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# In Search of a Better World: Financial Markets and Developing Countries

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Bond financing has replaced bank loans and other sources of capital flows as a major source of funding for emerging markets. This shift has been particularly impressive in Latin America. Disentangling the dynamics of emerging bond markets and the information flow about them has attracted the attention of the OECD[1]. Are decisions about bond market investments based on good and neutral information, or is something else driving investors' choices?

Part of the answer lies in how analysts behave and how they reach their recommendations. The possible macroeconomic implications of investment banks' advice are far-reaching. Based on foreign sovereign debt outlooks by 10 major Wall Street and City investment banks, the OECD Development Centre has constructed a unique database with over 3 400 recommendations from July 1997 to July 2006. This data has been matched with other series, such as underwriting recommendations, fixed income and equity portfolio flows towards emerging economies, and spread databases. The evidence from this exercise shows that there is a strong relationship between investment banks' recommendations and their business in each country. When bonds are issued by those countries in which where they are acting as lead managers, 90 per cent of the bond underwriters recommend buying or maintaining them in their portfolios. Investment banks' recommendations also depend on the relative size of the secondary bond market. In fact, there is a "too big to underweight" phenomenon: investment banks do not send negative signals to investors of countries that, given their size, are considered important for their business.

These issues need to be taken into serious consideration since, in emerging markets, brokers' recommendations have a significant impact on cross-border portfolio allocations.

## Policy Implications

Government agencies, most notably at the Central Bank and the Ministry of Finance, need to monitor financial market recommendations closely. If they know what financial markets are hearing about home-country financial investments, such monitoring would permit them to take a more proactive policy stance.

For their part, investment banks should be transparent in the release of information. While a tremendous amount of resources have been channelled by developing countries and international organisations into improving the data release by governments, the same effort should be exerted on financial intermediaries. In particular more detailed disclosure of underwriting activity should be considered: at the moment the disclosure introduced in brokers' reports is limited to the number of sell or buy recommendations. Reports should also include information on the sovereign bond issues underwritten, the amounts and their timing.

1. See Sebastián Nieto Parra and Javier Santiso (2007), "The Usual Suspects: A Primer on Investment Banks' Recommendations and Emerging Markets", *Working Paper* No. 258, OECD Development Centre, January.

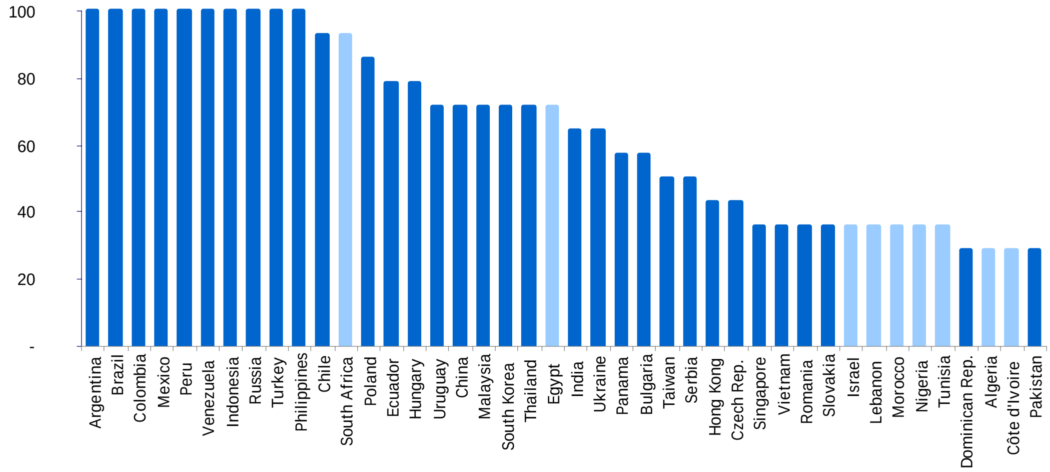
Leading emerging-market investment banks also need to take the initiative to encourage brokers to cover more countries. International multilateral banks, as well as OECD-country financial institutions such as the German development finance agency KfW, have been playing an important role in facilitating developing countries to issue financial bonds. These countries remain, however, largely ignored by brokers' analysts and therefore the private sector. Increasing the scope of analysis to include information on such countries might help to attract more investor attention and therefore potentially more capital flows.

Country coverage by leading investment banks and leading emerging-market benchmarks like the EMBI produced by JP Morgan for the bond markets or leading global banks like Citigroup, Deutsche Bank, HSBC, JP Morgan or Morgan Stanley, rarely cover or sample more than 35 economies. The other 120 developing countries simply do not exist for global financial-market investors. Only 10 countries enjoyed systematic coverage from the major financial institutions. For the other 32 countries that benefited from some coverage, almost half of them were analysed by fewer than half the banks. Only 6 African countries appeared on the radar screens of some major international banks (in lighter colour in Figure 1, along with Egypt, Israel and Lebanon for the Middle East). No Central Asian and only one Central American country appear in the sample based on their monthly research products.

A partnership agreement could be reached between a leading international organisation, supported by donor agencies, and a "market maker" – an influential brokerage analyst – in emerging markets, in order to boost country coverage in Africa, Central Asia or in Central America, where such coverage is lacking.

Experiences of public-private partnerships have already been implemented in order to improve country coverage. In 2005, Standard & Poor's, one of the two leading rating agencies, initiated the rating coverage of some African sovereigns, with the support of UNDP. In 2006, 14 sovereigns were rated. Five years earlier and with the help of the European Commission, the OECD Development Centre and the African Development Bank launched the first edition of the *African Economic Outlook*. In 2006, the report covered 30 African countries. All these initiatives boosted the economic and rating coverage of a continent lacking attention from investment banks. These initiatives could be complemented by a similar agreement between an international organisation and an investment bank in order to boost the coverage by a leading broker and help to catch the attention of international investors.

Figure 1. **Emerging Markets Covered by Financial Institutions in 2006**
(% of total brokers)




*Note:* Countries most frequently analysed by Emerging Markets Analysts or covered by leading financial institutions. The percentage represents the average presence in their analysis. Only countries analysed by more than 25 per cent of the selected financial reports appear on the graph.

*Source:* OECD Development Centre, calculation according to 10 selected investment banks (Barclays, Bear Stearns, Citigroup, Credit Suisse, Deutsche Bank, HSBC, JP Morgan, Lehman Brothers, Merrill Lynch and Morgan Stanley), 3 relevant emerging market indices (EMBI, FTSE and MSCI) and 1 global association of financial Institutions (IIF).



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