

Financial Development and Globalization in Emerging Economies

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Chief Economist Office-Latin American and the Caribbean



Introduction

- ✚ Based on Flagship Report, Chief Economist Office for Latin America (Latin American centered)
- ✚ Here, focus on basic trends in EMs (emerging markets)
 - Where they stand on basic and new indicators of financial development
 - Latin American perspective, with lessons for other EMs
 - No focus on one particular region
 - Some scattered evidence given time constraints
- ✚ Whole study is much broader
 - Access
 - Agency problems with financial intermediation
 - Issues in financial development and role of the state
 - Issues in globalization
 - Macro-prudential regulation over the cycle
 - Issues in regulation and supervision

Introduction

- ✚ Why stock taking useful?
- ✚ Efforts to build solid, deep, and complete financial systems
 - Foster financial intermediation across segments
 - Latin America at the forefront
- ✚ Now, long history of reforms, innovation, and fine tuning
 - Since early 1990s, pro-market reforms
 - E.g., large scale privatizations, creation of institutional investors, large foreign bank entry, liberalization
 - Since early 2000s, prudent macro policies that foster growth, stability, and resilience
 - E.g., adoption of int'l standards and reduction of mismatches

Introduction

- ✚ Fundamental faith on free markets and competition
- ✚ Emulate US (“democratic”) model of financial development
 - Dispersed ownership: households saving and investing in firms
 - Institutional investors channeling funds
 - Firms raising funds in strong, public capital markets (avoid banks and obtain risk and long-term capital)
 - Market discipline
 - Financial development positively correlated with income
- ✚ Role of the state
 - Provide enabling environment
 - Regulate and supervise to safeguard soundness of financial sector
 - Avoid crowding out
- ✚ What are the returns and limits to this approach?

Introduction

- ✚ In the past, somewhat pessimistic view – no simple prescriptions
- ✚ Up to early 2000s, outcomes did not match expectations and reforms
- ✚ But more reasons to be more hopeful this time
- ✚ Recent comments and new developments in financial markets
 - Better macro performance and fine tuning of reforms
 - Development of local markets, with explicit effort by public sector
 - Reduction in mismatches
 - Good performance and resilience in recent years
 - Many EMs have become attractive once more
- ✚ Plus global crisis, large capital flows, and discussions around G20 and int'l financial architecture gathering interest
- ✚ Thus, poised for new stock taking exercise

Introduction

- ✦ Here, try to provide bird's-eye view by synthesizing new, disperse evidence
- ✦ Also provide many details for the interested readers
- ✦ Make several comparisons that can shed new light
- ✦ Problem of benchmarking
 - Before/after analysis?
 - Developed countries? Which ones? US? Germany?
 - Which regions and countries among developing ones?
 - Some benchmarking done for financial development indicators
- ✦ Stock taking exercise
 - Broad and systematic comparisons across selected countries and regions of the world
 - More detailed data and comparisons within Latin America
 - Mostly over past two decades

Introduction

- ✚ Focus on domestic financial development, and capital markets
- ✚ Compare to globalization process
 - Essential given large extent of globalization
 - And nature of financial intermediation in integrated markets
 - Two aspects: dom. vs. foreign investors; dom. vs. foreign markets
- ✚ Focus on banks and capital markets (bond and equity markets)
- ✚ Shed light on borrowers' and creditors' side
- ✚ Different indicators
 - Standard (e.g., over GDP) and relative sizes of different markets
 - Indicators capturing the changing nature of financing
 - Illustrate issues like currency and maturity composition, liquidity, concentration, firms' access to financing, among others

Comparisons of Key Markets Around the World

- ✚ **G7:** Canada, France, Germany, Italy, Japan, UK, and US
- ✚ **Other Advanced Economies:** Australia, Finland, Israel, New Zealand, Norway, Spain, and Sweden
- ✚ **Asia:** Indonesia, South Korea, Malaysia, Philippines, and Thailand
- ✚ **China**
- ✚ **India**
- ✚ **Eastern Europe:** Croatia, Czech Republic, Hungary, Lithuania, Poland, Russia, and Turkey
- ✚ **LAC7:** Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Uruguay

Summary of Findings

- ✚ Mixed, nuanced picture from all the data gathered
- ✚ While financial systems have developed in the last two decades, they have also become significantly more complex
- ✚ Important dimension: transition from a mostly bank-based model to a more complete and interconnected model
 - Non-bank markets (bonds and equities) have increased in absolute and relative sizes
 - New markets are also developing
 - Non-bank institutional investors now play more central role
 - The number and sophistication of participants (including cross-border investors) are increasing
 - Banks connected to capital markets and institutional investors

Summary of Findings

- ✚ The nature of financing also changing slowly
- ✚ In general, but with exceptions, towards the better
 - Increased maturity of bonds (both private and public sectors in domestic and foreign markets)
 - Decline in the extent of dollarization of loans and bonds in LAC
 - Even some issues of local currency bonds in foreign markets
- ✚ Local developments accompanied by two-way process of internationalization, with some particular aspects
- ✚ Big chunk of the globalization happened in the 1990s
- ✚ But now, safer integration
 - EMs net creditors in debt and net debtors in equity
- ✚ Different stories for bond and equity markets
 - Bonds domestically and equity abroad

Summary of Findings

- ✚ Despite all new developments, large heterogeneity across regions and countries
 - Somewhat different stories in different regions, but some general trends
 - Many of the improvements concentrated in certain areas, in some countries (e.g., in Latin America, Brazil and Chile)
- ✚ Several shortcomings in several important EMs
 - Bank credit has stagnated in various countries
 - Firm financing from banks has decreased in relative terms
 - Bond markets have expanded, but with limitations
 - In banks and bonds, public sector still capture significant share
 - Equity markets still small, illiquid, and concentrated in large firms
 - Institutional investors sophisticated and large in several countries, but with a more limited role than previously thought

Implications of Findings

- ✚ Far away from model of dispersed ownership and participation
- ✚ Supply versus demand effects
 - Constraints not on lack of available funds
 - Many assets available for investment not purchased by institutional investors or foreigners, which hold large resources
 - Institutional investors seem to shy away from risk
 - Incentives to asset managers and the overall functioning of financial systems does not contribute to expectations
- ✚ Many firms not becoming public: Control? Costs?
 - Substantial financing through retained earnings and banks
- ✚ Regulations do not seem to be the main obstacle
- ✚ Several challenges ahead
 - E.g. role of financial intermediaries, growing public savings, spillovers to all firms, access to finance

Outline of Presentation

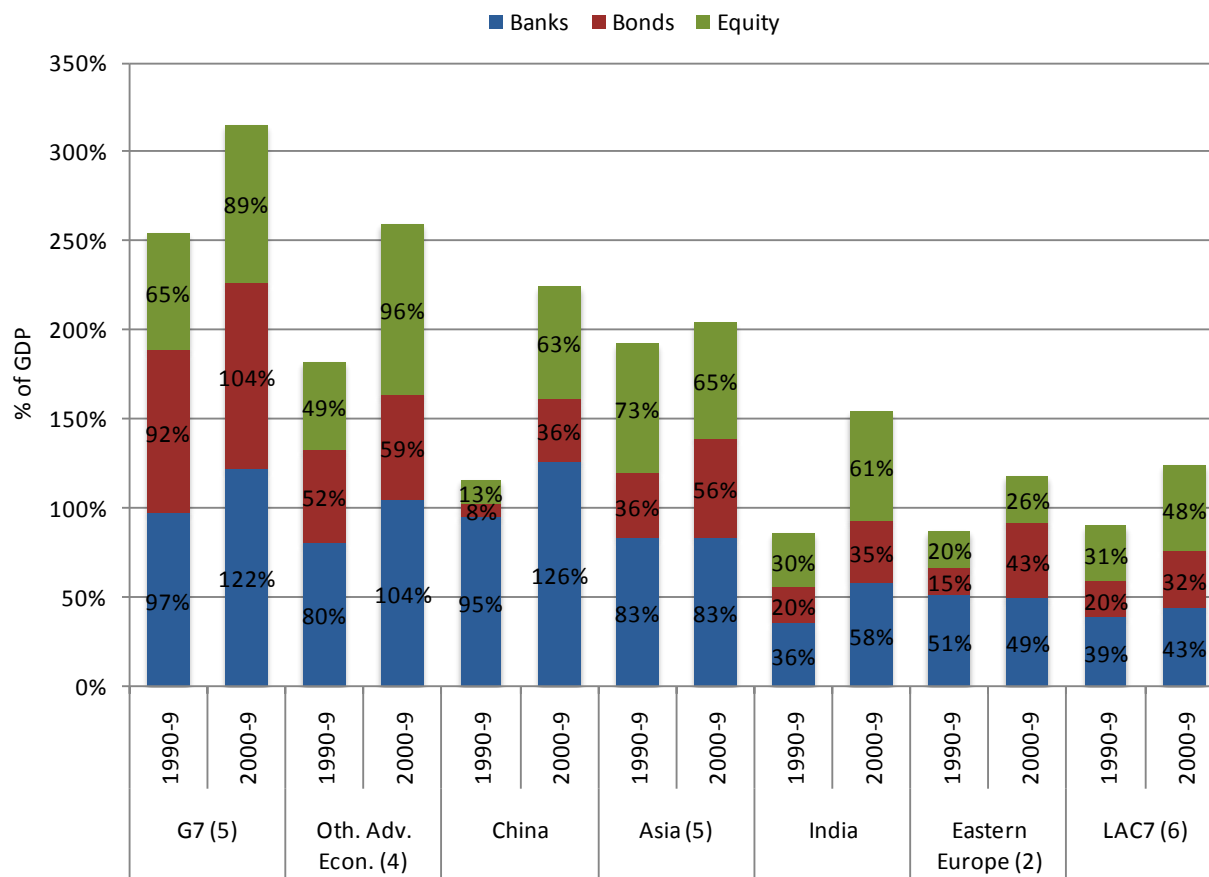
1. Market size
2. Structure of financial systems
3. Financial globalization
4. Conclusions

Outline of Presentation

1. Market size
2. Structure of financial systems
3. Financial globalization
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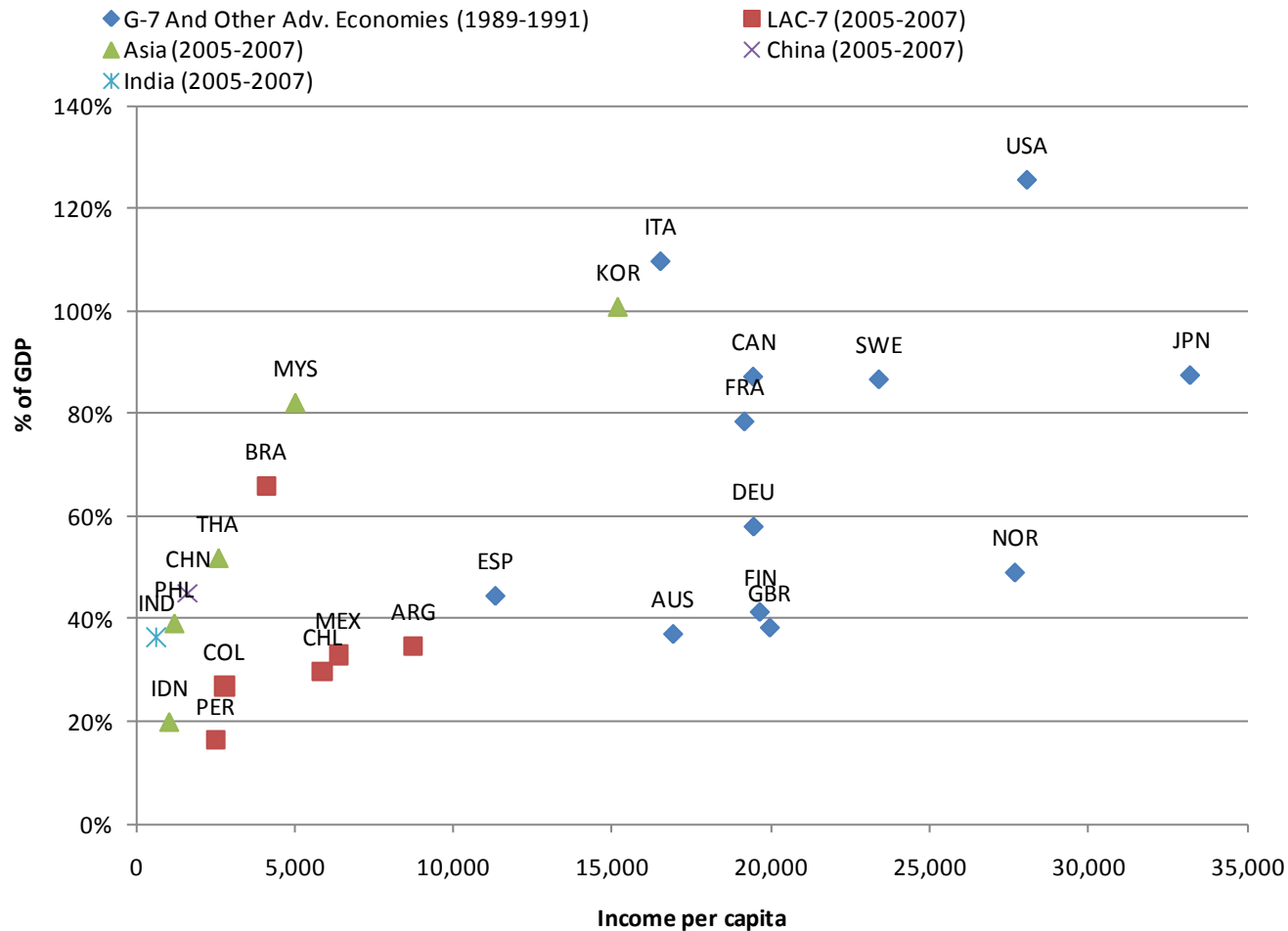
Relative Size: All Markets Increased over GDP

Size of Domestic Financial System

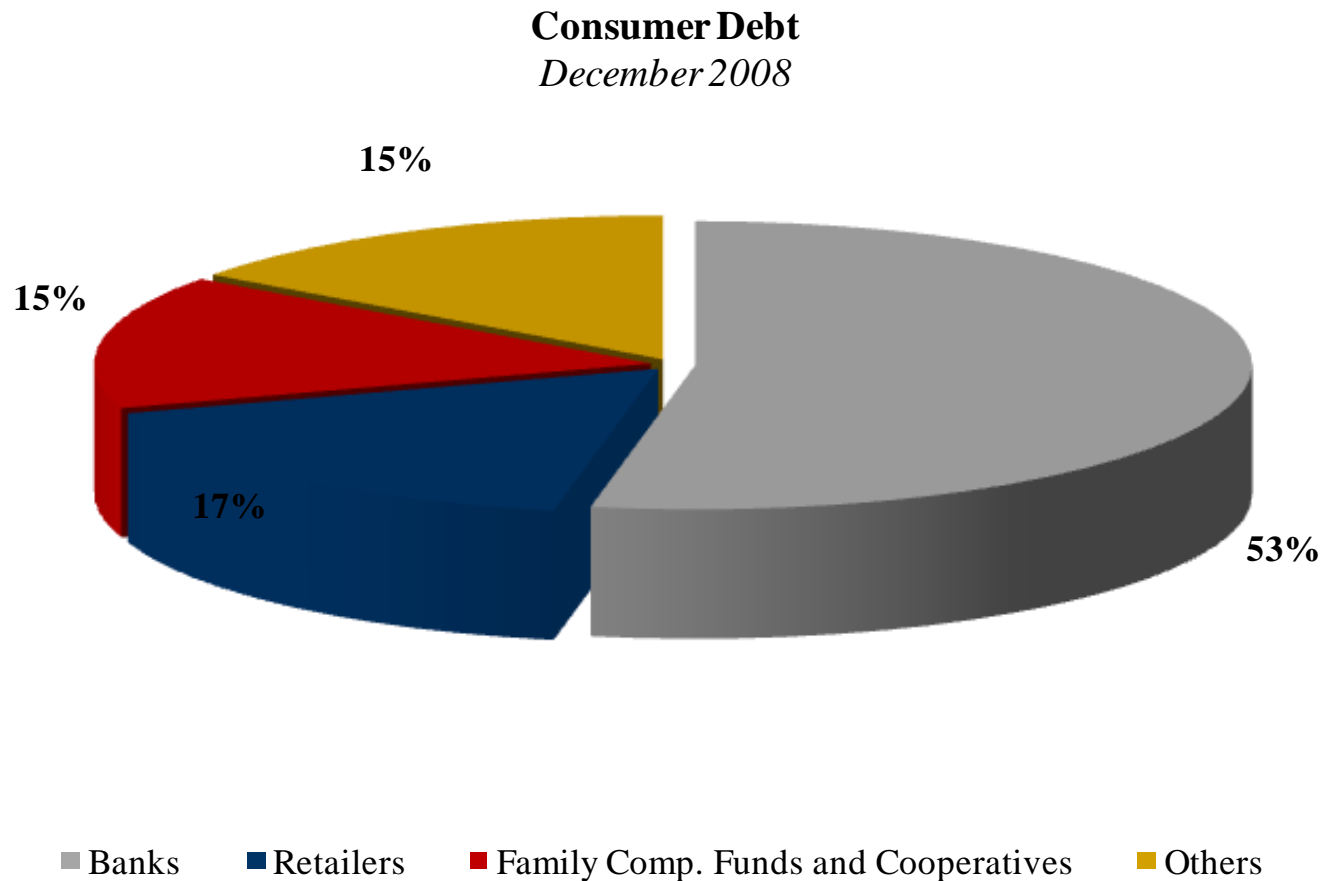


Market Size: Some Way to Go in Bonds

Total Bonds Outstanding and Income per Capita



Retail Stores: Hold Significant Fraction of Debt

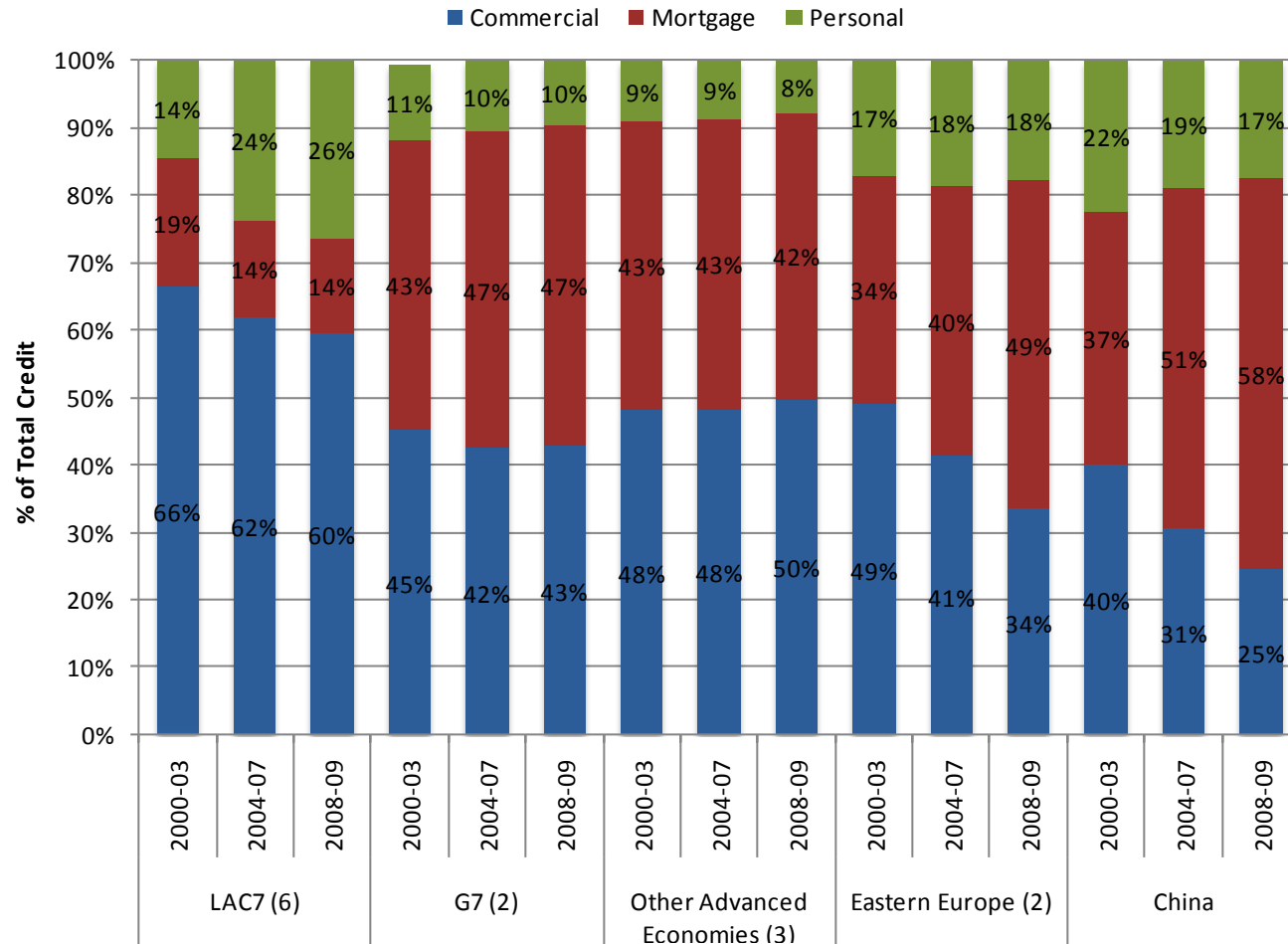


Outline of Presentation

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Banks: Decline in Corporate Lending and Different Shares of Mortgages

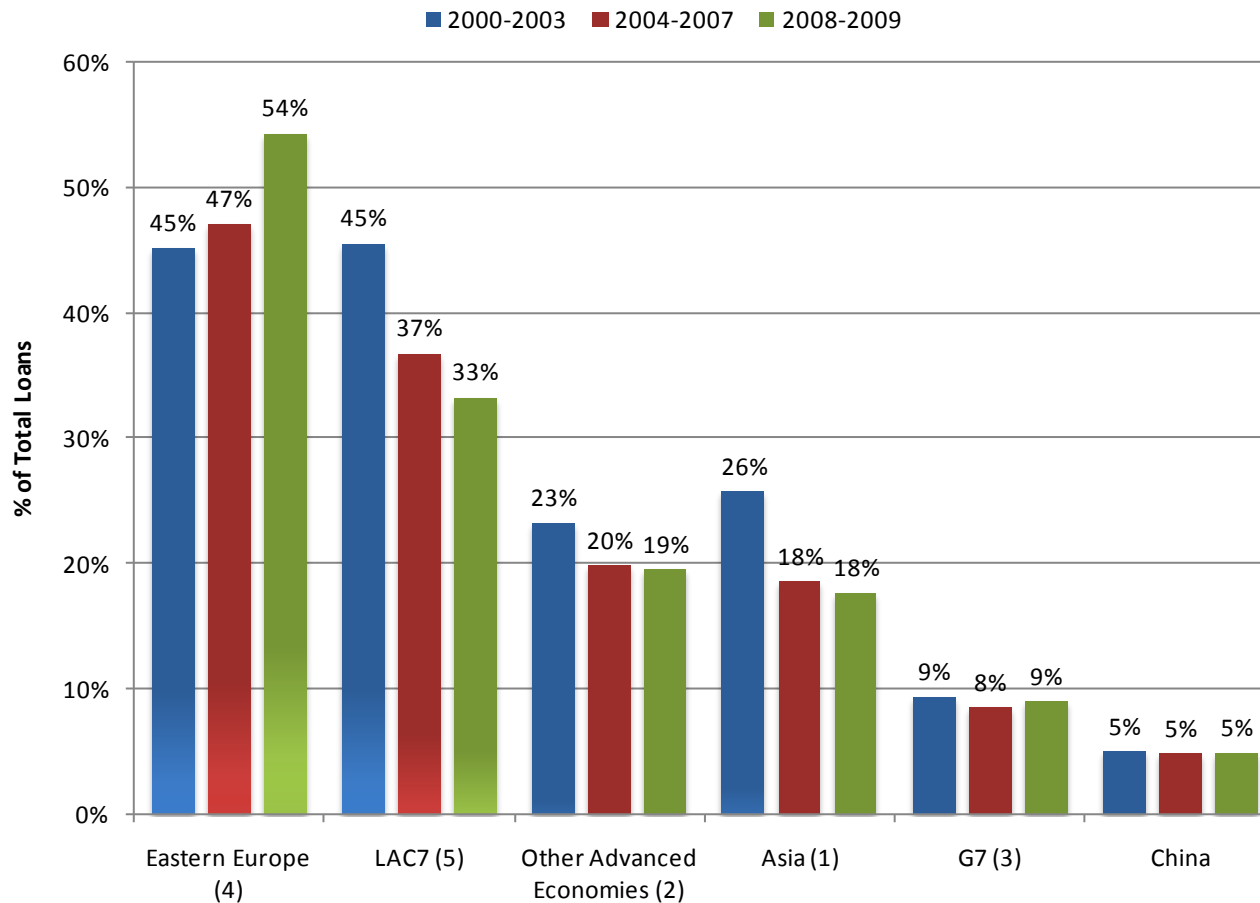
Credit Composition



Source: Local Sources

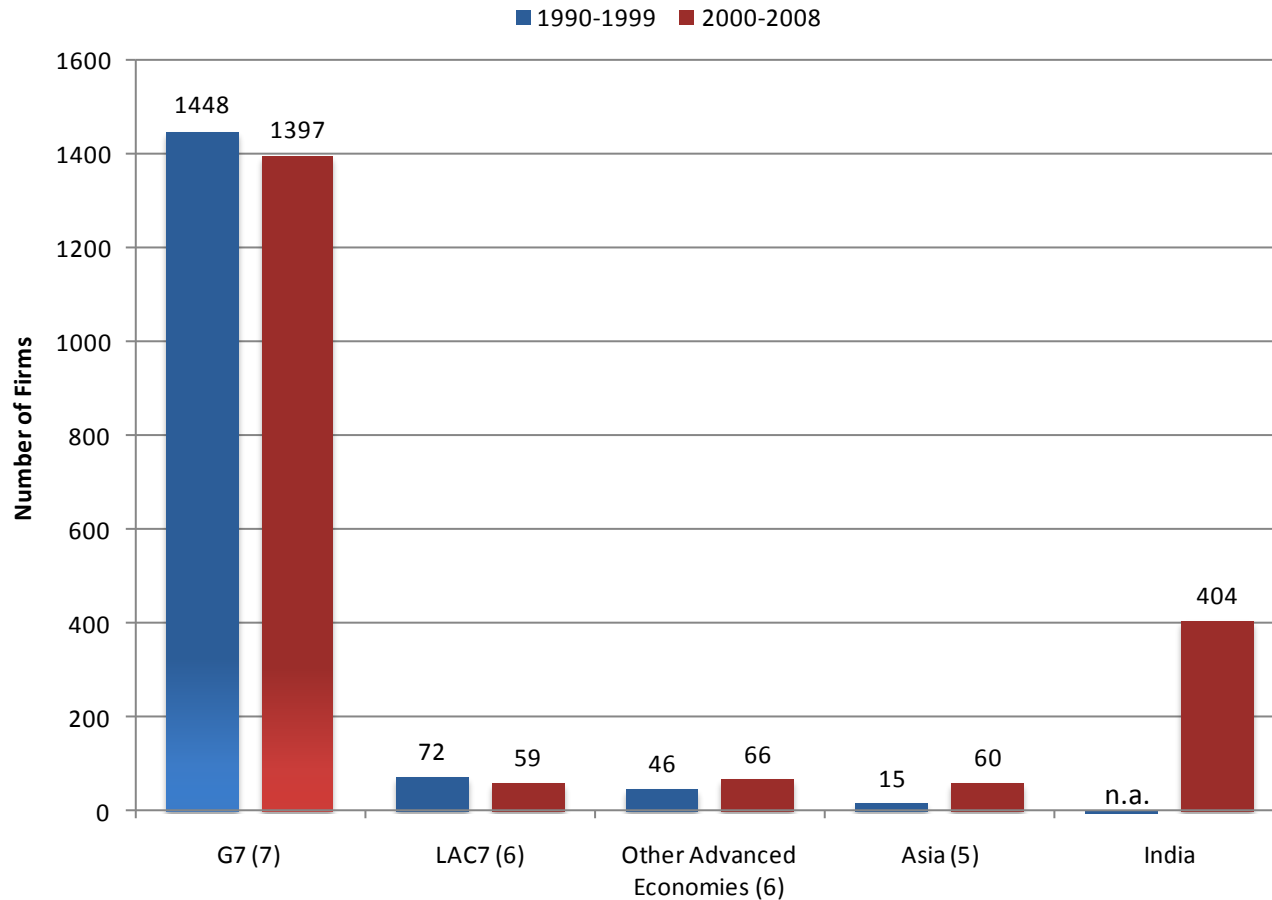
Banks: Decline in Dollarization

Banking System - Loan Dollarization Share of Foreign Currency Loans



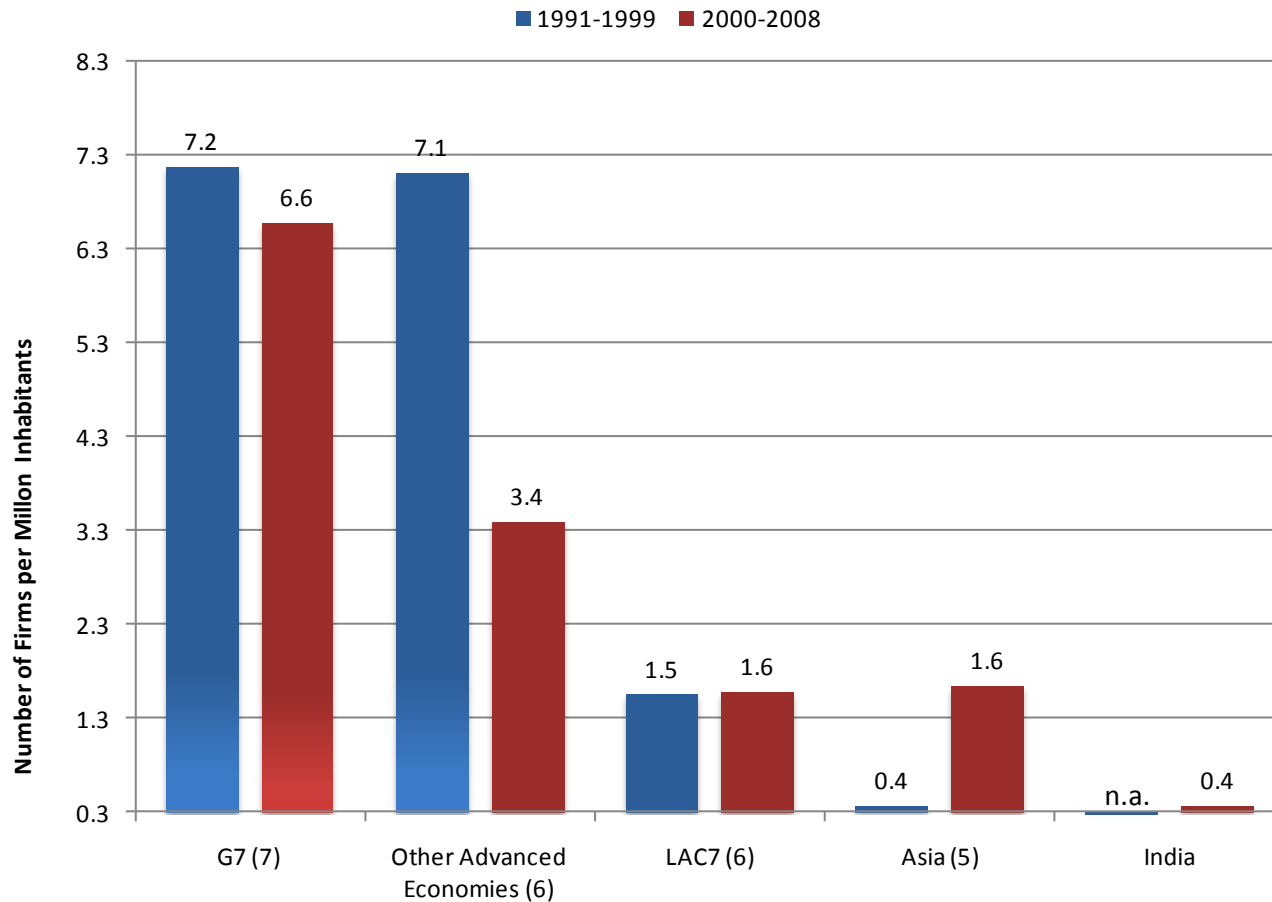
Bonds: Few Firms Issuing

Average Number of Firms Issuing Bonds



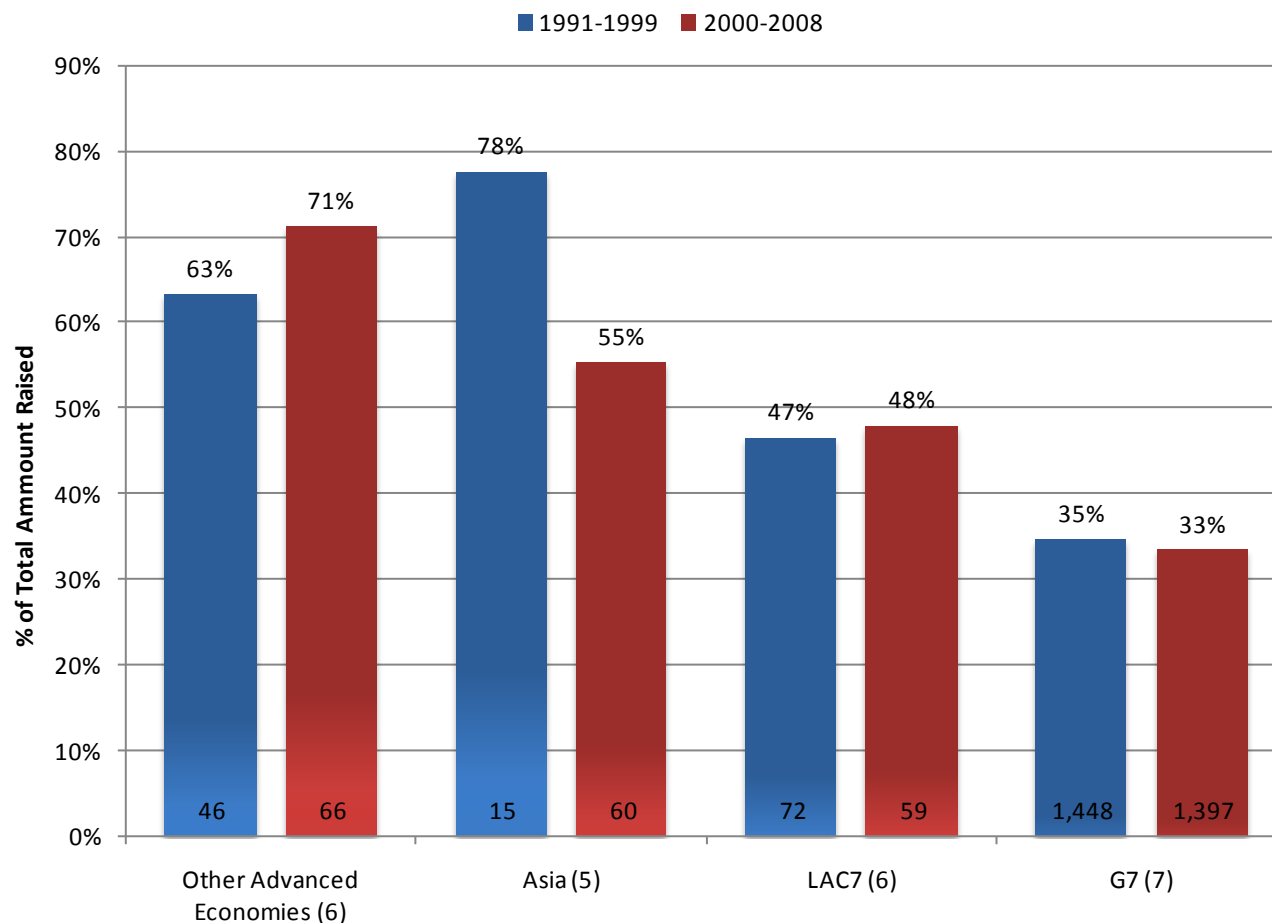
Bonds: Few Firms Issuing

Average Number of Firms Issuing Bonds
Per Million Inhabitants



Bonds: Few Issues Capture Significant Share

Concentration in Private Bond Markets Amount Raised by Top 5 Issues

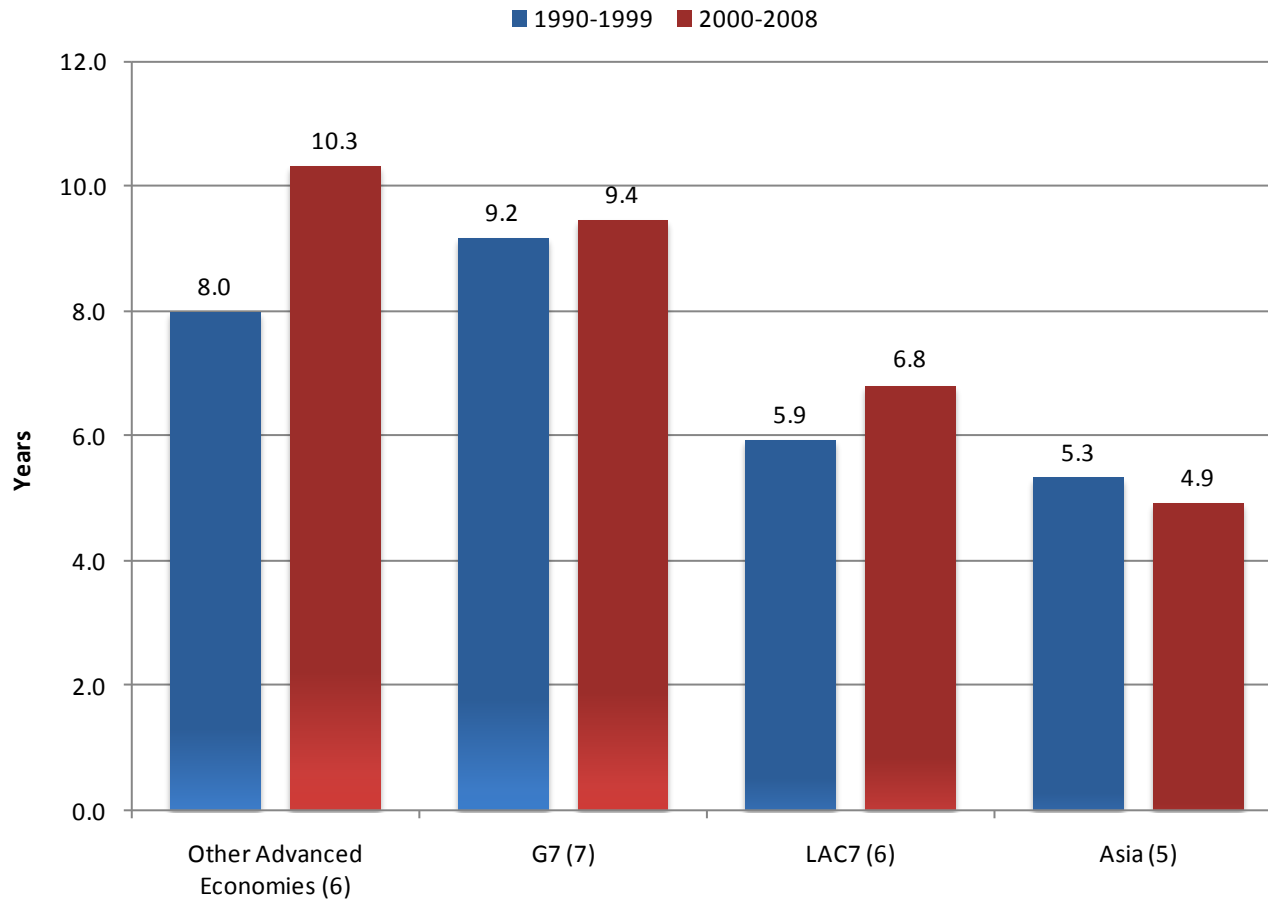


Source: SDC

Note: Numbers in the base of the bars represent the average number of yearly issues

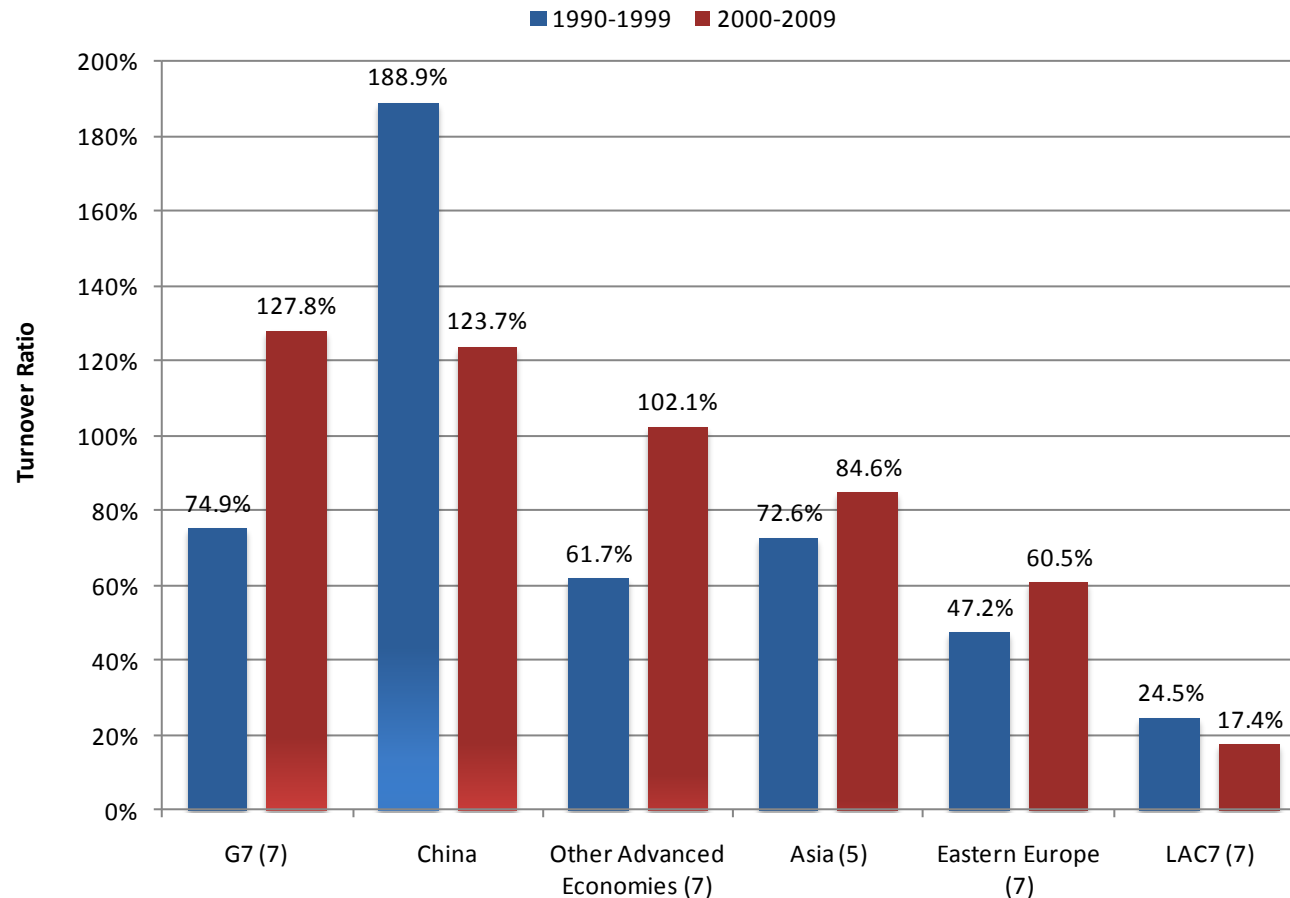
Bonds: Longer Maturity

Average Maturity in Private Debt at Issuance



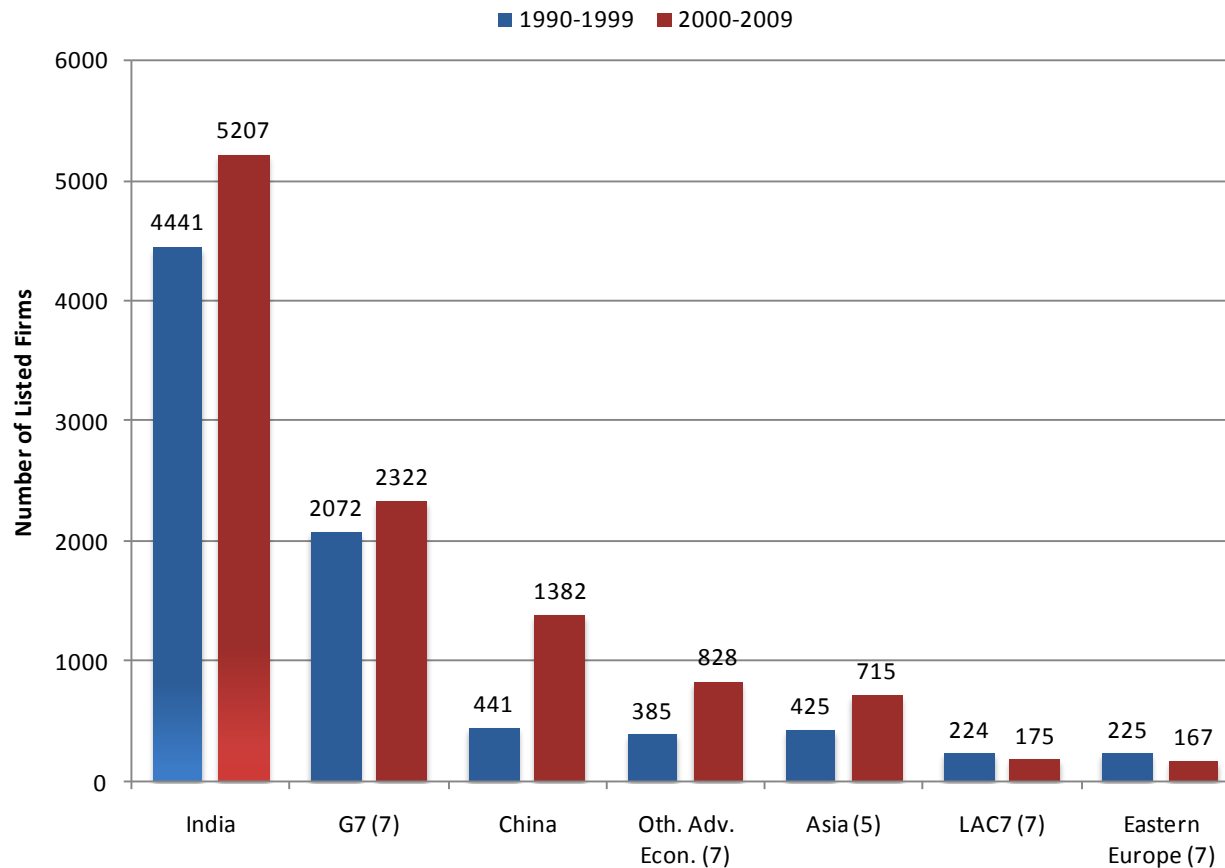
Equity: Trading Shows a Different Picture than Market Size (Which Appears Booming)

Trading Activity – Turnover Ratio



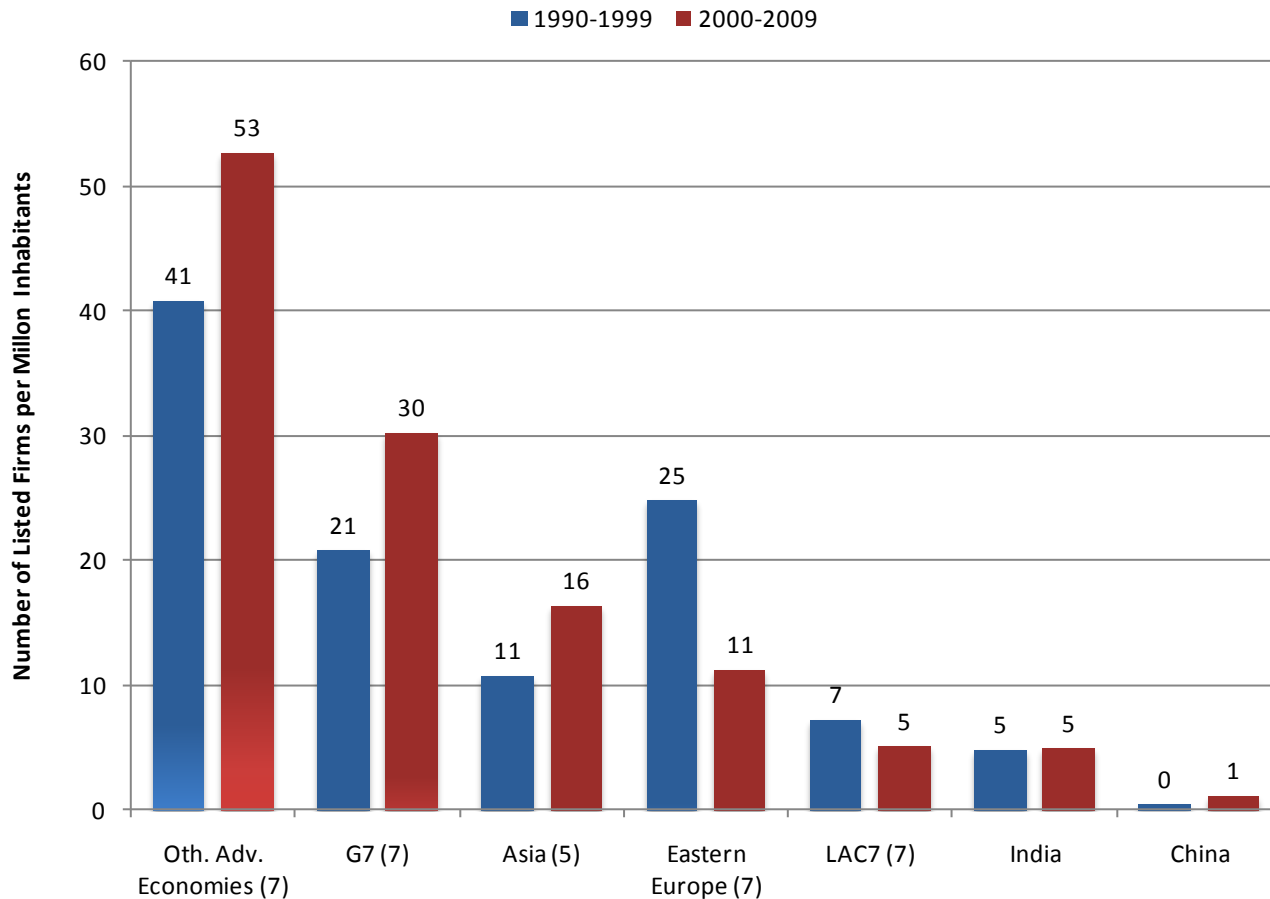
Equity: Few Firms Participating

Number of Listed Firms



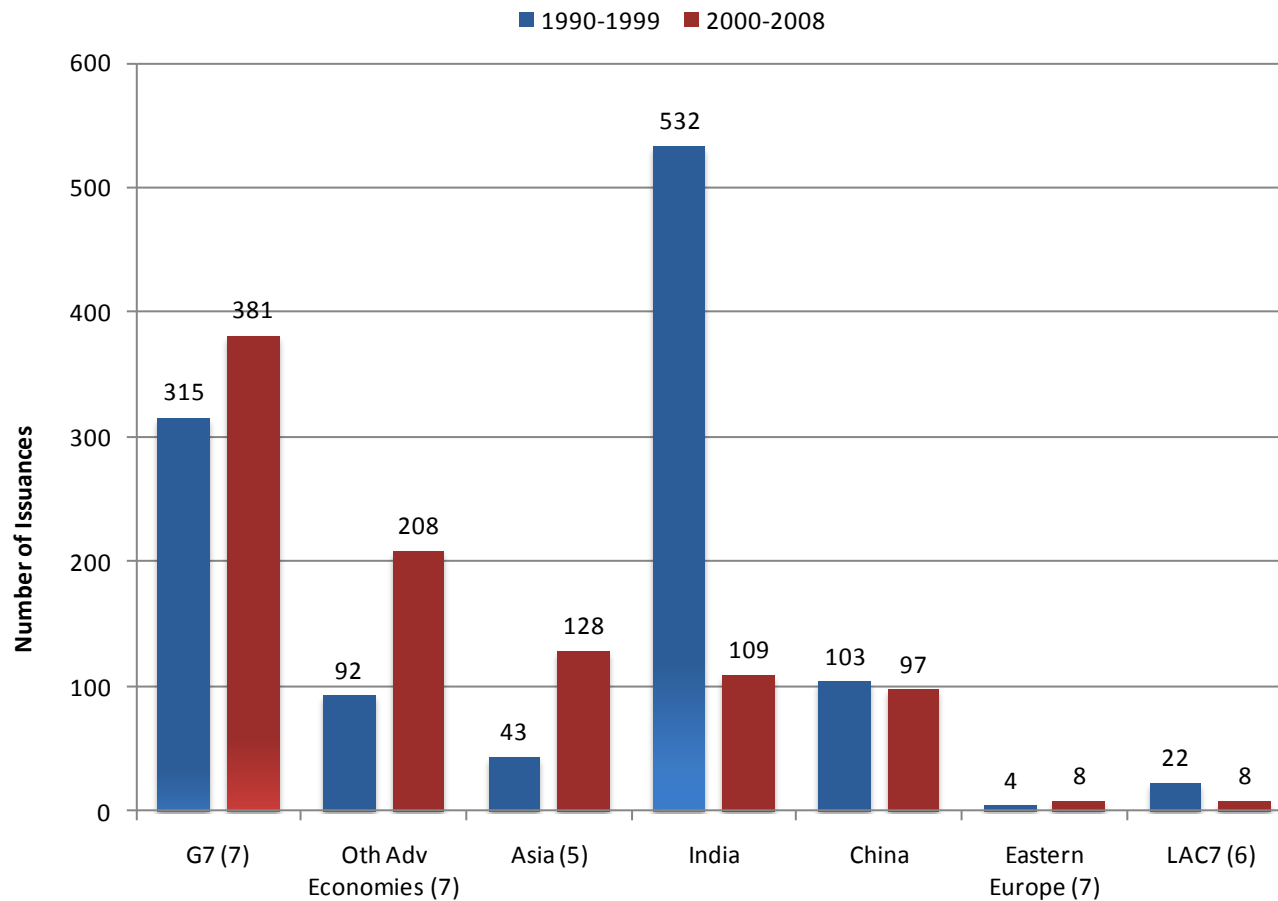
Equity: Few Firms Participating

Number of Listed Firms per Million Inhabitants



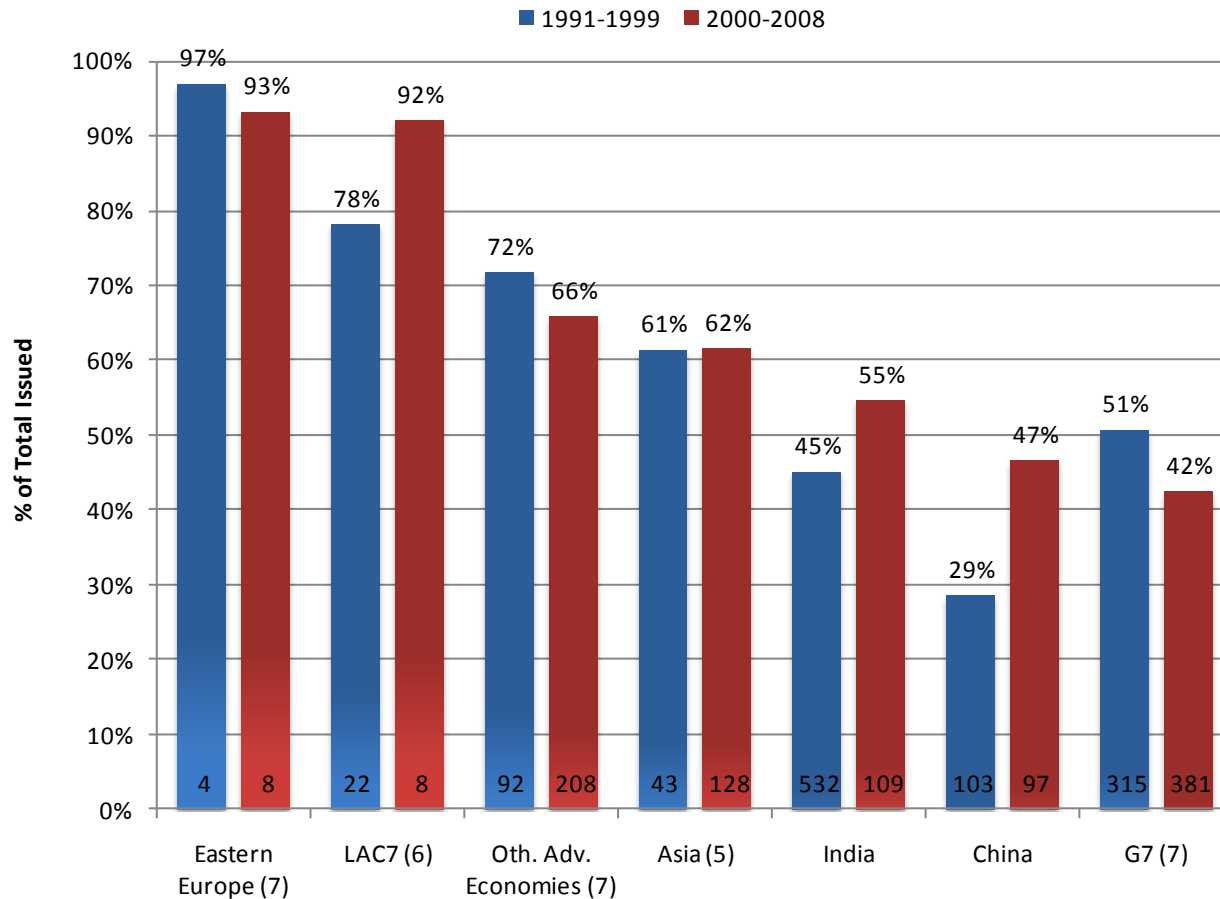
Equity: Fewer Firms Raising Capital

Average Number of Capital Raisings



Equity: Also Shows Significant Concentration

Concentration in Domestic Equity Markets Share of Amount Raised by Top 5 Issues

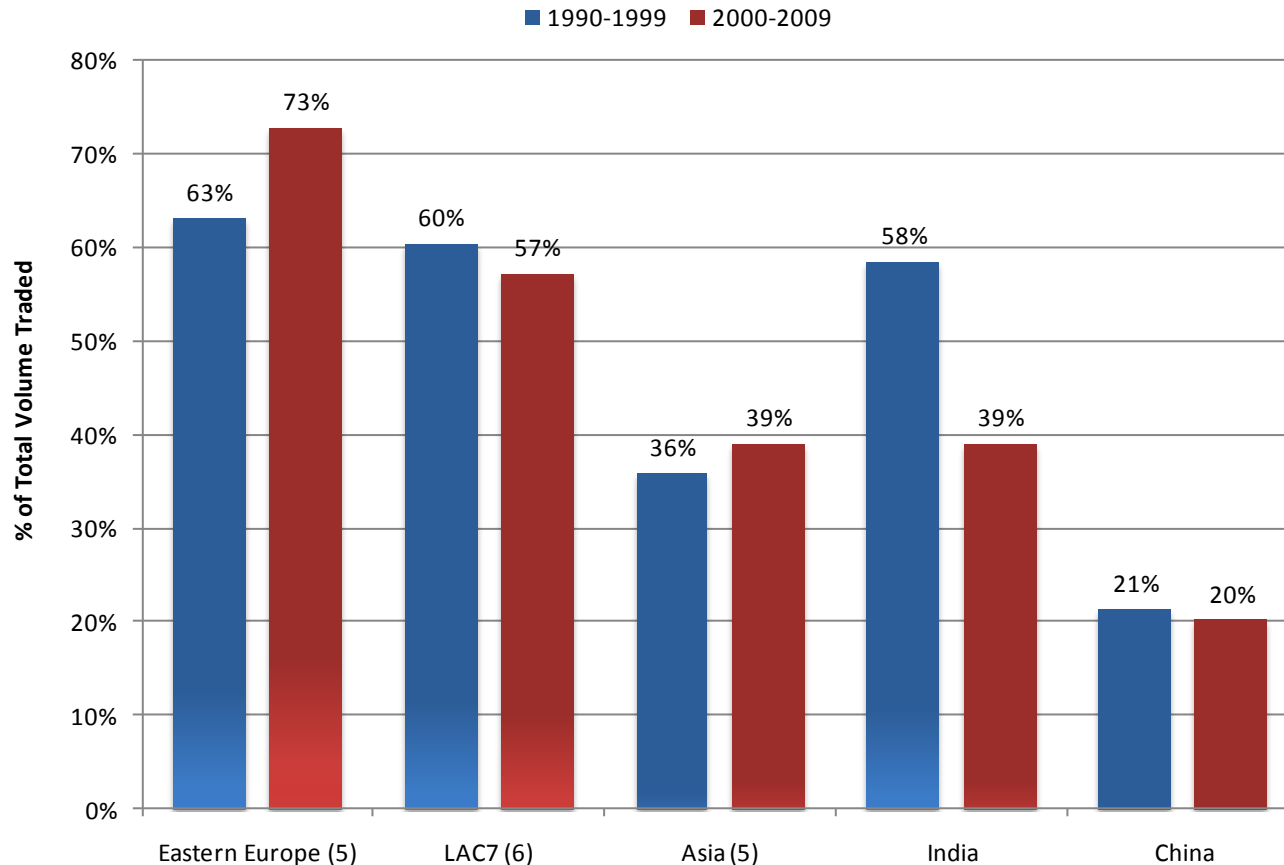


Source: SDC

Note: Numbers in the base of the bars represent the average number of yearly issues

Equity: Also Shows Significant Concentration

Concentration in Domestic Equity Markets Share of Value Traded by Top 5 Companies

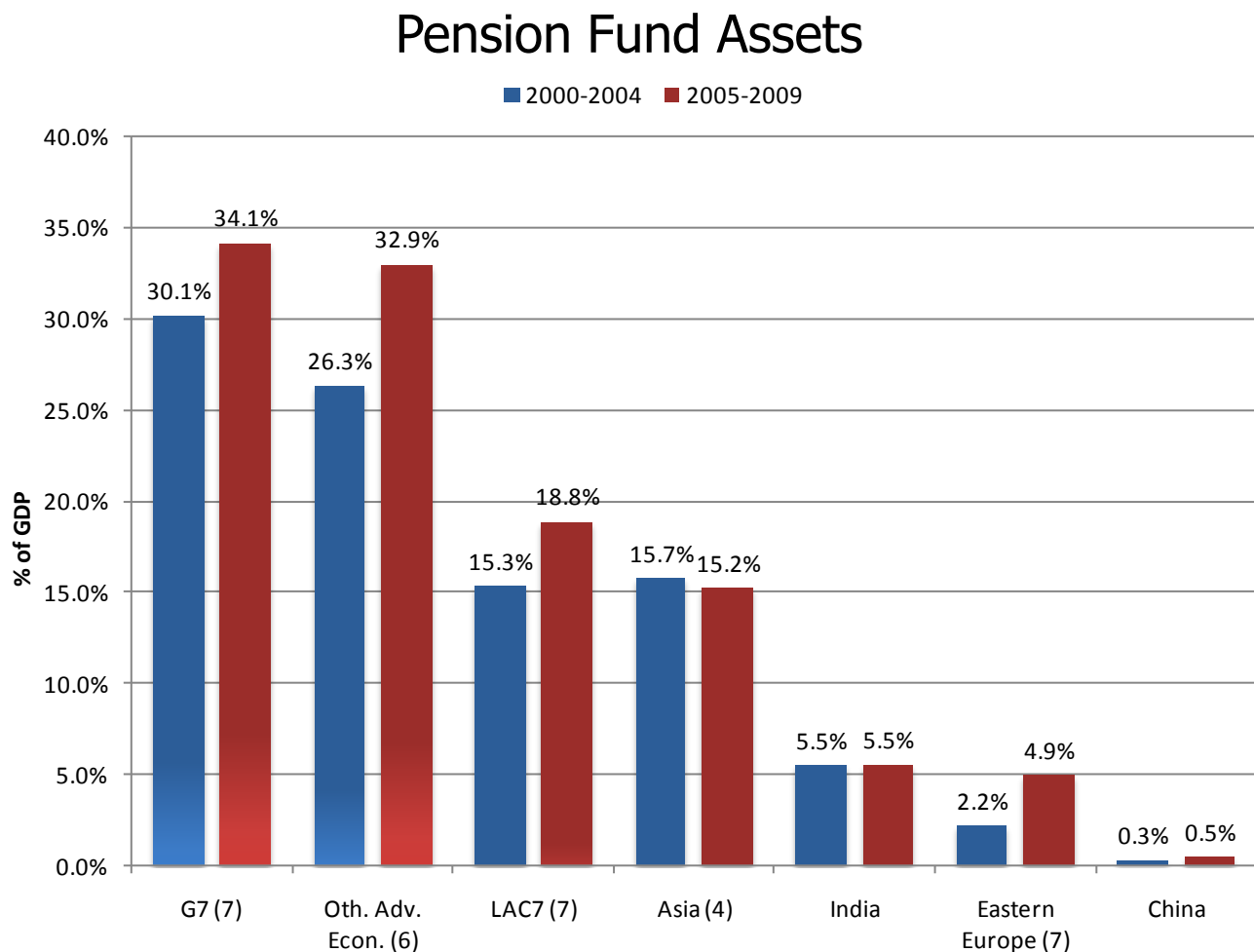


Larger Firms Ones Using Home Capital Markets

Domestic

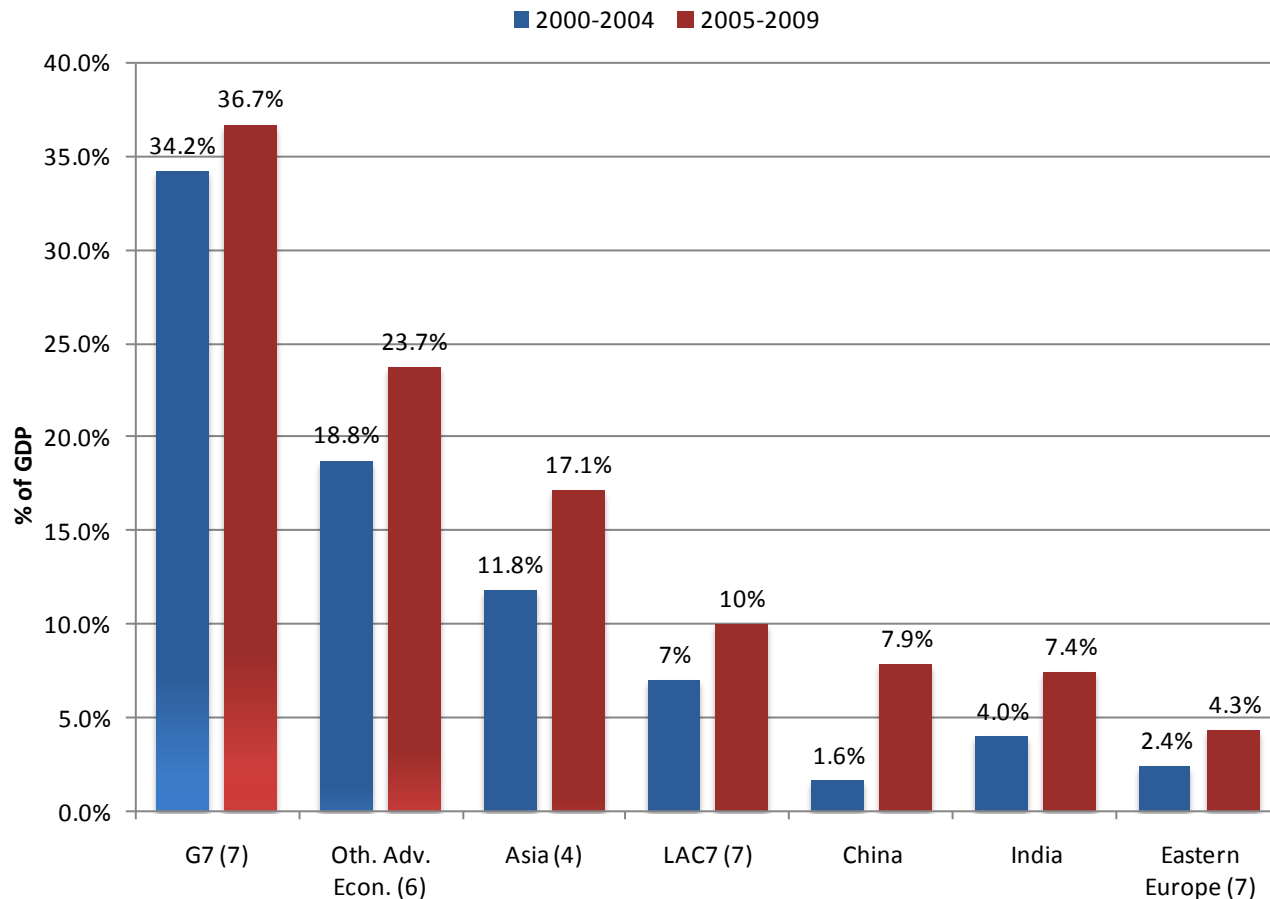
		1990s					2000s				
		No Issues		Bonds or Equity Issuances		Difference between Any Issues and No Issues	No Issues		Bonds or Equity Issuances		Difference between Any Issues and No Issues
		No. of Firms	Average	No. of Firms	Average		No. of Firms	Average	No. of Firms	Average	
Total Assets	Argentina	50	0.4	37	2.0	1.6 ***	74	1.0	24	1.6	0.6
	Brazil	327	1.2	82	2.5	1.3 **	363	1.1	79	2.9	1.8 ***
	Chile	131	0.6	62	0.7	0.1	156	0.7	55	1.6	0.9 **
	Colombia	20	0.5	16	1.0	0.4	34	0.7	8	2.6	1.9 ***
	Mexico	107	1.1	66	3.2	2.1 ***	130	1.6	42	5.3	3.7 ***
	Peru	58	0.4	12	0.8	0.4	73	0.3	16	1.0	0.6 *
Foreign Sales/	Argentina	6	5.8	12	13.0	7.2	17	26.0	4	17.2	-8.7
	Brazil	52	6.5	42	12.8	6.3	103	6.5	41	8.1	1.6
	Chile	23	0.9	16	5.7	4.8 *	6	43.4	6	44.6	1.2
	Colombia	12	3.2	6	0.3	-2.9	4	12.2	1	39.8	27.6
	Mexico	16	13.7	25	14.8	1.1	22	29.8	17	25.0	-4.8
	Peru	23	5.3	6	0.0	-5.3	12	20.8	3	1.9	-18.9
Net Sales	Argentina	32	18.7	31	33.8	15.2	72	21.7	24	19.1	-2.6
	Brazil	116	249.9	68	358.1	108.2 **	356	13.9	79	23.4	9.5 ***
	Chile	82	15.1	48	17.9	2.8	159	9.5	54	13.3	3.8
	Colombia	18	25.6	16	29.4	3.8	34	21.3	8	10.5	-10.8
	Mexico	76	23.7	62	32.6	8.8	128	6.6	43	18.5	11.9 **
	Peru	37	24.5	10	37.6	13.0	73	7.3	16	1.5	-5.8

Pension Funds Gaining Ground



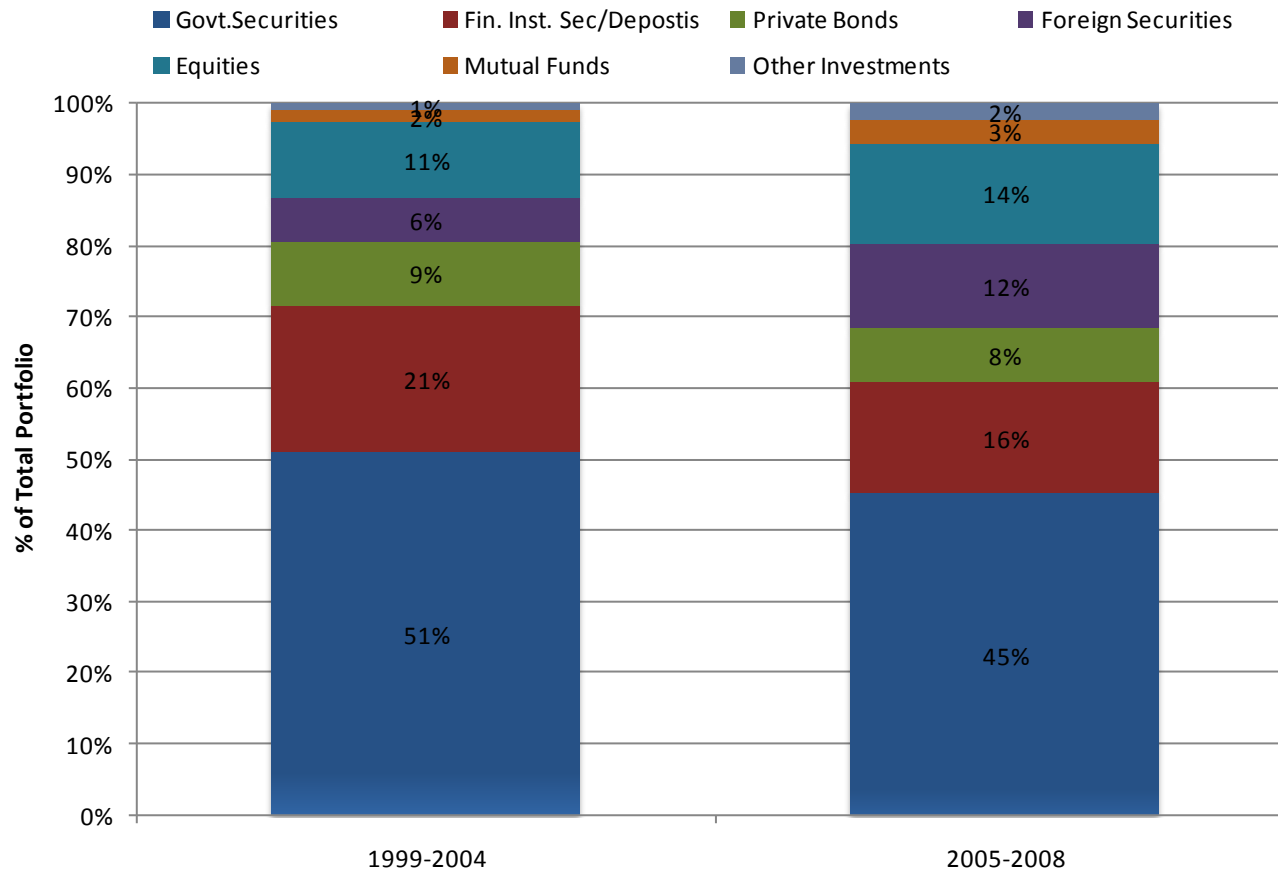
Mutual Funds Growing Too

Mutual Fund Assets



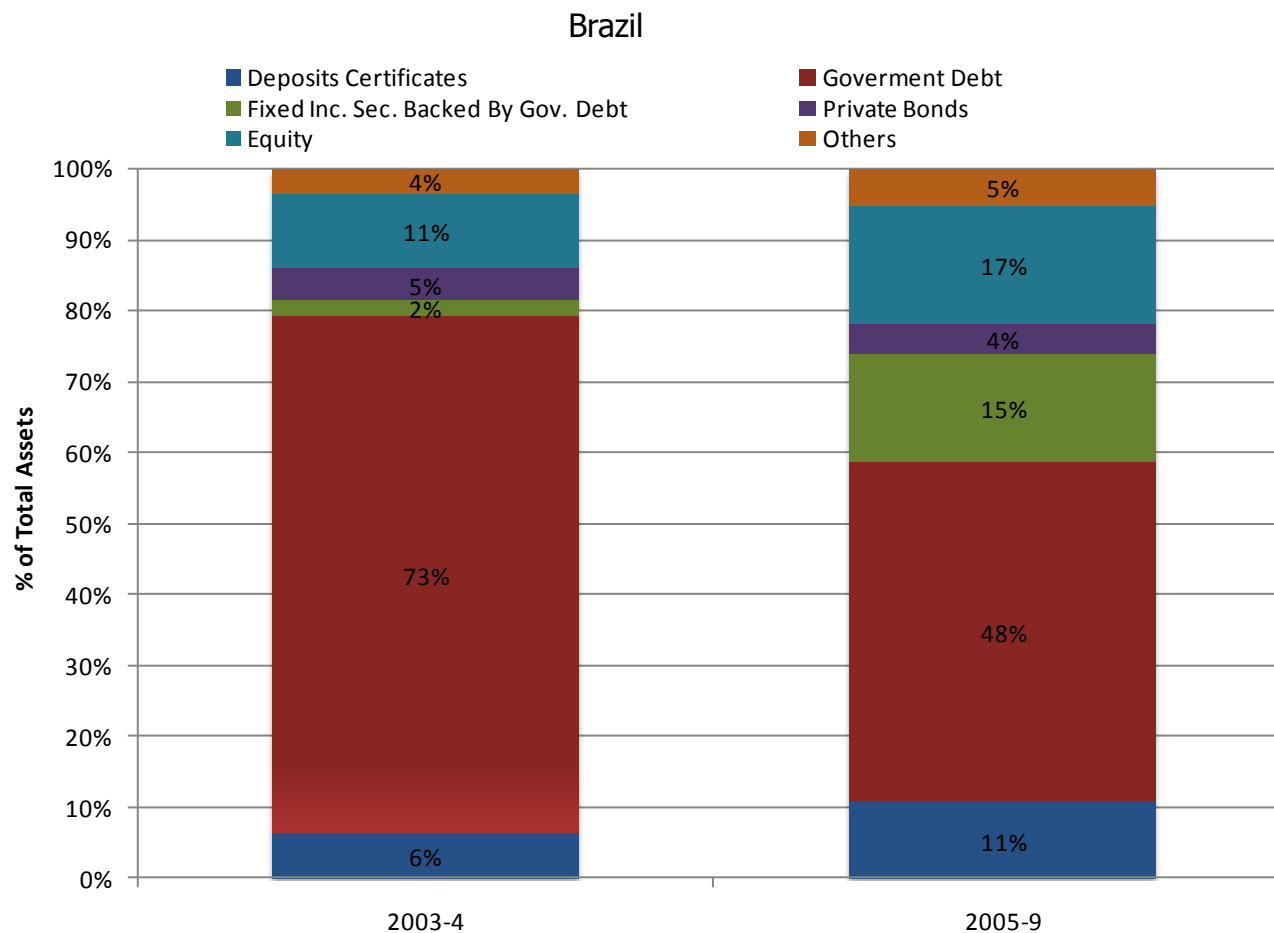
Pension Fund Assets Concentrated in Public Bonds and Deposits

Composition of Pension Fund Investments in Latin America



Mutual Fund Assets Also Concentrated in Bonds and MM Instruments

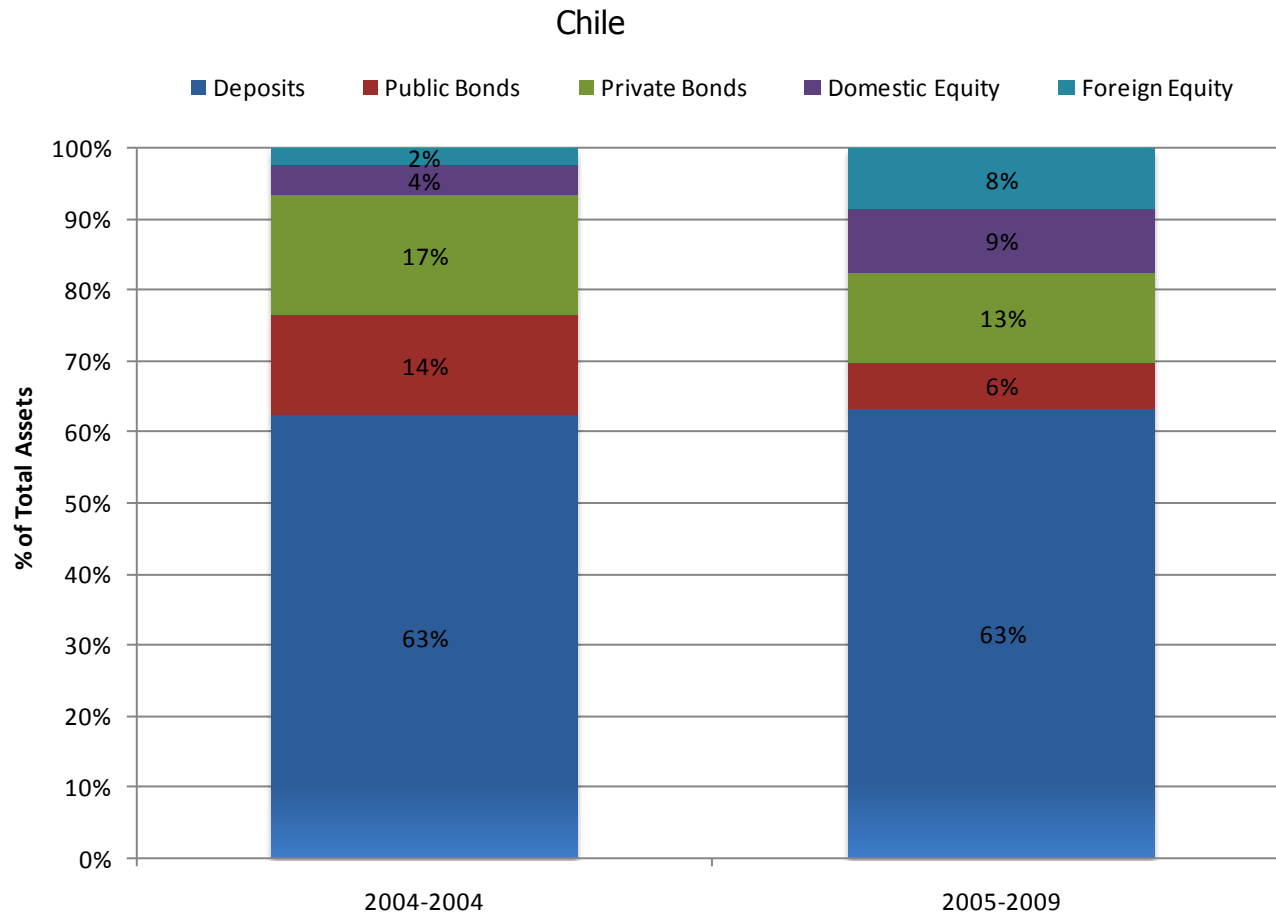
Mutual Funds - Portfolio Holdings



Source: IMF's IFS, FGV-Rio, Conasev, Superfinanciera, Andimia, and Banxico

Mutual Fund Assets Also Concentrated in Bonds and MM Instruments

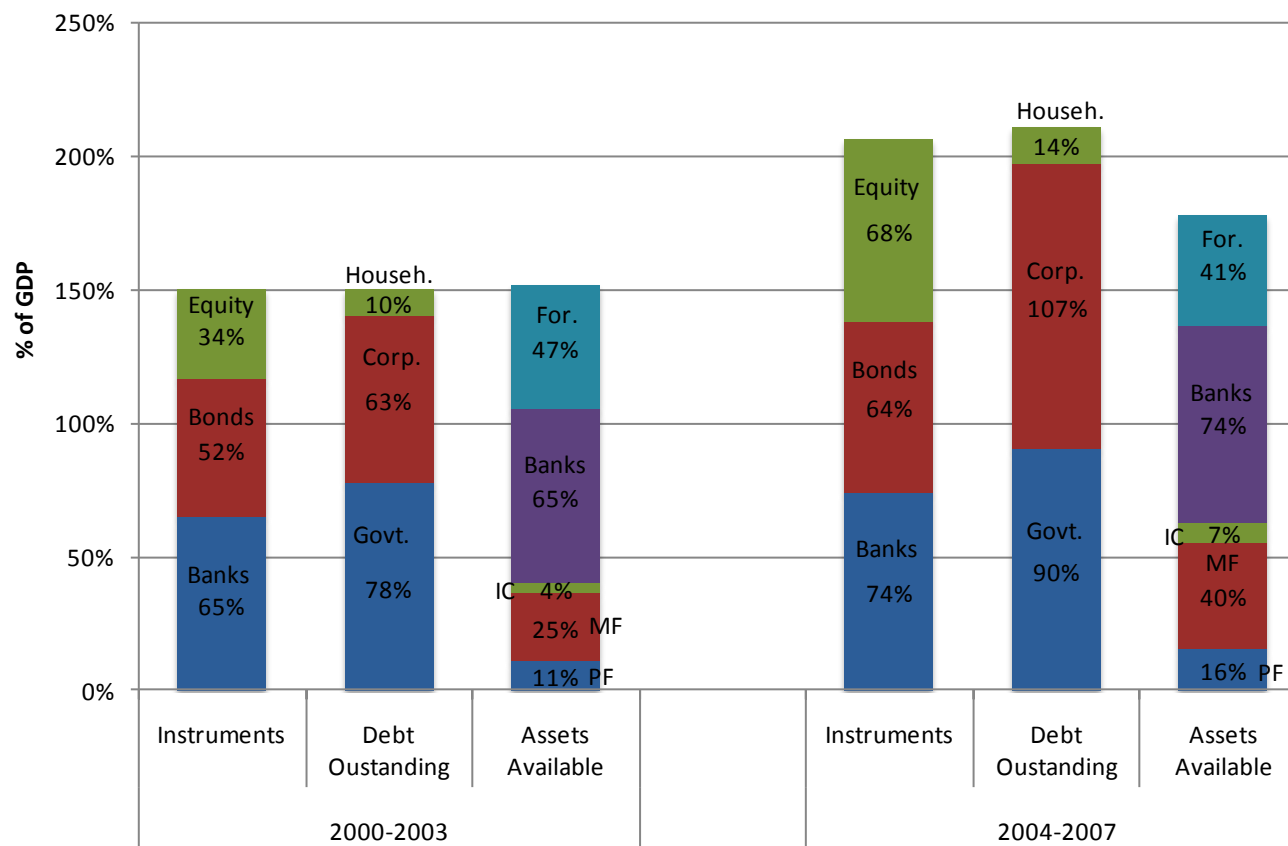
Mutual Funds - Portfolio Holdings



Source: IMF's IFS, FGV-Rio, Conasev, Superfinanciera, Andimía, and Banxico

"Big Picture" of the Financial Sector

Brazil



Instruments: Banks, Bonds, and Equities

Debt Outstanding: Government, Corporate, and Households

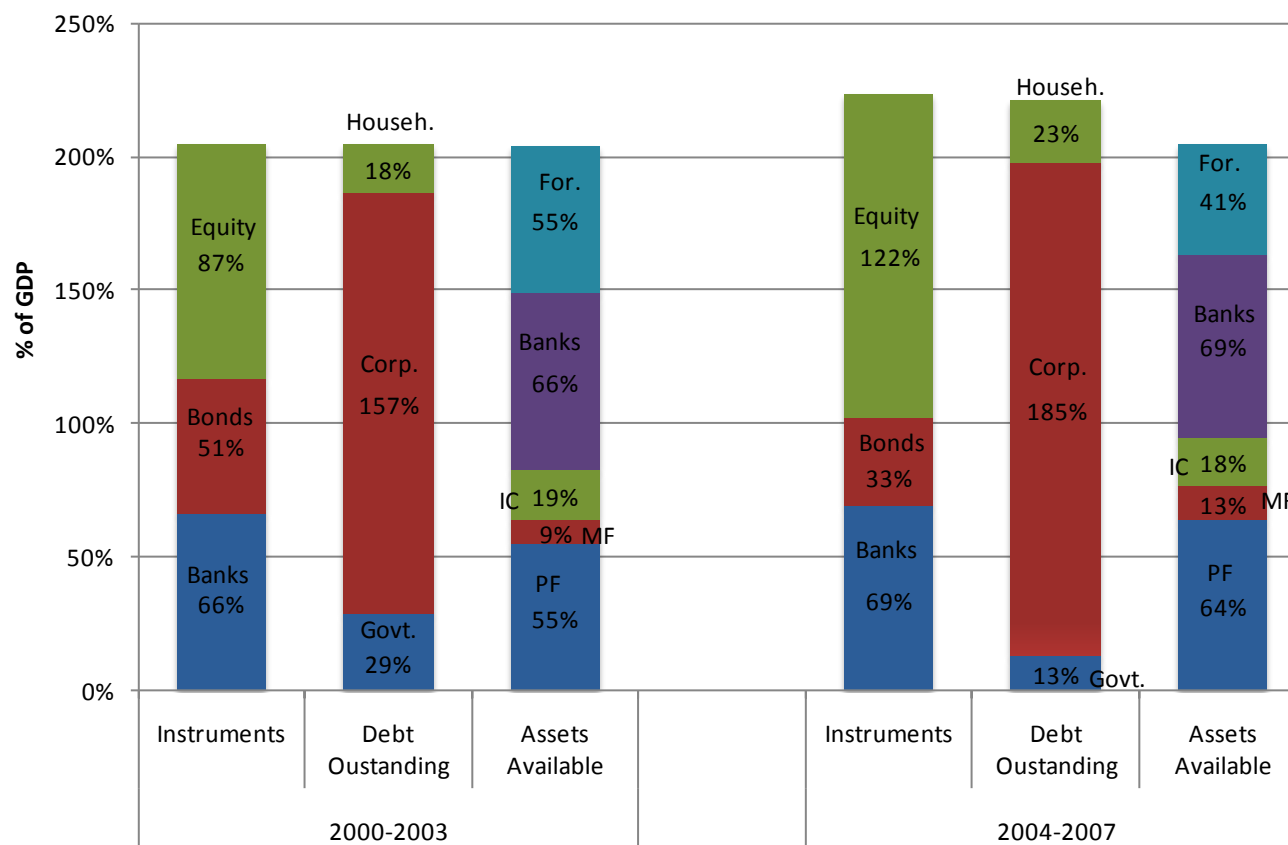
Assets Held: Pension F., Mutual F., Insurance C., Bank Assets, and Foreign

Foreign assets include both domestic and international debt holdings

Source: IMF's IFS, WDI, EMDB, BIS, ICI, ASSAL, AIOS, and Local Sources

"Big Picture" of the Financial Sector

Chile



Instruments: Banks, Bonds, and Equities

Debt Outstanding: Government, Corporate, and Households

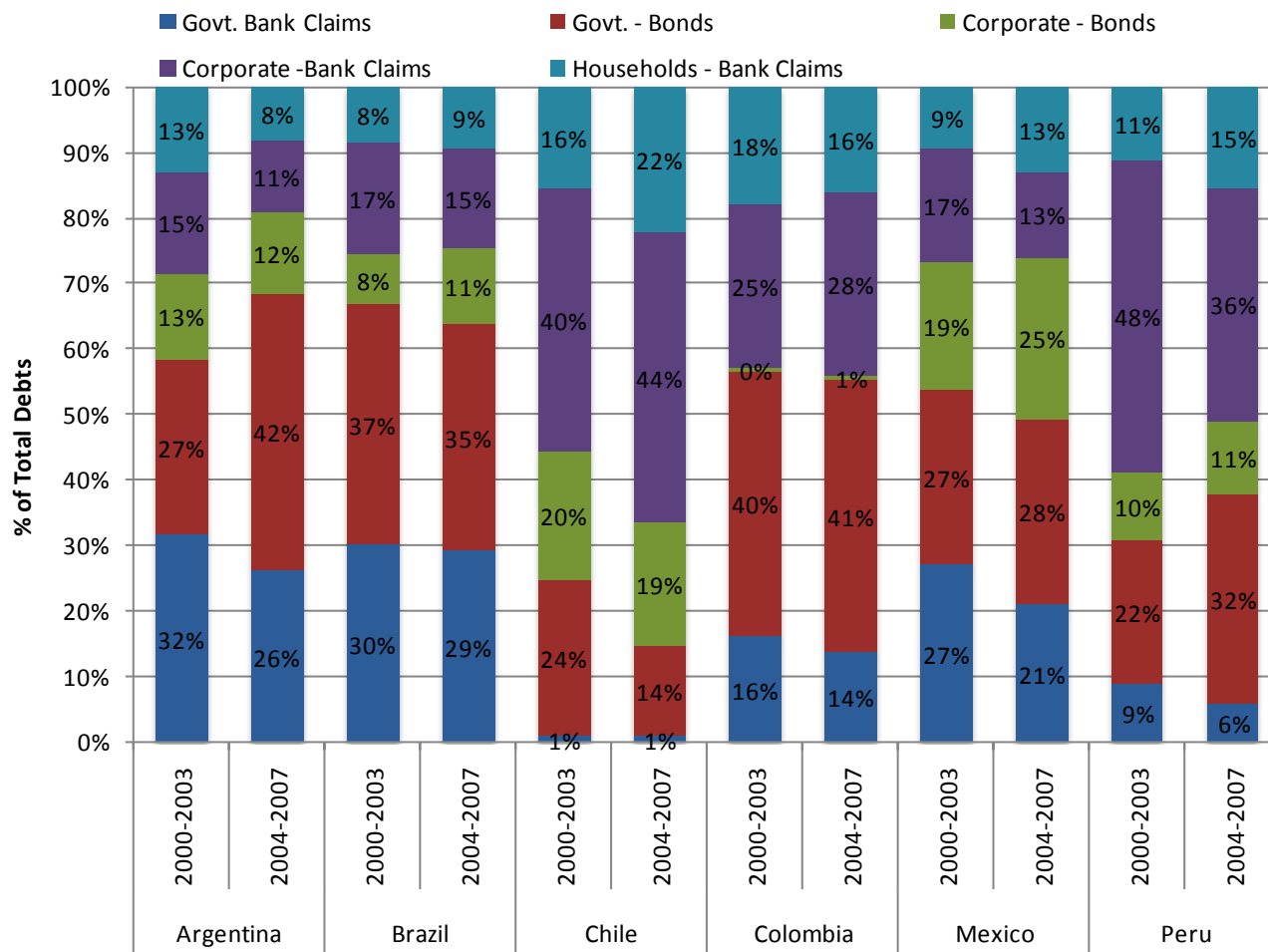
Assets Held: Pension F., Mutual F., Insurance C., Bank Assets, and Foreign

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“Big Picture” of the Financial Sector: Government Still Large

Debtor Composition

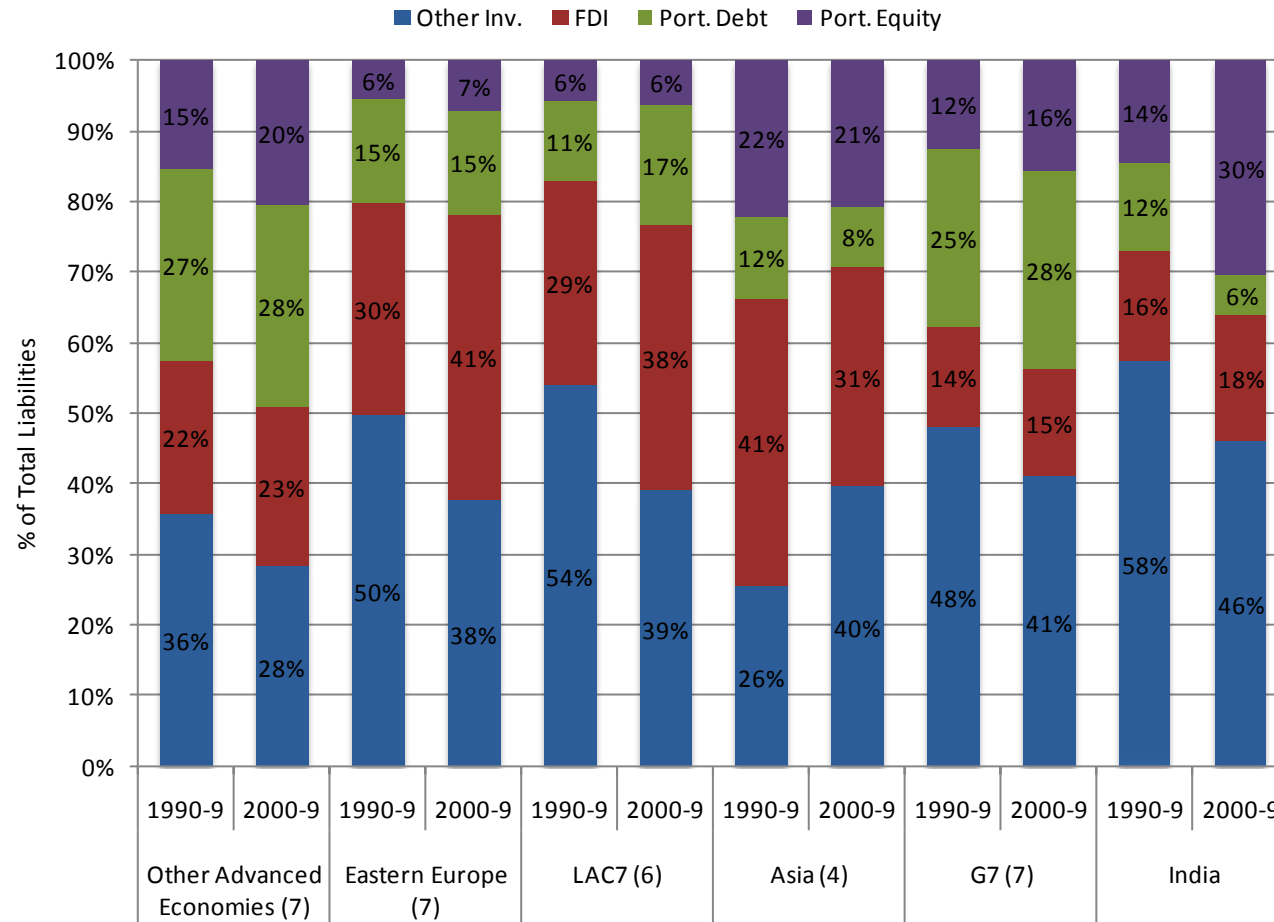


Outline of Presentation

1. Market size
2. Structure of financial systems
3. Financial globalization
4. Conclusions

Liability Composition (Foreigners at Home): FDI and Bank Flows Capture Lion Share

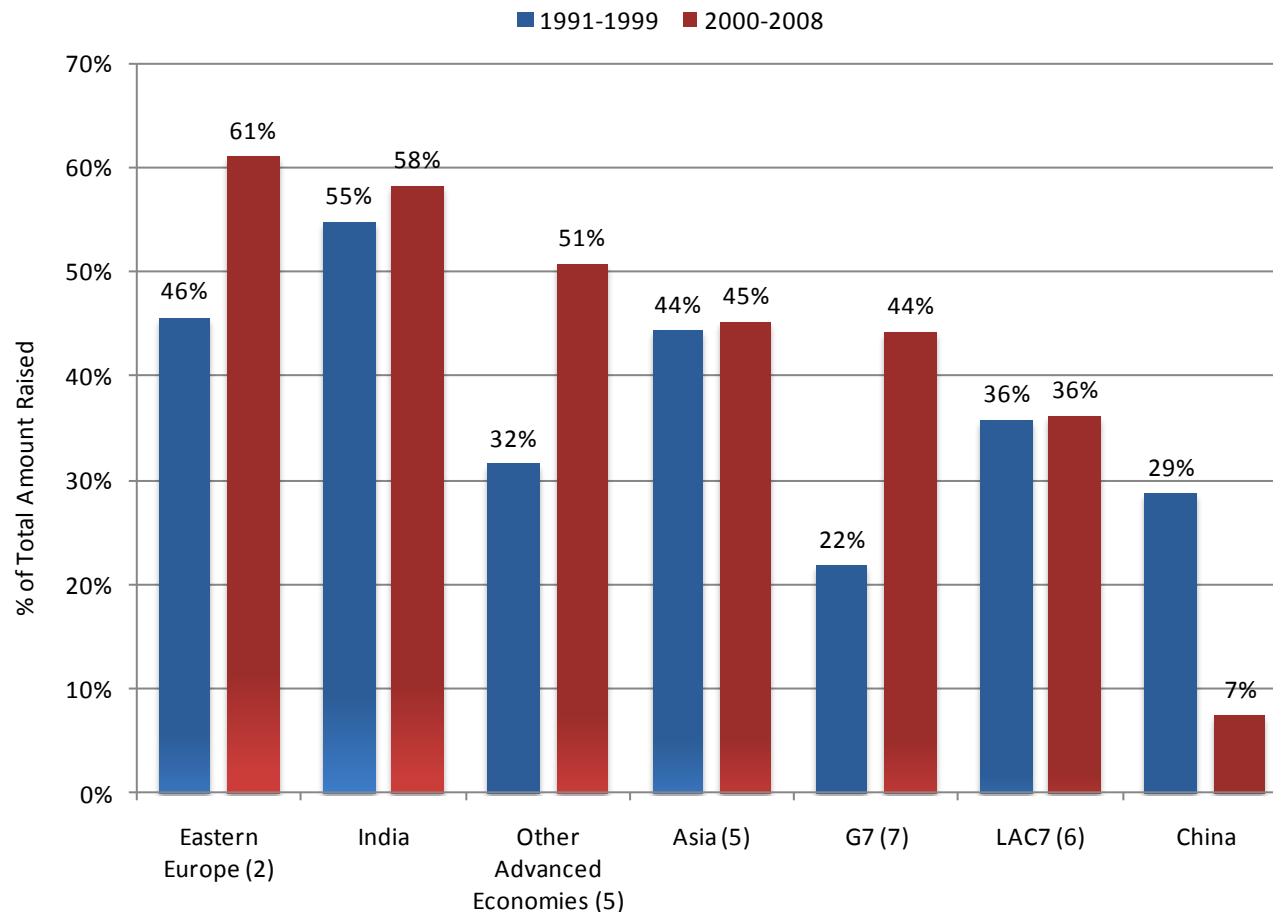
Liabilities Composition



Source: Lane and Milesi-Ferretti (2007)

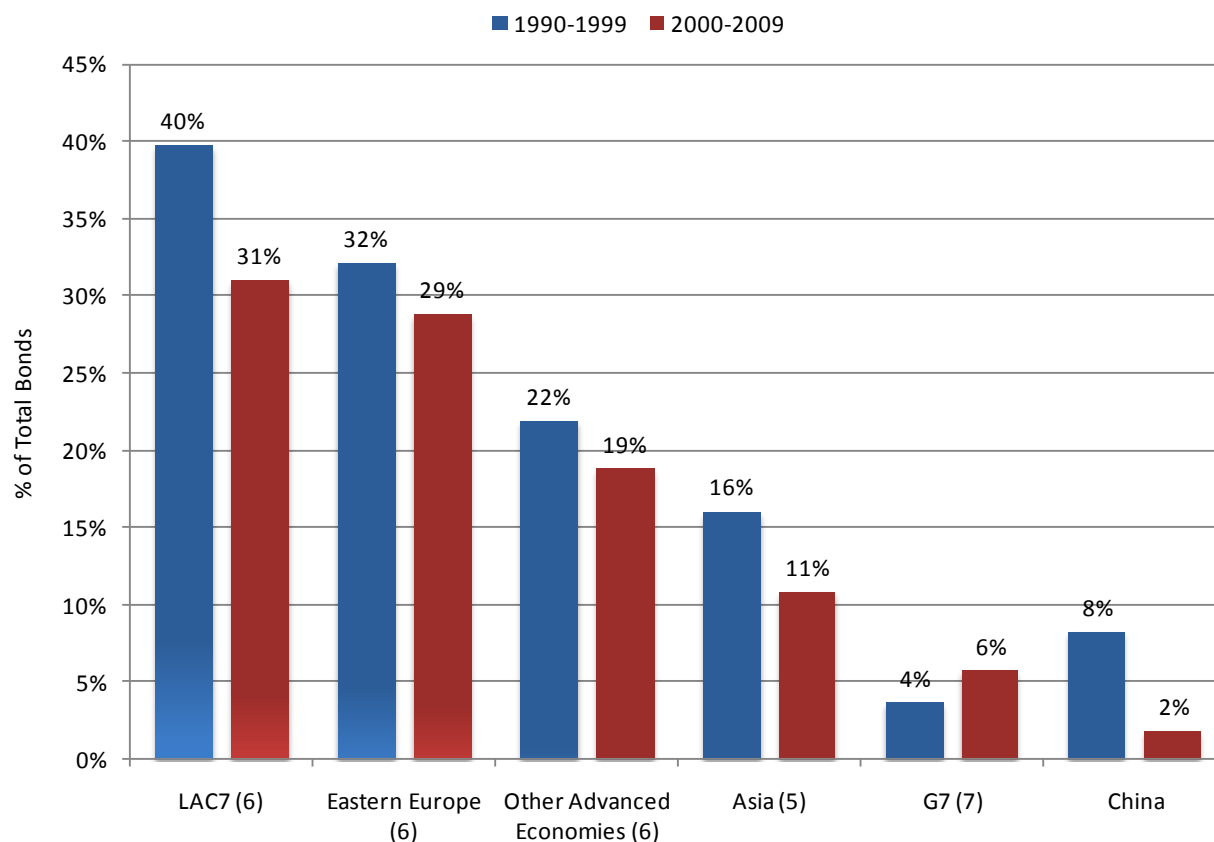
Bonds: However, Foreign Markets Important for Some Countries

Relative Size of Bond Financing for the Private Sector
Amount Raised Abroad as % of Total Amount Raised



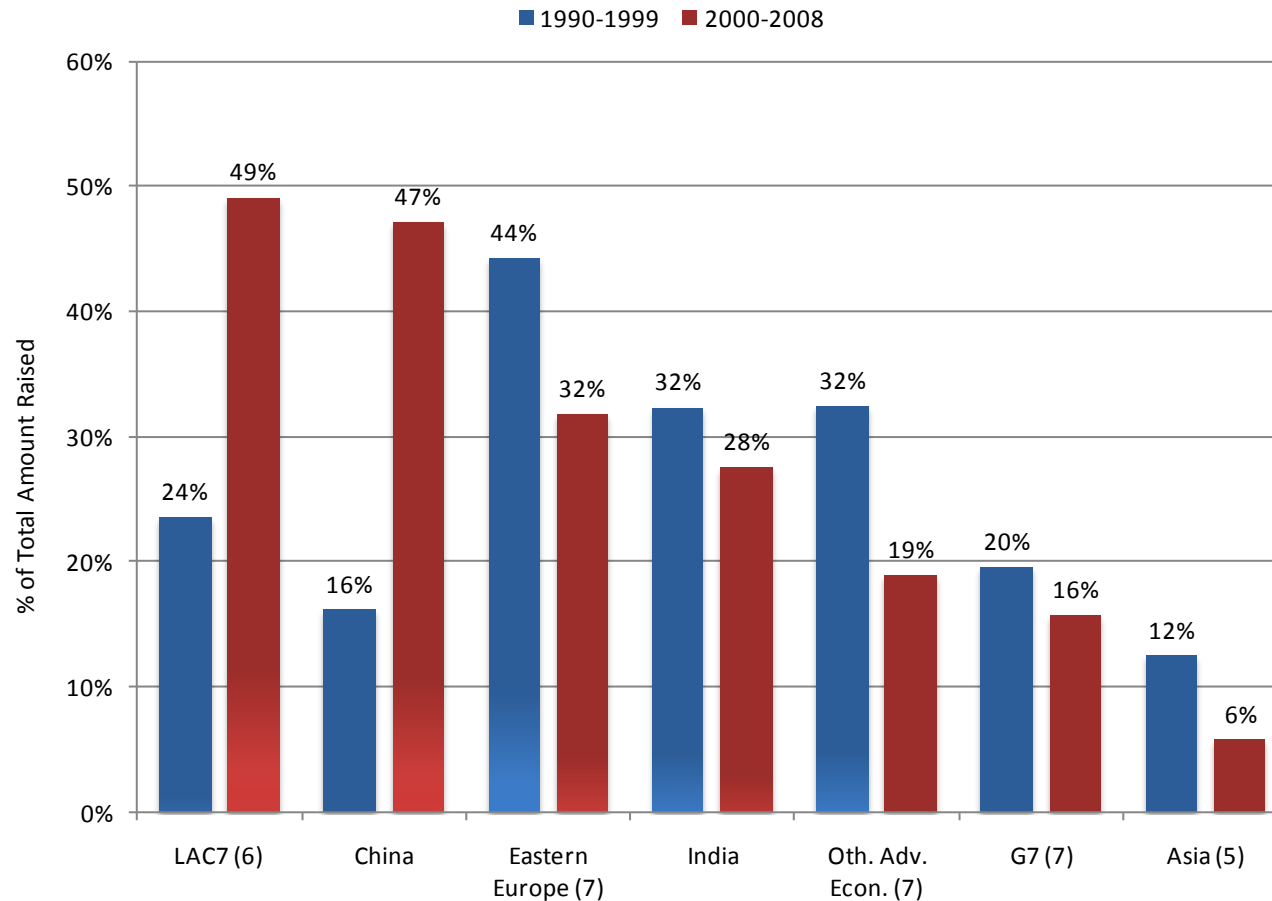
Relative Size of Foreign and Domestic Bond Markets: Public Sector

Relative Size of Bond Financing for the Public Sector International Outstanding Bonds as % of Total Bonds



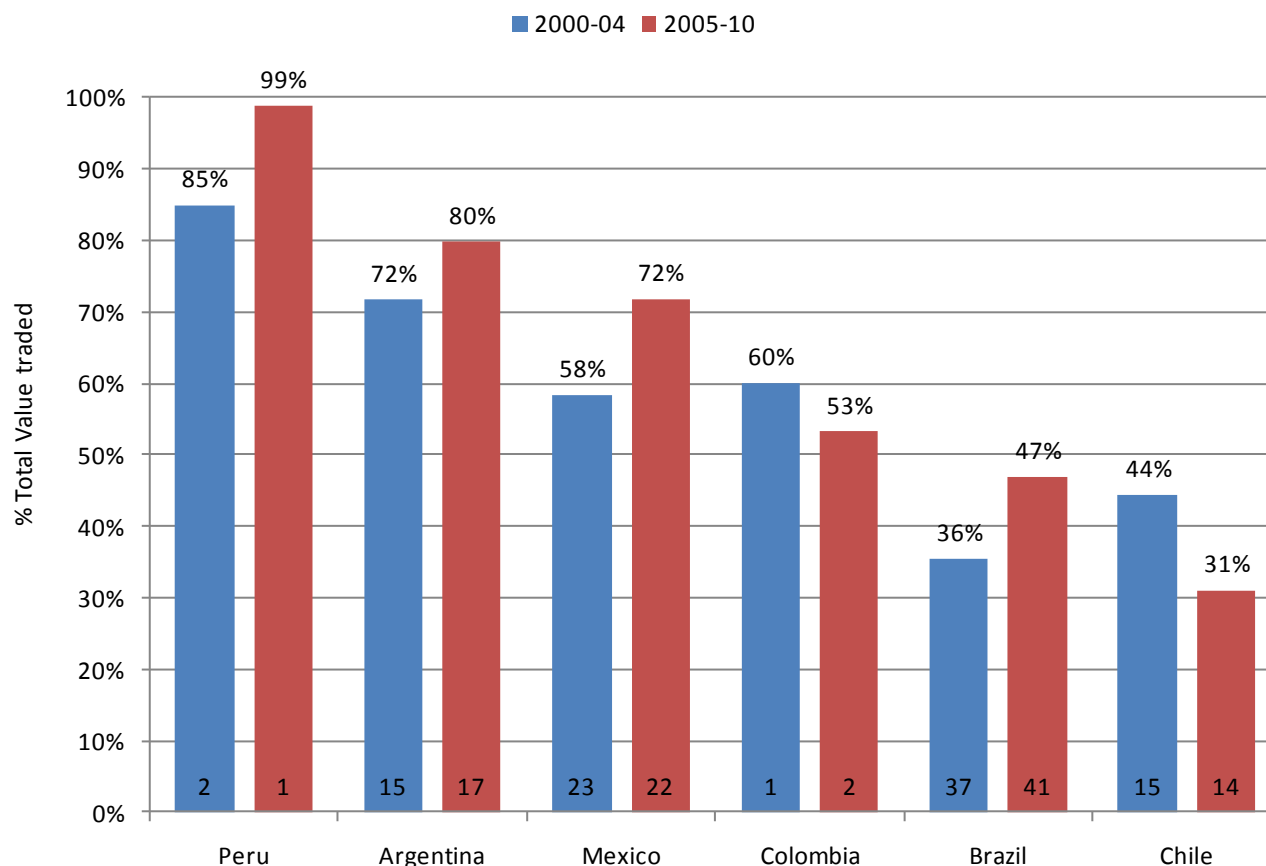
Equity: Though Foreign Financing Important for Some

Equity Financing – Amount Raised in Foreign Markets



Equity: Foreign Markets Significant for Trading

Value Traded Abroad Over Total Value Traded Value Traded through Listed ADRs in the United States

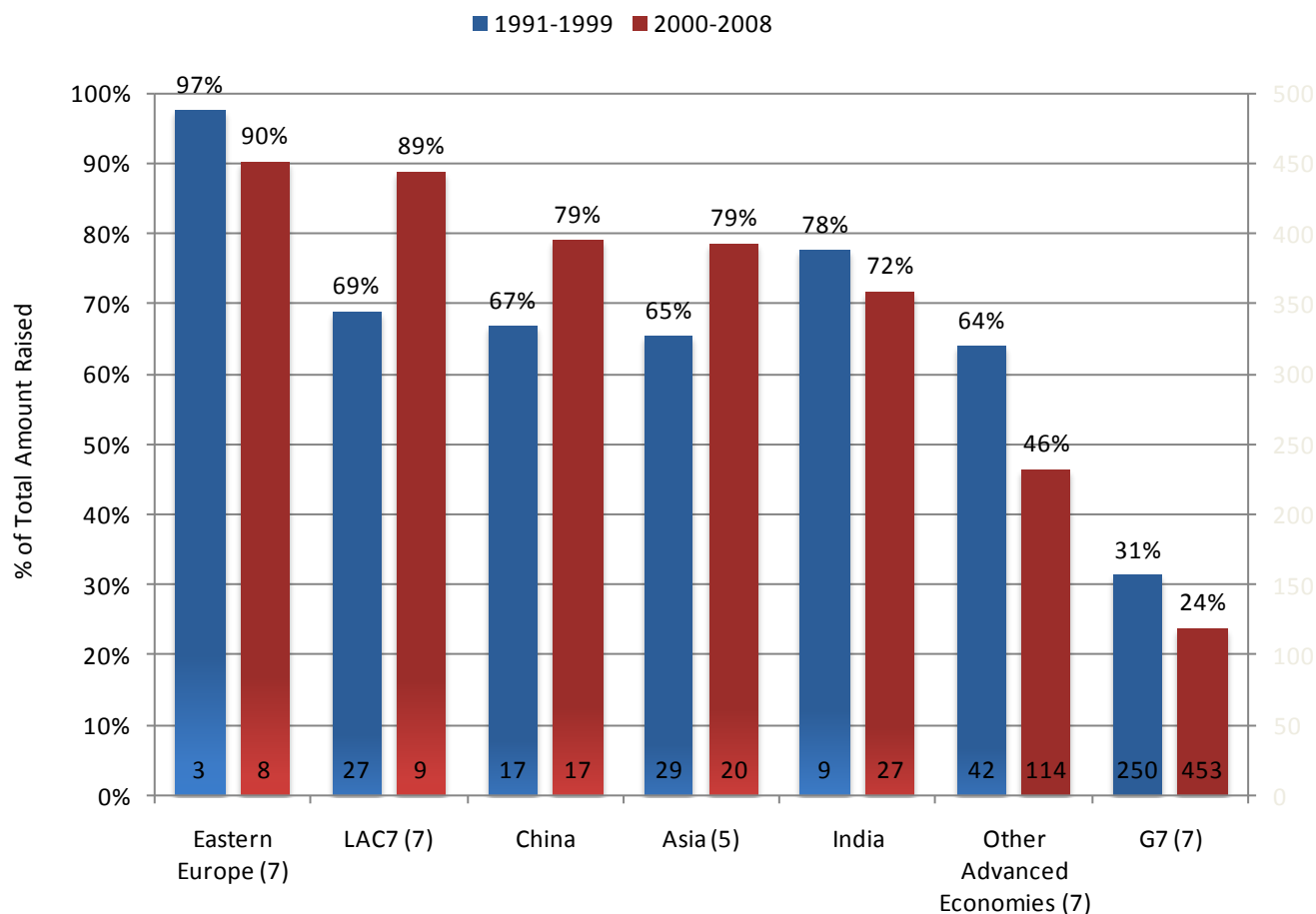


Source: Bank of New York and Bloomberg

Note: The number in the base of the bars represent the number of firms with ADR Trading

Foreign Issuance Concentrated in Few EM Firms

Private Foreign Debt – Concentration in Bonds Markets Amount Raised by Top 5 Issues

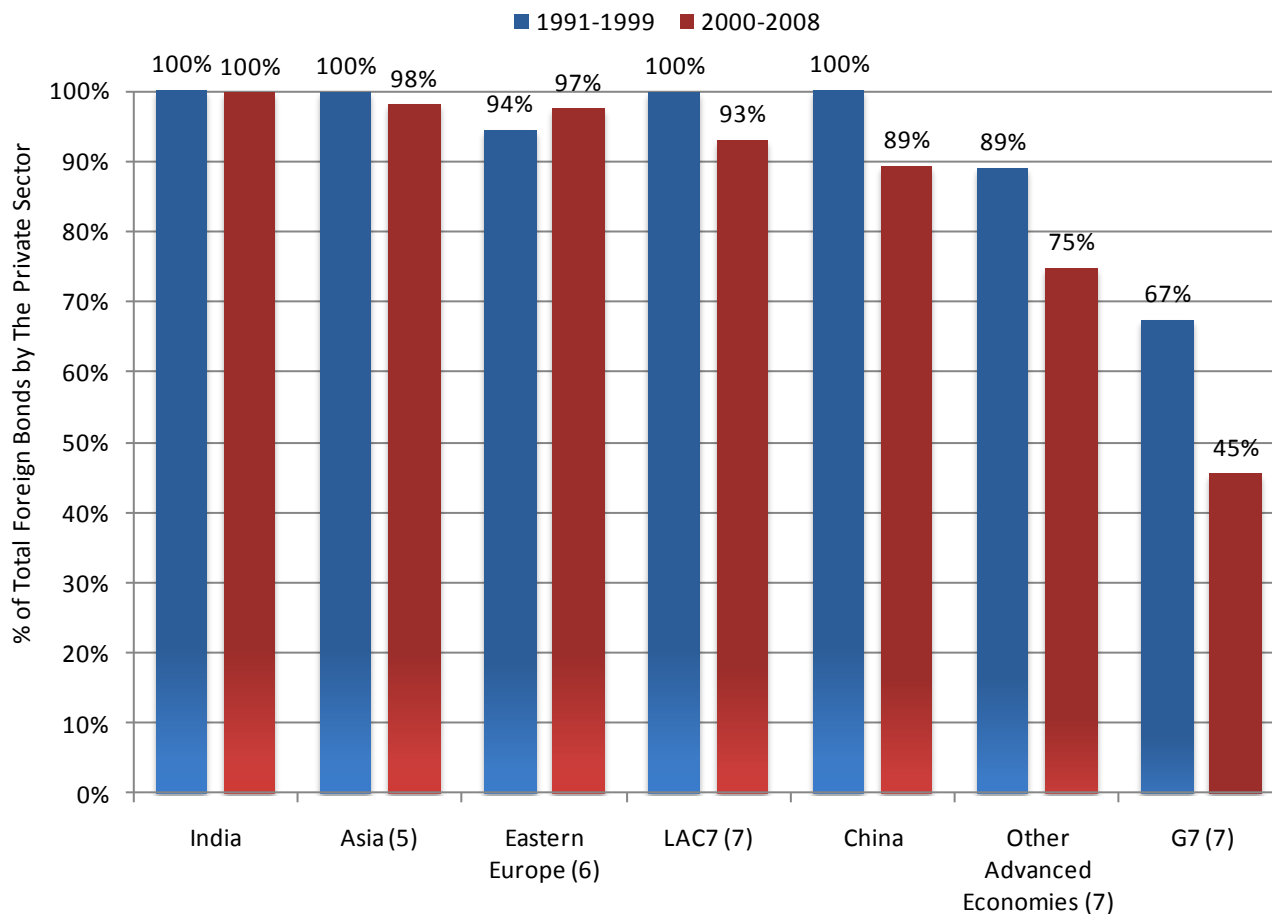


Source: SDC

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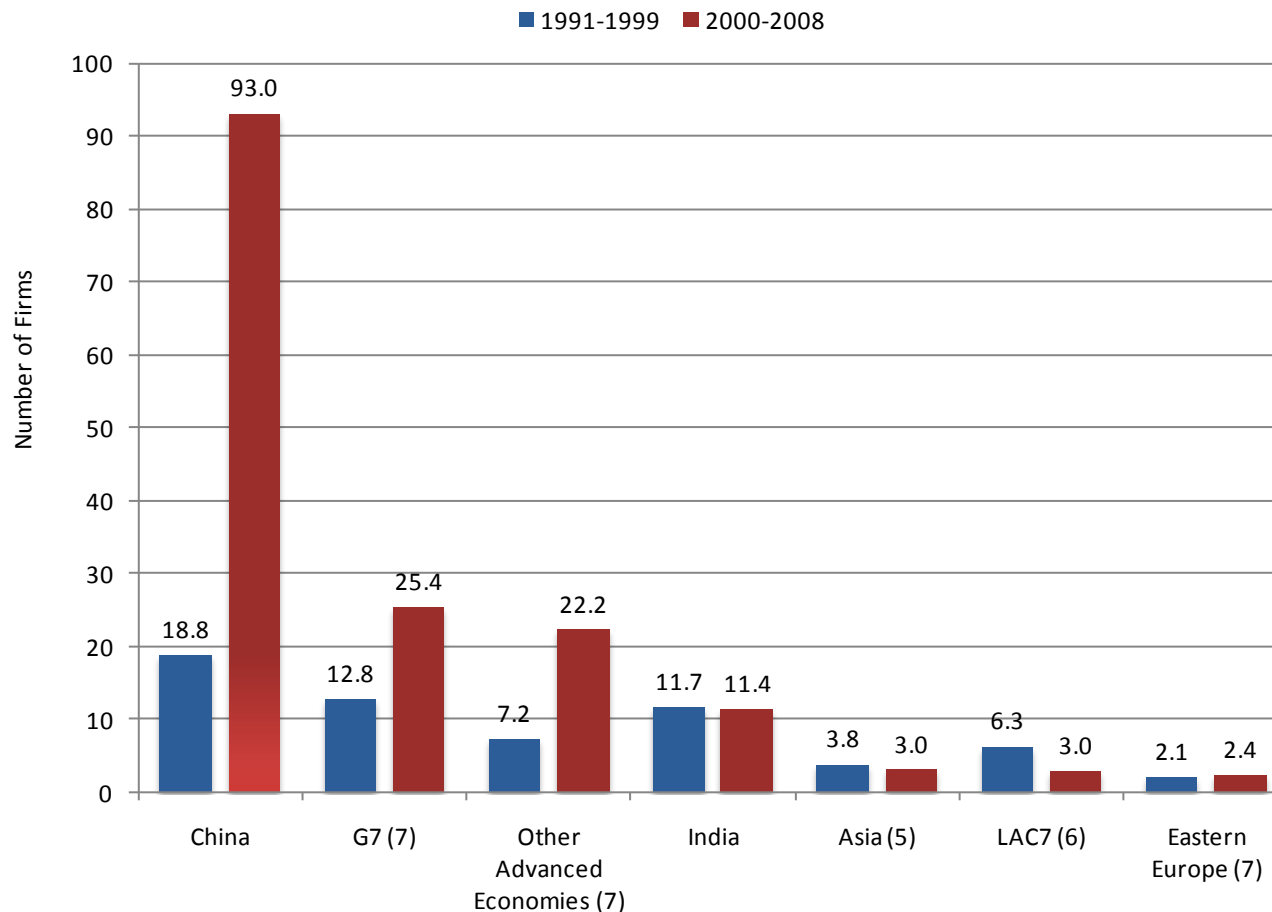
Foreign Issues Predominantly Foreign Currency

Private Bond Market – Issuance Activity Foreign Currency Bonds as % of Total Foreign Bonds



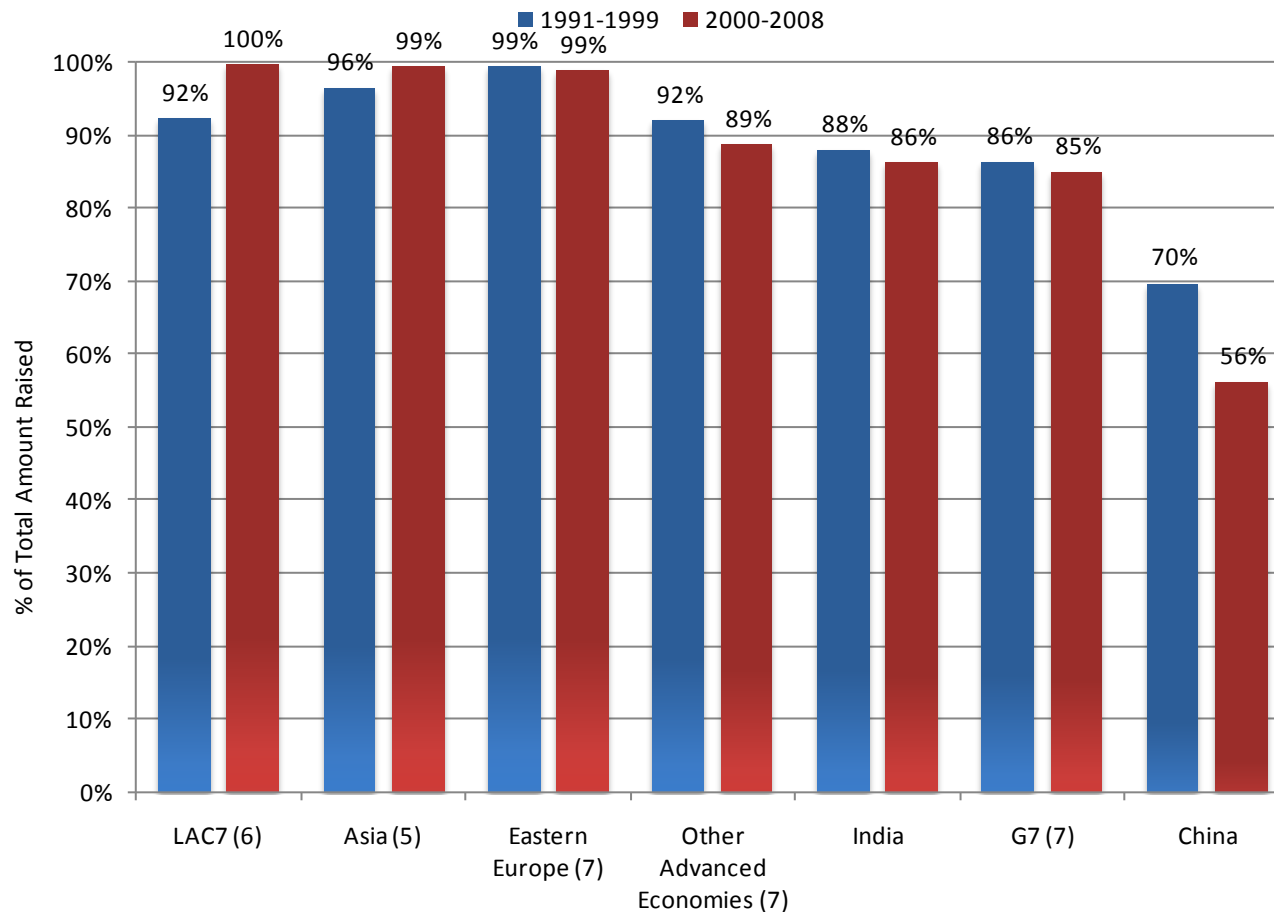
Few Firms Issue Equity Abroad

Equity Market – Issuance Activity



Equity Issuance Abroad Highly Concentrated

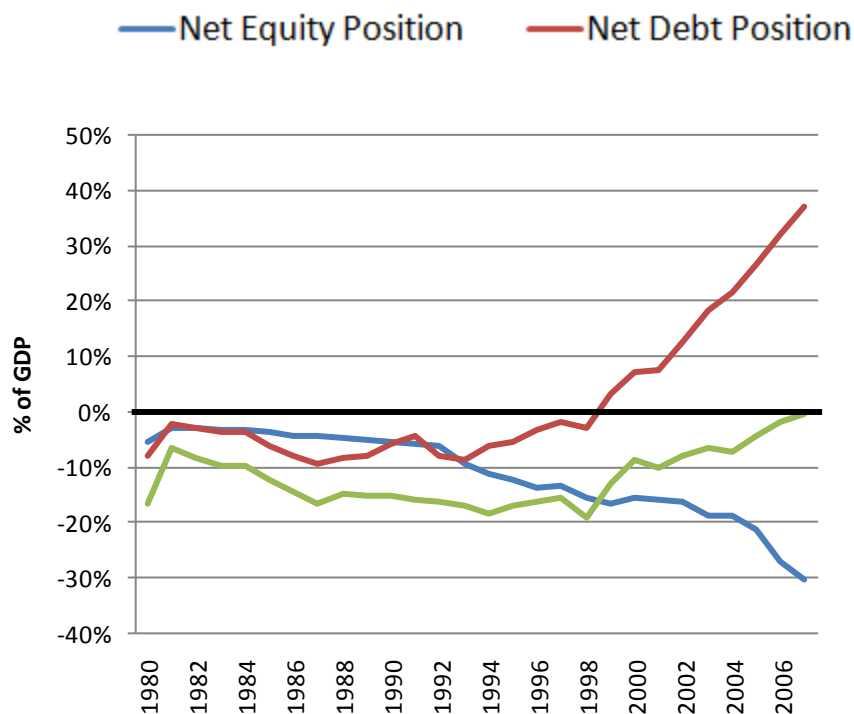
Foreign Equity – Concentration in Equity Markets Amount Raised by Top 5 Issues



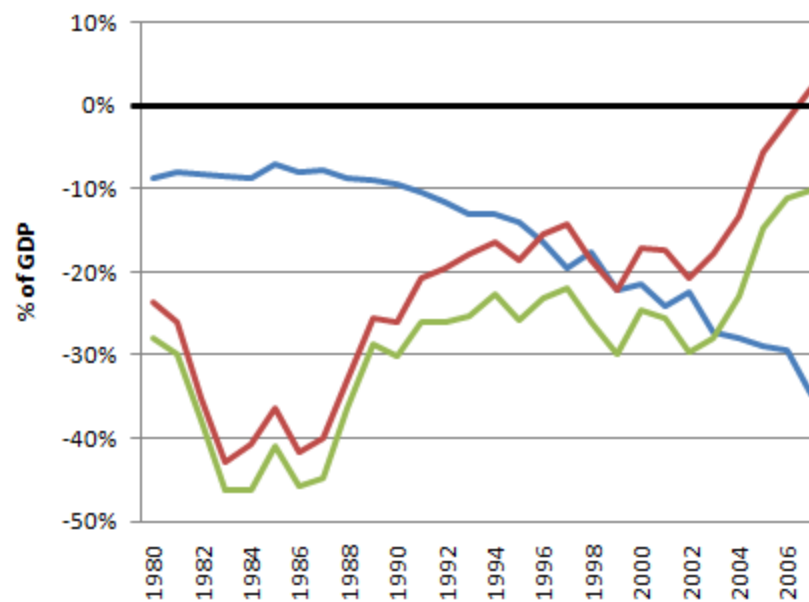
Safer Integration

Net International Debt and Equity Positions

Asia



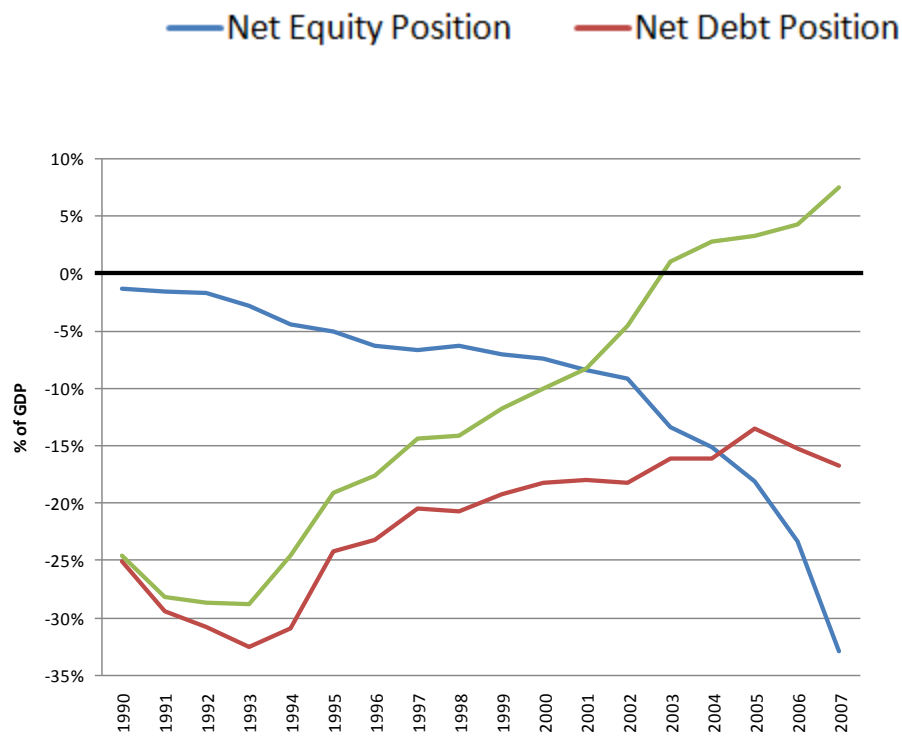
Latin America and the Caribbean



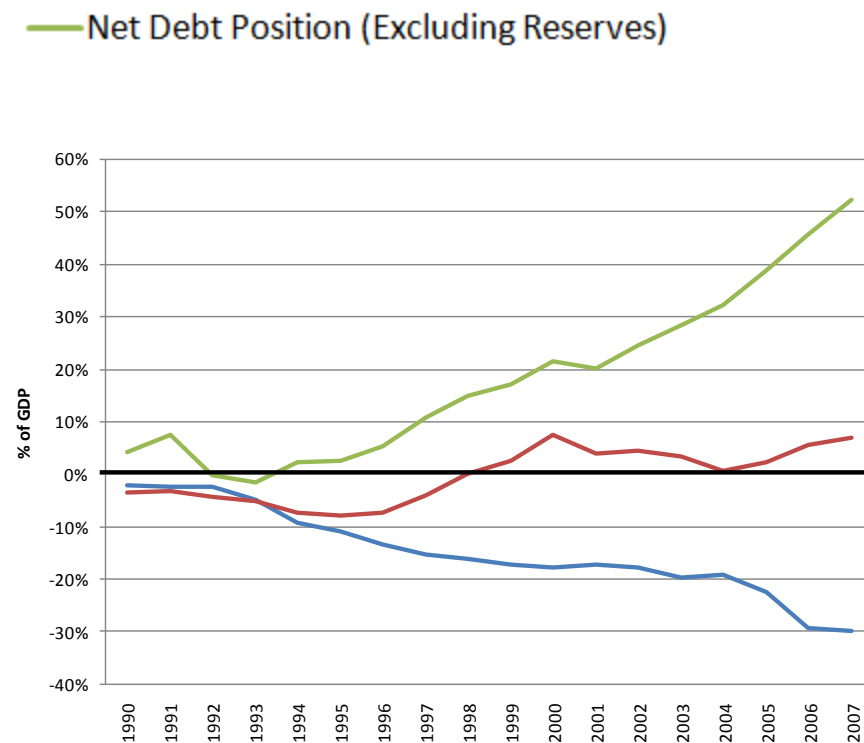
Safer Integration

Net International Debt and Equity Positions

India



China



Outline of Rest of Presentation

1. Market size
2. Structure of financial systems
3. Financial globalization
4. **Conclusions**

Concluding Remarks: Bottom Line

- ✚ Substantially different and better than before, even when seemingly insurmountable
 - Deeper systems, in domestic and international fronts
 - More saving and more resources available in the economy
 - Less crowding out by governments, but government still large
 - According to some measures, consumers appear to be better served
 - Financial system more complex, somewhat more diversified
 - Not that much bank-based
 - Bonds and equity play bigger role, corporate bonds emerging
 - Institutional investors much more prominent
 - Other types of financing taking off
 - Nature of financing is also changing
 - Longer maturities and less dollarization – less credit risk
 - More local financing (bonds, deposits)
 - Safer international integration

Concluding Remarks: Bottom Line

- ✚ But several countries still lagging behind in many respects
- ✚ No finance for all!
 - Financial development through capital markets not spread directly to all firms
- ✚ Constraints not on the supply side of funds
 - Based on more evidence than what presented here
- ✚ Constraints likely not on specific regulatory issues
 - These get much attention at country level, but cross-country issue
- ✚ Financial intermediation process more difficult than thought
 - First expands to areas relatively easy to finance
 - Incentives might play crucial role for more risk taking
 - Might not yield socially optimal outcome
 - Financial intermediaries brain of the economy, but with MS

Concluding Remarks: Bottom Line

- ✚ Not clear how to proceed in many areas
 - Institutional investors are emblematic
 - Similarly with banks and capital markets
- ✚ Nor what to expect of capital market financing
- ✚ Plus lack of obvious paradigm at int'l level
 - Fall of paradigms: no roadmap after the crisis
 - E.g. what to make of securitization and mortgage financing?
- ✚ Eventually, need to catch up, grow, and take risk without undermining stability: strong trade-off
 - Macro-prudential policies might not help
 - Hard to distinguish spurious boom from leapfrog
 - Especially for lagging areas and countries

Concluding Remarks:

But Many Questions Remain Unanswered

- ✚ Why dissimilar capital market development across regions?
- ✚ Where to set expectations?
- ✚ Are firms receiving adequate financing?
- ✚ What to make of globalization?
- ✚ How to set incentives and institutional designs?
- ✚ Constraints on supply or demand side of funds?
- ✚ Different treatment for bond versus equity contracts?
- ✚ What is the role of government?
- ✚ How to proceed with regulation and supervision post crisis?

Thank you!