WORLD POLICY BLOG

Under the Radar

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With the Dow Jones Industrial's 512-point plunge yesterday, the largest since the 2008 financial crisis, billions of dollars vanished. European stock exchanges did not escape the carnage. Britain's FTSE 100 lost 3.4 percent, representing the fifth consecutive day of losses, Germany's DAX 3.9 percent, and France's CAC 3.4 percent.

The movements of those major exchanges kept anxious traders riveted to their monitors. But in places as varied as Cambodia, Sri Lanka, Cameroon, Nigeria, and Peru, small players are joining the global financial rollercoaster with their own stock markets. The ride, as everyone knows (or will soon learn), is incredibly risky—the rewards, however, can trickle down to more than just the shareholders, as a stock exchange could lay the groundwork for business transparency and, in the longer term, financial literacy.

On July 11, 2011, Cambodia opened its stock exchange with hopes of enticing investors to its small, developing economy. The Cambodia Securities Exchange, of which the Korea Exchange has a 45 percent stake, earned little international fanfare and had no companies listed upon opening, although the state-owned enterprises Telecom Cambodia, Phnom Penh Water Supply Authority, and Sihanoukville Autonomous Port are preparing IPOs.

A lack of shares, however, is only one limitation that Cambodia must navigate to maintain its stock market. In addition to a population unfamiliar with capital markets and familiar to poverty, the Southeast Asian nation is hardly a shining model of transparency. In Transparency International's 2010 Corruptions Perception Index, the country ranked 154 out of 178 countries with a meager score of 2.1 on a corruption scale of 0 to 10, where 10 indicates "highly clean." (The United States ranked 22, with a score of 7.1; Denmark, New Zealand, and Singapore tied for first with scores of 9.6.)

Cambodia's challenges—and tall ambitions—are not unique. Stock exchanges have blossomed all over the developing world, though the combined market capitalization of the smallest ten exchanges amount to less than 1 percent of the NYSE's.

The benefits of a stock exchange are alluring. Most obviously, they can draw foreign investors interested in the unique advantages of smaller markets. Leopard Capital, a private equity fund with offices in Laos, Cambodia, Sri Lanka, Bangladesh, and Haiti, invests funds in "frontier markets where the reality has moved ahead of perceptions," wrote Douglas Clayton, founder, in an email. "Many pre-emerging markets have low debt levels, powerful demographics, and produce relatively inelastic items like food and cheap clothes. They don't burden businessmen with mountains of regulations."

Lack of information and liquidity in the market make it a risky place to invest, but if the goods (such as natural resources) are relatively inelastic, businesses—and their shares—have a good chance doing well so long as the likes of China and India remain hungry for basic goods and resources.

Of course, creating a successful exchange comes with its fair share of hurdles. Firstly, simply getting the attention of foreign investors can be difficult. "These countries do not really know how to market themselves overseas and always have difficulty attracting foreign investors," Clayton said. "Also most institutional investors favor larger, more liquid exchanges, but a few frontier investors show up early and usually do pretty well."

Secondly, developing markets come with their own unique set of challenges that can leave them at the mercy of external economic powers. In Cambodia's case, a potential influx of foreign investment, couched in dollars, would further erode the country's monetary policy influence. Cambodia's reliance on the American dollar, rather than the local riel, for a majority of its economic transactions means that Cambodia's central bank cannot use internal tools to control the value of the most-used currency, which is tied instead to global markets and the decisions of the U.S. Federal Reserve. Acknowledging this concern, Cambodia has announced an unprecedented dual currency listing where stocks can be bought in either riel or U.S. dollars, with some hoping that the stock exchange could encourage the "de-dollarization" of the economy.

Another proposed benefit of a healthy stock exchange is that ordinary citizens can cash in on national wealth. Despite drawing hungry gazes from international investors for its rich natural resources, Mongolia is reserving 10 percent of the shares from a planned IPO of a hotly contested Mongolian coal mine exclusively for Mongolian citizens, with another 10 percent for

Mongolian companies. Each individual share of the coalmine is thought to be valued at $300, a windfall for citizens living in a country with a GDP per capita of approximately $1,573.

Issues of education and financial literacy, however, remain. How will citizens know what a stock exchange is and how to invest, especially if the population is not accustomed to capital markets? (Mongolia's stock exchange is preparing a huge investor education effort.) In January 2011, the Dhaka Stock Exchange plummeted 587 points. Angry investors, some violent, took to the streets not only in Dhaka but other towns in Bangladesh, furious that their savings had vanished and demanding measures to moderate the market.

Many experts believe low levels of financial literacy drove the stock market volatility. "You had this situation in which an average Bangladeshi person would make some money on the stock exchange, tell his friends, and they would invest. And this was driving the exchange for a long time. It was obviously increasing demand and the level of investment," says Stephen Finch, former business editor of the Phnom Penh Post and expert in the stock exchanges of the developing world.

Many Bangladeshis were simply unaware of the risk that they could lose money—a lot of money. "People thought they could put money in, and what came out the other end was a larger amount. What Bangladesh is a good example of is an exchange that has suffered because of a very low level of financial literacy," Finch continues.

Finally, stock exchanges may encourage the financial sophistication and transparency that are vital for a thriving business climate. Many companies in developing economies are cold to the idea of having stockholders, especially as many are run informally or as family ventures, which prevents capital from reaching a wider population. But having a market for stocks and securities may persuade them to join in as they could benefit from fresh cash investments.

As for transparency—with the introduction of a stock exchange, international accounting and auditing firms have the incentive to move in for a piece of the action. "PricewaterhouseCoopers has been in Cambodia for a very long time, but it just opened a brand new office in the center of Phnom Penh," Finch says. "Now they have a shiny glass building that goes up a certain number of stories…The fact that [the stock exchange] has come, they've had to build all this financial infrastructure around this new stock exchange—so that definitely has a knock-on effect. Your average company in Cambodia barely keeps accounts but I think the knock-on effect will happen."

Companies may clean up their books for the sake of auditors and, subsequently, more valuable IPOs. "A securities exchange provides a fundamental incentive for companies that list to become transparent and tax compliant in order to achieve a higher market valuation," Clayton wrote. "The market rewards positive behavior." So, though a stock exchange doesn't indicate a country's spotless corruption track record, it may herald a new era, with large businesses maintaining transparent operations to attract and keep international shareholders.

The presence of a stock exchange, therefore, is not so much an indicator of a country's current business environment. For example, Cameroon, Maldives, Tanzania, and Syria all have small exchanges. On Corruption Perceptions Index, they rank 146, 143, 116, and 127 respectively. In World Bank's "ease of doing business" rankings as of 2010, Cameroon was ranked at 168 out of 183 countries.

But like Cambodia, betting on their stock exchanges can be an investment in their future. Transparency and corruption must be, and are, addressed not only to get stock exchanges off the ground but to sustain and grow them. With government regulation and policies to encourage financial literacy and sophistication, installing a stock market can help attract wealth and investment to a developing economy.

The world's smallest stock exchanges are often just under the radar, written off as capricious and insignificant. But with time and hard work, these new nodes in the global financial network can help countries earn an ample pay-off—not just in dividends, but by improving business transparency and, hopefully, financial literacy in some of the world's most corrupt and impoverished places.