bond field. In Latin America, where domestic bond markets have been stifled by high inflation and low liquidity among other factors, FIIs first focused almost exclusively on Mexico, where the auction and trading of cetes and tesebonos was modeled after the framework for US treasury bills as the country prepared to enter NAFTA. Argentina, Chile, and Venezuela also received small government paper inflows. For Chile the advantages of an investment grade rating and long term maturities available over ten years were outweighed by its obligatory holding period seen to limit flexibility and liquidity. For corporate bonds, activity was confined to East Asia where economic conditions and a vibrant state enterprise sector supported more active markets.

1994-Present: Retrenchment, Regrouping, and Reinforcement

The past year and a half has witnessed wholesale corrections in global emerging markets as the US Federal Reserve's interest rate hike and the Mexican financial crisis accelerated selective FII withdrawals already begun amid indications of speculative overheating. Recovery is slowly underway despite the precipitous declines prompted by these two events, and extreme fluctuations which have often accompanied reexamination of individual markets. However reviewing FII emerging market exposure as a percent of the foreign total shows that it stands at the same 13 percent at end-June 1995 that it was following 1993's boom, suggesting a prevailing "buy and hold" philosophy. While short-term trading objectives can be decisive and panic ensue in the face of uncertainty, a stable core of institutions seems to recognize -- and reiterate to their customers and the public at large -- that the volatility inherent in these less mature markets does not alter their fundamental high-growth-high return, global diversification attractiveness over time. This belief may apply to Latin America especially, where allocation compared with the larger emerging market universe has held constant (Chart 2), despite fears of contagion from Mexico's currency debacle. By region, the Pacific Rim has suffered the most during the period as the opening of South Africa -- now the biggest component in the IFC Index[5] and deepening of Eastern European exchanges captured previous inflows.

Supporting this long term theme, an array of the most cautious by nature pension funds and insurance companies has ventured into the markets amid the turmoil. In the US they were major buyers in 1994 of ADRs led by region by Latin American issuers with 42 programs

[5]IFC Index Markets as of November, 1995: Latin America: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela; East Asia: China, Korea, Philippines, Taiwan; South Asia: India, Indonesia, Malaysia, Pakistan, Sri Lanka, Thailand; Europe/Mideast/Africa: Czech Republic, Greece, Hungary, Jordan, Nigeria, Poland, Portugal, South Africa, Turkey, Zimbabwe.

worth US$4.3 billion according to Bank of New York, and continue to be a primary market for Section 144a private placements targeting eligible sophisticated institutions. At the other investor extreme, individuals have not rushed to redeem their holdings in country funds. The top 100 funds have maintained combined assets in excess of 100 billion since the beginning of 1994 according to fund tracker Micropal.[6] Their number, scope, and variety continue to expand. Over 500 now exist, and they increasingly concentrate on niches like small-cap companies and infrastructure. Local mutual funds, with lower management fees and exposure to lesser-known firms, have also started competing for foreign investors, and simultaneously play an important institutional role in overall securities market development.

On the fixed income side, even with Mexico's tesebono default scare domestic bond and money market involvement by FIIs has increased just as overseas interest has spurred the creation of separate US (Yankee) and Japanese (Samurai), and Asian (Dragon) markets, alongside their Eurobond predecessor. Locally issuers have received permission to offer high yield hard currency denominated paper mitigating exchange risk, and withholding taxes on interest income have been reduced to align treatment with stocks. Over 25 markets worldwide grant tax free status to government paper, and access by FIIs has been eased to bolster secondary trading, lengthen maturities, and establish benchmarks at both ends of the yield curve.

Finally, the turbulence of 1994-95 has ushered in the use of derivatives to hedge both debt and equity risk. Warrants, indexed-based products, and currency futures and options structured and sold over-the-counter have been the main tools, but their value has been less

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[6] *Micropal Emerging Market Fund Monitor*. Edited by Emerging Market Fund Research, Glen Allen, VA. Published by Micropal Limited, London, October 1995.

than five percent of total emerging market portfolios given their high cost and limited availability.[7] Activity has been conducted mainly by foreign banks and brokers offshore, but local counterparts have begun to acquire the know-how. In Latin America, Mexican brokers packaged bolsa-linked warrants as early as 1993. In response to demand, exchange-traded alternatives are surfacing rapidly. Since their introduction early in 1995, volume has soared in futures and options tied to the Mexican currency and stock market at the Chicago Mercantile Exchange, and officials plan to add soon offerings for other Latin and Asian markets. The latter meanwhile are proceeding to establish their own formal exchanges following the success of markets like Brazil, although their viability and potential for speculative abuse will depend on the attractiveness and soundness of underlying cash markets as well as institutional and regulatory credibility.

Weighing Micro and Macro Concerns: The Basis for Decision Making

Whether at boutiques where individuals exercise wide discretion and rapid judgment or at large organizations where committees deliberate more slowly, FIIs use some form of systematic screening to differentiate markets. The process often attempts to follow a set formula that combines objective and subjective, and qualitative and quantitative dimensions, but the diversity and fluidity of emerging markets can frustrate its consistent application. Proprietary and legal guidelines on country and risk exposure, debt-equity balance, minimum investment and liquidity must always be met and portfolio managers constantly monitor the behavior of competitors. "Herd movement" into and out of markets occurs frequently due to a tendency to follow rivals. Nevertheless, assessment generally

[7] "Emerging Securities Markets Investment: Sixth Annual Survey." Kleiman International Consultants, Inc., July, 1995

falls under a series of headings which address the background environment and detailed parameters for capital market participation. As the prerequisites for economic, political and social stability are well-established, determination hinges increasingly on complexities in the institutional, legal, and regulatory framework in the emerging markets which is the direct responsibility of local securities authorities.

Economic Indicators and Issues

These criteria are mainly the same local Finance Ministers and central bankers employ to gauge performance and ensure sound management. Domestically, they include high real GDP growth and savings and investment rates -- with a figure above 20 percent desirable -- low inflation, and fiscal and monetary polices that bring budget balance and money supply restraint. Externally, balance of payments and reserve positions will serve to support exchange rate values to forestall a Mexico-style currency run. Long-term capital inflows will offset current account deficits, and foreign debt servicing/export ratios will stay below the traditional 25 percent danger zone. Progress in structural adjustment -- such as tax and tariff overhaul, liberalization of interest and currency controls, central bank independence and privatization -- will complement effective growth and stabilization stances. Against these assumptions both FIIs and economic policy makers seek a strong executive branch, legislative, and multi-party consensus for free markets and fiscal and monetary discipline to provide political ballast. Likewise reductions in unemployment and poverty levels, and advances in education and health promote necessary social cohesion. Certain cultural and physical characteristics such as a reputation for entrepreneurship and integrity and freedom from crime and violence bolster a positive macro context. A more complete list of factors under this rubric are covered in Annex 2.

The Role of International Ratings Agencies

FIIs routinely consult the opinion of the major rating organizations such as Standard and Poor's, Moody's, and IBCA to gain insight in to the general country risk creditworthiness question. Public and corporate pension funds in the US and elsewhere do so since by statute and their own bylaws they are limited to certified safe investments, while other institutions want a supplemental outside view which they also get from published risk services available from *The Economist* and other providers. However both groups criticize ratings coverage for a number of weaknesses which diminish their utility as an evaluation tool. Many small nations are not reviewed at all or only infrequently, and the companies profiled are the few with the resources and track record able to tap international capital markets. "Investment grade" status is conferred hesitantly as it is equated with industrial country safety: in Latin America, only Chile and Colombia have qualified. Investors question the arbitrary methodology employed by international rating agencies which automatically assigns higher grades to local versus foreign currency offerings when parity exchange regimes exist, and sets the sovereign rating as a ceiling for corporates when credit enhancements can afford immediate claim to future cash flows. Due to these perceived deficiencies, FIIs often juxtapose rater findings with prices of non-performing and Brady debt on the secondary market as a kind of ratings proxy. Latin American countries dominate trading in this over $1 trillion yearly volume market,[8] which is influenced greatly by arbitrage opportunity and US Treasury yields, but functions nonetheless as a rough daily barometer of creditworthiness.

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[8] *1994 Debt Trading Volume Survey*, Emerging Markets Traders Association, New York, May 1, 1995.

Financial Sector and Securities Market Conditions

For FIIs the framework above yields only a partial picture which aids in a preliminary review of prospective markets but is hardly decisive. The actual technical and operating regime in which investment takes place is critical and in a group of broadly comparable economies steers the allocation decision. Its scope ranges from the health and vibrancy of the financial system laying the landscape to the "root and branch" matters of regulation and transaction conduct. The former is partially a measure of the extent to which structural reforms have specifically targeted banking and securities markets. Solvency and sophistication are promoted by the liberalization of interest rate and lending directives, divestiture of state-owned financial institutions and breakup of monopolies, opening to private domestic and foreign competition, universalization of financial services allowing both credit and investment activity and launch and reinvigoration of stock, bond, and money markets, and venture capital.

Beyond these favorable atmospherics, FIIs want freedom of maneuver and to receive the same treatment as domestic counterparts. Onerous processing and registration requirements upon entry, discrimination barring them from certain markets and instruments, and difficulties in repatriating capital and profits can quickly eliminate exchanges from further consideration even when they are officially open. By extension, markets that have historically been closed will have trouble generating enthusiasm unless liberalization of access is sweeping.

Prudential Norms and Supervision

Before the emerging markets take-off of recent years, few rules existed in this realm and the body of regulation which has since evolved was adopted in direct response to FII concerns over information scarcity and unreliability, market confusion and manipulation, and broker bankruptcy, fraud, and incompetence. FIIs pressed for the formation of independent securities commissions; international standards for public offerings, accounting, disclosure, and capital adequacy; insider trading definition and penalties; and guidelines on margin buying, corporate takeovers, and shareholder rights. In addition to these steps to protect themselves through institution building, rule-making, and transparency and enforcement mechanisms, overseas investors insist on establishment of professional industry standards via auditor and broker testing and licensing. Exchange self regulatory organizations promulgating ethical codes of conduct, formal dispute resolution and efficiency in day-to-day operating procedures, as well as industry associations which serve as a forum for airing views, also strengthen confidence that trading will be fair and orderly.

Infrastructure

As with oversight, FIIs seek a certain level of efficiency and institutional capacity in mechanical exchange dealing. They desire central share depositories, unified national exchanges, automated custody and settlement within T+ deadlines[9], computerized trading

[9] Recommended by the Washington and London-based Group of 30 forum of public and private sector financial market representatives.

and advanced telecommunication, and modern bank clearing and payment systems. Other technical considerations include:

- Formal market-makers for equities
- Primary dealers and credit rating agencies for bonds
- Techniques for short-selling and securities lending
- Development of separate small company and derivatives markets
- Insurance funds which inject liquidity and honor customer accounts in the event of broker default
- Availability of exchange seats
- Presence of price fluctuation limits
- Effectiveness of price and order driven trading methods

Taxation

Levies on capital gains, dividends, interest, and corporate income, and trading taxes like stamp duty and commission charges affect real returns and the comparative attractiveness of financial assets. Frequent shifts in the regime and ambiguity permitting arbitrary case-by-case interpretation alienate overseas investors who demand predictability and transparency. They also expect compatibility with overall emerging market trends toward lowering tax rates and simplifying regulations. Previously punitive rates for capital gains have been slashed, multiple tax levels eliminated, and stamp duty and turnover taxes slashed. Deregulated brokerage commissions, nominal exchange participation fees, and the establishment of treaties with major investor countries reducing double taxation and ensuring equal treatment with domestic investors contribute to controlling costs. To

facilitate instrument comparison, FIIs typically prefer parity in the fiscal provisions for equities, bonds, and bank deposits so not to create artificial preferences for one class of investment. When opening local offices foreign brokers also shun mandatory hiring requirements hampering personnel and salary flexibility.

Exchange Absorption and Reporting

FIIs need sufficient market capitalization, number of listed companies, trading volume and share float to accommodate the huge sums of money they handle. They seek markets with listings and active trading in a wide range of industries. The presence of dynamic local institutional investors is also sought since their absence impedes dealing in big blocks of shares and raises the specter of illiquidity which can lock them in even though formal capital retention is not required. FIIs prefer their "buy-and-hold" strategy to be the result of voluntary action rather than as a result of structural deficiencies in a market. For regular monitoring of economic events, company news, and index performance FIIs depend increasingly on on-line desktop service like Reuters, Bloomberg, and Dow Jones/Telerate. Overseas investors see improving responsiveness from dedicated international departments at emerging market exchanges. In turn, FIIs expect issuer companies to communicate material developments beyond minimum disclosure and welcome their site visits as part of an active investor relations effort.

FII In Latin America and Asia: A Warmer Embrace

In the past decade as institutions have awakened to the emerging markets story, recipient exchanges have likewise undergone a monumental change in their attitude toward foreign portfolio inflows reflected in continuing efforts at modernization and internationalization. Belief that benefits of foreign portfolio investment outweigh potential disadvantages have remained firm despite the debate over "hot money" volatility in the aftermath of the Mexican crash. As shown in the previous section overseas institutions have come to constitute a long-term funding base. The IMF, in its official review of the Mexican crisis, concluded that capital flight was triggered first by domestic investors and that FIIs demonstrated notable staying power after preliminary confusion subsided. In addition to their funds, local authorities appreciate other resources that overseas investors bring. Securities firms often establish offices in country creating jobs and in their daily interaction with brokers and exchanges transfer knowledge and technology. Although typically passive investors, they help foster a shareholder mentality with demands for better corporate accountability and performance. This increasing demand for corporate accountability is particularly important as fund managers increasingly seek venture capital-type private equity participation, in addition to public listings, through which they gain seats on the board of directors carrying consultation and voting rights. FIIs insistence on adequate regulation advances consumer protection standards for domestic investors as well.

While the sudden mass exodus of FII has proved to be an exaggeration, so has the opposite extreme of unrelenting portfolio inflows causing run-away currency appreciation and money supply expansion. Most countries have refined effective "sterilization" techniques through exchange rate intervention and open market operations to neutralize these effects. Such measures are used frequently in response to heavy foreign direct investment inflows

which along with their portfolio counterparts have accelerated through privatization offerings. From an economic standpoint, the logic of expanded foreign portfolio investment into emerging markets is compelling when comparing relative developing and industrial country proportions of world GDP and market capitalization. As of end-1994, emerging markets represented 20 percent of world GDP but only 13 percent of market capitalization,[10] and following empirical patterns financial economists predict closer convergence of the two in the coming years, implying a large shift in institutions holdings of emerging market debt and equity as a portion of their combined domestic and overseas portfolios. This figure, currently estimated at less than 0.5 percent of their global assets, will reach 2-3 percent by end-decade by most projections generating hundreds of billions of dollars in new inflows.[11] As the shift results, regional capital market integration already underway will intensify and emerging markets will look to neighboring emerging markets as major sources of FII.

In their basic development model, Latin and Asian markets will continue to be influenced heavily by the cultural and commercial preferences of the industrial country FIIs in closest proximity. Asia will tend to follow the Japanese pattern of government guidance and caution in operation and informal understanding and trust instead of law centered regulation. Latin America, especially as an hemispheric free trade zone evolves for both capital and goods and services as supported by national leaders at recent summits in Denver and Miami, will feel the example of the more open and rule-based US whose approach already pervades gatherings of the nascent Pan-American securities organization. East European markets for their part are on track to enter the European Union Single Financial Market which requires implementation of numerous operating and supervisory norms.

[10] *Emerging Stock Markets Factbook 1995*. International Finance Corporation, Washington, DC.
[11] This figure is regularly cited by Barings and the World Bank, as well as other analysts.

Finally, emerging markets will be expected to acquire industrial country standards of liberalization, investor protection, and efficiency as they gain entry to the OECD to which Mexico already belongs, and to which South Korea and the Czech Republic are negotiating membership.

Asia and Latin America have proceeded to revamp their institutional, legal, and regulatory frameworks for FDI and FII, although at varying speeds. Basic information compiled by the IFC in its *Annual Emerging Stock Markets Factbook*, a standard reference for FIIs, attest to the sweep of these changes. As compared with the highly restricted and closed markets of the late 1980s, entry and exit is now free in the vast majority of emerging markets. Brazil, India, South Korea, and Taiwan opened to direct participation to FII which had previously been allowed only through special offshore funds. Argentina and Chile eliminated lengthy holding periods prior to remittance of capital of three and five years, respectively. The IFC now grades investor protection and accounting standards as "adequate" in almost all its markets, whereas before "poor" marks were common. All markets require annual financial disclosure from companies for which reports prepared by local or international brokers are regularly available. The automation and consolidation of national exchanges and depository functions have markedly lowered transaction risk. According to the Global Securities Consulting Services Ranking, a benchmark widely followed by global custodian banks, safekeeping in the main East Asian and Latin American markets averages above 90 on a scale of 100, and settlement about 80. The former measures ease of collection of dividends and interest, and the latter the likelihood of failed trades. A separate index covers overall operating risk in terms of adherence to the G-30 standards for which the markets average approximately 70 as of end-1994.

Taxation meanwhile has dropped precipitously. For investment in listed shares, many IFC markets have eliminated a levy on capital gains, (see Table 1) while withholding rates on dividends and interest average below 20 percent. In 1988, withholding taxes on dividends and capital gains in Argentina and Chile were 17.5 percent and 15 percent and 45 percent and 40 percent, respectively. Since then, Argentina has removed all levies, and the withholding rates for dividends and capital gains in Chile have been reduced to 10 percent. In Asia, Indonesia has eliminated its formerly steep capital gains tax of 35 percent, and reduced withholding tax on dividends from 35 percent to 15 percent. Exchange depth and reporting have advanced greatly from 1985 to 1994: IFC index market capitalization climbed ten-fold from US$170 billion to nearly US$2 trillion, the number of listed companies rose 75 percent from 8,000 to 14,000, and combined trading volume went from US$4 billion to US$1.6 trillion.[12] All exchanges have a local share performance index, regular publications and documentation on price-earnings and yield, and electronic international coverage. Recent IMF guidelines for release of economic data in a dozen categories for countries accessing international capital markets will reinforce this information flow. At the same time, local currency corporate and government debt outstanding has reached an estimated half of equity market capitalization. The profiles below offer examples of the extent to which the FII climate has improved in representative markets as exchanges attempt to address overseas investor priorities in proceeding with their own domestic objectives. Regular communication and consultation, and specific internationally accepted policy and operating steps have defined the approach of capital market authorities as they come to terms with the FII phenomenon and prepare for its further implementation and permutation in the coming years.

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[12] *Emerging Stock Markets Factbook 1995*. International Finance Corporation, Washington, DC.

Latin Case Studies: Argentina, Chile, Mexico, Peru

Despite the US interest rate and Mexico shocks of the last eighteen months which have prompted calls for a return to controls on FIIs, and for less emphasis on transaction speed and quality, the main Latin markets remain committed to such foreign institutional flows as part of real sector corporate and economic growth and securities market development plans. With the extension of NAFTA beyond Mexico to include Chile and eventually others, integration with US and Canadian capital markets will accelerate liberalization and modernization efforts in the Latin American markets. The proliferation of intra-regional free trade pacts meanwhile will promote bilateral and multilateral capital flows, and institutional, legal, and regulatory convergence. Divestiture and partial privatization of state enterprises remedying fiscal and current account shortfalls will continue to spur equity market development, while on the debt side activity will jump as public sector programs, private sector opening and infrastructure development demand massive multi-year debt finance beyond the capacity of banks to provide. The creation of private pension and mutual funds in local markets will separately deepen the institutional investor base, while raising the domestic savings rate reducing potential vulnerability to foreign portfolio shifts.

Argentina eliminated all restrictions on FII securities ownership in all sectors except the mass media as well as abolished the compulsory holding period before repatriation of capital. Privatization share offerings have specifically targeted overseas buyers. The global placement by the YPF oil company was the biggest in the region to date. To spur additional listings and share availability apart from privatization, traditionally closely-held

family-controlled companies as are common throughout Latin America, have been encouraged to go public by allowing up to 30 percent of their stock to be issued in non-voting form. In the same vein, the Buenos Aires bolsa has signed a cross-listing agreement with next door Santiago which has created new bilateral flows.

When FIIs first arrived to explore opportunities in the wake of the stabilization and debt reduction successes of the Convertibility and Brady plans, they found supervision of markets among the worst in the region. The unwillingness to define and sanction insider trading was a particular deterrent. A US-trained securities commissioner was appointed to tackle this issue. The Comision Nacional de Valores (CNV) soon gained the passage of laws promoting market transparency and initiated a crackdown against instances of stock manipulation. However, the effort was short-lived amid continued clashes with the Finance Ministry, and FIIs continue to press for an independent oversight authority to weed out such practices.

In infrastructure and institutional building, formal over-the-counter and indexed futures markets have been launched, although activity has been limited. In the framework for bonds, Argentina has been among the pioneer issuers of dollar-denominated securities aided by the peso's dollar parity under the exchange regime, and its recently re-activated Treasury bill market holds auctions via a primary dealer network. Mandatory ratings requirements for issues have fueled the establishment of local credit rating agencies, and FIIs can settle their trades through Euroclear, a main processor of Eurobond transactions. In taxation, Argentina eliminated capital gains obligations and for bonds withholding tax on interest income is 12 percent. To boost exchange depth aside from the non-voting share incentive for additional listings, Argentina was the first to implement a Chilean-style private pension fund system in 1994 which has so far been disappointing. Following initial

confusion, many potential affiliates chose the option of staying under the state social security scheme. Nevertheless, even the latter alternative has been designed to catalyze the stock market as pensioners have had the chance to receive past due benefits in the form of YPF shares.

Chile, despite its international investment grade rating, has arguably been the most ambivalent toward FII in Latin America due to its unique economic circumstances and developed domestic institutional investor base. The domestic savings rate is equal to the East Asia tiger economies addressed below, and sustained direct investment in the mining sector brings long-term capital which places upward pressure on the currency and monetary aggregates requiring sterilization measures. As of end-1994, Chile's private pension funds controlled an estimated US$20.6 billion in assets -- equal to 43.2 percent of GDP -- leaving little room for FII. To broaden the range of securities outlets available to local pension funds and to alleviate currency and money supply friction, authorities, earlier this year, decreed that pension funds can invest up to one third of their assets abroad. In Chile, internationalization of portfolio flows implies outward as well as inward movement. In the same sense, to allow blue chip companies access to cheaper funding and promote their name overseas, capital and ratings requirements for ADRs were relaxed last year generating a flurry of placements which had been on hiatus since the path breaking TeleChile New York Stock Exchange listing in 1990.

Nonetheless, a half dozen major international country funds focus on Chile with interest increasing as the former five-year holding period before capital and profits could be remitted dropped to one year for earnings only. The rationale for this retention, which was just supplemented with reserve requirements for secondary trading of ADRs, is to facilitate

conduct of exchange rate and monetary policy and to dampen speculation. However, Chile is one of the few major emerging markets with this lock-in obligation which frustrates FIIs otherwise attracted by the country's decade long record of high GDP growth, low inflation, and structural reform. But given its exceptional domestic savings and stable FDI status, Chile can afford to keep this distinction.

In the tax and infrastructure areas, for equities Chile has been more accommodating to FII desires. Tax rates have been slashed to a uniform ten percent for capital gains, interest, and dividends. It was among the first in the region to create a central depository, and its NASDAQ-type electronic bourse is distinguished for the large portion of activity it has drawn from the traditional open outcry floor. In bond markets, Chile offers the longest maturities -- up to twenty years -- on government paper, and it has a well developed mortgage-backed securities market fashioned with the assistance of Freddie Mac and Fannie Mae in the US. However, withholding tax on interest income is steep at 35 percent, deterring FII from fixed income investment. As it prepares to enter NAFTA, the current divergence from both standard emerging market and industrial country practice in tax and exit policies may be addressed at an early stage.

NAFTA member **Mexico**, by contrast, has most dramatically revamped its FII environment in line with financial market interaction with the US and Canada and treaty provisions. These commitments have remained intact notwithstanding the post-devaluation stock market upheaval. FII access to the stock market had originally been limited to non-voting trust shares but is now unrestricted. Strides in regulation have been compelling for an exchange once noted for the absence of basic oversight and insider trading prohibition. A US modeled securities commission adopted electronic session surveillance, replicating

the New York Stock Exchange's "Market Watch." Detailed disclosure and anti-manipulation rules were introduced, although enforcement has been haphazard, particularly in the case of banks controlled by conglomerates which are subject to few prudential norms. However, brokers on the exchange are enjoined from trading equities for their own account to forestall abuses. Meanwhile, with most of the blue chips which dominate trading also having issued ADRs, US level disclosure is common. The exchange is one of the few in Latin America to have an insurance fund for customers in the event of broker insolvency, and to work with the government's Nafinsa Bank as an emergency provider of liquidity in case of system-wide threats. These mechanisms were mobilized during the recent crisis. Commission officials, as a group, have increasingly earned an exacting reputation penalizing exchange members for minor infractions like untidy working areas.

In infrastructure, Mexico is considered the regional pacesetter. Automated quotation systems and formal market making expedite turnover and liquidity, and warrants and Brady bonds can be traded on the exchange. A second-tier small cap and short selling market has been launched, although activity so far has been lackluster. The computerized central depository *Indeval* is the bellwether for emerging markets. It handles settlements on a tight T+1 time-frame for equities and T+2 for bonds, and was the first to meet the recommended G-30 standards. In bonds, Mexico has developed both active government and corporate markets. Local currency and dollar denominated short-term treasury instruments are auctioned through primary dealers and are highly liquid in secondary trading. They are held in large proportion by overseas buyers who purchased an estimated half of outstanding issues in 1994. Altogether last year FIIs put US$21 billion into government instruments including one and two-year bonds, and through the first half of 1995 the total came to US$11 billion according to official figures, implying sustained participation despite the tesebono repayment uncertainty following devaluation. Corporate bond issuance was

US$10 billion in 1994, and commercial paper value almost US$1 billion.[13] This activity is strongly supported by the presence of the major international ratings agencies all of which have established local arms in Mexico.

Peru, the latest Latin addition to the IFC Index in 1993, has probably undergone the most prominent shift in attitude toward foreign portfolio investments which had previously been barred before President Fujimori came to power and implemented his "Fuji-shock" deregulation and liberalization program which included privatization of hundreds of state companies through direct trade sale and domestic and overseas share offerings. From a balance of payments standpoint however, Peru is not as reliant as Argentina and Mexico on portfolio inflows to offset the current account deficit and weak domestic savings. Like Chile, it receives heavy mining related foreign direct investment which diminishes the need for portfolio capital. Nevertheless, the Lima Stock Exchange has enthusiastically welcomed FII participation. Investors both from North and South America account for an estimated 70 percent of daily trading volume. Chilean pension funds are active in Peru's market, as were Mexican funds following the signature of information sharing and supervisory accords between the Lima and Mexican bolsas.

In response to complaints about inadequate information disclosure and insider trading, the securities superintedency has adopted consolidated balance sheet and anti-manipulation rules. Lima has absorbed provincial exchanges to consolidate national activity, and launched Chilean-style private pension funds in an effort to bolster institutional investor capacity. These moves have attracted overseas investor interest, and confidence likely to be

[13] *Emerging Bond and Money Market Guide: 1995 Edition.* Kleiman International Consultants, Inc., August 1995. Information obtained from Bolsa Mexicana de Valores.

reinforced by October's signature of a Brady debt reduction accord which may also include provisions for debt-equity swaps in privatizing companies to further dynamise the stock market. In bond markets meanwhile, nascent dollar-denominated corporate paper offers maturities up to five years with the total issuance projected by the securities authorities to reach US$500 million by year-end, driven in part by the instruments' tax-free status.[14]

Asia Case Studies: Indonesia and Thailand

In contrast to Latin America, East Asian equity markets on the whole offer FIIs less access and regulatory and infrastructure satisfaction. South Korea and Taiwan impose ceilings on aggregate and individual company foreign ownership capped at 15 percent, China and the Philippines restrict FII participation to designated non-voting B Shares, and approved FIIs in India are limited in their fund allocation to company shares and to fixed-income instruments: only 30 percent of a total FII portfolio may be in fixed-income securities and ceilings on share ownership cover both individual limits and total foreign shareholding. Majority ownership by foreign portfolio investors of local companies is rarely permitted in the region. This restraint is due to a combination of cultural and economic factors. The region has historically been sensitive to outside control. High domestic savings rates and FDI flows reduce incentives for attracting portfolio capital. Privatization which has been a boon to stock market performance has also proceeded more slowly in Asia where a legacy of state-run strategic industrial and financial institutions exist alongside a well developed private sector. On exchanges, this interventionist tendency is manifested in the creation of support funds subscribed jointly by the public and private sector to influence economic

[14]*Emerging Bond and Money Market Guide: 1995 Edition.* Kleiman International Consultants, Inc., August 1995. Information obtained from CONASEV.

direction through the market, and which act to support the markets in times of severe decline. Free trade pact progress has also been hesitant with Asean yet to evolve from a diplomatic to commercial alliance.

In other aspects of the institutional, legal, and regulatory framework, the area has differed noticeably. The independent oversight function has been stifled by a tradition of informal group understanding and trust, and all-embracing ministerial decision making. Paper-based settlement has resulted in tremendous processing backlogs, and opportunities for fraud and manipulation reflected in a spate of scandals. Development of local institutional investors like mutual and pension funds has lagged with compulsory state social security schemes enjoying huge surpluses and small retail investors eager to play the market.

Nevertheless, East Asian securities markets have grown rapidly as a percentage of GDP eroding historical bank domination of the financial sector. As of end-1994, the World Bank states that East Asian equity markets came to 72 percent of GDP as compared with 92 percent for the banking system. Bond market capitalization also rose to 22 percent of GDP. Asian local debt markets account for an estimated one third of emerging market activity, (Chart 3) focused on corporate placements and government borrowing activity for infrastructure since issuance of other government paper is unnecessary in the absence of fiscal deficits. For the region, net portfolio equity inflows came to a high of US$18 billion in 1993 out of an emerging market total of US$46 billion,[15] (Annex 3) and has continued strong as FIIs are attracted by rapid economic growth, low inflation, and exchange rate stability, which combined with underlying improvements in the institutional, legal, and regulatory regimes pose a stiff challenge to rival Latin exchanges.

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[15] World Bank Debt Tables, 1994.

Indonesia had been closed to foreign investors until 1989 when it allowed up to 49 percent stakes in a half dozen of the biggest shares. Bank and financial sector issues were initially off limits until 1993 when they were subject to the same ceiling. An initial FII stampede halted quickly amid concern over poor infrastructure and regulation. For several years, the exchange was considered the worst of all emerging markets on regulatory oversight.[16] Many FIIs traced the difficulty to the original dual responsibility of the exchange authority as supervisor and promoter, and the government's decision making monopoly on operations excluding exchange members and impeding adoption of even basic prudential norms. The public offering process was erratic, with favored customers preferentially gaining purchase rights and company information routinely withheld or misrepresented. Brokers absconding with investor funds and forged stock certificates were frequent practices, and loss and failure prone paper-based settlement took weeks and often months.

In the past three years, major strides have been taken to correct these deficiencies. The exchange itself has been privatized, and the supervisor no longer has a promotional role of the exchange. Listing and offering procedures, company reporting and disclosure guidelines, and requirements for broker minimum capital and margin buying have been enacted, although the IFC still grades accounting standards as "poor." Insider trading rules and penalties for dealing in fraudulent stock certificates have been mandated, but only the latter enforced. Screen-based book entry trading began earlier this year to improve efficiency and transparency with an on-line link to the provincial Surabaya exchange. A

16"*Emerging Securities Markets Investment: Annual Surveys 1989-1995.*" Kleiman International Consultants. Inc., 1989-95.

central depository is under study, and settlement is now compulsory at T+4, a day beyond the Group of 30 benchmark. Other vehicles designed to bolster the FII climate include privatization share offerings and a proposed separate small company trading board on the Jakarta market. The state-owned Indosat telephone company GDR placement last year was the largest to date for the region: the joint domestic/foreign offering raised US$1 billion. With most of the biggest companies having reached the 49 percent shareholder limit, FIIs increasingly look to smaller and mid-sized companies which have had trouble meeting listing requirements and receiving permission to offer an equivalent stake to international buyers. The proposed over-the-counter small company market would remedy this situation.

Criticized for many of the same access, regulatory, and mechanical impediments as those of the Jakarta exchange, **Thailand** has advanced further than Jakarta on these fronts. The similar 49 percent international ownership cap has been liberalized by allowing companies to issue additional non-voting trust shares although the specific mechanism is still being finalized. A separate over-the-counter exchange with reduced capital listing criteria and formal market makers which is just starting will allow participation of small and mid-sized companies as issuers. Bangkok created an independent securities commission which has elaborated norms for public offerings exchange listing, broker capital adequacy, and insider trading. Officials have taken action to de-list shares and sanction big market manipulators, although administrative delays between offering and actual exchange trading are frequent. The Bangkok exchange was among the first in the region to install computerized trading systems to handle large volume, and recently joined the Cedel clearing facility in Europe to facilitate settlement of international trades. It spawned a well developed mutual fund sector with the breakup and privatization of state-owned and operated enterprises, and a

derivatives market is slated for launch. Once sizable contributions to the compulsory exchange support fund which increased transaction costs have been lowered. Thailand has also increased its commitment to developing local bond markets. To date, activity has focused on infrastructure bonds with maturities averaging five years and carrying tax exempt status. Local debt market development efforts have been bolstered by mandatory ratings for all public issues by the joint public/private Thai Ratings Agency established in 1993. A licensed bond dealers club to which foreign houses belong was formed in 1994 to stimulate secondary market trading.

For all the markets above, progress tracked by numerical measures of exchange depth has mirrored qualitative advances in the institutional, legal, and regulatory framework. They all rank in the top 40 exchanges in the world -- both developed and developing -- by market capitalization, trading volume, and listed companies, although Peru features only in the third category.[17] (see Table 2) In the countries with provincial exchanges -- like Surabaya in Indonesia and Cordoba in Argentina -- activity is overwhelmingly concentrated in the capital city, and close connections facilitating trading are maintained. For reassurance as to exchange size and depth and for competitive reasons, FIIs monitor the number of international mutual funds dedicated to a country. According to *Micropal Emerging Market Fund Monitor,* Argentina and Chile each have just over half a dozen, Mexico a dozen, while Peru has three, and Indonesia and Thailand more than twenty five.[18]

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[17] *Emerging Stock Markets Factbook 1995*. International Finance Corporation, Washington, DC.
[18] *Micropal Emerging Market Fund Monitor*. Edited by Emerging Market Fund Research, Glen Allen, VA. Published by Micropal Limited, London.

Colombia in Global FII Context: Priority Considerations for Reform

Against this background of ease of access and operations for FIIs demonstrated in the experience of the sample markets above, Colombia arguably lags and capital market authorities may wish to consider certain measures to align practice with features in competing exchanges. Among IFC markets, Colombia ranks toward the bottom by all the standard statistical indicators of exchange depth including market capitalization, listed companies, trading volume and concentration. (see Table 3)

With a few possible exceptions, like India, it may be the most fragmented with three geographically dispersed, only partially connected exchanges each absorbing a large share of activity. Only one international country fund, sponsored by Foreign and Colonial of the UK, has been launched, and FIIs account for a mere 5 percent of market capitalization.

In particular better FII access may be necessary to keep pace with prevailing liberalization in other emerging markets. Colombia is one of the last bastions of entry only through authorized funds under a laborious screening approval and monitoring process complicated by requirements for individual fund shareholder disclosure. This vetting may in part be designed to flag money launderers, but the applicants are overwhelmingly well known institutional investors with globally recognized professional reputations. Provisions requiring that investor home country regulators exercise consolidated oversight have been narrowly interpreted. The Bank of England was found ineligible under this criterion, leading Foreign and Colonial to base its country fund in Luxembourg. The mandatory fund structure requirement could be greatly streamlined or removed altogether subject to pro forma registration with government authorities. The prohibition on real estate

investment, also designed in part to combat money laundering, is likewise extraneous for well established FIIs and prevents them from participation in the construction and tourism sectors which are popular emerging market plays. At the same time, ADR rules which have fluctuated between extremes of stringency and relaxation the past two years could also be clarified to offer greater steadiness in the issue pipeline.

In fixed income as well, investment limits and prohibitions could be eased and lifted. Barriers stifle the creation of benchmarks and yield curves, as well as suppressing secondary trading and long-term finance needed for infrastructure. Local bond markets open to FIIs can provide a cheaper and larger pool of funds than is available either at home or abroad. However, in addition to having more leeway than is currently allowed under FIIs 20 percent ceiling for government and financial institution fixed income participation, their need to balance portfolios and have short-term liquidity could be eased through an ability to tap monetary control instruments. A small portion of this paper could be made available without unduly compromising the exchange rate and monetary policy. Even with these moves however, FIIs will be reluctant to consider this asset class with the near 40 percent effective tax rate which puts it among the steepest in emerging markets and dramatically contrasts with tax free capital gains for equities (see Table 4 and Chart 4).

A second main theme for overhaul in the institutional, legal, and regulatory structure is unification of the three exchanges to gain economies and efficiencies of scale, provide regulatory clarity and stability, and reduce bureaucratic and system redundancy. Lack of supervisory and disclosure rigor, combined with insular geographic and cultural tendencies of Bogota, Medellin, and Cali may foster a climate of insider control and misrepresentation. The securities superintendency could work with issuers and intermediaries to deepen oversight and transparency standards to ensure fairness and

forestall proprietary information abuses. Institutional investors -- both domestic and foreign, particularly those confined to risk adverse safe allocation -- demand these assurances to meet legal obligations and internal guidelines. In this sense, further expansion of the nascent private pension fund system will not only add exchange depth, but bring pressure for greater corporate and regulatory responsibility essential for their successful operations. Additionally, full cross-listing and trading arrangements and electronic links common elsewhere on multiple exchanges could be finalized. Among the three exchanges, better cooperation could also facilitate the launch of over-the-counter and derivatives markets and asset backed securities authorized by law but still lacking commercial and organizational support by practitioners to be viable.

At the same time, separate industry and self regulatory organizations grouping brokers nationwide would enhance credibility and trust in the profession, and assist in governing exchange dealings. They could work with authorities on tightening capital adequacy and licensing criteria and continuing education efforts to ensure adequate integrity and sophistication to handle FII customers. Upgrading infrastructure could also be a joint priority. Meeting all aspects of the G-30 custody and settlement guidelines, establishing formal market makers and primary dealers for respective equity and debt activity, introducing short-selling and stock lending, and creating an insurance fund to protect clients and guarantee liquidity would be key elements of a modernization drive.

Colombia's local capital market weakness stands in contrast to the enthusiasm with which FIIs receive its overseas debt and equity issues. Its international investment grade rating, decade long record of sound economic management, and independent central bank fostering a healthy financial system offer a positive foundation for internal securities market development. But the history of emerging markets investment to date clearly shows that

these features alone are not sufficient to harness the potential associated with FIIs long-term shift into the southern hemisphere. To attract and sustain inflows detailed policy and practical frameworks from entry guidelines to exchange operation are required. Colombia can build upon its economic leadership in emerging markets by incorporating practices which have proven effective in stimulating internationally supported domestic capital market expansion or risk falling further behind in the global competition for funds in all its statutory and structural dimensions.

Immediate Recommendations

FIIs are often discouraged from local investment opportunity in Colombia for reasons outside the control of capital markets regulators. In Colombia, for example, a lack of confidence in the physical security climate for companies and individuals often serves as a deterrent to foreign investment. However, a concerted commitment in Colombia to align the capital market regime with steps taken by Latin and Asian competitors in recent years is also missing. The lagging FII framework prevents entry into the emerging markets mainstream, and seemingly contradicts Colombia's concerted efforts to expand regional free trade. Like the vast majority of emerging markets, Colombia has no compelling size or strategic advantage which in examples like Brazil, India, and Russia can offset regulatory or other market deficiencies. As illustrated by the experience of neighbors like Peru, smaller remote markets must be especially aggressive in efforts to attract FII.

A complete overhaul of the status quo is not however warranted as progress already underway such as automated exchange linkage is proceeding steadily. And change should honor traditional Colombian policy maker caution. In any event, abrupt shifts could

unduly disturb markets and interfere with monetary conditions. Against this background, a modest but firm capital market policy program achievable over the next year or two is preferable, embracing the following goals:

- Entry: Many institutions do not pass beyond the initial stage of interest in Colombia due to rigorous fund authorization and operation provisions. Relaxation and simplification of norms in conformance with prevailing emerging market patterns could include reduction in paperwork and reporting criteria for approval, and expanded debt and equity ownership ceilings to include access to real estate and increased participation in government bonds. At the end of a transition period of reduced requirements for registration and approval of institutional funds, the "fund" designation could be phased out entirely to permit direct investment subject to routine Central Bank registration and monitoring. This opening would parallel liberalization by emerging markets worldwide which have eased screening and allocation procedures.

- Regulation: Scant and unverifiable company reporting, exacerbated by lax information disclosure standards between the three exchanges, has fostered a climate inimical to outsiders for fear that manipulation and misrepresentation are widespread. Greater transparency in filings with the Securities Superintendency and enforcement action against suspected insider traders would boost market credibility. Informal "Chinese walls" between the brokerage and other functions of financial intermediaries would also suggest that even internal transactions are at "arms length."

- Professional Upgrading: Colombia's brokerage community is not seen as adequately capitalized to handle the large deal flows of FIIs, or technically equipped to meet their advanced research and forecasting needs. Ethical practice has also been questioned and

career dedication has been low without a universal code of conduct and industry association. Tougher capital adequacy for brokerage firms, and licensing, testing, and training requirements for individual brokers could help address these concerns.

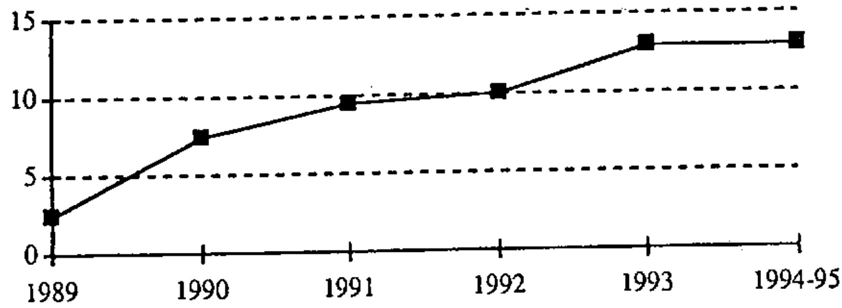
- Taxation: The wide divergence in levies between tax-free stocks and heavily taxed bonds creates distortions between asset classes and drives investors and issuers of bonds to minimum tax locations offshore. Lowering the fixed income tax rate by at least half would repatriate and reduce costs for placements while generating a possible supply side revenue effect with increased demand. In addition, allowing foreign funds tax deductions of local expenses such as legal and fund administration fees would place them on more equal footing with local investors and help fulfill the spirit of the foreign investment regime of equal treatment under the law of foreign and local investors. At the same time, tax incentives could be granted to encourage closely held family firms to go public, and tax exemption for investment through private pension schemes should also apply to mutual funds in keeping with emerging market practice.

- Infrastructure: Full automation of dealing, depository, and custody and settlement functions among the exchanges would facilitate onset of a de facto national market in place of today's fragmented provincial ones. Formal market makers should be encouraged to operate in the market. Market makers would bring additional professionalism while ensuring completion of trades and underlying liquidity. An insurance fund for small investors to cover brokerage bankruptcy would help the exchanges attract individual as well as institutional funds.

The above agenda details incremental near term reforms to respond to the most pressing demands of foreign institutional investors to propel Colombia from the margin into

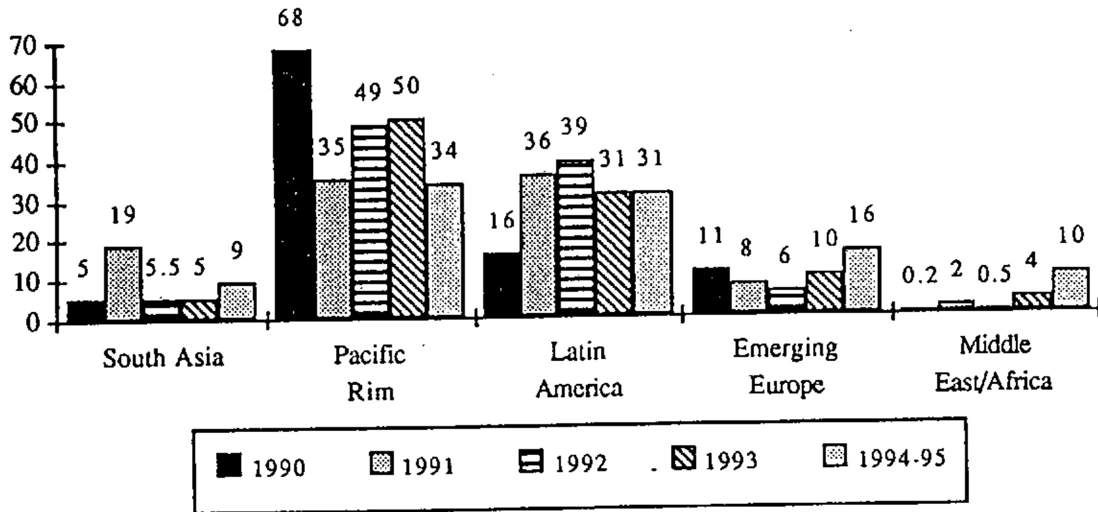
emerging markets acceptability. Adoption of these measures can lay a foundation for Colombia's ascendance into the top ranks of emerging markets. However, authorities must first deepen their determination to alter the country's less preferred status among FIIs applying conventional institutional, legal, and regulatory criteria to the marketplace. For this challenge Colombia's internationally recognized affinity for economic and financial orthodoxy is well suited.

Chart 1
Allocation to Emerging Markets as a Percentage of Total International Investments: 1989-1995



Source: Sixth Annual Emerging Securities Markets Investment Survey, Kleiman International Consultants, July 1995.

Chart 2:
Allocation to Emerging Equity Markets by Region*



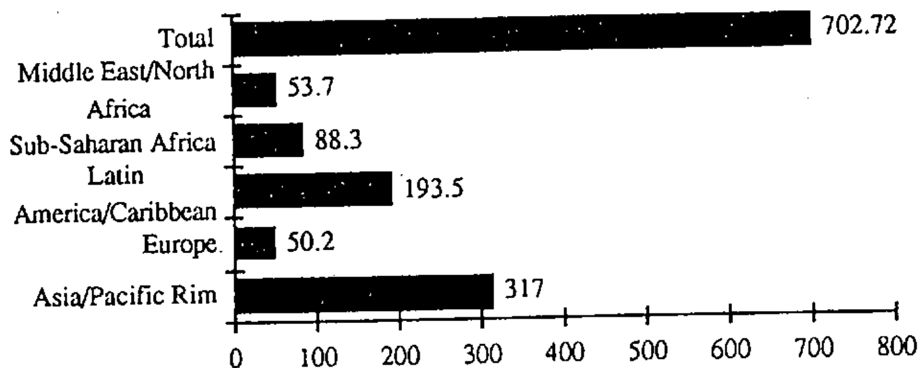
**As a percentage of total emerging markets allocation*
Source: Sixth Annual Emerging Securities Markets Investment Survey, Kleiman International Consultants, July 1995.

Table 1:
Selected IFC Index Markets:
Long-Term Capital Gains on Listed Shares

Market	Capital Gains Tax (%) 1988	Capital Gains Tax (%) 1994
Argentina	45	0
Chile	40	10
Colombia	20	0
India	40	20
Indonesia	35	0
Mexico	0	0
Nigeria	20	20
Thailand	12.5	0
Zimbabwe	30	10

Source: Emerging Stock Markets Factbook, 1989 and 1995 editions, IFC.

Chart 3:
Total Outstanding Local Currency Debt and Bonds in Emerging Markets (US$ billion)



Source: Emerging Bond and Money Market Guide: 1995 Edition. Kleiman International Consultants, Inc.

Table 2:
World Rankings: End-1994 Levels

Market	Market Capitalization	Total Value Traded	Number Listed Companies
Argentina	31	32	40
Chile	24	37	23
Colombia	NR*	NR*	NR*
Indonesia	27	31	30
Mexico	21	18	33
Peru	NR*	NR*	28
Thailand	19	20	18

**NR: not ranked in top 40*
Source: Emerging Stock Markets Factbook, 1995. IFC.

Table 3:
Market Concentration: Selected IFC Markets

Market	10 Largest Stocks/ Market Capitalization	10 Most Active Stocks/ Market Capitalization	Largest Single Sector/ Market Capitalization
Argentina	41.7	47.7	38.2
Chile	46.4	57.4	50.0
Colombia	**61.2**	**52.5**	**57.7**
India	19.4	6.2	81.7
Korea	29.9	12.8	47.0
Mexico	33.8	57.6	27.5
Peru	55.8	55.2	36.1
Indonesia	29.8	35.4	69.3
Thailand	35.6	28.0	50.9

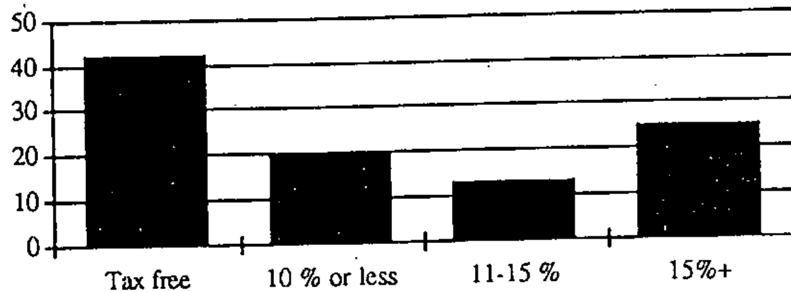
Source: Emerging Stock Markets Factbook, 1995. IFC.

Table 4: Withholding Tax on Local Currency Bonds: Selected Markets

Market	Tax Rate for FIIs*
Argentina	12
Chile	35
Mexico	15
Peru	0
Indonesia	20
Thailand	15

**Rates may be reduced under double taxation treaties*
Source: Emerging Bond and Money Market Guide: 1995 Edition

Chart 4: Emerging Markets Taxes on Local Currency Debt and Bonds*



**Percent of universe of 74 emerging markets covered*
Source: Emerging Bond and Money Market Guide: 1995 Edition

Annex 1:

Securities Firms and Pension Advisor Participants in *Emerging Securities Markets Investment Surveys, 1989-1995.* Published by Kleiman International Consultants, Inc.

AIG Global Investors	Mutual fund manager
Alliance Capital	Mutual fund manager
Barra	Pension fund advisor
Baring Securities	International brokerage
Batterymarch	Mutual fund manager
Buchanan Partners	Mutual fund manager
James Capel	International brokerage
Capital International	Mutual fund manager
Crosby Securities	International brokerage
Emerging Markets Investors Corp.	Mutual & pension fund manager
Fidelity	Mutual fund manager
Fiduciary Trust Company International	Mutual & pension fund manager
Fleming	Mutual fund manager
Foreign and Colonial	Mutual & pension fund manager
Gartmore	Mutual fund manager
Genesis	Mutual fund manager
Grantham, Mayo, van Otterloo	Mutual fund manager
GT Management	Mutual fund manager
Henderson	Mutual fund manager
HSBC Asset Management	Mutual fund manager
Invesco	Mutual fund manager
Ivory & Sime	Mutual fund manager
Kleinwort Benson	Mutual fund manager
Lazard Freres	Mutual fund manager
Lehman Brothers	International brokerage
Lloyds Investment	Mutual fund manager
Marc Faber Limited	Mutual fund manager
Martin Currie	Mutual fund manager
Mercury Asset Management	Mutual & pension fund manager
Merrill Lynch	Mutual fund manager/International brokerage
Mercator	Mutual fund manager
Montgomery Asset Management	Mutual fund manager
JP Morgan	Mutual fund manager
Morgan Stanley	Mutual fund manager
New Japan Securities	Mutual fund manager
Newport Pacific	Mutual fund manager
RCB International	Mutual fund manager
Rothschild	Mutual fund manager
Rogers, Casey	Pension fund advisor
T. Rowe Price	Mutual fund manager
Frank Russell	Mutual fund manager/Pension fund advisor
Scudder, Stevens & Clark	Mutual fund manager
S-E Banken	Mutual fund manager

State Street Bank	Mutual fund manager/Custodial Bank
Schroder	Mutual fund manager
Smith New Court	International brokerage
Templeton	Mutual fund manager
Trust Company of the West	Mutual & pension fund manager
Yamaichi	Mutual fund manager
Wellington	Mutual fund manager

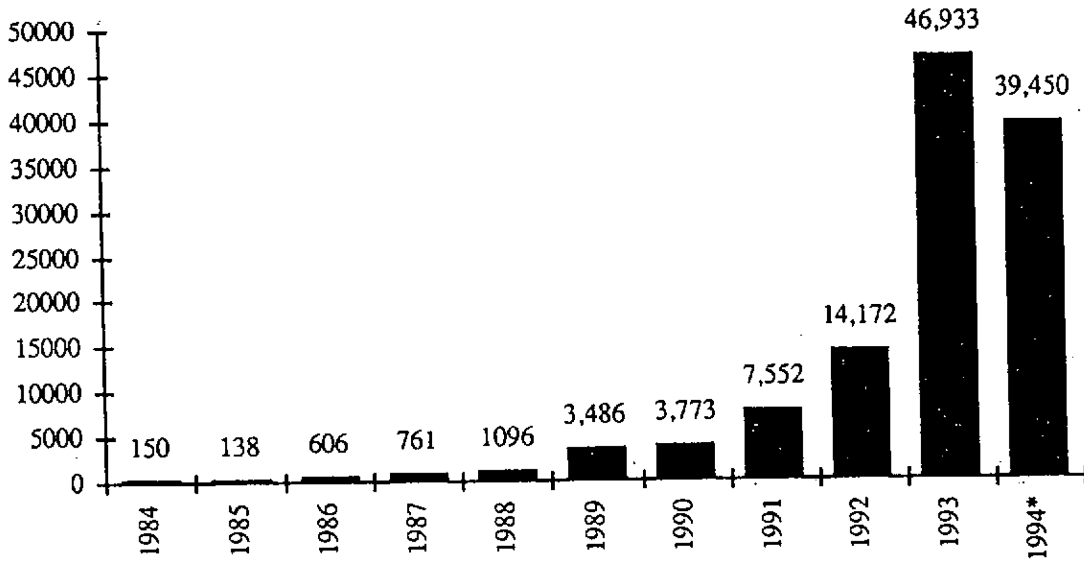
Annex 2

COUNTRY RISK MATRIX: SELECTED INDICATORS

Domestic	External	Political	Social	Operational
Real GDP Growth	Exchange rate	Dedication to free markets	Unemployment	Institutional/
Real Per Capita Growth	Balance of Payments	Fiscal responsibility	Poverty	legal ease
Inflation	Purchasing Power Parity	Institutional structures	Distribution of wealth	Ease of Entry
Investment/GDP Ratio	Current Account	Peaceful transitions	Education	Broker solvency &
Savings/GDP Ratio	Capital Account	Cabinet changes	Literacy	expertise
Consumer Output	Exports/GDP	Election cycle	Health/Nutrition	Transparency
Business Output	Types of Exports	Cabinet coherence	Life expectancy	Disclosure
Commodity Output	Total foreign debt	Diplomatic relations	Urban vs. Rural	Accounting standards
Public vs. Private Sector	Foreign debt servicing	Law and order	Communications	Market infrastructure
Privatization	Debt servicing record	Commitment to reform	Housing	Tax obligations
Informal Economy	International reserves	Legislative support for	Worker/citizen rights	Equal treatment
Money Supply	Debt/exports	reforms	Environment	Liquidity
Fiscal Balance	External relations	Official integrity	Public Services	Settlement

Source: Kleiman International Consultants, Inc.

Annex 3
Portfolio Equity Flows to Emerging Markets (US$ millions)



**1994 is estimate*
Source: World Bank, 1995 Fund Flows to Developing Countries

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1989	2.5
1990	7.5
1991	9.5
1992	10
1993	13
1994-95	13

	1990	1991	1992	1993	1995
South Asia	5	19	5.5	5	9
Pacific Rim	68	35	49	50	34
Latin America	16	36	39	31	31
Emerging Euro	11	8	6	10	16
Middle East/Af	0.2	2	0.5	4	10

	South Asia	Pacific Rim	Latin America	Emerging Euro	Middle East/Af
1990	5	68	16	11	0.2
1991	19	35	36	8	2
1992	5.5	49	39	6	0.5
1993	5	50	31	10	4
1994-95	9	34	31	16	10

	Total	Corporate/CP		
Asia/Pacific Ri	317	123.8		
Europe	50.2	5.6		
Latin America/	193.5	17.1		
Sub-Saharan A	88.3	27.8		
Middle East/No	53.7	3.6		
Total	702.72	177.9		
	Total			Corporate/CP
Asia/Pacific Ri	317		Asia/Pacific Ri	123.8
Europe	50.2		Europe	5.6
Latin America/	193.5		Latin America/	17.1
Sub-Saharan A	88.3		Sub-Saharan A	27.8
Middle East/No	53.7		Middle East/No	3.6
Total	702.72		Total	177.9

		in %
Tax free	42	
10 % or less	20	
11-15 %	13	
15%+	25	

	Portfolio Equity	
1984	150	
1985	138	
1986	606	
1987	761	
1988	1096	
1989	3,486	
1990	3,773	
1991	7,552	
1992	14,172	
1993	46,933	
1994*	39,450	