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Understanding the International Capital Markets and its Prospects as Well as Potential Threats Thereof: Advice to the Government of Ghana on the Planned Access of the International Capital Market

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EXECUTIVE SUMMARY
This written piece seeks to independently advise the Government of Ghana on the planned access of international capital market. International capital market (ICM) involves residents of different countries trading in different assets. Mostly, governments take advantage of the international capital market to borrow for domestic investment projects. In this era, globalization of international capital markets and also the existence of large financial businesses have shown that crises that hit international capital markets can be transferred in the form of financial shocks to different countries. When capital markets are liberalized, stringent regulations and supervisions are required to be in place to shield the capital market from instability. The findings of this paper indicates that the current state of the international capital market is sound and there are benefits in line with accessing the international capital market as well as risks especially with the international bond market. Also, potential financial crisis the nation (Ghana) may be exposed to through the back-up of issuance of bonds in the international capital market include speculative investment behavior and potential economic instability, capital flights among other factors. An attempt by government to design systems and structures to prevent potential crisis is no longer an option but a necessity as the sound measures put in place will go a long way to enhance buoyant economic growth. The measure which government could employ includes prudent regulations and supervisions, maintaining strong macroeconomic fundamentals among other factors discussed in this paper. 3

Keyword: *Capital Market, International Capital Market, Advice to Ghana Government*

I. INTRODUCTION

Globalization in this era has provided the means for countries to interact among themselves through the flow of the factors of production (mainly capital, labour and entrepreneurship). Today, in accessing capital for development, governments of various countries take advantage of the international capital market to borrow. The international capital market is a group of closely interconnected markets in which residents of different countries trade assets such as currencies, stocks and bonds (Francis et al, 2003).

Trading in currencies take place at the foreign exchange market while trade in stocks and bonds take place at the international stock market and bond market respectively. Major trading centers include Tokyo, London, New York, and Paris, Singapore among others. Recently based on the Budget Statement and Economic Policy of the Government of Ghana for 2013, the government indicated her preference to accessing the international capital market to finance the current budget deficit so as to reduce pressure on the local capital market. While it is significant to rely on the international capital market for developing an economy, it is also significant to key to build an economy that could resist potential crisis associated with supporting foreign capital. The aim of this paper is to advise the Government of Ghana on the international capital markets, its prospects as well as potential threats including the measures that could be adopted by government to prevent potential crisis. To execute this task, the paper will first of all focus on the current state of the international capital market, the key issues to justify the merits of accessing the international capital market for development, evaluate the potential of a crisis as Ghana strives to attain rapid economic growth through the encouragement of foreign capital and then finally recommend policy issues to address future crisis.

II. AN ASSESSMENT OF THE CURRENT STATE OF THE INTERNATIONAL CAPIAL MARKET

The growing importance of national trade over the years has been accompanied by growth in the international capital market which tends to link the capital markets of individual countries. Since the 1960's, huge international capital market have emerged most notably the famous London Eurodollar market. Most scholars ascribe the era of global capital market to the 1990's as a result of the existence of offshore markets that made individual countries to liberalize their capital markets and overtime it created a higher internationalization of capital markets (Woepking, 2007). Empirical study by Beck and Levine in 2001 showed that more developed countries have efficient financial systems including capital markets (Beck et al, 2001).

The international capital markets can be broken into international bond market, note market (flows and stocks of private sector and government securities); international bank markets (liabilities/ stocks). International notes comprises of Euro commercial paper, Euro medium-term notes and other short-term paper. For bonds and notes, they are usually securities whose maturities go beyond a year. In facilitating trade in assets the international capital markets allow the parties involved to better off by allowing them to reduce risks and maximize returns through diversification of their portfolio. Trading in international assets involves different classes including bonds, deposits in different currencies, stocks, currency swaps, currency options etc. Issuers who borrow through debt instruments repay fixed principles plus interest irrespective of economic conditions compared to equity instruments in which payoff vary based on the circumstances. Also, the main actors in the international capital market include commercial bank, corporation, Central bank, government agencies and other non-banking financial institutions such as insurance companies and pension funds. The commercial banks are the center 6

of the international capital markets because of their activities such as underwriting issues of corporate stocks and bonds by agreeing to find buyers for those securities at a guarantee price. Corporations which are particularly multinational also financing their operation through the debt instruments such as bonds. Non-bank financing institutions like Lazard Freres, Goldman Sachs and Credit Suisse are also important market players as they help in underwriting stocks and bonds of corporations and governments and central banks and government agencies that are involved in the capital market through foreign exchange involvement. The growth of international capital markets has led European countries to create a currency union to have a fixed exchange rate which has facilitated the freedom of international capital movements.

The growth of international capital markets have led to offshore banking which involves foreign banks conducting businesses outside their home countries and offshore currency trading such as Eurocurrencies, Eurodollars which involves trading in a currency of foreign origin. Today, major international capital markets including NASDAQ, NYSE, Euronext, Deutsche Borse, Eurodollar market, Euroequity etc. The recent ones include BOVESPA (Brazilian main stock exchange) BMW (Mexican stock exchange), JSE (Johannesburg stock exchange) amongst others. The US securities market is the richest source of capital in the world. However, getting to these markets requires companies to manage their operations and demonstrate transparency, accountability and integrity. The operations of international capital markets have impacted the international markets greatly.

They facilitate international trade through transfers and trade in financial instruments. Also it helps to manage risks and allocate capital properly through derivative instruments. The international capital markets by improving the efficiency of investments and also by strengthening the discipline on governments and central banks to pursue some policies. The 7 current state of the international capital market is sound which enables corporations and governments to trade in such markets.

III. JUSTIFICATION DETAILING THE IMPORTANCE OF ACCESSING THE INTERNATIONAL CAPITAL MARKET FOR NATIONAL DEVELOPMENT

The international capital market provides numerous opportunities for borrows and issuers. In the case of Ghana where the government has indicated her preference to borrow in the international capital market by issuing Eurobonds, it is important for government to understand the characteristic of countries that have accessed the market as well as conditions for countries to issue bond including the characteristics of the bond issue. Countries accessing the international capital markets for the first time generally had demonstrated a good macroeconomic performance for many years. According to the IMF in 2003, countries that access the international capital markets have real GDP growing, employment increasing and inflation aws well under control. For instance, Bulgaria real GDP was established to have grown by about 4% in 1998-2000, rising 4.5% in 2001(the year it accessed the international capital markets). Countries like Croatia, El Salvation and Tunisia have also shown that successful market access depends to a great extent on good economic management. Croatia which has accessed the capital market, quadrupled its international reserve since 1994 before accessing the capital market since 1997 issuing 14 international bonds. Tunisia maintained good external debt management at 60% of GDP which has broadly remained stable since 1994 and since 1994 the country accessed the international capital market with a total of 15 bonds including El Salvador which accessed the international market on seven occasions since 1999 including a 30-year issue in 2002(IMF, 2003). Also, countries that access the international capital market need to have in place debt management strategies that are sufficiently robust to be able to meet debt-service obligations even in the face of major changes in the domestic and international circumstances. Significantly in issuing bonds, countries need to consider the characteristics of the bond by considering questions such as which investors the bond should target, the maturity of the bond, whether the bond should have a fixed or flexible coupon, whether to register or list the bond among other factors. The need for the government of Ghana to put in place solid macroeconomic policies in its attempt to borrow from the international capital market is fundamental.

Intertemporal trade is a major justification for accessing the international capital market for development. The Government of Ghana indicated her preference to issue Eurobonds can be interpreted as a kind of international trade since the government borrows now for payment in the future. Just as different countries with different resources and abilities gain from trade by focusing on areas where they have comparative advantage, countries can also gain from focusing their investments in economies that is best able to transform current input into future output. This indicates that since in Ghana, the investment environment is not really solid compared to the developed economies, it is essential and reasonable for government to invest little at home and channel more investments abroad to yield higher returns, and also government current account deficit guarantees the need to borrow abroad. The international capital markets allows countries to engage in intertemporal trade for future production and consumption (Dornbusch, 1998). In this case, since government is issuing a debt instrument, it exposes government to international scrutiny. This is because when government issues bonds to undertake investment projects, it commits government to use the money to develop the economy for a long period of time the government will be accountable for a specified period of time.

Moreover, when governments go to the international capital markets, they become more transparent which helps to provide domestic investors with better investment opportunities. As the governments of Ghana floats bonds abroad, there will be a potential for a "crowding in" effect which increases domestic financing from other issuers. This borrowing from government from the international capital market helps to avoid the crowding out of the private sector. This is because, if government finances its spending with more taxes and borrowed money, it leaves businesses with less money and eventually "crowding them out" (taken them out of business). Also, should government borrow large amount of money, its activities could increase interest rates discouraging individuals and businesses from borrowing money and reducing their investment activities. By borrowing in the international capital market, it shields the private sector to grow and create more employment opportunities.

In addition to this, deep pools of capital and diverse range of investors can be accessed in the international capital market. When government accesses the international capital market, it gains access to the world's deepest pools of capital and varied investor base. This indicates that governments will benefit from an established and reliable source of funding. These investors which governments are exposed to have potentials to invest in research and developmental activities in the country.

Also, creating prestige and profile on the world stage is another reason for accessing the international capital market. When government accesses the international capital market, the country gains prestige from being admitted to trade in the international scene which helps to boost awareness of the country and strengthen the position of the country with other international employees and business partners. The profile that the country creates from trading in the international market creates a solid platform for expansion and growth in the economy.

Benchmarking of other assets is another major justification for accessing the international capital market. Since the Government has indicated her preference to borrow abroad by issuing Eurobonds, such assets could be used as a standard of comparison to other assets issued within the domestic economy. When government borrows from the international capital market, it has the potential of creating international yields which benchmarks for local firms to access international markets. In effect, this creates investments within the economy for developments and growth.

In spite of the benefits of accessing the international capital markets, it has got its own side risks. One key risks of accessing the international capital markets is that financing in international markets is volatile with risk premium increasing substantially during a crisis period. Mostly, foreign bond financing tends to be denominated in foreign currency, exposing issuers to currency risks. Also, when governments access international capital markets which benchmarks for local firms to access international markets, it may lead to the situation where large domestic firms tend to be listed on the international markets which tends to have a negative impact on domestic market trading and liquidity as trading activity migrates abroad.

In addition to this, there may be costs involved in accessing the international capital markets which the government of Ghana must settle before listing on the international scene. For instance, Securities Exchange Act of 1934 of the US requires foreign governments and businesses to file report and pay registration fees including meeting the listing qualifications of that exchange and complying with its rules (Accessing US Capital Markets, 2012). 11

IV. EVALUATING THE POTENTIAL OF A FINANCIAL CRISIS AS GHANA STRIVES TO ATTAIN RAPID ECONOMIC GROWTH THROUGH THE ENCOURAGEMENT OF FOREIGN CAPITAL

The issue of financial crisis exposes countries to a number of problems. Financial crisis is the situation in which the value of financial institutions or assets drops rapidly characterized by instability which is accompanied by volatility and increasing uncertainty (Badea, 2011). The Global Financial Crisis began in the early months of 2007 and 2008 due to the collapse of the US Sub-prime mortgages, excessive leverage and human greed. The financial crisis led to the paralysis of the international capital market around that period as the number of investors in the market began to decline. The Romanian Capital Market is one of the markets that were affected greatly by the financial crisis. The financial crisis affected the capital market developments in Romania since 2008 because of the contagion phenomenon manifested in the European Capital Markets and beyond. Around 2008, there was an increase in the number of participants in the Romanian capital markets; however this could not prevent the decrease in interest rate transactions. In 2009, the number of participants decreased significantly compared with the end of 2008 because of the characteristics of economic crisis in Romania where the local crisis superimposed over a global one. At the end of the day, investors moved away from the Romanian capital market and changed their investment options. According to analytical report in 2010, Romania had the lowest share of global capitalization with a rate of only 0.02% causing the country to lose due to capital flight (Bucharest Stock Exchange Annual Report, 2008-2010).

In the case of Ghana, evaluating the potential of a financial crisis as the nation strives to attain economic growth through the issuance of bond on the international capital market, a major setback that is likely to affect the Ghanaian economy is capital flight since government is going to the international capital market is going to the international capital market to borrow, it will allow foreign capital inflow into the domestic economy. In the case where the country experiences domestic shocks (like when government defaults its debts or poor macroeconomic performance in Ghana) it could have significant pressure on its currency and interest rates and thus capital is likely to flow out from the domestic capital market which could potentially have adverse consequences for the domestic economy. For instance, during the European Debt Crisis in Greece, the government was unable to meet its obligations on its debt payments. This caused a high capital flight in Greece as investors quickly sold their holdings of Greek Government bonds causing a high net capital outflow (Hope, 2010). The impact of technological advancement has made it difficult for governments to trace and regulate the flows of international capital as they want to. The Government of Ghana should therefore put in place effective mechanisms that will prevent the collapse of the domestic economy through indiscriminate withdrawal of capital from the domestic economy when investors panic. In the event of a potential crisis, domestic economies are vulnerable to impoverishment worsening the possibility of investments and prospects for further development of the economy (Kosarev, 2000).

In addition to this, as the government goes to borrow from the international capital market, in the event of a potential financial crisis, it could lead to speculative investment behavior. When government borrows from the international capital market, it causes more liberalization of the domestic capital market as people will be investing more, enjoy capital growth and a better standard of living. However, the liberalization of capital market could also have huge impact on the instability and riskiness of the Ghanaian financial market. For instance, during the Thailand crash which was caused by speculators and US Financial Crisis in 2008, few people benefitted from the collapse of the Thailand and US Financial Crisis in 2008, while a large number of people went bankrupt? With the government of Ghana's preference to borrow abroad, in a possible financial crisis, the economy will attract speculators who will trade with the objective of achieving profits through their successful anticipation of price movements within the economy. The Greek Crisis for instance led investors to engage in speculative behaviours as numerous negative media reported that the financial status of the country pushed towards the danger zone. Also, during the 1997 East Asian Crisis, speculators were the group of people that benefitted from speculation in foreign exchange market (Understanding the Financial Crisis, 2009).

Moreover, uncertainty and hard behavior needs to be addressed in line with a likely financial crisis as the government of Ghana goes to borrow from the international capital markets. As governments borrows from the international capital market and invests within the domestic economy, in a possible financial crisis, investors are likely to demand for their money due to uncertainty or doubt on the performance of the economy. Also, investors within the economy may decide to hold more money. This could further worsen the plight of the economy as supply of money will increase, decreasing the equilibrium real interest rates. Whenever economic actors are unable to overcome uncertainty in a conventional manner, they prefer liquidity to satisfy their want of safety (Roubine,2010).

Also, regulatory failures are bound to happen on the event of a financial crisis if government borrows from an international capital market. During the global financial crisis, policy makers failed to realize that the "invisible hands" were actually choking the economy. Should government borrow from the international capital market, the large inflows from government and other businesses could cause exchange rate depreciation. In a likely financial crisis, fiscal and monetary policies set by government will be a disappointment. 14

V. OUTLINE SOME OF THE POTENTIAL POLICY MEASURES THAT GOVERNMENT COULD EMPLOY TO PREVENT POTENTIAL CRISIS

Any crisis that has been experienced or yet to be experienced is as result of some loop holes that were ignored or experts had little knowledge around it. Government definitely has an idea about the recent financial crisis that hit major financial institutions around the globe as it trickled down to developing countries such as Ghana. Hence there will be a need for government to outline potential measures to prevent such potential crisis. Macroeconomic discipline is an essential element that mitigates any form of financial crisis. This can be achieved if domestic banks attain high coverage ratio(ie have enough funds to pay off their liabilities to prevent the possibility of a bank collapse).Hence banks should avoid using unproductive assets (risky in nature).In addition this, the banks should decline from lending loans to people who cannot meet their financial obligations or lack creditworthiness.

The Government of Ghana should adapt the strategy of the capital account liberalization. Access to the ICM basically involves the inflow and outflow of money. Hence policies must be enacted in the domestic economy to prevent investors from taking making massive capital flights.

Furthermore, consecutive capital account liberalization will curb the over-accumulation of foreign debt by domestic banks and other financial institutions and prevent them from reaching their borrowing limits within a short period of time. Also, the appreciations of the real exchange rates via the liberalization of capital and potentially expedite the unrestricted movement of foreign direct investments (Sachs, 1995). The government and the central bank will have to inculcate essential supervision to reduce the likelihood of potential economic crisis. This can be achieved if the law of 'separation of powers' (i.e. an independent body under the umbrella of large hierarchy that accounts for the actions taken in their zone without overlapping to prevent any form of bias or injustice).This will keep them on their toes as separate independent bodies are vigilantly at work to achieve the desired goal. Occasionally, the banking systems should be granted support in the form of emerging cross-border lending as a result of the sudden withdrawal of foreign-denominated funds (Sachs, 1995). Also, government's current account balance should be impressive. In other words must attract investors. That is to say trade balance should be at a surplus. To do this, productivity should be encouraged to grow so as to make exports improve.

VI. CONCLUSION

The global capital market creates a platform or opportunity for countries to trade assets that will primarily boost the economy of both the beneficiaries and benefactors. Such is the case of Ghana that wants huge capital via the international capital market to position itself for rapid economic growth and ease the pressure on domestic treasury market. This as a result will aid in putting up developmental investments such as schools, hospitals, roads etc. Also, the current state of the international capital market is stable despite the shocking financial crisis that hit the world in 2007/2008 which is a potential ground for less cost of borrowing. Hence government must put in place some measures to curtail potential financial crisis. Some of the measures highlighted in previous paragraphs include macroeconomic discipline, decline from loan grants to people with lack of credit worthiness, capital account liberalization, essential supervision and the improving the current state of the current account balance. Thus, Ghana can achieve the desired goals if the policies are enacted and monitored.

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