Brazil on the global finance map: an analysis of the development of the Brazilian capital market

Economic Analysis
Madrid, 15 November 2011
Brazil on the global finance map: an analysis of the development of the Brazilian capital market

Enestor Dos Santos.

November 2011

Abstract
The expansion of the Brazilian capital markets over recent years has been impressive. Stock and private bond markets reached 93% of GDP in 2010 in comparison to 33% in 2002. The recent development of the Brazilian capital market is the result of the political and economic stability reached over recent years and of the implementation of microeconomic reforms and specific policies that succeeded in improving the institutional environment of the capital market in the country. Even though there is a series of problems to address, prospects for expansion of the Brazilian market are positive because it is hoped that the country will continue to grow and increase its importance in global markets and because the improvement process of the institutional environment must continue in the future.

Keywords: capital market, Brazil, development, stock market, bond market, securities.

JEL: G18, G19.
1. Importance of the Brazilian capital market

After a long period of uncertainty and standstill, the Brazilian economy has grown at a rate close to 4% over the last decade. As with other emerging countries, Brazil has been able to increase its role in the global economy and furthermore consolidate its regional hegemony. In addition to recent good performance, prospects for future growth are positive: over the coming decade Brazil will become the fourth contributor to worldwide growth, only behind China, the US, and India.

The expansion of the Brazilian capital market over recent years has been, however, even more impressive than the macro-economic performance.

The size of the private domestic bond market has grown by a factor of 12 since 2002 and has reached approximately US$508 billion in 2010. In terms of GDP, the expansion was from 8% in 2002 to 24% in 2010 (see Chart 1). The domestic private bond market now represents 18% of the worldwide total and 73.6% of the Latin American total according to the BIS. Just a few years ago, in 2002, these levels were far more conservative: 0.2% and 61.9%, respectively.

In 2010, net private debt issues in Brazil were US$58.7 billion, the fourth largest worldwide. Indeed, in terms of stock the proportion of Brazilian private bonds in the world total is still limited. The activity seen over recent years suggests that the country will continue to gain market share in global markets.

The growth of the capital market has not been restricted to the fixed income market. The expansion of the equity market has been equally significant over recent years. Specifically, the capitalization of the Sao Paulo Stock Exchange (BOVESPA) in dollars has increased approximately 12 times since 2002. Its worth in terms of GDP has gone from 25% in 2002 to 69% in 2010 (See Chart 1). In absolute terms, the BOVESPA was in 2010 in tenth place among the major stock exchanges of the world and the first in Latin America. In 2002, the Brazilian stock exchange ranked 22 worldwide.

The issuance of capital in the stock market of the BOVESPA in 2010, whether from newly-listed companies or through shares already listed amounted to US$100.5 billion. This was the third largest issuance volume in the world during the period, only under that of the New York and Hong Kong exchanges.
Activity in other capital market segments, especially that of derivatives, also points to the recent leading role of the Brazilian market on the global financial map. The number of equity option contracts in BOVESPA, for instance, has increased from 90 million in 2002 to over 800 million in 2010, above the volume negotiated in any other market in the world over the last year. Another example is that of the currency futures and currency option contracts, which multiplied their volumes by 7 and 12 respectively between 2002 and 2010. In these markets the Brazilian stock exchange is also among the most important in the world.
2. On the recent development of the Brazilian capital market

The recent development of the Brazilian capital market is the result of the political and economic stability reached over recent years and, as well, of implementation of microeconomic reforms and specific policies that succeeded in improving the institutional environment of the capital market in the country.

The newly achieved stability is above all the result of the maturing of the democracy and the successive access to power of political groups of distinct ideological tendencies. This political stability ensured institutional stability and allowed consensus building over a series of economic points, specifically the non-tolerance with inflation, the commitment to solvency of the public sector, and the adoption of a flexible exchange rate.

In this way the country was able to stabilize the economy and stop the creation of serious domestic distortions that could have impeded the development of the country. After years of instability, the country has been able to control inflation and significantly reduce its foreign and public debt. Specifically, inflation was brought down over recent years to levels in a range between 3 and 7%, public debt fell from 60.6% of GDP in 2002 to 40.2% in 2010, and net foreign debt went from 27.7% of GDP in 2002 to -2.5% in 2010 (the country went from being a foreign debtor to creditor in net terms). Brazil has also been able to bring down its real interest rate from around 11% in 2002 to around 5.5% more recently; however, it continues to be at a very high level, a situation that constitutes a pending task for the country’s economic authorities.

The macroeconomic environment is fundamental for the development of the capital market, but so is the sector’s institutional framework according to the literature on the topic (see, for instance, De La Torre et al [2008] and Beck and Levine [2005]).

In the case of Brazil, in addition to macroeconomic advances, the progress of the institutional environment for the capital market is also behind the development of the stock exchange and fixed income markets in the Country. The evaluations of “Doing Business” by the World Bank demonstrate that current levels of transparency in the capital market as well as extent of executive liability are superior to the average in the region and to the average in OECD countries as well. Still, advances in the institutional environment were not sufficient to, for instance, increase the capacity of shareholders to sue executives involved in cases of improper conduct, which is a remaining task (see Chart 3).

From halfway through the nineties, the end of hyperinflation, the opening of the economy and reduced state participation in it improved growth prospects for the capital market. Moreover, a series of legal changes were approved to increase investor rights and increase the availability and quality of information.
These reforms, in addition, consolidated the Brazilian strategy for the self-regulation of the capital market, which made it possible for the Brazilian capital market regulator, the "Comissao de Valores Mobiliarios" (CVM), to implement and complement adopted legislation with respect to the capital market. Activity of the CVM over recent years, in addition, has made it possible to create benchmarks and favored the spreading of conduct codes and good practices. Good management by the CVM resulted in a new institutional stability environment, eliminating a large part of previously existing legal risks.

The self-regulating environment extends to the BOVESPA, which today has an efficient information system as well as custody and settlement structures that exceed international requirements.

Among the main changes adopted in the capital market over the last decade is the implementation in 2000 of the "Novo Mercado" of the BOVESPA with the segmentation of equity markets in line with strict and modern corporate governance rules, which has permitted the increase of availability of information to market participants and, therefore, reduction of risk to investors. Implementation of the "Novo Mercado" has recently played a fundamental role in the development of the capital market in Brazil.

The adoption of the "New Market" is, in addition, an example of a measure related to the auto-regulation system given that in this case adherence is voluntary and corporate requirements exceed those established by law.

Other reforms linked to various areas of the capital market were also implemented and helped the development of the Brazilian capital market. Among these reforms, the payment system implemented in 2002 is worth highlighting.

The series of social security reforms implemented during the governments of Cardoso and Lula stimulated the growth of pension funds and, consequently, of the capital market. In 2010 the resources of pension funds were around US$340 billion (among the ten largest in the world in absolute terms and around 14.5% of Brazil's GDP). Of this amount, 10.2% was, at the end of 2010, invested in private bonds and 31.9% in shares, which demonstrates the importance of these funds for the country's capital market. Specifically, investment in pension funds corresponded in 2010 to 6% of the private bonds market in the country and 7% of the stock market.

In spite of the importance of pension funds in private financing in Brazil, their investments continue to be over-concentrated in public bonds (constituting 48% of total investment in bonds) due to the high return of these securities, which is in turn explained by the very high interest rates that the country continues to maintain.

Another important example of micro-economic action that had a positive impact on the capital market was the legal measures taken to promote the real estate sector after decades of paralysis. Among the most important are legislative changes that facilitate the recuperation by the owner of the home in case of non-payment.

Regulatory changes linked to the real estate sector made it possible for private bonds linked to this sector to go up from US$278 million in 2002 to US$42.401 million in 2010.
3. Development prospects of the Brazilian capital market

Consolidating recent growth and meeting challenges

In spite of the significant growth observed recently and the regional and worldwide importance of the Brazilian capital market, comparison between other more developed markets or markets in the process of development show that there is space for growth to continue over coming years (see, for instance, Chart 2).

Prospects for expansion of the Brazilian market are positive because it is hoped that the country will continue to grow and increase its importance in global markets and because the improvement process of the institutional environment must continue in the future.

There is, however, a series of problems and challenges to address.

Interest rates in Brazil continue to be too high, some of the highest in the world. Currently, the real interest rate in the country is 5.5%, significantly more than other countries with the same risk classification (BBB, according to Standard and Poors): India: -1.5%, Colombia: 11%, Peru: 14%, Hungary: 2.5%. The high interest rates render the purchase of public bonds very attractive, which creates a barrier for the development of private bonds. In spite of the significant growth of this market over recent years, public bonds continue to maintain a dominant position in the Brazilian bond market. In 2010, public bonds accounted for 62% of the total of the bond market, according to BIS data. Although the proportion is lower each time—it was 81% in 2002—these levels are too high (see Chart 4).

The reduction of interest rates in Brazil seems to be one of the objectives of the current economic authorities. However, they will not be reduced without a stricter fiscal policy and without the adoption of measures to correct some of the well-known problems of the Brazilian economy (low domestic savings, high savings accounts remuneration, excessive indexing of the economy, high proportion of earmarked credits, very high reserves requirements for the banking system in the Central Bank...).

The reduction of interest rates and an adjustment in public spending would stimulate, in addition, the extension of the mid-term range of Brazilian private bonds, which are today highly concentrated in the short-term range. At the end of 2010, almost 100% of Brazilian private bonds had an expiry of less than one year according to BIS data. Domestic long-term financing is almost exclusively concentrated in the BNDES, the public development bank. BNDES loans, whose interest rates are subsidized by the public sector, represent over 20% of the credit stock in Brazil.
In order to increase the role of the capital market in long-term financing of the private sector, the government announced at the end of 2010 a series of measures, among which:

- the tax on income from debentures linked to investment in infrastructure was reduced to 0.0% for households and non-resident investors, and 15% for companies;
- the tax on income from bonds related to some specific investments was reduced to 0.0% for non-resident investors;
- a new legal framework was created for debentures without guarantees (the former legal framework established by Law 6.404 was modified);
- the IOF (tax on financial transactions) on foreign capital entry into venture capital funds was reduced to 2.0%.
- a liquidity fund was created: financial institutions can now assign up to 3 pp of their reserve requirements at the Central Bank linked to time deposits towards a liquidity fund for private bonds; in addition, tax incentives were introduced to stimulate the secondary market for private bonds.

In spite of the fact that long-term financing with foreign resources currently offers the most attractive rates for Brazilian companies, financial upheavals in international markets are causing fears that foreign financing markets could close and end up stimulating the development of the domestic long-term market, as suggested by the recent announcements of long-term private bonds issuance in the Brazilian market.

Another question that will have to be resolved is how to address the problems related to increasing foreign capital flows into the country due to the fact that main growth and business opportunities will be for a good time in emerging countries, as well as to the high commodity prices.

If, on the one hand, the entry of foreign capital increases possibilities of capital market growth, on the other it creates pressures on the exchange rate that may result in intervention measures in the exchange markets, as demonstrated by policies recently adopted by the country. These interventions can slow down the liberalization process of the capital account and create barriers to the development of the Brazilian capital market. The recent announcement of increased intervention by the economic authorities in the foreign currency derivative contracts, which includes the taxation of short positions kept in dollars by financial and non-financial agents could, for instance, lead to certain operations to be carried out abroad.

In order not to excessively damage its capital market the country will therefore have to find a way to uphold the competitiveness of its economy in an environment marked by significant capital influx and currency appreciation. An alternative would be, for instance, to design a tax reform permitting the lowering and streamlining of taxes that, currently, represent some 34% of GDP, a level that is rather high for a developing economy. Another alternative would be to incentivize measures to increase productivity of the economy such as an increase in education and technology, which continues to be a pending task in spite of recent progress.

Another challenge for the country and the capital market in particular is to avoid an excessive concentration in securities linked to the commodities sector. High commodity prices as well as the strengthening currency result in growth for the primary sector at the expense of other sectors of the economy. Currently, Petrobras and Vale represent over 26% of the BOVESPA index.

Finally, the need of the country to reform social security represents on the one hand a challenge for the government and on the other an opportunity for growth for private pension funds as well as, consequently, the Brazilian capital market.
Bibliography


Working Papers

09/01  K.C. Fung, Alicia García-Herrero and Alan Siu: Production Sharing in Latin America and East Asia.

09/02  Alicia García-Herrero, Jacob Gyntelberg and Andrea Tesei: The Asian crisis: what did local stock markets expect?

09/03  Alicia García-Herrero and Santiago Fernández de Lis: The Spanish Approach: Dynamic Provisioning and other Tools.

09/04  Tatiana Alonso: Potencial futuro de la oferta mundial de petróleo: un análisis de las principales fuentes de incertidumbre.

09/05  Tatiana Alonso: Main sources of uncertainty in formulating potential growth scenarios for oil supply.

09/06  Ángel de la Fuente y Rafael Doménech: Convergencia real y envejecimiento: retos y propuestas.


09/08  Alicia García-Herrero, Philip Woolbridge and Doo Yong Yang: Why don’t Asians invest in Asia? The determinants of cross-border portfolio holdings.

09/09  Alicia García-Herrero, Sergio Gavilá and Daniel Santabárbara: What explains the low profitability of Chinese Banks?

09/10  J.E. Boscá, R. Doménech and J. Ferri: Tax Reforms and Labour-market Performance: An Evaluation for Spain using REMS.


09/12  J.E. Boscá, R. Doménech and J. Ferri: Search, Nash Bargaining and Rule of Thumb Consumers.

09/13  Ángel Melguizo, Angel Muñoz, David Tuesta y Joaquín Vial: Reforma de las pensiones y política fiscal: algunas lecciones de Chile.


09/15  Angel Melguizo, Angel Muñoz, David Tuesta and Joaquín Vial: Pension reform and fiscal policy: some lessons from Chile.

09/16  Alicia García-Herrero and Tuuli Koivu: China’s Exchange Rate Policy and Asian Trade.


09/18  Alicia García Herrero y Daniel Santabárbara García: Una valoración de la reforma del sistema bancario de China.


10/01  Carlos Herrera: Rentabilidad de largo plazo y tasas de reemplazo en el Sistema de Pensiones de México.


10/05 Soledad Hormazabal D.: Gobierno Corporativo y Administradoras de Fondos de Pensiones (AFP). El caso chileno.


10/07 Rafael Doménech y Juan Ramón García: ¿Cómo Conseguir que Crezcan la Productividad y el Empleo, y Disminuya el Desequilibrio Exterior?

10/08 Markus Brückner and Antonio Ciccone: International Commodity Prices, Growth, and the Outbreak of Civil War in Sub-Saharan Africa.

10/09 Antonio Ciccone and Marek Jarocinski: Determinants of Economic Growth: Will Data Tell?

10/10 Antonio Ciccone and Markus Brückner: Rain and the Democratic Window of Opportunity.

10/11 Eduardo Fuentes: Incentivando la cotización voluntaria de los trabajadores independientes a los fondos de pensiones: una aproximación a partir del caso de Chile.

10/12 Eduardo Fuentes: Creating incentives for voluntary contributions to pension funds by independent workers. A primer based on the case of Chile.


10/16 Soledad Zignago: Determinantes del comercio internacional en tiempos de crisis.

10/17 Angel de la Fuente and José Emilio Boscá: EU cohesion aid to Spain: a data set Part I: 2000-06 planning period.

10/18 Angel de la Fuente: Infrastructures and productivity: an updated survey.

10/19 Jasmina Bjeletic, Carlos Herrera, David Tuesta y Javier Alonso: Simulaciones de rentabilidades en la industria de pensiones privadas en el Perú.


10/21 Máximo Camacho and Rafael Doménech: MICA-BBVA: A Factor Model of Economic and Financial Indicators for Short-term GDP Forecasting.

10/22 Enestor Dos Santos and Soledad Zignago: The impact of the emergence of China on Brazilian international trade.

10/23 Javier Alonso, Jasmina Bjeletic y David Tuesta: Elementos que justifican una comisión por saldo administrado en la industria de pensiones privadas en el Perú.

10/24 Javier Alonso, Jasmina Bjeletic y David Tuesta: Reasons to justify fees on assets in the Peruvian private pension sector.

Carlos A. Herrera: Long-term returns and replacement rates in Mexico’s pension system.

Soledad Hormazábal: Multifondos en el Sistema de Pensiones en Chile.

Soledad Hormazábal: Multi-funds in the Chilean Pension System.

Javier Alonso, Carlos Herrera, María Claudia Llanes y David Tuesta: Simulations of long-term returns and replacement rates in the Colombian pension system.

Javier Alonso, Carlos Herrera, María Claudia Llanes y David Tuesta: Simulaciones de rentabilidades de largo plazo y tasas de reemplazo en el sistema de pensiones de Colombia.

Alicia García Herrero: Hong Kong as international banking center: present and future.


Angel de la Fuente: Human capital and productivity

Adolfo Albo y Juan Luis Ordaz Díaz: Los determinantes de la migración y factores de la expulsión de la migración mexicana hacia el exterior, evidencia municipal.

Adolfo Albo y Juan Luis Ordaz Díaz: La migración mexicana hacia los Estados Unidos. Una breve radiografía.

Adolfo Albo y Juan Luis Ordaz Díaz: El Impacto de las Redes Sociales en los Ingresos de los Mexicanos en EEUU.

María Abascal, Luis Carranza, Mayte Ledo y Arnoldo López Marmolejo: Impacto de la Regulación Financiera sobre Países Emergentes.


Angel de la Fuente y Rafael Doménech: El impacto sobre el gasto de la reforma de las pensiones: una primera estimación.

Juan Yermo: El papel ineludible de las pensiones privadas en los sistemas de ingresos de jubilación.

Juan Yermo: The unavoidable role of private pensions in retirement income systems.

Angel de la Fuente and Rafael Doménech: The impact of Spanish pension reform on expenditure: A quick estimate.


David Tuesta: Una revisión de los sistemas de pensiones en Latinoamérica.

David Tuesta: A review of the pension systems in Latin America.

Adolfo Albo y Juan Luis Ordaz Díaz: La Migración en Arizona y los efectos de la Nueva Ley “SB-1070”.

Adolfo Albo y Juan Luis Ordaz Díaz: Los efectos económicos de la migración en el país de destino. Los beneficios de la migración mexicana para Estados Unidos.

Angel de la Fuente: A simple model of aggregate pension expenditure.

Angel de la Fuente y José E. Boscá: Gasto educativo por regiones y niveles en 2005.

Maximio Camacho and Agustín García Serrador: The Euro-Sting revisited: PMI versus ESI to obtain euro area GDP forecasts.

Eduardo Fuentes Corripio: Longevity Risk in Latin America.

Eduardo Fuentes Corripio: El riesgo de longevidad en Latinoamérica.


11/25 Adolfo Albo and Juan Luis Ordaz Díaz: Migración mexicana altamente calificada en EEUU y Transferencia de México a Estados Unidos a través del gasto en la educación de los migrantes.

11/26 Adolfo Albo and Juan Luis Ordaz Díaz: Highly qualified Mexican immigrants in the U.S. and transfer of resources to the U.S. through the education costs of Mexican migrants.


11/28 Adolfo Albo and Juan Luis Ordaz Díaz: Migration and Climate Change: The Mexican Case.


11/30 Juan Ramón García: Desempleo juvenil en España: causas y soluciones.

11/31 Juan Ramón García: Youth unemployment in Spain: causes and solutions.


11/33 Javier Alonso, Miguel Angel Caballero, Li Hui, María Claudia Llanes, David Tuesta, Yuwei Hu, Yun Cao: Potential outcomes of private pension developments in China.

11/34 Javier Alonso, Miguel Angel Caballero, Li Hui, María Claudia Llanes, David Tuesta, Yuwei Hu, Yun Cao: Posibles consecuencias de la evolución de las pensiones privadas en China.

11/35 Enestor Dos Santos: Brazil on the global finance map: an analysis of the development of the Brazilian capital market.