Finance for Development: East Asia, Latin America, Eastern Europe

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Presenter

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This product presents a policy-oriented summary of the Smart Talk.

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East Asia has often been singled out for its remarkable economic growth, especially in comparison to economies in other regions of the world. Many scholars have sought to explain this unprecedented growth, such as in relation to the changing role of finance, and what this implies about the future of the world economy.

How have the views on the role of domestic finance and financial markets changed in recent years? How do the financial markets in East Asia, Latin America, and Eastern Europe, for instance, compare to one another? Why does East Asia have the strongest markets, and what does this mean for the future?

The East Asia Institute invited Barbara Stallings, William R. Rhodes Research Professor at the Watson Institute for International Studies at Brown University, to discuss these questions at its first Smart Talk held on May 7, 2009. Stallings made regional comparisons of both the liberalization process and changes in bank ownership, and how the economies of East Asia vary from those in Latin America or Eastern Europe. She also outlined macroeconomic performance, strong institutions, and international financial relations as explanations for the unusual strength of East Asian economies, and argued that the world has much to learn from the example of East Asia.

Following Barbara Stallings' presentation, a panel of experts, moderated by President Sook-Jong Lee, discussed the prospects of taking a regional approach to the global crisis, the path of financial liberalization and its implications for future growth, and how to approach an analysis based on regional comparison.

Presentation

Changing Views on Finance

To answer the question of why East Asia has the strongest and deepest markets, it is necessary to compare data from different regions and examine their possible implications on the future. The first step to such an analysis requires a closer look at the changing views on finance, particularly its relation to developing countries. Traditionally, finance was thought to be of only minor importance, and attention was focused mainly on the "real" sector of the economy. The limited interest in finance was mainly on foreign direct investment.

With the emergence of financial liberalization and other reforms, however, finance began to be viewed as a vehicle for growth. As markets were liberalized, state banks were no longer viewed as being efficient. They were then sold off, often to foreigners, thus changing their role as agents for development. It is in such a context that economies throughout the world began to take their current form.

Regional Comparisons

In comparison to other regions of the world, East Asia, Stallings argued, has the deepest markets, whether measured in their entirety or just by each individual component. Although Latin America and Eastern Europe are similar in total size, they differ in the way their components are structured. Capital markets are important for Latin America, while bank credit is more important for Eastern Europe.

Furthermore, Stallings asserted that there are significant differences in how the three regions experienced both the liberalization process as well as changes in bank ownership. The liberalization process in East Asia and Latin America has been more gradual when compared to Eastern Europe. And although markets in East Asia have tended to be less liberalized, the difference is not so great when compared to Latin America. Eastern Europe has the most liberalized markets, but this is the culmination of a rapid process that began with the fall of the Berlin Wall.

In terms of changes in bank ownership, East Asia also shows a rather interesting dynamic. While the figures indicate that there has not been much change in the ownership from public to private, Stallings pointed out that the data is affected by the 1997 financial crisis. Although a process of bank privatization took place, these banks were renationalized again following the 1997 crisis. In comparison, Latin America has seen a more gradual shift from public to private ownership, and Eastern Europe has shown a strong trend toward foreign ownership.

Explanations for East Asian Strength

Stallings highlighted three ways in which to explain why East Asia has been so strong: macroeconomic performance, institutions, and international financial relations.

The macroeconomic explanation is a rather obvious factor in the sense that East Asia has had a very strong macroeconomic performance, which in turn promotes financial development. Macroeconomic performance is usually associated with high and stable growth rates, low inflation, high savings rates, and current account surpluses. Stallings argued that in all of these areas, East Asia has performed well above Latin America, even when looking at the performance of individual countries of the two regions.

In addition, the strength and durability of institutions in East Asia have also been an important factor in promoting financial growth. Measuring institutions can be difficult, but usual indicators would relate to government effectiveness, regulatory quality, the rule of law, and anti-corruption. According to Stallings, East Asia has had very strong institutions, particularly in comparison with Latin America. Strong institutions, in turn, also promote financial development.

Lastly, international factors contributed to promoting financial growth. Latin America in this respect has made greater use of international finance. While this has created some benefits such as greater volumes at cheaper prices, Stallings argued that it has also caused greater volatility. Furthermore, foreign borrowing undermines some elements in the domestic market, particularly small- and medium-sized firms.

Adding Eastern European to this comparison poses some difficulties in this analysis. While the macroeconomic explanation still holds, Eastern Europe actually has stronger institutions when compared to East Asia and Latin America. It also has a large share of foreign capital coming mainly from Western Europe. In fact, its relationship with Western

Europe and in particular the European Union (EU) is a strong factor for the region having stronger institutions and attracting more foreign capital. As countries in Eastern Europe geared up to join the EU, they were required to implement strong institutional reform and development. And as they integrated themselves with the EU, foreign capital flowed in as the region was increasingly seen as safe and a place of new opportunity. According to Stallings, this indicates that for Eastern Europe, the relationship it has with the EU has been fundamental towards its growth.

Implications for the Future

What implications does all of this have for future development? The first and most prominent implication, according to Stallings, is that a lack of finance undermines growth. All three regions have shown how finance can be the catalyst for growth. Yet international finance can bring with it some problems that can, in some cases, lead to crises.

And this can be transformed into policy implications as well. Although a return to a domination of state-owned banks is not the way to move forward, Stallings pointed out that the state does have an important role to play in this area. In this sense, regulation is also important. For example, there has been talk of drawing up rules on the movement of foreign capital, which may go some way of alleviating strains on developing economies.

With all its successes and the way it has overcome adversities, East Asia has many lessons for Latin America and Eastern Europe, if not for the United States and Western Europe. Its experiences in the financial crisis of 1997, in particular, can hold valuable lessons for various developing economies throughout the world.

Discussion

Motivations for a Regional Comparison

The discussion began with the participants addressing the motivations behind Stallings' research approach of regional comparison. In her presentation, Stallings had compared the three regions of Latin America, Eastern Europe, and East Asia which was the main focus. While there are some institutional factors that are similar between certain countries like Korea and Taiwan, one participant wanted to hear more on the other motivations for regional comparison. In other words, why did Stallings choose to take the approach of using regions as single units to be compared between one another?

In response, Stallings pointed out that while it is important to recognize that comparing regions or comparing nations both have merits on their own, regions today tend to increasingly cluster and operate together as a single actor on the international stage. Therefore, it is fair enough to make regional comparisons when taking into account the way they operate.

The Path of Financial Liberalization

Drawing upon the main argument made by Stallings that financial liberalization leads to growth, one of the participants wanted to look more into the extent of financial liberalization. In the context of the current financial crisis, questions have been raised about the extent of financial liberalization. The participant therefore wanted to hear Stallings' thoughts on the current path of financial liberalization. Because financial liberalization has important implications for growth, another discussant drew the panel's attention to the progress in East Asia, Latin America, and Eastern Europe with regard to liberalization.

Stallings suggested two important points that need to be noted when setting out on the path of financial liberalization. First, there needs to be a middle ground between full liberalization and partial liberalization. Secondly, it is critical to note that financial liberalization done poorly can create a crisis, a lesson that the past has repeatedly taught us. At the same time, there also needs to be a realization that sometimes private ownership is not always the "be-all and end-all" in finance.

There was a strong consensus among the participants with regard to the role of institutions in promoting growth. From the analysis on the important role of strong institutions, the participants agreed that countries which know how to manage themselves efficiently have more options when confronting difficulties.

Regional Approach to a Global Crisis

With the current global crisis, there have been regional efforts to resolve some of the problems of setting out on an economic recovery. One participant raised the question of this regional approach in dealing with the global crisis. He noted that this regional effort was an issue that was expressed during recent discussions on the Chiang Mai Initiative (CMI). Such a regional approach would not only be useful in addressing the global crisis, but can also have potential benefits for member states. For example, he suggested that the CMI will increase East Asia's bargaining position on the international stage, as made apparent by the way countries in the region have tried to maintain an Asian membership and a degree of independence from the International Monetary Fund.

Stallings accepted that grouping together as a region increases the countries' bargaining strength, this was part of her approach to the topic, but she stressed that there are other factors involved. For example, she noted that this kind of approach is about self-finance – first borrowing nationally and then borrowing regionally. She also indicated that different crises require different solutions.

Conclusion

As the East Asia Institute's first Smart Talk, the participants highlighted the differences between the markets of East Asia, Latin America, and Eastern Europe, especially in terms of liberalization processes and changes in bank ownership. It was also suggested that East Asia is strong due to its macroeconomic performance, strong and durable institutions, and international financial relations.

Some questions were left to be answered. While there was more or less a consensus on the importance of financial liberalization, the extent and scope of liberalization was a matter of debate. Similarly, the regional grouping was also questioned. While the participants noted its approach of increasing its global voice, Stallings noted the economic role of operating regionally.

In general, the discussion participants

agreed that while financial liberalization is beneficial, it is imperative for countries to find a middle ground between full liberalization and partial liberalization. The state should also pay a limited but significant role in financial matters, and regulation is important in alleviating the strains of foreign capital on developing economies and preventing future economic crises. The example of East Asia's success, including both its successes and failures, can serve as a valuable lesson for other developing economies. ▪

—— Barbara Stallings is the William R. Rhodes Research Professor at the Watson Institute for International Studies at Brown University, co-director of Brown's Graduate Program in Development, and editor of *Studies in Comparative International Development*.

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