THE BRAZILIAN STOCK MARKET DEVELOPMENT: A CRITICAL ANALYSIS OF PROGRESS AND PROSPECTS DURING THE PAST 50 YEARS

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Abstract

This paper highlights the origin of the stock market in Brazil, and traces the reforms that have been undertaken to develop the stock market. It also highlights the growth of the Brazilian stock market, as well as the challenges currently facing the market. The country has one big stock market, known as the BM&FBOVESPA, which is one of the world's largest stock markets. Over the years, a number of stock market reforms have been implemented in Brazil. Among these reforms have been the restructuring of the financial market, the replacement of the traditional trading systems by full electronic trading systems, the enactment of new laws governing the stock market, as well as the revision of the existing laws. In addition, the formation of a regulatory body known as Securities and Exchange Commission (CVM) in 1976 also assisted in the creation of an environment conducive for the growth and development of the stock market. Since the implementation of these reforms, the Brazilian stock market has developed significantly in terms of market capitalisation, the total value of stocks traded, and the turnover ratio.

Keywords: Brazil; BM&FBOVESPA; Stock Market; Reforms

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1 Introduction

Stock-market development is an important component of financial sector development, as it supplements the role of the banking system in economic development. Stock markets assist in liquidity provision, a reduction in transactions costs, price discovery and risk transfer. They reduce information costs through the generation and dissemination of information on firms – thereby leading to efficient markets, in which prices incorporate all the available information (Garcia and Liu, 1999; Yartey and Adjasi2007).

Generally, stock markets provide market liquidity that enables the implementation of long-term projects with long-term payoffs, thereby promoting a country's economic growth. Moreover, efficient stock markets not only make resources available to investors, but they also facilitate the inflow of foreign financial resources into the domestic economy (Yartey and Adjasi, 2007). The role of the stock market in the development of an economy cannot, therefore, be overemphasised.

The Brazilian stock market is no exception – it lubricates the Brazilian economy in more ways than one. These include the mobilisation of domestic savings to bring about the reallocation of financial resources from dormant to active agents, as well as the enhancement of the inflow of international capital.

Despite the importance of the stock market in the economic growth process of Brazil, this area has not yet been fully explored. The documentation on Brazil's stock market is very scant. This paper, therefore, aims to fill this gap, and to put the Brazilian stock market in the spotlight, by highlighting its origin and growth – since the establishment of the first Brazilian stock exchange, the Rio de Janeiro Stock Exchange, in the 19th century – and the developmental challenges it has faced.

Long-term capital is deemed crucial for economic development, as evidenced by the positive relationship between long-term capital and economic growth (Demirguc and Levine, 1996). In recognition of this, the Brazilian Law No. 4.728, dated 14 April 1965 was passed, culminating in the first Capital Market Act, which brought order in the Brazilian stock market (Ministry of Finance, Brazil, 2012). The reforms undertaken by Brazil as part of the revitalisation process stretched over a century. They include, amongst others, the formation of a regulatory body called the Securities and Exchange Commission (CVM) in 1976, to assist in the creation of an environment conducive for the growth and development of the country's stock market, as well as the gradual replacement of the traditional trading systems by full electronic trading systems.

The Brazilian stock market responded largely positively to the various stock market initiatives implemented over the years. Thus, Brazil achieved substantial progress in stock market development. The menu of available financial instruments expanded, the market infrastructure was reformed and strengthened, and a diversified investor base was built. Despite this notable progress, challenges still remain. These include the still-prevalent short-term indexation, still-low liquidity in the secondary market, and the small number of listings.

The rest of this paper is organised as follows: Section 2 covers the origin of the stock market in Brazil. Section 3 outlines the reforms implemented to revitalise the stock market; while Section 4 tracks the growth of the Brazilian stock market, in response to the reforms. Section 5 highlights the challenges facing stock-market development in Brazil. This is followed by the 6th and concluding section.

2 The Origin of the Brazilian Stock Market

The Brazilian stock market has enjoyed years of development, especially during the 1990s and the late 2000s. The history of the stock market in Brazil dates back to as early as 1817, when the first Brazilian stock exchange was inaugurated. Today, Brazil has several stock exchanges, which gradually emerged over the years; and which have also gradually acquired one another and/or merged over the years to form one big stock exchange: the BM&FBovespa.

3.1 The Rio de Janeiro Stock Exchange/Bolsa de Valores do Rio de Janeiro (BVRJ)

The Rio de Janeiro Stock Exchange/Bolsa de Valores de Rio de Janeiro (BVRJ) was inaugurated in 1820. It was Brazil's second largest exchange after the Bovespa stock exchange in São Paulo, and the oldest of Brazilian stock exchanges in activity. It was from its inception through the early 1970s, the most important Brazilian Exchange. Following the 1971 markets crash's effects, little by little, the BVRJ started losing ground to the Bovespa.

After the national stock markets crash in 1989, this stock exchange lost its definitive rank as the main stock exchange of the country and of Latin America, to the São Paulo stock exchange – Bovespa. It was eventually sold on 11 April 2002 to the Brazilian Mercantile and Futures Exchange/Bolsa de Valores, Mercadorias (BM&F).

3.2 The São Paulo Stock Exchange/Bolsa de Valores de São Paulo (Bovespa)

On August 23, 1890, the São Paulo Stock Exchange/Bolsa de Valores de São Paulo (Bovespa), was founded. It has had a long history of service to the stock market and the Brazilian economy. Until the mid-1960s, Bovespa and the other Brazilian stock markets were state-owned companies, tied with the Secretary of Finances of the states to which they belonged, and the brokers were appointed by the government. After the reforms of the national financial system and the stock market implemented in 1965/1966, Brazilian stock markets assumed a more institutional role. In 2007, the Exchange demutualized and became a for-profit company (Ministry of Finance, Brazil, 2012).

Through self-regulation, Bovespa operated under the supervision of the Securities and Exchange Commission of Brazil/Commissão de Valores Mobiliários (CVM), analogous to the American Securities and Exchange Commission. Since the 1960s, it has constantly evolved with the help of technology, such as the introduction of computer-based systems, mobile phones and the internet. In 1972, Bovespa was the first Brazilian stock market to implement an automated system for the dissemination of information online and in real-time, through an ample network of computer terminals (Ministry of Finance, Brazil, 2012).

In 1997, a new system of electronic trading, known as the Mega Bolsa, was implemented successfully. The Mega Bolsa extended the potential volume for the processing of information; and this has allowed the Exchange to increase its overall volume of activities.

In 2000, Bovespa created three new listing segments: the Novo Mercado (New Market), Level 2 and Level 1 of Corporate Governance Standards, allowing companies to accede voluntarily to more-demanding disclosure, governance and compliance obligations. The new listing segments largely languished until 2004, when a growing number of newly public companies began to list on the Novo Mercado and other segments as part of a capital-raising effort. The stock market index of Novo Mercado listed companies (the IGC) has consistently outperformed the broader Bovespa index since its launch.

The recent success of the Brazilian equity capital markets is attributed to a significant extent to the credibility engendered by the Novo Mercado regulations. On May 8, 2008, the São Paulo Stock Exchange (Bovespa) and the Brazilian Mercantile and Futures Exchange (BM&F) merged, creating the world's third-largest stock exchange, the BM&FBOVESPA, located in São Paulo, Brazil.

3.3 The São Paulo Commodities Exchange (BMSP)

On October 26, 1917, exporters, businessmen, and commodity producers founded the São Paulo Commodities Exchange (BMSP). This was the first Brazilian institution to offer forward trading. With the passage of time, BMSP established a rich tradition in the trade of agricultural commodities, especially coffee, live cattle, and cotton.

3.4 Mercantile and Futures Exchange (BM&F)

In July of 1985, the Mercantile and Futures Exchange (BM&F) was founded. Trading sessions commenced on January 31, 1986; and within a short period of time it attained a position of respect amongst the world's major futures exchanges by offering derivatives on varied financial assets.

On May 9, 1991, the BMSP and the BM&F decided to unite their operations. This act brought together the tradition of the former and the dynamism of the latter, thereby creating what is now called the Brazilian Mercantile and Futures Exchange, which maintained BM&F as its title (BM&FBovespa, 2012).

On June 30, 1997, another operational agreement took place, with the Brazilian Futures Exchange (BBF) of Rio de Janeiro, which was founded in 1983. The purpose of this agreement was to strengthen the domestic commodity market, and to consolidate the BM&F as the major derivatives trading centre in Mercosur.

On 22 April 2002, the BM&F Foreign Exchange Clearing house initiated its activities. Three days later, on 25 April, BM&F acquired the rights to manage and operate a clearinghouse for government bonds, fixed-income securities and other securities issued by financial institutions from the Brazilian Clearing and Depository Corporation (CBLC). On the same day, it also acquired all of the Rio de Janeiro Stock Exchange (BVRJ) equity memberships, along with the rights to manage and operate the electronic system known as SISBEX.

On 12 November 2002, BM&F negotiated an agreement with the Brazilian Federation of Banks (FEBRABAN), and with the Central clearing of Clearing and Settlement S.A., in a move to cease all of the latter's activities related to registration, clearing and settlement of trades involving public and private fixed-income securities, consequentially centralising all of these activities at BM&F. The culmination of these events took place on 14 May 2004, when the BM&F Securities Clearing house was inaugurated, and began its activities.

With these initiatives, BM&F broadened its capacity to become the major clearing house in Latin America, providing an integrated set of assets, securities and derivatives clearing services, while at the same time offering economies of scale, competitive costs, and operating security. Moreover, the three BM&F Clearing houses are ISO 9001 certified: The Derivatives Clearinghouse since October 1996; the Foreign Exchange Clearinghouse since June 2002; and the Securities Clearinghouse since March 2005.

On 29 August 2002, BM&F launched the Brazilian Commodities Exchange, which united the commodity exchanges from the states of Goiás, Mato Grosso do Sul, Minas Gerais, Paraná and Rio Grande do Sul, and from the city of Uberlândia, thereby transforming these exchanges into regional operating centres. BM&F renders clearing and settlement services to this new exchange. The result was the creation of an integrated domestic market for agricultural commodities with modern price-discovery mechanisms and an organised marketing structure. The Brazilian Commodities Exchange opened for trading on 22 October, 2002.

In 2004, another regional operation centre was created in the state of Ceará; and a field office linked to the Paraná operation centre was opened in Florianópolis (state of Santa Catarina).

The BM&F established the BM&F Settlement Bank, which went into operation on 30 November 2004 (BM&FBovespa, 2012).

3.5 BM&FBOVESPA

On May 8, 2008, the BM&F and the Bovespa merged, creating the then world's third largest stock exchange, the BM&FBOVESPA, which is Brazil's most sophisticated stock exchange. The BM&FBOVESPA, as of December 31, 2011 had a market capitalisation of US $1.22 Trillion, making it in the 8th largest stock exchange in the world (BM&FBovespa, 2012).

The benchmark indicator of BM&FBOVESPA is the Índex Bovespa (IBOVESPA). As of April 30, 2008, there were 381 companies listed on Bovespa. The number had, however, increased to 594 by mid-2012 (BM&FBOVESPA, 2012). There are currently 533 listed companies at BM&FBOVESPA. Although it is a Brazilian company/exchange, BM&FBOVESPA has offices in New York, Shanghai and London. It is the most important Brazilian institution to intermediate equity market transactions, and the only securities, commodities and futures exchange in Brazil.

BM&FBOVESPA further acts as a driver for the Brazilian capital markets. Currently, BM&FBOVESPA is a fully electronic exchange (BM&FBovespa, 2012). BM&FBOVESPA is Latin America's leader in the securities and derivatives segments. Its mission is to operate in the macro-economic dynamics of market growth, and to make the Exchange and Brazil a socially responsible international financial hub for trading excellence in stocks, derivatives, commodities, bonds, OTC and structured transactions (BM&FBovespa, 2012).

As a result of an early 2008 stock swap, Chicago Mercantile Exchange (CME) Group owns a 5% stake in BM&FBovespa, and in turn, BM&FBovespa owns a 5% stake in CME Group. The agreement has also created an order-routing trading system between both exchanges (BM&FBovespa, 2012).

The stock market in Brazil is monitored and regulated by the Securities and Exchange Commission (CVM), a Federal agency that is part of the Ministry of Finance. Among its principal responsibilities is the monitoring of organised over-the-counter markets (assets traded outside the Stock Exchange), publicly traded companies, stock exchange and futures markets, in addition to fund and equity administrators.

The Commission also regulates the issue of shares on the BM&FBovespa, the Brazilian Stock Exchange. The CVM has the duty of protecting the interests of investors and ensuring the dissemination of information concerning securities that are traded and the companies that issue them (Securities and Exchange Commission (CVM) 2012).

3 Stock Market Reforms in Brazil

Before 1960, Brazilians invested mainly in real assets, avoiding investments on public or private bonds. To an economic environment of growing inflation – mainly from the end of the 1950's – a legislation that imposed limits of 12% per year to which maximum interest rate charges were added, was passed. This was called the Usura Act, which used to limit the development of an active capital market (Ministry of Finance, Brazil, 2012). With the enactment of a new government to power in 1964, national building became a priority; and a programme aimed at great national economy reforms began. Amongst these reforms was the restructuring of the financial market, that came with the enactment of new laws and the revision of existing laws governing the stock market (Ministry of Finance, Brazil, 2012).

Among the laws that brought greatest importance for the stock market were: i) Law No. 4.537/64. This instituted the monetary adjustment through the creation of the Brazilian Readjustable National Treasury Bond; ii) Law No. 4.595/64, named the Banking Reform Act, which reformulated the entire national financial intermediation system and created the National Monetary Council and the Central Bank; and iii) Law No. 4.728, dated 14 April 1965, the first Capital Market Act, which disciplined the capital market and established measures for its development (Ministry of Finance, Brazil, 2012).

The introduction of the above mentioned legislation resulted in many alterations in the stock market, such as: the reform of the legislation governing the transactions in the stock market; the transformation of public fund brokers into Legal Entity Brokerage Firms; forcing the practice to become professionalised; and the creation of Investment Banks, of which the main task was to develop the investment fund industry (Ministry of Finance, Brazil, 2012).

With the specific goal to regulate and inspect the securities market, the Stock Market Exchanges, the financial intermediaries and the public-held companies – functions that are nowadays carried out by the CVM – a directive board in the Central Bank was created: the Capital Market Board of Directors. At the same time, some incentives for investment in the stock market were introduced, including the Funds 157 of 1967, created by Decree Law No. 157. The Funds 157 was an option given to taxpayers to use part of their income tax owed at the time of the Income Tax Filing, to purchase shares of public-held companies' share funds.

According to the Brazil Ministry of Finance (2012), the injection of Decree Law 157 as a long-term instrument was a logical method, in order to lift refinancing pressures off management and allow concentration on production.

With the great volume of resources taken to the stock market in the late 1960s, mainly due to tax incentives created by the Federal Government, there was a rapid demand growth for stocks on the investors' side, without accounting for a simultaneous increase of new stock issuance by the companies. That chained a "boom" in the Rio de Janeiro Stock Exchange between December 1970 and July 1971. There was a strong speculative tide; and the stock values continued to rise (Ministry of Finance, Brazil, 2012).

After stock values reached their highest point in July 1971, a process of cashing in the profits by more experienced and knowledgeable investors, who started to sell their investments began. Although the speculative tide, known as the "boom of 1971," did not last long, its consequences yielded many years of a depressed market for some stock offerings – from extremely fragile companies without any commitment to their stockholders during that time. These companies generated large losses; and they left the stock market's reputation tarnished for a long time (Ministry of Finance, Brazil, 2012).

In 1975, the stock market witnessed a recovery of the quotations, beginning in 1975, due to the new investment of resources; which included the technical reserves of the insurance companies, the resources from the social contribution fund, additional to the Fund 157, and the creation of the Investment Companies Decree Law No. 1401, to collect external resources, and to invest in the stock market.

As time passed, many other incentives were adopted, aimed at incentivising market growth. Such incentives included: tax exemption of the gains obtained in the stock markets; and the possibility of income-tax deduction of part of the amounts invested in the public subscription of stocks. These amounts were derived from capital increases and the financial programmes at interests subsidised by the BNDES, the

Brazilian Development Bank, to the subscribers of stocks publicly allocated.

In 1976, during the stagnation condition and stock-market recovery attempts, two new legal rules – still in effect today – were issued. Law No. 6.404/76 was issued. This was known as the New Corporations Act, which aimed at modernising the rules that guided the corporations that were, until then, regulated by an old Decree-Law from 1940. Also issued within the same year was the Law No. 6.385/76, the second Capital Market law that, among other innovations, created the Securities and Exchange Commission (CVM) and introduced into the market a governmental institution, exclusively destined to regulate and develop the capital market, to inspect the Stock Exchanges and the public-held companies (CVM, 2012).

In spite of all those incentives, the stock market did not present the expected growth, even though, in some lapses, it had experienced an increase in the number of companies going public (BM&FBovespa, 2012). From the mid-1990s, with the acceleration of the opening-up of the Brazilian economy, the volume of foreign investors operating in the Brazilian market increased. Furthermore, some Brazilian companies began to access the foreign markets through the listing of their stocks on foreign stock-market exchanges, mainly the New York Stock Exchange, in order to capitalise through the issuing of securities abroad (Ministry of Finance, Brazil, 2012).

As time passed, the Brazilian stock market started to lose space to other markets, due to the lack of protection for the minor stockholder, and due to uncertainties as regards the financial investments. The lack of transparency in management and the absence of adequate instruments for the supervision of the companies influenced the perception of risk, and, consequently, increased the companies' capital cost.

In order to put a stop to this negative development, some institutional and governmental initiatives were implemented in the last few years, aimed at ensuring improvements in the corporate governance practices of Brazilian companies. This led to the approval of Law No. 10.303/01 and the creation of the New Market, as well as the 1 and 2 Corporate Governance Levels by the then São Paulo Stock Exchange (Bovespa) (Ministry of Finance, Brazil, 2012).

Towards the end of the1990s, it was evident that the Brazilian stock market was facing a tremendous crisis. The number of companies listed in Bovespa had dropped from 550 in 1996 to 440 in 2001. The volume exchanged after reaching US$191 billion in 1997 retreated to US$101 billion in 2000, and to US$65 billion in 2001 (Ministry of Finance, Brazil, 2012). Furthermore, many companies were going private, and only a few were going public.

However, as of 2003, there was a reheating of the market, increasing three times the average daily business deal volume recorded by BOVESPA prior thereto. Furthermore, the average volume exchanged in BOVESPA increased in practice three times from 2004 within this same period (Ministry of Finance, Brazil, 2012). In 2010, BM&FBOVESPA released a document that consolidated the trading rules.

Technological innovation was part of the Brazilian stock-market reform process. Since the 1960s, the stock market has constantly evolved with the help of technology, such as the introduction of computer-based systems, mobile phones and the internet. In 1972, an automated system for the dissemination of information online and in real-time, through an ample network of computer terminals, was implemented. At the end of the 1970s, a telephone trading system was introduced in Brazil.

In 1997, a new system of electronic trading, known as the Mega Bolsa, was implemented successfully. The Mega Bolsa extends the potential volume for the processing of information; and it allows the Exchange to increase its overall volume of activities. Currently, BM&FBOVESPA is a fully electronic exchange (BM&FBovespa, 2012).

4 Stock Market Growth in Brazil

After a “lost decade” of debt crisis, stagflation, and sharply decreasing growth rates in the 1980s, Brazil initiated a modernisation strategy in the 1990s that, inspired by the Washington consensus, replaced import-substitution subsidies with international competition, and inaugurated a comprehensive privatisation process. The reduction in the barriers to foreign capital enabled a major influx of foreign investment into the country, and the São Paulo Stock Exchange saw a record increase in its market capitalisation compared to that of previous periods (Gilson et al., 2010).

The ratio of stock market capitalisation to GDP in Brazil jumped from an average of 8% in the 1980s to an average of 26.3% between 1993 and 1998, while the ratio of trading volume to GDP increased from 2.7% to 15.6% in the same period. By the early 1990s São Paulo’s Stock Exchange had become the only active stock exchange in Brazil, as a scandal involving default by a major speculator in the options market in the late 1980s had led to the demise of the Rio de Janeiro Stock Exchange (Gilson et al., 2010).

Although the market capitalisation was rising, there was a steady decline in the number of publicly listed firms and in the liquidity of local markets. As a result, the trading volume on the Bovespa fell from more than $191 billion in 1997 to $101 billion in 2000 and to $65 billion in 2001 (BM&FBovespa, 2012). By December 1997, a single company, the telecom firm, accounted for almost 60% of Brazil’s market-trading volume. This was, in large part, a direct consequence of a government-sponsored reform to the Corporations Law in 1997, the Federal Law 9,457/1997 (Gilson et al., 2010).

This new law removed even the limited statutory protection then available to minority shareholders upon control sales, such as statutory appraisal rights at book value, and the weakened mandatory bid rule. This was done in order to allow the federal government to maximise its privatisation proceeds (Gilson et al., 2010).

The expectation of minority expropriation depressed share prices, which in turn, deterred further offerings. Brazilian companies that still sought equity investments at reasonable valuations did so by circumventing local markets and listing almost exclusively on the New York Stock Exchange (NYSE), thereby piggybacking on more protective NYSE listing requirements, and on the application to foreign issuers of elements of U.S. securities laws that accompanied NYSE listing. However, a NYSE listing provided an alternative to only a limited range of firms; such a listing was too expensive for small Brazilian issuers, which then lacked not only equity financing, but also long-term debt financing options in the private sector (Gilson et al., 2010).

There have been impressive improvements in the performance of the Brazilian stock market. As of July 2007, around BRL23 billion (roughly USD12 billion) of initial public offers (IPOs) were launched to the market in 12 months. In 2004, seven companies performed IPOs amounting to BRL4.5 billion; while for 2005, eight companies performed IPOs amounting BRL5.4 billion. In 2006, a sharp rise was observed in the number of companies accessing the equities market – when around BRL30 billion was tapped using this type of instrument. This represented an overall record in terms of capital raised in BOVESPA since the early 1990s. This activity ranked the Brazilian Stock Exchange as second in terms of capital-raised activity among emerging markets (National Treasury, Brazil, 2007).

Total trading value increased by 66% in 2006, compared to 2005, reaching BRL599 billion, the highest ever registered as at that date. The new market raised the daily average to BRL2.4 billion, 51% higher than the BRL1.6 billion registered in 2005; and it stood at BRL4 billion in June 2007. The number of trades increased 39%, levelling off at 21.5 million in 2006, against 15.5 million in 2005 (National Treasury, Brazil, 2007).

The number of listed companies in the Brazil stock market has been on the increase, although marginally. In 2006, there were 394 listed companied at Bovespa. The number increased to 419 in 2007; and to 594 in 2012 (BM&FBovespa, 2012).

The growth of the stock market in Brazil can also be explained by using the stock-market capitalisation of listed companies, the total value of stocks traded, and the turnover ratio of stocks traded. The stock market size of Brazil, as measured by stock-market capitalisation, was stagnant in the late 1980s – with a sharp decline in 1990 – and it started improving in 1993, reaching 34.6% of GDP in 1994, before it deteriorated to 19% in the following year.

The year 2007 registered a peak in market capitalisation of 100.3% of GDP – the highest thus far in the history of Brazil’s stock market. After the year 2007, the stock market suffered a heavy blow, as the market capitalisation fell below the 2003 level. This was due to the global financial crisis that started in 2008. Despite the economic meltdown, the Brazilian stock market showed a quick recovery by registering a market capitalisation of more than 70% of GDP in 2009, from 35.7% in 2008.

In terms of market liquidity, as measured by total value traded/GDP and turnover ratio, Brazil had a less-liquid market during the late 1980s. However, as with stock-market capitalisation, the total value of stocks traded and the turnover ratio fluctuated upwards, forming a zigzag trend from 1988 to 1997. Thereafter, the two declined, only to pick up momentum in 2002, and reach a peak in 2007 – thereby creating a deep and wide trough between 1997 and 2007 – before resuming its yo-yo pattern (World Bank, 2012).

Despite the depth and sophistication of Brazilian financial markets, Brazil's stock market could still explore its possibilities. Its trading had been once quite highly concentrated in the stocks of just a few companies, even though this trend has been reversed lately, reflecting the fact that family groups (or, in the case of recently privatised firms, small consortia of controlling shareholders), continue to control even the most publicly traded private enterprises (National Treasury, Brazil, 2007).

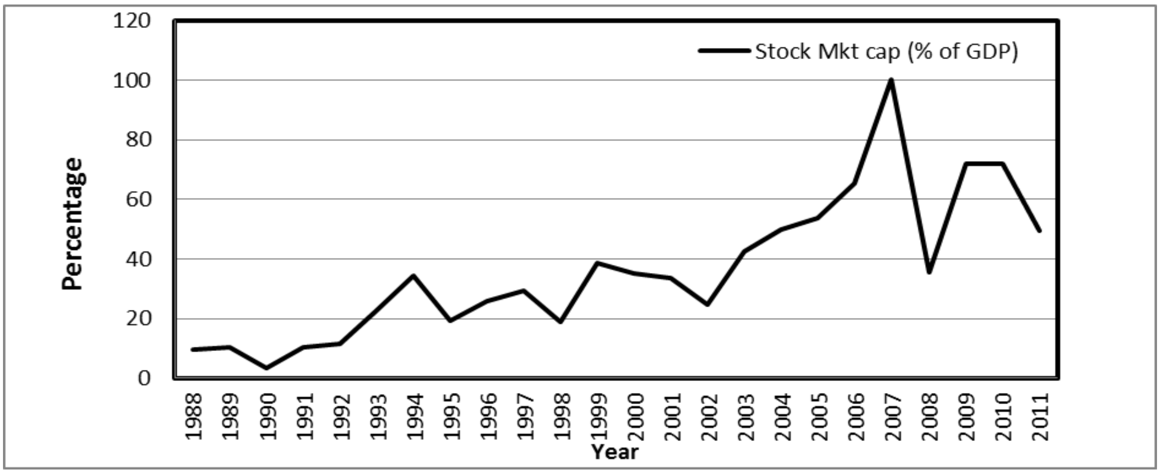
Figures 1 - 3 track the Brazilian stock market growth during the period 1988-2011.

5 Some Challenges Facing the Stock Market Development in Brazil

During the last decade, Brazil has achieved substantial progress in its stock market development. The menu of available financial instruments has been expanded; the market infrastructure has been reformed and strengthened; and a diversified investor base has been built. This was a high-priority agenda for the authorities, and the reforms were introduced in close co-operation with the market participants.

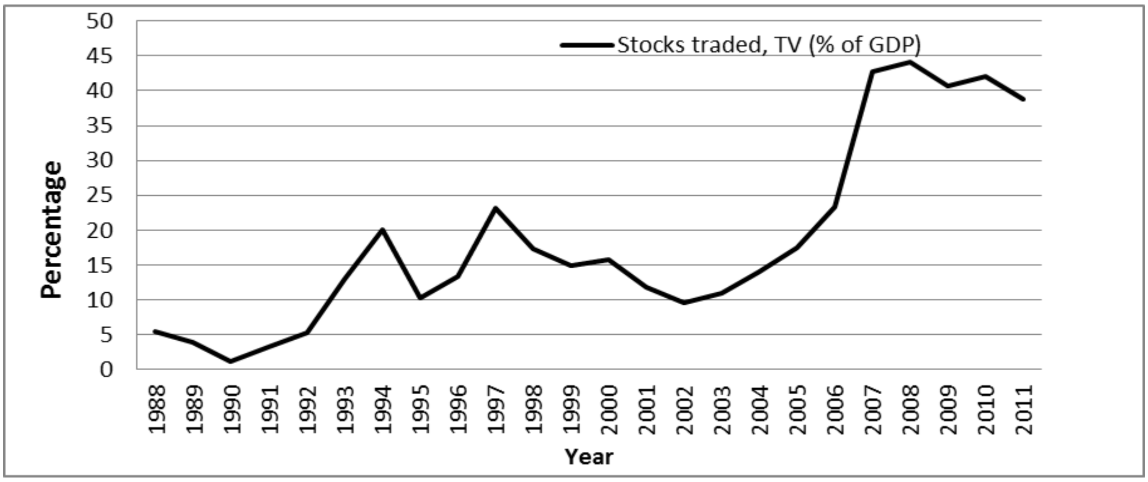
Nonetheless, challenges remain; and the continued development process will need careful management (Park, 2012). Despite the country’s great potential – the large size of the economy, its sound fiscal management, and the large mutual fund industry – Brazil’s stock market is still facing a number of challenges. These include: the still-prevalent short-term indexation, still-low liquidity in the secondary market, and managing the role of Brazil’s National Development Bank (BNDES), (Park, 2012).

Figure 1. Trends in Stock Market Capitalisation in Brazil (1988-2011)



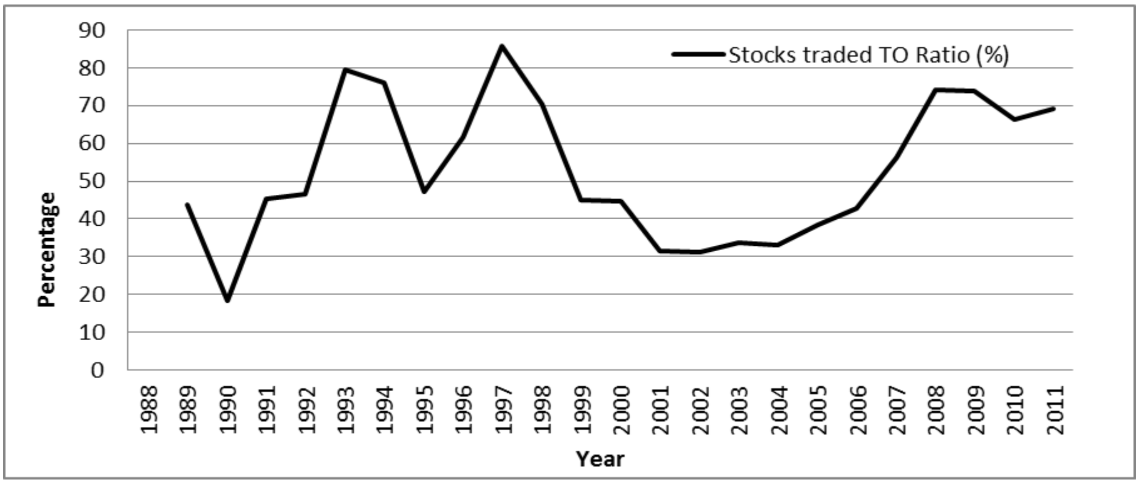
Source: World Bank Development Indicators (2012)

Figure 2. Trends in Total Value of Stocks Traded in Brazil (1988-2011)



Source: World Bank Development Indicators (2012)

Figure 3. Trends in Turnover Ratio of Stocks Traded in Brazil (1988-2011)



Source: World Bank Development Indicators (2012)

Brazil's stock market remains focused on short-term instruments; and this poses a developmental challenge. Most financial contracts among residents are indexed to the overnight interest rate, although there has been a gradual trend towards increasing duration in recent years. This largely short-term structure reflects long-standing fundamental factors, including a legacy of past high inflation, which is typically associated with a more short–term focus for investing. Thus, high levels of short-term interest rates, and the degree of indexation of debt holders contribute to a low secondary market turnover ratio, constraining the overall market development (IMF, 2012).

Although Brazil's equity market has grown rapidly in terms of both market capitalisation and transaction volumes, it still has a small number of listings. Following a record 76 offerings (IPO and follow-on) in 2007, the number of offerings in the past three years has stabilised at lower levels, in part reflecting the weak global financial conditions (IMF, 2012). The growth in market capitalisation and the number of listed companies has slowed down in recent years. Cross-country comparisons show that the number of listed companies is still lower than those of Brazil's peers in Asia. Indeed, the share of the top 10 companies in market capitalisation has remained over 50% in recent years, showing a limited diversification of the issuer base, in line with the experience in several other emerging markets (IMF, 2012).

Another challenge facing the stock market in Brazil is the high number of foreign investors, as significant players in the equity market. Foreigners are majority investors, especially, in the public-offering market. Most non-resident investors are domiciled in the U.S. and Europe, introducing an important link between the offering market and conditions overseas. In August and September 2011, for example, there was no share issuance – several public offerings were cancelled or postponed due to investors' concerns on contagion risks from the Euro zone (IMF, 2012).

Although BNDES has traditionally had an important role in the Brazilian financial system, its role needs to be managed, according to the IMF (2012). BNDES has typically been a major source of long-term financing for industry and infrastructure. During the crisis, it played an important counter-cyclical role, as private bank credit fell off sharply in 2009 – during the height of the Lehman-related global tensions. However, the size of BNDES' balance sheet has doubled – from 7.5% of GDP in 2007 to over 15% of GDP in 2011.

The challenge is that BNDES has traditionally provided significant financing to large strategic companies in Brazil, notwithstanding the fact that these companies also have recourse to alternate sources of financing. Recently, its resource distribution has shifted at the margin towards its more-traditional development-banking operations. According to the IMF (2012), looking further ahead, BNDES could gradually shift towards promoting the development of long-term stock/capital markets, by playing a role in standardisation and market making (e.g., co-financing of infrastructural projects with the private sectors) in the long-term financing market (IMF, 2012).

6 Conclusion

This paper has discussed the origin of the Brazilian stock market, the reforms undertaken to develop the market, the growth of the stock market, as well as the challenges facing the Brazilian stock market development. Brazil had several stock exchanges, which gradually emerged over the years; and which have now gradually acquired one another and/or merged over the years to form one big stock exchange: the BM&FBovespa. This is one of the world's largest stock exchanges. In order to boost the performance and significance of the Brazilian stock market, a number of reforms targeting the stock market have been implemented over the years. Amongst these reforms was the restructuring of the financial market that came with the enactment of new laws and the revision of existing laws governing the stock market. The Capital Market laws, among other innovations, created the Securities and Exchange Commission (CVM), tasked with the monitoring and regulation of the stock market in Brazil. Technological innovation was part of the Brazilian stock market-reform process as well. Following the reforms, the Brazilian stock market has developed significantly in terms of market capitalisation, the total value of stocks traded, and the turnover ratio. Even the number of listed companied in the Brazil stock market has been on the increase. Thus, Brazil has achieved substantial progress in stock market development. The menu of available financial instruments has been expanded, the market infrastructure has been reformed and strengthened, and a diversified investor base has been built. Despite the country's great potential – the large size of the economy, the sound fiscal management, and the large mutual-fund industry – Brazil's stock market still faces a number of challenges, when compared with the stock markets in developed economies, such as the USA, UK, Japan, etc. Some of these include: i) the short-term indexation when compared to those of the developed economies; ii) a relatively low liquidity in the secondary market; and iii) a small number of listings when compared with those of developed economies.

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