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Finance for Development: Issues and Trends

Access to finance is a crucial determinant of the development process in emerging market economies. Although it may seem obvious now, this view was not always widely accepted. The tendency in development economics during most of the postwar era was to focus on the "real" sector of the economy—namely, industrialization, technology transfer, and the international exchange of goods—with the financial sector relegated to the sidelines. Insofar as finance formed part of the constellation of priority topics, it centered on international finance, in the form of foreign direct investment, bilateral and multilateral aid, and international commercial bank loans.

Over the last decade, a large body of literature has highlighted the role of the domestic financial system in developing economies. Three topics have been of particular interest. The first centers on financial crises: why they erupt, how to prevent them, and how to foster financial stability. A second topic is the link between finance and growth. While the long-standing debate on the causal relationship between finance and growth continues, the current empirical literature clearly argues that finance should be considered the independent variable—and thus of interest to policymakers. A third issue, much less studied than the other two, concerns access to finance. The questions researchers are asking include who can obtain finance, at what cost, and how access affects the potential of small and medium-sized firms to contribute to economic growth and a more equal distribution of income and wealth.

Recent interest in financial crises began with the Mexican debacle of 1994–95, which has been called the first financial crisis of the twenty-first century.[1] That is, it did not match the traditional pattern whereby crises were the result of loose macroeconomic policy or poor management of individual banks. New theoretical approaches were introduced, but it was not until the Asian crisis of 1997–98 that they attracted much attention. Among the new elements was a switch in focus from the behavior of the current account of the balance of payments to the capital account and from flows to stocks. Another dominant theme was the role of external factors, especially international capital flows, in causing problems for countries that had made major strides in liberalizing their economies in line with formulas promoted by the international financial institutions. Ironically, successful economies have turned out to be the most vulnerable.

Crises and stability are not the only concerns of experts and policymakers, however. Governmental authorities have two potentially contradictory roles to play in dealing with the financial sector. On the one hand, they must try to maintain the stability of the system as a whole. This requires establishing broad guidelines for the behavior of individual institutions, including limits on the amounts and types of credit that they can offer and requirements for capital and liquidity. On the other hand, today's governments are also expected to promote growth. In the financial realm, this involves providing incentives so that financial institutions will channel investment funds to productive enterprises. Since such loans embody varying types and amounts of risk, they must be balanced against the need for stability at both the micro- and macroeconomic levels.

Another role that governments are expected to play in modern economies is to correct market failures that may lead to gross distortions in the distribution of income and wealth. The tax system has traditionally been the instrument of choice for carrying out this task, but finance can be useful too. The trade-off mentioned above also comes into play here. If too much emphasis is put on stability, banks will not lend to productive enterprises in general and will certainly avoid dealing with more risky small and medium-sized firms (SMEs). Unwillingness on the part of banks to lend to SMEs is especially problematic since the capital markets and international finance are the exclusive domain of larger, more established firms. Access to finance for SMEs is relevant not only because of the effect on income distribution, but also for its important impact on job creation: in virtually all economies, SMEs are the major source of employment.

The trade-offs among stability, growth, and access exist in all countries, but they pose a particularly daunting challenge for developing nations. There are a number of reasons for the greater difficulty. The financial systems themselves are more fragile in developing countries, and governments lack the instruments and institutions, as well as the trained personnel, that are typically found in industrial nations. At the same time, high growth rates are more necessary in develop-

1. Camdessus (1995).

ing countries to begin to provide their populations with an adequate standard of living, and inequality is likely to be more prevalent. Finally, international attempts to provide help and guidance on financial issues may actually increase problems for developing countries, as has been argued with respect to the new guidelines established by the Bank for International Settlements (BIS).

The trend toward financial liberalization and international integration has further complicated the task of financial management for all, but again it has posed special problems for developing countries. As a result of liberalization, developing countries lost the instruments—however imperfect they were—that they had previously used to maintain financial stability. The transition to a more open system frequently took place so rapidly that substitutes could not be created in time; the industrial countries established strong systems of regulation and supervision over decades, not months. In addition, the small scale of most developing countries' financial systems made them particularly vulnerable to the large, volatile flows of international capital that have characterized the global markets in recent years. While these flows can help to relieve the foreign exchange constraint that has typically limited growth in developing countries, they can also undermine stability and result in major crises with profound implications for macroeconomic performance and serious negative effects on both growth and equity.

Finance within a New Development Model in Latin America

We examine these issues with respect to Latin America in the decade and a half beginning around 1990. This time frame is a critically important one for Latin America because it witnessed an acceleration of the move toward an open, market-based development model in place of one that relied heavily on the state and was semiclosed with respect to foreign trade and capital flows. The financial sector was a key part of the transformation, and it changed dramatically as a consequence.[2] Since most other economies, including those of East Asia, have also been moving toward greater reliance on the market in financial and nonfinancial areas, this time period increases the relevance of the book's findings beyond the Latin American region itself.

During most of the postwar period, Latin American countries followed some version of the so-called import-substitution industrialization (ISI) model. The ISI approach featured a dominant role of the state in the economy, including extensive regulation of prices, a high share of GDP made up of government expenditure, control of credit, regulation of labor markets, and direct ownership

2. This section is taken from Stallings and Peres (2000). That book includes an extensive review of the literature on economic reform in Latin America up to 2000. Notable works published since then include a new quantitative regional overview (Lora and Panizza, 2002) and several comparative country-oriented studies of the political economy of reform (for example, Snyder, 2001; Teichman, 2001; Weyland, 2002).

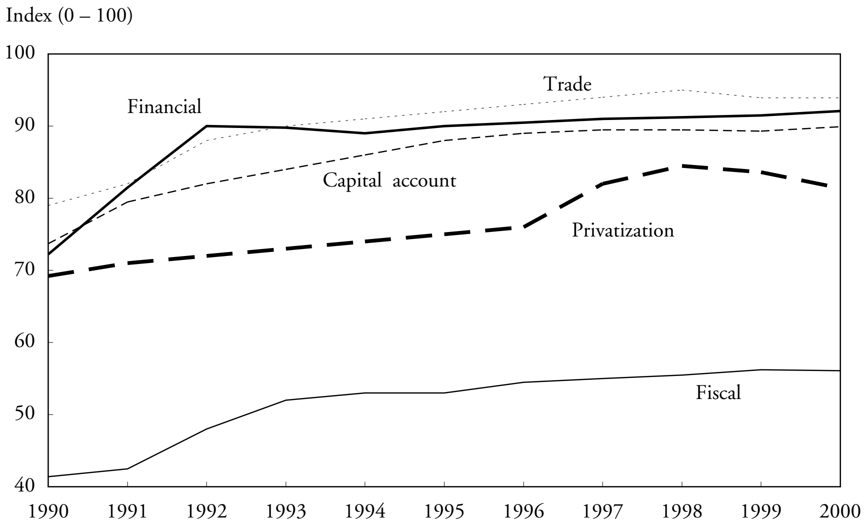
of key industries. At the same time, barriers limited Latin America's interactions with the rest of the world economy. Trade protection was pervasive through taxes on exports and high tariffs or quotas (or both) on imports. Financial integration was also restricted via controls on foreign exchange transactions by citizens, limits on foreign capital inflows and their sectoral destination, and restrictions on capital outflows including remittance of profits and interest.

The authorities began to rethink these policies after following them for several decades. The reasons varied over time. For the earliest cases in the 1970s (Argentina, Chile, Uruguay), new ideological currents arose with the return of newly minted Ph.D.s from the United States. A second wave followed in the 1980s (Bolivia, Costa Rica, Mexico), when countries were heavily influenced by the debt crisis, the accompanying role of the international financial institutions, and new conservative leadership in the industrial countries. The 1990s were the key decade, however, as the pioneering countries moved further along the path toward the market and most of the rest of the region joined them, encouraged in part by the positive examples of neighbors, especially Chile, and the disappearance of the socialist bloc in Europe. Nonetheless, ideological and international factors also continued to play a role in governmental decisionmaking.

The reform package was made up of a number of separate but related policies. Price controls were reduced or eliminated, import restrictions were lifted, state-owned firms were privatized, tax rates were lowered and shifted from income to consumption, and labor regulations were made more flexible. Another important component of the reforms centered on the financial system. In this sphere, two changes are often conflated that are really separate policies. One is the deregulation of domestic financial activities, for example, freeing interest rates on loans and deposits, lowering reserve requirements, ending directed credit, and making it easier for new firms to enter the market. The other is the liberalization of international financial transactions, including the elimination of controls on capital flows, the end of regulation on offshore borrowing by financial and nonfinancial firms, and the suppression of multiple exchange rates.

Financial liberalization has been arguably the most controversial of all the structural reforms. While government decisions to lower tariffs, sell state-owned enterprises, or increase labor market flexibility have certainly encountered opposition, it has typically been concentrated in certain groups that face losses as a result of the changes. Financial liberalization, by contrast, has a far broader impact across all sectors of the economy. In addition, the financial sector is generally regarded as the most fragile part of the economy, subject to dramatic swings stemming from changes in economic or political variables or even shifts in market psychology. Nonetheless, domestic financial liberalization is second only to trade liberalization in terms of its implementation record, and it has advanced more (relative to its starting point) than any other reform in the Latin American

Figure 1-1. *Economic Reforms in Latin America, 1990–2000*[a]



Sources: ECLAC (2001, p. 47), based on Morley, Machado, and Pettinato (1999).

a. Indexes range from 0 (complete government control) to 100 (no government intervention). They are normalized according to the following formula: I_{it} = (Max – IR_{it})/(Max – Min), where I_{it} = index value for country i, year t; Ir_{it} = raw value of reform measure, country i, year t; MAX = maximum value of reform measure for all countries, all years; MIN = minimum value of reform measure for all countries, all years.

region; see figure 1-1. Moreover, although opposition to the reforms has generally increased since the late 1990s, when growth rates began to fall after the Asian crisis, the reversion of domestic financial liberalization has been limited.

Latin America's Financial Sector Today: Stylized Facts

Financial liberalization greatly changed the characteristics of the financial sector in Latin America. In particular, the liberalization process created new rules by which the system operates. The new rules, in turn, led to a number of additional changes, such as ownership in the sector and the nature of the government's role. Other dimensions, however, displayed far less variation. Indeed, many characteristics—especially the shallowness of the financial system as a whole and the failure to develop a capital market segment—remained surprisingly similar to the prereform period; proponents had argued that financial liberalization would produce more dramatic and extensive advances. Combining the differences and similarities, we can portray the financial sector today in terms of six stylized facts.

First, Latin America's financial systems remain bank based, meaning that bank credit is more important than other forms of finance such as the flotation

of bonds or stock market offerings. Nonetheless, bank credit as a share of GDP is very low in comparison with industrial economies or other developing countries, and it has grown slowly since the early 1990s. On average across the region, bank credit represented only 41 percent of GDP in 2003; the figure was 96 percent in East Asia and 94 percent in the Group of Seven (G-7) countries. Another characteristic that sets Latin America apart is the low share of total bank credit that goes to private borrowers rather than the public sector (22 percent versus 82 percent in East Asia). Short maturities also characterize bank credit, especially from private sector banks, so that firms must continually roll over credit or find other ways to finance investment.[3]

Second, trends in bank behavior have been highly volatile in recent years, and crises have become more frequent in the wake of financial liberalization. Moreover, a link has developed between banking and currency crises, leading to the emergence of so-called twin crises. World Bank data show that Latin American countries had the highest average number of financial crises in the last three decades, at 1.25 per country. Former Soviet bloc countries and sub-Saharan Africa followed with 0.89 and 0.83, respectively. East Asia had only 0.38 crises per country, which approaches the 0.21 level of the Organization for Economic Cooperation and Development (OECD). Latin American countries were also the most likely to have recurrent crises: 35 percent of the countries in the region suffered two or more crises, compared with 8 percent in East Asia and none in the OECD.[4]

Third, bank ownership has changed in two main ways. Many public sector banks have been privatized, with some being sold to local individuals or firms and some to foreigners. In the process, the share of foreign ownership in the banking sector has increased; even banks that were initially privatized through sale to local owners have often been bought by foreigners at a later stage. Recent BIS data, which compare ownership patterns for 1990 and 2002, indicate that the share of assets in government-owned banks in the six largest Latin American countries fell from 46 to 22 percent. Domestic private ownership also fell during this period (from 47 to 32 percent), leaving foreign owners as the major group that gained market share (from 7 to 47 percent). East Asia also saw a rise in foreign ownership, but government ownership rose simultaneously in response to the Asian crisis of 1997–98. Reprivatization is ongoing in East Asia, however, with an important share of assets being purchased by foreigners, so these trends are likely to change in the near future.[5]

3. Data for Latin America and East Asia are from table 5-2; for the G-7 economies they are calculated from IMF, *International Financial Statistics Yearbook.* For countries included in Latin America and East Asia, see section on methodology below. See also García-Herrero and others (2002); Liso and others (2002); IDB (2004) on the general characteristics of Latin American banks.

4. Data are from IDB (2004, p. 30). See also Kaminsky and Reinhart (1998) for a comparison of crises in Latin America and East Asia. Kaminsky and Reinhart (1999) introduce the concept of twin crises.

5. See table 3-2. For earlier comparative analysis, see Litan, Masson, and Pomerleano (2001); foreign bank strategies in Latin America are analyzed in ECLAC (2003, part III).

Fourth, capital markets, the other major source of formal sector finance, remain incipient in most countries of the region. Bonds outstanding represented only 37 percent of GDP in 2003, while stock market capitalization was 34 percent. Comparable figures for East Asia were 60 percent and 80 percent, and for the G-7 they were 141 percent and 100 percent, respectively. On the positive side, Latin American markets grew substantially in the 1990s, albeit with two caveats. First, with respect to bond markets, the large majority of funds in Latin America are going to the public sector; private sector finance represents only 8 percent of GDP (37 percent in East Asia). Second, on the stock market side, capitalization figures greatly overestimate their importance in Latin American economies. New issues (primary markets) have virtually dried up, representing only around 2 percent of GDP in recent years. In addition, the number of listed firms fell between 1990 and 2003. In both markets, liquidity is low as most stocks and many bonds are not traded; this fact discourages entry into the markets since investors cannot exit if they wish.[6]

Fifth, because of the characteristics just described, the financial sector—including both banks and capital markets—has made less of a contribution to economic growth in Latin America than is possible and desirable. A good deal of evidence purports to show that finance is an important determinant of growth in all countries, although analysts disagree on the channels.[7] Our focus in this book is on finance for investment. Investment as a share of GDP is very low in Latin America compared to the high-growth economies of East Asia; the average figures for the period 1990–2003 were 20 percent and 35 percent, respectively.[8] While many factors play a role in explaining low investment rates, evidence from several sources suggests that finance is a particular constraint in the Latin American case, which is logical given the shallow financial markets in the region.[9] Another important factor in the finance-investment relationship is the maturity structure of finance and the lack of a long-term segment in most countries of Latin America today. Indeed, the higher investment ratios in the early postwar period may have been partially due to the availability of long-term government finance. In indirect terms, finance for consumption and mortgages is in its infancy, so demand from these sources is failing to stimulate further investment.

6. Data on bonds outstanding and stock market capitalization for Latin America and East Asia are from tables 5-3 and 5-4. G-7 figures are from Standard and Poor's (2005) and the BIS website (www.bis.org/statistics/qcsv/anx16a.csv). New issues are from Mathiesen and others (2004). Litan, Pomerleano, and Sundararajan (2003) provide information on capital markets in developing countries; World Bank (2004c) analyzes Latin American capital markets.

7. The most up-to-date review of the literature on finance and growth is Levine (2004); see also World Bank (2001, part II). On how the channels of influence may differ depending on the level of development of a particular economy, see Rioja and Valev (2004a, 2004b).

8. Data are from World Bank, *World Development Indicators* (online).

9. See, for example, IDB (2001, chapter 2); Kantis, Ishido, and Komori (2001); Batra, Kaufmann, and Stone (2003). On Latin America in particular, see Pollack and García (2004).

Sixth, access to finance remains severely limited throughout most of the Latin American region, an issue that is closely related to finance and growth. The deficiency in finance for consumers and prospective homeowners is segmented by income group, with lower income earners being especially penalized. Likewise, small and medium-sized enterprises have significant difficulties in obtaining finance. Both bond and stock markets are clearly limited to the largest firms in any given country, so bank finance is the sole alternative to self-finance for smaller firms.[10] The only comparable data on access to finance across Latin American countries are from the World Bank's World Business Environment Survey, which shows that SMEs generally face substantially greater problems than large firms in obtaining access to finance. The difficulties, however, vary by country. For example, only 25–30 percent of small firms in Brazil, Chile, Colombia, and Venezuela report that finance is a major obstacle, while over 50 percent do so in Argentina, Mexico, and Peru. Individual country data, discussed in chapters 6 through 8 of this book, explain some of the reasons for the intraregional differences. Interregional variation is also important: East Asian firms are much less likely than Latin American firms to cite finance as a major obstacle to their operations, since they have access to much deeper financial markets.[11]

Substantive and Methodological Contributions

The book aims to explain these characteristics of the financial sector in Latin American countries. It is the first book-length study of the financial sector as a whole in the region, including banks as well as capital markets. We argue that both components of Latin America's financial system are weak in comparison with East Asia, which we use as a benchmark. In our search for explanations, we make both substantive and methodological contributions to the debates on finance for development that are taking place in the academy as well as the policy world.

In substantive terms, we differ from the new, but increasingly dominant, trend in the literature to place the blame for Latin America's weak financial markets on public banks, overregulation, and a refusal to acknowledge that small size makes full-scale integration with international financial markets the best policy option.[12] While we agree that most public banks have been poorly managed, that heavy-handed and inept regulation and supervision can undermine markets, and that small size is a hindrance, we argue that the solutions need not be total privatization, substitution of private monitoring for public supervision,

10. This is also true of access to the international financial markets, in that only a handful of very large, well-known firms can raise money there.

11. World Bank website (info.worldbank.org/governance/wbes).

12. Chapters 2 through 5 provide extensive literature reviews that document the new views and contrast them with traditional approaches.

and complete integration with international capital markets. More pragmatic solutions need to be considered that take into account the particular circumstances—political as well as economic—in individual countries.

With regard to public banks, a substantial amount of privatization has already taken place, as development and commercial banks have been closed, sold, or merged with private domestic or foreign institutions. Nonetheless, a significant number remain, and the question is what to do with them. One answer is to move toward full privatization as quickly as possible, and in some cases this may be the only answer. For example, the Governor of Bolivia's central bank has argued that it was impossible for Bolivia's public banks to be improved sufficiently, such that the best solution was to eliminate them—which was done.[13] At the same time, there are circumstances in which democratic political decisions have been made to the effect that privatization is not acceptable. Costa Rica is an example here. What can be done under these circumstances?

Our evidence, as explained in chapter 3, suggests that strong institutions may be able to overcome many of the typical problems with public banks. Cleaning their balance sheets, putting competent professionals in charge, and requiring them to compete without special advantages is an alternative to privatization where citizens have decided that they want the public sector to maintain control of certain spheres of the economy. Discussions of exactly this type took place in Costa Rica in the mid-1990s.[14] Similar decisions seem to have been made to maintain Brazil's National Bank for Economic and Social Development (BNDES) and Banco do Brasil and Chile's BancoEstado as public institutions, and similar steps have been taken to require them to operate in an efficient manner. The literature warns of rent seeking, corruption, and a possible contradiction between the economic and social functions of public banks. Our argument is not that public banks should return to the position of power they held in most Latin American countries in the early postwar years. Rather, if citizens so desire, and a strong institutional context can be created, public banks can do a reasonable job in terms of efficiency and in carrying out certain social functions.[15] We also find that weak institutions can undermine otherwise efficient banking institutions.

On regulation and supervision, an important public role clearly needs to be maintained. As discussed in chapter 4, we find (weak) evidence that corroborates the studies by private monitoring advocates with respect to a negative relationship between government-based supervision and bank performance. Likewise, we find a positive relationship between performance and private monitoring indicators. At the same time, we also find evidence of the procyclical tendencies that are

13. Morales (2005).

14. Personal interview with a former Costa Rican official.

15. The Bolivian example is useful in this sense. In an extremely poor country, with weak institutions and few skilled personnel, a solution à la Costa Rica, Chile, and Brazil may indeed be impossible.

the justification for prudential regulation and supervision. The disagreement is not about the empirical relationships, but the conclusion that private monitoring can adequately deal with the problems of stability that plague financial institutions as a result of collective action problems. We see private monitoring and public regulation and supervision as complements, not substitutes, and we join in the call for greater transparency, more public information, director liability, and outside audits to become part of a government-based system of prudential regulation and supervision. Our evidence suggests, however, that it would be a serious mistake to rely exclusively on private initiative.

Finally, on the issue of international integration, we again find space for a middle ground that others do not seem to see. For very small economies, such as those in Central America or the Caribbean, vibrant domestic capital markets are probably not feasible, just as economies of scale make it impossible to support certain nonfinancial sectors. Nevertheless, participation in international financial markets is not the only alternative. While a few large borrowers can access such resources, participation in the international markets is an illusion for the vast majority of firms—even large firms in a local context. We propose that attention be paid to a regional option in those cases, especially where other regional integration agreements already exist. Regional financial markets are not easy to construct, but East Asian governments have been moving in this direction, and Latin America's regional development banks provide an important resource for supporting the necessary infrastructure. Flexibility is needed with respect to possible solutions to the size problem.

In summary, we are not opposed to the new calls for a greater private role (in bank ownership and in regulation and supervision) and greater openness (with respect to participation in international financial markets). We propose, however, that more emphasis be placed on the context in which domestic financial markets operate. By strengthening the macroeconomic and institutional context in individual countries, as well as establishing rules for cautious financial integration at the international and the regional levels, more space is created to take account of local conditions and preferences. This, in turn, increases the chances of making proposals that are relevant to policymakers. Another aspect of the focus on context is the role of governments in creating, completing, and strengthening markets in which the private sector can operate. It is too often forgotten in the new literature that private initiative depends on the context.[16] We develop these ideas more fully in the remainder of the book.

Beyond discussions of the structure of financial markets and their governance, we also want to propose that more attention be paid to two problems

16. We refer to what some call *market-enhancing policies*, often seen as an intermediate position between laissez-faire capitalism and a government-centered version. See Aoki, Kim, and Okuno-Fujiwara (1997); in particular, the chapter by Hellmann, Murdock, and Stiglitz (1997) discusses the link between finance and market-enhancing policies.

that are prevalent throughout the region in terms of existing financial systems. One is the need for a long-term segment, which will support investment and help to raise Latin America's very low rates of capital formation and thus support faster economic growth. We point to a number of experiences that may offer models of how to proceed and make some recommendations on possible steps, but our main aim is to put the issue on the agenda. A second problem that also requires more attention than it has received is how to expand access to financial markets for micro, small, and medium-sized firms. In most countries, the government and a small group of very large firms have no financial constraints in that they can move at will among international markets, domestic capital markets, local banks, and nonbank finance. Their smaller counterparts have much greater difficulties, and under current circumstances they have too few options in the formal financial system. Again, a number of experiences may be adaptable across countries, and we hope to stimulate more discussion of this issue since it has important social and economic ramifications.

Most of the literature that we have discussed in the previous paragraphs is based on large-sample regression studies combining cases from both industrial and developing countries. These studies offer important insights and ways to test hypotheses, but we are troubled by the inclusion of countries with widely divergent levels of development without partitioning the sample to see if relationships are due to this factor. A number of recent studies show that the financial behavior of the two groups of countries differs substantially. In addition, large-sample studies always require the use of highly simplified measures of very complex realities that cannot take adequate account of qualitative distinctions. We argue that these are serious problems, which require an effort at compensation if we are to draw the proper lessons for policymaking.

Our way of dealing with these methodological problems—and an important contribution of the book—is to work at several levels of analysis and to use several methodologies. Our principal approach is small-sample comparative analysis of a dozen countries from Latin America and East Asia, but we also look at three country case studies in a comparative perspective. Another approach is to engage in theoretically informed case studies of single countries; a number are cited in the chapters that follow. Economic historians are in the best position to exploit within-country time series data, which can produce results that complement those from cross-country studies of large or small samples.

Our main comparative referent is East Asia, which we argue is the developing region with the greatest similarities to Latin America and the one that has the most lessons to offer Latin America. Table 1-1 contrasts some of the most important macroeconomic and financial indicators of the two regions. Latin America clearly lags behind on all of them, although the region has much more experience with managing crises, a point that proved to be of interest to East Asia after the Asian financial crisis of 1997–98.

Table 1-1. *Latin America and East Asia: Economic Indicators, 1965–2003*

Indicator	*Latin America*	*East Asia*
GDP growth rates		
1965–80	6.0	7.3
1981–90	1.6	7.8
1991–2000	3.3	7.7
2001–03	0.4	6.8
Export growth rate[a]		
1965–80	–1.0	8.5
1981–90	3.0	9.8
1991–2000	8.7	12.1
2001–03	2.0	12.7
Savings rate[b]		
1965	22.0	22.0
1990	22.0	35.0
2000	20.0	35.0
2003	21.0	41.0
Financial depth[c]		
1990	63.0	141.0
1995	86.0	185.0
2000	104.0	203.0
2003	112.0	236.0
Inflation[d]		
1965–80	31.4	9.3
1981–90	192.1	6.0
1991–2000	84.1	7.7
2001–03	6.0	3.1

Sources: World Bank (1992) for GDP growth, export growth, savings, and inflation, 1965–90; World Bank, *World Development Indicators* (online) for GDP growth, export growth, and savings, 1990–2003; IMF, *International Financial Statistics Yearbook* for inflation, 1990–2003; table 5-1 for financial depth.

a. Merchandise exports only for 1965–90; goods and services for 1990–2003.

b. Gross domestic savings as share of GDP.

c. Bank credit plus bonds outstanding plus stock market capitalization as share of GDP.

d. Consumer price index.

Within the two regions, we disaggregate to a number of cases that share an important set of characteristics; this is the middle-income group that is frequently referred to as *emerging market economies*. Given data problems, the particular set of countries varies somewhat from chapter to chapter, but we try to keep a core group intact. In Latin America, we focus on Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. In Asia, the cases are Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan, and Thailand. Table 1-2 shows the population and per capita GDP for these countries. In Latin America, population ranges from 16 million to 177 million, and per capita GDP from $4,900 to $11,500. For East Asia, the range is 4 million to 215 million and $3,400 to $24,500, respectively. On average, East Asia's population slightly

Table 1-2. *Latin America and East Asia: Population and Per Capita GDP, 2003*

Region and country	*Population (millions)*	*GDP per capita*[a]
Latin America[b]	61.4	7,951
Argentina	38.4	11,586
Brazil	176.6	7,767
Chile	15.8	10,206
Colombia	44.4	6,784
Mexico	102.3	9,136
Peru	27.1	5,267
Venezuela	25.5	4,909
East Asia[b]	65.4	12,964
Indonesia	214.5	3,364
Korea	47.9	17,908
Malaysia	24.8	9,696
Philippines	81.5	4,321
Singapore	4.2	24,481
Taiwan	22.6	23,400
Thailand	62.0	7,580

Sources: World Bank, *World Development Indicators* (online); Republic of China (2004) for Taiwan.
a. Dollars (purchasing power parity).
b. Unweighted average.

exceeds that of Latin America, while the per capita GDP differential is much larger.

In the chapters on changes in the financial system, we make use of quantitative data sets that have been gathered by others, putting them into comparable form to the extent possible to be able to describe and explain the differences between and within regions. In the chapters on the impact of the changes, we switch to country case studies of Chile, Mexico, and Brazil. These three not only have the most sophisticated financial systems in Latin America, but they also show three rather different approaches to finance—based on different ownership patterns—in the new market-oriented era. By combining quantitative and qualitative methods, we provide both a broad comparative overview and a nuanced analysis of the interaction of individual characteristics and global trends.

The dependent variables differ in the two parts of the book. In the initial chapters, we are trying to explain the characteristics and changes in Latin America's financial sector and how it differs from that of the more successful East Asian region. In the later chapters, we want to understand the financial sector's contributions to economic success in Latin America itself, where success is defined as a combination of stability, economic growth, and equity. These are broad and ambitious goals, but they are necessary to discover the extent to which the financial sector is pulling its weight in the economic development process and what steps can be taken to improve its performance.

Overview of the Book

The rest of the book is divided into two substantive parts, followed by a policy-oriented conclusion. Part I consists of four chapters that analyze changes in the financial sector over the past fifteen years. Chapter 2 starts with the financial liberalization process. It looks at how much liberalization has taken place in Latin America in comparison with other regions, the relationship between financial liberalization and crisis, and the characteristics of the rescue operations if a crisis occurs. The main findings are that Latin America has liberalized its domestic financial sector extensively, but in an unusually volatile way. Domestic liberalization was accompanied by international liberalization, while macroeconomic stability and prudential regulation lagged behind. Institutions also tended to be weak, which was a disadvantage: good policies require good institutions, and these take time to develop. The combination helped to promote twin banking and currency crises, which were extremely expensive to resolve—in terms of both opportunity costs for government revenues and other costs such as lost GDP, high real interest rates, and falling asset prices. These negative consequences lasted for many years after the crises themselves had subsided. Looking at these facts, we conclude that a gradual approach to liberalization should be pursued to give the authorities time to develop an adequate policy and institutional environment in which to cope with the new challenges.

Chapter 3 begins an examination of three other trends that were associated with financial liberalization and crisis. The focus of this chapter is on changes in ownership of the banking sector. We confirm the generally accepted trend toward less public and more foreign ownership, but we find that substantial heterogeneity still exists. Looking at banking systems within countries, rather than individual banks across countries, we find that East Asia behaves as the new literature predicts: foreign-dominated banking systems perform best, public systems worst, and private domestic systems in the middle. The situation in Latin America is more complex: foreign-dominated banking systems behaved less well than predicted, but public systems performed better. To explain these anomalies, we turn to the role of institutions. Incorporating institutional variables reinforces the results from East Asia and enables us to account for the unexpected findings in Latin America. We conclude that with strong institutions, public banks can perform reasonably well, while weak institutions can undermine the operations of even world-class foreign banks.

Chapter 4 examines another aspect of the government's role in the financial sector. Regulation and supervision were loosened as part of the financial liberalization process, and banks frequently took advantage of the laxity to behave in ways that led to crises. In the postcrisis period, new, more sophisticated systems of prudential regulation and supervision were introduced. It has recently been

argued, however, that the new rules are stifling financial development and that private monitoring is a preferable approach. Our findings suggest that private monitoring can be a useful supplement to government-based regulation, but the problems of procyclicality that characterize the financial sector require that governments provide stability as a public good. We also emphasize the interrelationship of macroeconomics and banking regulation and examine the increased role played by international actors in setting rules on regulation and supervision. In this context, an important agenda item for the coming years is the impact of the new BIS agreement on the financial systems of developing countries.

Chapter 5 turns from banks to the capital markets, the other key element of the financial system. While neither banks nor capital markets have been shown to be superior to the other as a source of finance, evidence is growing about the advantages of having both. Latin American bond and stock markets, however, are weak in comparison to their East Asian counterparts, with the possible exceptions of Chile and Brazil. Our findings suggest several reasons for the discrepancy: better macroeconomic performance in East Asia, stronger institutions in East Asia, and the availability of U.S. capital markets as an alternative to domestic markets for large firms in Latin America. Nonetheless, Latin American governments have recently begun to promote domestic capital markets with some success. One method is to create institutional investors, especially through the privatization of pension funds. Others include mandating greater transparency and accountability in the financial sector as a whole and strengthening corporate governance in nonfinancial enterprises. A worrisome issue is new evidence on possible negative interactions between domestic and international financial systems.

Part II of the book shifts from regional analysis of changes in the financial system to case studies of how the changes manifested themselves in individual countries and their impact in terms of growth, investment, and access to finance. Chapter 6 begins with the Chilean case. In the mid-1970s, Chile became the first country in Latin America to embark on a sustained program of financial liberalization. After a serious crisis in the early 1980s, the country was a pioneer in revamping its regulatory and supervisory systems. Since 1990, the Chilean financial sector has been the most successful in the region in terms of depth, efficiency, and stability. These characteristics, in turn, have contributed to a virtuous circle with the highest rates of investment and growth in Latin America. The financial sector model is a combination of domestic and foreign banks; in addition, a single, well-managed public sector bank pursues both social and economic goals. Capital market depth exceeds that of any neighboring country. Reasons for the good performance include the bank clean-up in the 1980s, a stable macroeconomic and institutional environment, and a gradual international reopening after the crisis. Capital market deepening has depended heavily on demand by institutional investors. Despite good performance, challenges

remain: increasing long-term finance and liquidity and expanding access for small and medium-sized firms are among the principal ones.

Chapter 7 focuses on Mexico. Mexico's financial reforms began a decade after those in Chile and were followed by a major crisis in 1994–95. As a result, the Mexican government also reformed its banking laws and institutions. It not only reprivatized the banks taken over during the crisis, but eventually sold almost all domestic banks to foreigners; nearly 85 percent of bank assets are now controlled by foreign institutions. While this ownership structure offers potential opportunities, they have yet to be realized. Capital markets are weak, although the government has been promoting them in the last few years. The main problem with Mexico's banks, both foreign and domestic, is that they are not lending to the private sector, especially to private firms. Credit as a share of GDP is extraordinarily low, even in comparison with other countries in the region. This drought in the credit markets has not been a problem for the largest corporations, which can obtain funds internationally, but it has created serious difficulties for the large majority of firms. Despite an upswing since 2003, the negative implications for investment and growth are clear. Reviving bank credit is clearly Mexico's biggest challenge; closely related is the need to improve the country's institutions and expand access to finance for households and small firms.

Chapter 8 turns to Brazil, whose financial sector presents some interesting contrasts to those of Chile and Mexico. First, Brazil also liberalized its financial sector, but to a lesser extent than the other two countries. It still retains several very large and powerful public banks. The other major players are private domestic banks. Foreign competition, while increasing, is less important than in Chile or Mexico. Second, rather than waiting for a financial crisis to erupt, the Brazilian government cleaned up the banking system and revamped its laws and institutions after some serious problems emerged following a successful macroeconomic stabilization program in the mid-1990s. Third, Brazil has a long history of promoting capital markets, and it has some of the largest, most sophisticated markets among developing countries. Nonetheless, problems also remain in Brazil. Credit is scarce because banks prefer to hold government bonds rather than lend, and interest rates and spreads are extraordinarily high as a result of continuing macroeconomic problems. Not surprisingly, investment has been low and growth has been volatile. In addition, access to finance is limited, despite new programs in this area by the public banks.

Part III concludes with a summary of findings and a set of policy recommendations. The recommendations address the most important challenges facing the Latin American region if banks and capital markets are to be strengthened so that they can play a greater role in supporting economic development. The overall message is that emphasis should be placed on changing the environment

in which the markets operate, with particular focus on macroeconomic stability, institutional development, and links with the international economy. In addition, market-enhancing policies must be developed to resolve the two major problems we have identified: the lack of long-term finance for investment and the scarcity of finance for small and medium-sized firms. Both need to be resolved if the Latin American region is to overcome the low growth rates of recent years and the long-term heritage of inequality.