

DRAFT; PLEASE DO NOT QUOTE

**Domestic Capital Markets in Latin America and East Asia:
An Alternative to Foreign Capital?**

Barbara Stallings

William R. Rhodes Research Professor, Watson Institute, Brown University

Prepared for delivery at the LAEBA Conference on Economic Development and Integration
in Asia and Latin America, Tokyo, Japan, September 29-30, 2003.

Domestic Capital Markets in Latin America and East Asia: An Alternative to Foreign Capital?

Barbara Stallings, Brown University

Emerging market economies – including Latin America and East Asia – have traditionally had bank-based financial systems, where capital markets have been small and poorly developed. In these settings, bond markets have tended to be shallow, heavily dominated by government debt, and with low turnover. Stock markets, likewise, have featured few issues and most have not been traded with any frequency. Thus, the banking sector, which is usually a combination of private commercial banks and government development banks, has provided the main source of finance for both public and private borrowers. Recent financial liberalization reforms have changed the way the banking sector operates by limiting government controls over interest rates and over the volume and recipients of credit, but they have not necessarily provided much stimulus for capital market development.

According to one strand of literature, these characteristics do not pose any particular problem since it is argued that bank-based systems provide a perfectly viable source of finance; indeed, the majority of the industrial countries have bank-based systems. The so-called Anglo-Saxon model, based on strong capital markets, is an anomaly even among industrial economies. Another line of thought suggests that it is important to have capital markets in addition to the banking system. Among the reasons put forward is that domestic capital markets will lower dependence on volatile foreign capital flows. Noteworthy is the fact that governments of many Asian countries have become proponents of the latter position in the aftermath of the Asian financial crisis of the late 1990s. While a few Latin American countries have long had fairly active capital markets, less emphasis has been put on developing them than in the Asian context.

This paper focuses on several issues with respect to capital markets in emerging market economies. The first section reviews the literature about their role and relative importance. The second provides data on financial market trends in Latin America and East Asia. The third analyzes the differences between the two regions and explores some implications. The final section concludes with some policy proposals for stimulating capital markets in emerging markets and asks to what extent the domestic markets really can be a substitute for foreign capital in the near future.

Do Capital Markets Matter and Why?

In an influential study published two decades ago, John Zysman popularized the idea that financial systems can be divided into three types: a system based on capital markets (the United States and Great Britain), a credit-based system administered by the government (France and Japan), and a credit-based system dominated by financial institutions (Germany). Zysman himself was interested in this distinction because he believed that financial systems influence governments' capacity to intervene in the economy and the types of political conflicts that emerged.¹

In the economics field, an equally influential book by Franklin Allen and Douglas Gale looked at the same five countries. Their aim, however, was to criticize standard economic theory about the allocation of resources through financial markets. They set out “to develop theories that better capture how resources are allocated in practice and understand the normative properties of different systems.” They were also interested in comparing the advantages and disadvantages of market-based versus credit-based (intermediated) systems, although they came to the conclusion that different institutions can perform the same function and that the ideal system relies on both.²

A third book of interest for our topic, an edited volume by Asli Demirguc-Kunt and Ross Levine, brings two new elements to the discussion of banks and markets. First, they move away from the industrial countries and address the topic with respect to the developing world. (In this sense, they look back more to Raymond Goldsmith than to the authors just mentioned.³) Second, they set out to provide empirical data, including a new database, to compare the operation of the two types of systems. Echoing Allen and Gale, they do not find either type to be superior; rather the key is how well either functions.⁴

Developing countries tend to be on one extreme of the spectrum between banks and markets, since the requirements for setting up a banking system are much less stringent than for markets. Thus, even moving toward Allen and Gale's ideal of a combined system requires additional effort to promote capital markets. By the late 1990s, many calls were being heard – from economists, business people, government officials, and the international financial

¹ Zysman (1983).

² Allen and Gale (2000).

³ Goldsmith (1969).

⁴ Demirguc-Kunt and Levine (2001).

institutions (IFIs) – for more movement in this direction. In particular, the calls focused on the “missing market” – that for government and corporate bonds. Indeed, stock markets have been more common than bond markets in developing countries, in part because the upside of a bond is limited by the interest rate, while an equity claim has an unlimited upside and so can compensate for high risk.⁵

Those calling for support for the “missing market” offer a variety of reasons to explain the importance of an active bond market. First, a bond market is the only way to establish a market-determined interest rate, which will help investors calculate the opportunity costs of various investments. Second, without a bond market savers will have fewer investment choices and thus a lower volume of savings may be mobilized. Third, firms will face higher cost of funds without a bond market and, in trying to match maturities, may be biased toward short-term investments. Fourth, to compensate for the lack of a domestic bond market, firms and governments may borrow abroad and thus take excessive foreign exchange risks. Fifth, in the absence of a deep bond market, the banking sector will be more significant than it would otherwise be and thus make the economy more vulnerable to crisis.⁶

Other experts have concentrated on more specific institutional needs to justify the call for more emphasis on bond markets. From the government’s perspective, a bond market is useful to finance fiscal deficits without increasing inflation or taking on exchange rate risk and for running monetary policy. Borrowers, both firms and households, also need access to bond markets to obtain long-term finance for investment or mortgages.

Finally, combining some of the justifications above, an argument that has become increasingly common is that domestic capital markets can be an alternative to borrowing abroad with the risks that the latter entails. The head of the International Monetary Fund (IMF) capital market division recently stated, “The efforts to develop local securities markets have been motivated by a number of considerations, especially the desire to provide an alternative source of funding in order to self-insure against reversals in capital flows.”⁷ He goes on to quote Alan Greenspan’s well-known comment that smoothly functioning bond markets can act as a “spare tire” for when other sources of funds dry up.

⁵ See BIS (2002), box 2, for a discussion on “why equity markets may exist where bond markets fail to thrive.”

⁶ See Herring and Chatusripitak (2000), esp. pp. 14-24.

⁷ Hausler et al (2003).

Following up on this latter argument, the Asian governments have been especially eager to promote the growth of bond markets since the crisis, believing that the absence of a deep bond market was one of the causes of the crisis. Various regional organizations, including the Asian Development Bank (ADB), the Asian Development Bank Institute (ADBI), and the U.N. Economic and Social Commission for Asia and the Pacific (ESCAP), have carried out studies and made recommendations on how to strengthen the bond markets.⁸ The arguments in favor are similar to the ones already mentioned. Latin American governments have been less concerned with these issues, although the Inter-American Development Bank recently published a volume on the capital markets.⁹ Also, the Bank itself has sponsored programs to stimulate the development of financial markets.

Comparing Financial Market Trends in Latin America and East Asia

As a measure of the growing interest in capital markets in emerging market economies, especially bond markets, a number of empirical studies have recently been carried out that help to identify trends.¹⁰ Their message is that domestic capital markets have been expanding, though in a fairly uneven way across regions and individual countries. In general, this expansion has been accompanied by growth of bank credit and increased use of international financial markets. Thus, the fear that domestic capital markets would displace other sources of finance does not seem to have occurred, although a better understanding of the relationship among the various markets would be helpful.¹¹

This paper looks at an important sub-set of emerging market financial systems, focusing on Latin America and East Asia. Table 1 begins with an overview, comparing the structure of the financial markets as a whole, including banks, bonds, and equity, over the period between 1990 and 2001 (the last year for which full data are available).¹² These data provide the opportunity to contrast both the overall depth of the financial markets in the two

⁸ See, for example, ESCAP (1998); Kim (2001); Yoshitomi and Shirai (2001).

⁹ Dowers and Masci (2003).

¹⁰ See, for example, United Nations (1999); BIS (2002); Dowers and Masci (2003); Litan, Pomerleano, and Sundararajan (2003).

¹¹ On the relationship between banks and the capital markets, see Hawkins (2002).

¹² There are very significant data problems in this kind of exercise, so the numbers should be taken as approximations, although I believe that the trends are accurate. Different sources produce different figures for the same variables, and the same source can even produce different estimates in different publications! Problems also arise since the data are aggregated in U.S. dollars, which introduces distortions in GDP figures due to exchange rate variations.

regions and the relative weight of the different components. The principal measure used in this table (and most of the others in the paper) is outstanding amounts of finance as a share of GDP to show the importance of the volume of finance relative to the size of an economy. In addition, dollar figures are shown to compare the absolute size of the markets, both between the two regions and with the international capital markets; the latter will be an element of the discussion about the ability of local markets to substitute for international integration.

Several important points emerge from the first panel of the table. First, in 2001, domestic financial markets as a whole in East Asia were twice as deep as those in Latin America (216% of GDP as opposed to 108%). Each individual component echoed the gap between the two regions, although it was especially prominent in the banking sector. Second, the relative strength of East Asia has been present at least since 1990, and it has been growing since then. The growth rate of total domestic finance as a share of GDP in Latin America was 42% compared to 59% for East Asia. It is interesting to note, however, that the Asian figures did not increase between 1995 and 2001. As will be discussed later in the paper, this stagnation was due to the Asian financial crisis and the response to it. We can see from the table that, despite the overall stagnation, there was a change in composition between 1995 and 2001 as stock market capitalization fell substantially, but both bank credit and bonds continued their upward trend. Third, with respect to capital markets (bonds and stock markets), Latin America saw a bigger increase over the period as a whole. In that region, bank credit declined as a share of GDP, while the capital market share more than doubled. Nonetheless, despite the recent growth, the combined bond and stock market share of GDP in 2001 in Latin America was less than half that in East Asia.

The second panel of Table 1 shows the relative importance within each region of the three financial sector components. In 2001, the three were relatively evenly distributed in Latin America, although bonds were slightly more important than bank credit or the stock market. In East Asia, bank credit was substantially more important than either of the other components. Some shifts have occurred over time. For Latin America, the most obvious is the reduced importance of bank credit and the increased role of capital markets, especially the stock market. For East Asia, bank credit remained about half the total, while bonds rose somewhat and the stock market shrank.

While Table 1 focuses on amounts outstanding of each component, another way to look at the process is to focus on recent trends in financial flows. Flow data for the period 1997-2001 significantly reinforce some of the differences observed in the data on stocks. In terms of flows, bank credit was much more significant for Asia and less so for Latin America, bonds were much more important for Latin America (especially for the public sector), while the stock market faded in both regions but especially Latin America.¹³ If these trends continue, it can be expected that the financial systems in the two regions will become even more dissimilar.

Finally, the third panel shows the absolute size of these markets. In Latin America, the three together grew from \$770 billion in 1990 to \$1.8 trillion in 2001. Subtracting bank claims, the capital markets share went from around \$300 billion to a little less than \$1.2 trillion in the same period. East Asia's overall financial sector was substantially larger, but since the banking sector was also larger, the capital markets were about the same size as those in Latin America (around \$1.3 trillion). These regional figures need to be broken down by countries, since the markets are currently organized on a national basis. Combining bonds outstanding and stock market capitalization, there were six markets over \$200 billion in 2001: Argentina (\$231bn), Brazil (\$498), and Mexico (\$215) in Latin America, and Korea (\$525), Malaysia (\$202), and Taiwan (\$416) in East Asia. This compares with an average of around \$5 trillion for the five largest OECD markets in bonds alone.¹⁴

Moving to a closer examination of the three components, including the differences among countries within regions, we begin with bank claims as shown in Table 2. In addition to the overall trends that we have already seen, the table compares credit to the private sector with total credit in each economy. The dominant message is that the private sector got more credit in East Asia than in Latin America. Private-sector credit in Latin America remained a little less than 30% of GDP throughout the period studied, while it increased from 58% to 83% in East Asia. In addition, the private sector share of total credit was much higher in East Asia: over 90% in 1990, falling to 80% in 2001. For Latin America, the figures are 59% and 73%, respectively. In other words, the trend in Latin America was toward a greater share for the private sector, while the opposite occurred in East Asia. By the end of our period, the

¹³ Based on data calculated from IMF (2003, pp. 75-78).

¹⁴ Data are from BIS Website.

difference between the two regions on this indicator had been reduced, although a huge gap remained in terms of GDP share.

Table 2 also shows data for the seven Latin American and six East Asian countries for which data are most readily available. With one exception, they are also the largest emerging market economies in each region.¹⁵ A pattern emerges here that will be repeated with all our data: some countries in each region have much deeper financial markets than others. Indeed, the differences within regions are sometimes as important as those across regions. In terms of total bank credit, Brazil and Chile have much more credit available than other Latin American economies. In East Asia, the situation is more even across countries, though Indonesia and the Philippines lag behind. The same general pattern also holds for private-sector credit, although it is important to note that in several countries in both regions, private-sector credit as a share of GDP actually fell between 1990 and 2001 (Brazil, Colombia, Mexico, Venezuela, and Indonesia).

Table 3 shows total domestic bonds outstanding and bonds issued by the private sector. As can be seen, data problems are more severe for bonds than for bank loans. Several countries are missing from the table for 1990. It is not clear if the data are unavailable or if there were no bond issues; in any case, they would not have been large. For the private sector, data are only available as of 1993 and again for selected countries. For total bonds outstanding as a share of GDP, we already know that East Asia far outpaces Latin America, but an even greater difference exists for private-sector bonds. While the share going to the private sector increased in both regions, by 2001 the private sector (including both the corporate and financial sectors) in Latin America still accounted for only 20% of total bonds outstanding (representing 6% of GDP). In East Asia, the private sector represented 91% of total bonds (39% of GDP). By definition, then, the public sector accounted for 80% of bonds in Latin America, but less than 10% in East Asia.

Again, we see substantial differences within as well as across regions. Chile and Brazil continue to dominate in Latin America, as do Korea and Malaysia in East Asia. There nonetheless remains a very large gap between the leading economies in the two regions, with

¹⁵ Of course, China is by far the largest economy in the Asian region. It is not included for two main reasons. On the one hand, there are very serious data problems for China. On the other hand, including China in weighted averages would overwhelm the rest of the Asian region, making comparisons with Latin America quite difficult.

the two East Asian leaders having 55% of GDP in private-sector bonds, while the figure is less than 20% in Latin America.

The stock market is potentially an important source of finance for private firms,¹⁶ but the figures for market capitalization give a greatly inflated view of their role. As mentioned earlier, issuance of shares on the markets in both regions (the so-called primary markets) has fallen to a very low level in the last five years (to only 2% of GDP in Latin America and 8% in East Asia) compared to the market capitalization figures shown in Table 4 (39% and 62% of GDP, respectively). In terms of individual countries, there are some small changes in comparison with bank loans and bonds. Chile and Argentina have the two largest stock markets (in terms of GDP share) in Latin America, while Malaysia and Taiwan top the list in East Asia.

Table 4 also shows the turnover ratio, which is an indicator of how active the secondary market is in each country or region. The measure is defined as the total value of shares traded during a given period, divided by the average market capitalization for the period. The ratio is important because the more liquid a market is (the higher the turnover ratio), the more willing investors are to put money into the stock market. It is also argued that more active trading provides more accurate pricing of individual issues and improves the allocation of resources. The data show that turnover in East Asia vastly exceeds that in Latin America (95% to 14%, respectively); indeed, turnover has actually fallen in Latin America during the past decade. There appears to be some relationship between the absolute size of market capitalization and turnover, as opposed to share of GDP, which is our basic measure in this paper. Of the five markets with capitalization over \$100 billion, four (Brazil, Mexico, Korea, and Taiwan) had the highest turnover – although Brazil and Mexico were way below their Asian counterparts.¹⁷ Thailand is an exception with high turnover but a relatively small market. Chile is also an interesting case with the largest market in terms of GDP in Latin America but a low turnover; the reasons will become clear a bit later.

Finally, Table 4 shows the number of firms listed on each stock market over the period 1990-2001. The two regions started out in 1990 with very similar numbers: 1,624 in Latin America and 1,664 in East Asia. By 2001, however, the number of listed firms in Latin

¹⁶ Some public-sector firms have also listed a part of their shares on local stock markets.

¹⁷ The fifth country is Argentina, which had a relatively high turnover earlier, but was in the midst of a severe financial crisis by 2001.

America had fallen to 1,344, while in Asia they had more than doubled to 3,706. Every country in the Asian sample showed buoyant growth, while only two in Latin America grew at all. The trend in number of listed firms complements the data on market capitalization, so we can better understand the relative role of price and volume increases.

Up till now, we have been focusing on domestic financial markets, but governments and the private sector have another alternative through the international financial markets. International banks can provide loans to borrowers in emerging market economies (either through the head offices or local branches in emerging economies themselves), and actors in the latter can also issue bonds or stocks internationally. Table 5 provides information on international bank loans and bonds outstanding [data on equity will be added later], in 1995 and 2001. Here we find a somewhat different pattern than we have seen in previous tables: international loans and bonds in 2001 constituted a slightly larger share of GDP (29%) in Latin America than they did in East Asia (24%). The difference was more significant for bonds than bank loans. Looking at the data in another way, international finance (loans and bonds) as a share of total finance for Latin America was 21% versus 10% in East Asia. Nonetheless, the addition of the international component does not offset the difference we have already found with domestic finance between the two regions. Three countries had ratios well above the regional averages: Argentina, Korea, and Malaysia; in the case of the two Asian countries, this international dependence developed between 1995 and 2001, presumably related to the financial crisis. Argentina's share also rose substantially, and that country also was in crisis conditions in 2001.

International loans and bonds are not the only way in which international capital plays a role in the financial sector of emerging economies. The share of foreign ownership of banks and other financial service institutions has increased tremendously in the last few years, especially in Latin America but to a lesser extent in Asia as well. In addition to FDI, portfolio investment in local stock and bond markets has also increased as countries have liberalized their restrictions on foreign participation. It was hoped that a greater foreign presence would strengthen the financial systems through better management, newer technology, and deeper pockets, but the effects are still controversial.¹⁸

¹⁸ Clarke et al (2001); Crystal, Dages, and Goldberg (2001); Litan, Masson, and Pomerleano (2001); Montgomery (2003).

A final set of data that is essential for analyzing capital markets concerns the purchasers of bonds and stocks. Table 6 begins to shed some light on this issue, although data are difficult to compile and country-specific categories make them difficult to interpret; the data are also limited to debt securities. Nonetheless, some useful points can be extracted from the table. First, commercial banks are the dominant purchasers in East Asia, holding nearly half of all bonds; in Latin America, the banks' share is less than one third. Second, on the Latin American side, the single largest category of purchaser is institutional investors (private pension funds, insurance companies, and investment funds of various kinds). The third major difference concerns the category "others," which includes individual investors and corporations. This group is much more significant in Asia than in Latin America. These different types of buyers are important because they have different types of portfolio requirements. To take the two extremes, institutional investors tend to buy and hold, while individual investors may be much more likely to trade frequently. Thus, the profile of investors is probably related to the turnover rate we saw in Table 4 (assuming that owners of stock and bonds behave in similar ways).

Analysis of Financial Market Trends

The previous section has shown important differences between financial markets in Latin America and East Asia along a number of dimensions. The most important is the much deeper domestic markets in Asia, combined with more emphasis on providing resources to the private sector. Latin America's greater participation in international financial markets provides some counterbalance, but not enough to make up for Asia's advantage in the domestic sphere. In addition, as we will see, international capital market participation may be a double-edged sword, offering important benefits in terms of volume and price of finance but also providing channels for contagion in periods of financial crisis.

In this section, we want to examine several issues related to the different regional patterns. First, we explore some macroeconomic and structural reasons for the differences in the domestic markets. Second, we turn to policy differences as another aspect of the explanation. Third, we analyze the role of international financial markets in the two regions. Finally, we consider the implications for future economic performance and ask if East Asia is

positioning itself to continue to outperform Latin America as it did in the several decades before the 1997-98 crisis.

Why are East Asia's domestic financial markets twice as deep as those in Latin America when measured as a share of GDP, and why has the gap been widening? One reason has to do with differences in macroeconomic performance in the two regions. Table 7 compares them with respect to three macroeconomic variables that are relevant for financial sector development: the domestic savings rate, GDP growth, and inflation. The savings rate is obviously important since it is a nation's savings that are recycled through the financial system. Inflation influences the willingness to hold local currency and financial instruments priced in that currency. The role of growth is more complex. While most scholars currently argue that the dominant causal relationship between finance and growth runs from the former to the latter,¹⁹ there is also agreement that this is a messy area and that feedback and simultaneity are probably involved. In this sense, higher growth rates help stimulate financial markets, which leads to higher growth in a virtuous circle.²⁰

As Table 7 reminds us, the savings rate in East Asia has traditionally been almost double that in Latin America. Likewise, the inflation rate has been lower in East Asia, but in this case, Latin America's record improved substantially during the 1990s. Finally, East Asia's growth rate was the highest in the world in the 1960-90 period. It remained high in the 1990s, until the crisis of 1997-98. Latin America's growth rate, while high in the early postwar decades, nonetheless lagged East Asia and fell sharply in the 1980s as a result of the debt crisis. It then picked up in the early 1990s, only to fall back after the Mexican financial crisis of 1994-95. All of these comparisons suggest that financial markets should have performed better in East Asia than in Latin America, as indeed did happen. In addition, it is interesting to note the correlation between the halts in growth in both regions and problems in the financial markets. In Latin America, a serious credit crunch developed in the banking sector in several countries (especially Mexico) after 1995, while in East Asia stock market capitalization has fallen substantially since 1997-98, leading to overall stagnation in volume of finance outstanding.

¹⁹ World Bank (2001).

²⁰ Indeed, there is evidence of financial markets becoming overly exuberant in good times, with finance being offered to risky borrowers who would not be able to get it in "normal" times.

We have seen that the biggest source of the financial gap between East Asia and Latin America is bank credit. In this area, structural explanations supplement macroeconomic trends in explaining East Asia's superior performance. Specifically, there is a long history of close ties between governments, banks, and firms in East Asia; these links played a key role in propelling growth during the so-called East Asian Miracle period. Governments provided large amounts of funding to the banking sector with explicit or implicit instructions as to where and how it should be lent. In the extreme, banks were little more than conduits for government funds, and credit was readily available.²¹ Even absent this government role, the structural relationship between banks and firms, operating in close-knit economic groups in many Asian countries, led to relaxed lending policies to firms in a bank's own group and to high leverage for firms. While these tendencies also existed in Latin America – “directed lending” was present in most countries, and economic groups have been a prominent part of the economic landscape – they were never as extensive as in East Asia. These structural links make it less surprising that East Asia should have a deeper banking sector, although they have also created problems for the operation of the banks in the new, more liberalized environment.²²

Complementing the domestic structural argument is the sphere of influence in which the two financial systems developed. Japan, which had a major impact on its East Asian neighbors through trade and investment links (as well as military occupation in some cases), has been identified as a prime example among industrial countries of a “bank-based” financial system. There is a good deal of evidence that Japanese economic characteristics formed a model for developing Asian economies. In the Latin American case, the United States was the dominant partner, and the United States is regarded as the leading example of a “market-based” economy, where banks play a less important role.²³

Government policy with respect to capital markets is also likely to have had an impact on the trends observed. By the early 1990s, a number of countries in both East Asia and Latin America already had active stock markets. In addition, two in each region (Brazil and Chile, Korea and Malaysia) had relatively active bond markets, when measured as a

²¹ On the East Asian Miracle, see World Bank (1993); critiques include Amsden (1994) and Fishlow (1994).

²² For example, after financial liberalization, Asia's banks lacked the skills to carry out credit analysis of potential borrowers, and they experienced great difficulty in pressing delinquent clients to service their debts.

²³ On the role of regional development patterns, see Stallings (1995).

share of GDP. With the exception of Korea, however, the bond markets were mainly a way to finance government deficits, and the private sector raised minimal amounts. During the 1990s, governments in both regions took steps to expand their capital markets, but the nature of their policy measures varied. In East Asia, the government acted directly to promote market development. In Latin America, the most important step was to create private institutional investors, which, in turn, helped stimulate market development. As mentioned previously, international and regional financial institutions have also been active in promoting bond market development.

The main impetus to market promotion in East Asia was the financial crisis of 1997-98. Governments and other actors became convinced that if their countries had had adequate domestic bond markets, much less foreign borrowing would have taken place, and the crisis either would have been averted or would have been much milder. Individually, they began taking steps, such as opening financial markets to foreign investment, modernizing and expanding government bond markets, creating new institutions, and improving corporate governance.²⁴

In addition, both politicians and technocrats began promoting the idea of regional collaboration in market development. On the government side, political leaders recently approved plans for a pilot project to pool a small portion of the region's huge international reserves to purchase regional bonds. The initial size of the fund is only \$1 billion, but it is expected to increase. The fund would be used to buy sovereign dollar bonds, although its purview may be extended to include purchase of local currency corporate bonds with high credit ratings.²⁵ In a complementary vein, a prominent Korean technocrat has recently called on countries to strengthen the region's private-sector institutions in the financial services area (e.g., securities firms, investment banks, insurance companies), since U.S. and European firms currently mediate almost all of the region's international transactions.²⁶ In general, regional financial integration has been more prominent on the agenda in East Asia than in Latin America.

²⁴ Some of these same steps were taken in Chile, the only Latin American country that pushed capital markets in a major way.

²⁵ Reuters, June 22, 2003; see general discussion in Rajan (2003).

²⁶ Park (2002).

In Latin America, the most significant promotion of capital markets has been indirect. In 1981, as part of an overall program of market-oriented structural reforms, the Chilean government privatized its pension system. Individual accounts are managed by fund administrators (AFPs, by their Spanish initials), which have the obligation to have resources ready when members retire. Given their long time horizon, the AFPs became a source of demand for long-term assets. While initially pension monies were all invested in government debt, the AFPs were soon given permission to expand into domestic stocks and bonds, and eventually into international assets as well. Experts view the successful development of capital markets in Chile as directly related to the new institutional investors.²⁷

By the 1990s, many other Latin American countries were following the Chilean example. While their assets are not nearly as large as Chile's (as a share of GDP), they are already serving to buttress local capital markets. In most cases, however, governments in other countries have been more reluctant to permit investment in private-sector paper, so that government debt is their principal asset. Among major countries in the region, Brazil is the only one not to have embarked on privatization of its pension system. Thus, while the Brazilian pension system is very large, it consists mainly of employer-sponsored defined-benefit schemes; private funds complement the government controlled system for high-income individuals.

International capital has always played a large role in emerging market economies, although a few in Northeast Asia restricted foreign capital inflows in the early postwar period. The channels through which foreign capital entered have varied over time. Foreign direct investment (FDI) was the most important in the 1950s and 1960s, but was replaced by syndicated Euroloans in the 1970s. The latter led to a severe debt crisis in the 1980s in Latin America and some Asian countries as well. In the 1990s, while FDI again became significant (including important investments in banking, pension funds, and other parts of the financial sector itself), portfolio investment also played a large role. The latter entered via investment in local stock markets and, to a lesser extent, bond markets; in smaller countries where the capital markets were poorly developed, bank deposits constituted the main channel.

At the same time, governments, banks, and large non-financial corporations in emerging market economies sought funds on international markets by floating bonds, issuing

²⁷ For an analysis of the impact of the pension reforms on the capital markets, see Uthoff (2001).

American or Global Depository Receipts (ADRs/GDRs), or borrowing from international banks. As shown in Table 5, international bank loans reached about 15% of GDP for each region by 2001, while international bonds were about the same level in Latin America and nearly 10% in East Asia. [Add figures for ADRs/GDRs] Those with access to the international markets could obtain larger amounts of finance at a lower price than was available locally.

Despite these advantages, volatility, exchange rate risk, and (all too frequently) financial crises accompanied access to the international markets. This is not the place to go into the vast literature on financial crises and, indeed, much controversy exists over the relative weight of domestic and international sources of crisis. Nonetheless, at a minimum, there is agreement that international financial markets have been the source of serious problems, both for macroeconomic management and for the operation of firms at the microeconomic level.

Several significant problems have been identified. The most obvious is that foreign capital tends to move in waves. Large inflows enter as enthusiasm builds for emerging market economies, but they can retreat as rapidly as they arrived if confidence wanes for some reason. These surges and droughts are extremely difficult to manage, given their large size in comparison with most emerging economies. A related problem is the pro-cyclicality associated with private capital flows, which can produce asset price bubbles that – when they burst – wrack greater havoc on these economies than in the industrial countries. A third problem involves exchange rate appreciation, which is fed by capital inflows and undermines the trade balance – thus leading to the need for more capital inflows.²⁸

Adding up these various pieces, do they give us any clues about the future performance of the economies in the two regions? If we believe that finance is an important determinant of economic growth, then the vastly deeper financial markets in East Asia would appear, *ceteris paribus*, to provide the basis for continued higher growth in that region.²⁹ Equally important is the relative weight of private versus public finance; East Asia favors the private sector in both bonds and loans, while a large majority of Latin American finance goes to cover deficits or for other government activities (including public-sector investment and

²⁸ A recent analysis of these problems can be found in French-Davis and Griffith-Jones (2003).

²⁹ On the recent literature that finds a strong link between finance and growth, see Levine (1997); Levine, Loayza, and Beck (2001); and Wachtel (2001); for a critique, see Favara (2003).

sterilization of capital inflows as a part of monetary policy). While some of these government activities are surely useful for growth, crowding out the private sector can only have negative consequences for the future of Latin America's economic development.

Insofar as participation in international capital markets increases risks for emerging market economies, then the possibility of substituting local capital markets for international ones – for both public and private-sector actors – becomes a relevant issue for the policy agenda. Our research has some implications for this question, but it does not provide much source of optimism at the present time. The primary markets for equity in emerging market economies have been stagnant for a number of years; indeed, as seen in Table 4, delisting means that the number of firms has fallen in most Latin American countries, although not in Asia. At the same time, secondary markets have been extremely volatile, which lowers the incentive for listing. Bond markets, by contrast, have been expanding, but in a number of cases this has been due to heavy government pressure (e.g., Argentina) or to indexing bonds to the exchange rate (e.g., Mexico in 1994 and Brazil more recently). The latter creates many of the same problems as direct participation in international markets.

A crucial point for both equity and bond markets in emerging market economies is their absolute size. As Table 1 indicated, the two together were about \$1.2 trillion in 2001 in Latin America and \$1.3 trillion in East Asia, with the bond markets around \$500 billion in each. In individual countries, however, only six markets exceeded \$200 billion; only Brazil and Korea had bond markets over \$200 billion. As mentioned earlier, this compares with an average of \$5 trillion each for bond markets in the leading OECD economies. Overall, Latin America and East Asia accounted for less than 5% of total bonds issued in world markets.³⁰ This size factor has led some experts to argue that it would be much more efficient for emerging markets not to have local capital markets, but to become better integrated into international markets. The downside to this efficiency argument is precisely the problems outlined above: volatility, exchange rate risk, and contagion. An alternative for dealing with the size issue is greater regional financial integration as the Asians are trying to promote. We will return to this issue in the concluding section of the paper.

³⁰ Data are from the BIS Website.

Conclusions

This paper has provided data on a number of dimensions for comparing the financial markets in Latin America and East Asia. They can be summarized in the following six points.

- The overall financial sector – including banks as well as capital markets – is much deeper (when measured as a share of GDP) in East Asia than in Latin America, and the gap has been growing. While Latin America’s capital market segment (bonds and stocks) has been expanding faster, it still has not caught up.
- Banks claims as a share of GDP actually contracted in Latin America during the 1990s, in the presence of a serious credit crunch in a number of countries during the last half of the decade, while they boomed in East Asia. Of equal importance, a much higher share goes to the private sector.
- The bond market presents a slightly more balanced picture. Both regions saw bonds outstanding double between 1990 and 2001, but as a share of GDP the market was larger in Asia. Again, a much higher share was captured by the private sector in Asia.
- Stock market capitalization has grown rapidly in both regions, although new issues have fallen off substantially. In addition, the number of listed firms has fallen in Latin America, while it doubled in East Asia over the decade. East Asia’s markets are also more active in terms of trading volume.
- While Latin America lags behind East Asia in the domestic financial markets, this is partially offset by its greater participation in international markets. The share of international finance in total finance is almost twice as high in Latin America as in Asia.
- Finally, on all of the indicators above, there is great diversity across individual countries in the two regions. Indeed, in many cases, intra-regional differences are about as important as inter-regional ones.³¹

The greater depth of the markets in East Asia can be explained by several factors. One is the region’s superior macroeconomic performance (higher growth rates, lower inflation, and higher savings) since the early 1960s. Another is the traditional structural links between banks, governments, and firms. A third is government policies toward financial

³¹ For example, see Stallings (2003) on the growing similarities between the financial sectors in Chile and South Korea.

markets. While Latin America has indirectly promoted capital markets through the privatization of its pension system, thus creating a strong pool of institutional investors, East Asian governments have concentrated on legal changes and improved corporate governance. Latin America's greater participation in international capital markets has provided some important benefits in getting access to deeper markets and lower prices, but it involves high risks in terms of volatility, exchange-rate risk, and possible contagion in times of financial crisis. All of these factors suggest that, insofar as evidence is increasingly pointing to finance as an important determinant of economic growth, East Asia after the financial crisis of 1997-98 is again poised to outperform Latin America in the years ahead.

In both regions, there is scope for increasing the strength of the capital markets, and governments have recognized this as a goal. A number of policy measures are on the agenda; there is broad agreement on some, while others generate more debate. The first group includes a strong legal system to protect property rights, better corporate governance and transparency, improvements in market infrastructure, benchmark government issues, and liquid secondary markets which implies the need for more investors (households as well as institutional investors). The more controversial proposals include the use of indexed securities, the role of foreign investors in local markets, and the policies for promoting institutional investors. In particular, controversy surrounds the privatization of pension systems, which has been the most effective way to stimulate institutional investors.³²

If local capital markets were to increase in importance, to what extent would they really be able to substitute for international market participation? Ironically, East Asia – which already obtains 90% of its finance locally, compared to 80% in Latin America – is more concerned about the issue. The main problems are the small size of the local capital markets in all emerging economies and thus their high volatility. It is hard to imagine that governments and large corporations can satisfy their needs in small local markets, although the latter are a help to these borrowers and virtually the only option for smaller firms. It is certainly a desirable option to strengthen capital markets in addition to upgrading the banking sector. As we pointed out earlier, the two should not be seen as substitutes, but complements.

³² An excellent recent collection of articles pertaining to capital markets in emerging economies and the policy issues involved is Litan, Pomerleano, and Sundararajan (2003).

In addition, however, two other sets of policy measures are complementary to both. One concerns regional markets and regional financial integration. This topic is high on the agenda in Asia. The financial crisis stimulated Japan to propose an “Asian Monetary Fund” to help provide liquidity to regional economies. Although this proposal, like an earlier one by Malaysian Prime Minister Mahathir for an “East Asian Economic Caucus,” was shelved because of opposition from western countries and international financial institutions, other similar options continue to be pursued. The Chiang Mai Initiative of 2000 provided for swaps of local currencies in times of need, and the recent Thai initiative for a regional bond fund is part of the same agenda. While recognizing the enormous problems that would have to be overcome before Asia could follow Europe’s trajectory to a single currency, small steps are being taken.³³ In Latin America, trade integration has taken priority over financial integration, in part because of the macroeconomic volatility in many countries. Recently, however, calls for macroeconomic coordination as a prerequisite for later discussion of financial integration have emerged within all of the regional trade groupings.³⁴

Of greater interest in Latin America is a second set of policy measures to deal with problems of international capital markets. These are the highly controversial use of controls on incoming capital flows to moderate the surges and droughts discussed earlier. Such measures also try to lengthen the maturity of capital inflows, since short-term flows have proven to be the most problematic. Chile took the lead in implementing such controls in the early and mid-1990s, but other countries (including Brazil and Colombia) followed similar goals with slightly different policy instruments.³⁵ The governments concerned believed that the measures were useful in dealing with problems during periods of capital surges; at the moment, of course, the problem is lack of flows, so this option is not immediately relevant.

The most important lessons to be drawn from the experience of Latin America and East Asia with respect to the financial sector in general, and the capital markets in particular, is the need to pursue a pragmatic mix of policies. There is no one solution. Just as both banks and capital markets should be simultaneously strengthened, likewise local and regional options can also be complementary. And, given that participation in international capital

³³ See, for example, Bergsten and Park (2002); Henning (2002); for the views of the architect of the proposed AMF, see Sakakibara (2002).

³⁴ Ghymers (2001).

³⁵ On Chilean capital controls, see Agosin and Ffrench-Davis (2001). For a critique, see De Gregorio, Edwards, and Valdes (2000).

markets is sure to continue, policies to maximize the benefits and minimize the risks are an additional element of such a policy package. Each of the regions has relevant experiences that would be useful for the other. Future joint research in the area of finance would be an important contribution.

References

- ADB (Asian Development Bank) (2003), *Asian Development Outlook*, Manila.
- Agosin, M. and R. Ffrench-Davis (2001), "Managing Capital Inflows in Chile, in S. Griffith-Jones, M. Montes, and A. Nasution, eds., *Short-term Capital Flows and Economic Crisis*, Oxford University Press.
- Allen, F. and D. Gale (2000), *Comparing Economic Systems*, MIT Press, Cambridge.
- Amsden, A., ed. (1994), "The World Bank's 'East Asian Miracle: Economic Growth and Public Policy,'" *World Development* 22, 4 (special section).
- Bergsten, C.F. and Y.C. Park (2002), "Toward Creating a Regional Monetary Arrangement in East Asia," ADBI Research Paper No. 50.
- BIS (Bank for International Settlements) (2002), *The Development of Bond Markets in Emerging Economies*, BIS Papers No. 11, Basle.
- Clarke, G. et al (2001), "Foreign Bank Entry: Experience, Implications for Developing Countries, and Agenda for Future Research," World Bank Policy Research Working Paper 2698.
- Crystal, J., B. Dages, and L. Goldberg (2001), "Does Foreign Ownership Contribute to Sounder Banks in Emerging Markets?: The Latin American Experience," in R. Litan, P. Masson, and M. Pomerleano eds. (2001), *Open Doors: Foreign Participation in Financial Systems in Developing Countries*, Brookings Institution Press, Washington.
- De Gregorio, J., S. Edwards, and R. Valdes (2000), "Controls on Capital Inflows: Do They Work?" *Journal of Development Economics*, 63, 1.
- Demirguc-Kunt, A. and R. Levine (2001), *Financial Structure and Economic Growth*, MIT Press, Cambridge.
- Dowers, K. and P. Masci (2003), *Focus on Capital: New Approaches to Developing Latin American Capital Markets*, Inter-American Development Bank, Washington.
- ECLAC (Economic Commission for Latin American and the Caribbean) (2002), *Statistical Yearbook for Latin America and the Caribbean*, Santiago.
- _____ (2002/03), *Economic Survey of Latin America and the Caribbean*, Santiago.
- ESCAP (Economic and Social Commission for Asia and the Pacific) (1998), *Financial Sector Reform, Liberalization, and Management for Growth and Stability in the Asian and the Pacific Region: Issues and Experiences*, Bangkok.

- Favara, G. (2003), "An Empirical Reassessment of the Relationship between Finance and Growth," IMF Working Paper 03/123.
- Ffrench-Davis, R. and S. Griffith-Jones, eds. (2003), *From Capital Surges to Drought: Seeking Stability for Emerging Economies*, Macmillan/Palgrave, London.
- Fishlow, A. et al (1994), *Miracle or Design? Lessons from the East Asian Experience*, Overseas Development Council, Washington, DC.
- Ghymers, C. (2001), "La problematica de la coordinacion de politicas economicas," Serie Macroeconomia del Desarrollo, No. 10, ECLAC, Santiago.
- Goldsmith, R. (1969), *Financial Structure and Development*, Yale University Press, New Haven.
- Hausler, G. et al (2003), "Trends in Developing Country Capital Markets around the World," in R. Litan, M. Pomerleano, and V. Sundararajan, eds., *The Future of Domestic Capital Markets in Developing Countries*, Brookings Institution Press, Washington, DC.
- Hawkins, J. (2002), "Bond Markets and Banks in Emerging Economies," BIS Papers No. 11, Basle.
- Henning, C.R. (2002), *East Asian Financial Cooperation*, Institute for International Economics, Washington, DC
- Herring, R. and N. Chatusripitak (2000), "The Case of the Missing Market: The Bond Market and Why It Matters for Financial Development," ADBI Working Paper, No. 11, Tokyo.
- IMF (International Monetary Fund) (2003), *Global Financial Stability Report*, Washington, DC.
- _____ (2002), *Global Financial Stability Report*, Washington, DC.
- IMF (2002), *International Financial Statistics Yearbook*, Washington, DC.
- Kim, Y., ed. (2001), *Government Bond Market Development in Asia*, Asian Development Bank, Manila.
- Levine, R. (1997), "Financial Development and Economic Growth: Views and Agenda," *Journal of Economic Literature*, XXXV.
- Levine, R., N. Loayza, and T. Beck (2000), "Financial Intermediation and Growth: Causality and Causes," *Journal of Monetary Economics*, 48.

- Litan, R., P. Masson, and M. Pomerleano eds. (2001), *Open Doors: Foreign Participation in Financial Systems in Developing Countries*, Brookings Institution Press, Washington, DC.
- Litan, R., M. Pomerleano, and V. Sundararajan, eds. (2003), *The Future of Domestic Capital Markets in Developing Countries*, Brookings Institution, Washington, DC.
- Montgomery, H. (2003), "The Role of Foreign Banks in Post-Crisis Asia: The Importance of Method of Entry," ADBI Research Paper No. 51.
- Park, Y.C. (2002), "Financial Liberalization and Economic Integration in East Asia," Paper presented at conference on Financial Stability in Emerging Economies," Fondad, Amsterdam.
- Rajan, R. (2003), "A Bond Fund for Asia," *Far Eastern Economic Review*, March 20.
- Sakakibara, E. (2002), "Asian Cooperation and the End of Pax Americana," Paper presented at conference on Financial Stability in Emerging Economies," Fondad, Amsterdam.
- Stallings, B., ed. (1995), *Global Change, Regional Response: The New International Context of Development*, Cambridge University Press, New York.
- Stallings, B. (2003), "Financial Sector Development in Latin America and East Asia: A Comparison of Chile and South Korea," paper presented at XI Congress of the International Federation of Latin American and Caribbean Studies, Osaka.
- Standard and Poor's (2002), *Emerging Stock Markets Factbook, 2001*, New York.
- Turner, P. (2002), "Bond Markets in Emerging Economies: An Overview of Policy Issues," BIS Papers No. 11, Basle.
- United Nations (1999), *World Economic and Social Survey, 1999*, New York.
- Uthoff, A. (2001), "La reforma del sistema de pensiones y su impacto en el Mercado de capitales," in R. Ffrench-Davis and B. Stallings, eds., *Reformas, crecimiento y politicas sociales en Chile desde 1973*, CEPAL/LOM.
- Wachtel, P. (2001), "Growth and Finance: What Do We Know and How Do We Know It?" *International Finance*, 4, 3.
- World Bank (1993), *The East Asian Miracle: Economic Growth and Public Policy*, Oxford University Press for the World Bank, New York.
- _____ (2001), *Finance for Growth: Policy Choices in a Volatile World*, Oxford University Press for the World Bank, New York.

_____ (2003), *World Development Indicators, 2003*, Washington, DC.

Yoshitomi, M. and S. Shirai (2001), "Designing a Financial Market Structure in Post-Crisis Asia: How to Develop Corporate Bond Markets," ADBI Working Paper No. 15, Tokyo.

Zysman, J. (1983), *Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change*, Cornell University Press, Ithaca.