Finance for Development:

East Asia, Latin America, Eastern Europe

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Topics to be covered

- Changing views on the role of domestic finance and financial markets
- Comparison of financial markets in East Asia, Latin America and Eastern Europe
- Why does East Asia have strongest markets?
- Implications for the future

Changing views on finance

- In early postwar period in developing countries, finance was thought to be of only minor importance
- Attention on “real” sector of economy
- Finance seen as accomodating through government control of quantity and price
- Insofar as finance was seen as relevant, interest was in international flows (especially FDI)

Changing views on finance

- New situation emerged after financial liberalization and other reforms
- Finance seen as crucial for growth
- Opinion about state-owned banks changed radically; viewed as corrupt, inefficient, not agents of development
- Many were sold, often to foreigners

Regional comparisons

- East Asia has deepest markets (total and all components)
- Latin America and Eastern Europe are similar in total size, but components are different
- Bank credit more important for EE
- Capital markets more important for LA

Regional comparisons (% GDP)

Country/region	Bank credit to private sector	Priv sector bonds	Stock market capitalization	Total
East Asia	80.1	26.1	125.5	231.7
Latin America	36.0	9.0	65.5	110.5
East Europe	60.1	9.2	31.5	100.8

Country differences

- Significant differences exist within regions
- In East Asia, Malaysia and Singapore have the deepest markets, followed by Korea and Taiwan
- In Latin America, Chile and Brazil have deepest markets – but neither can match the four countries in EA

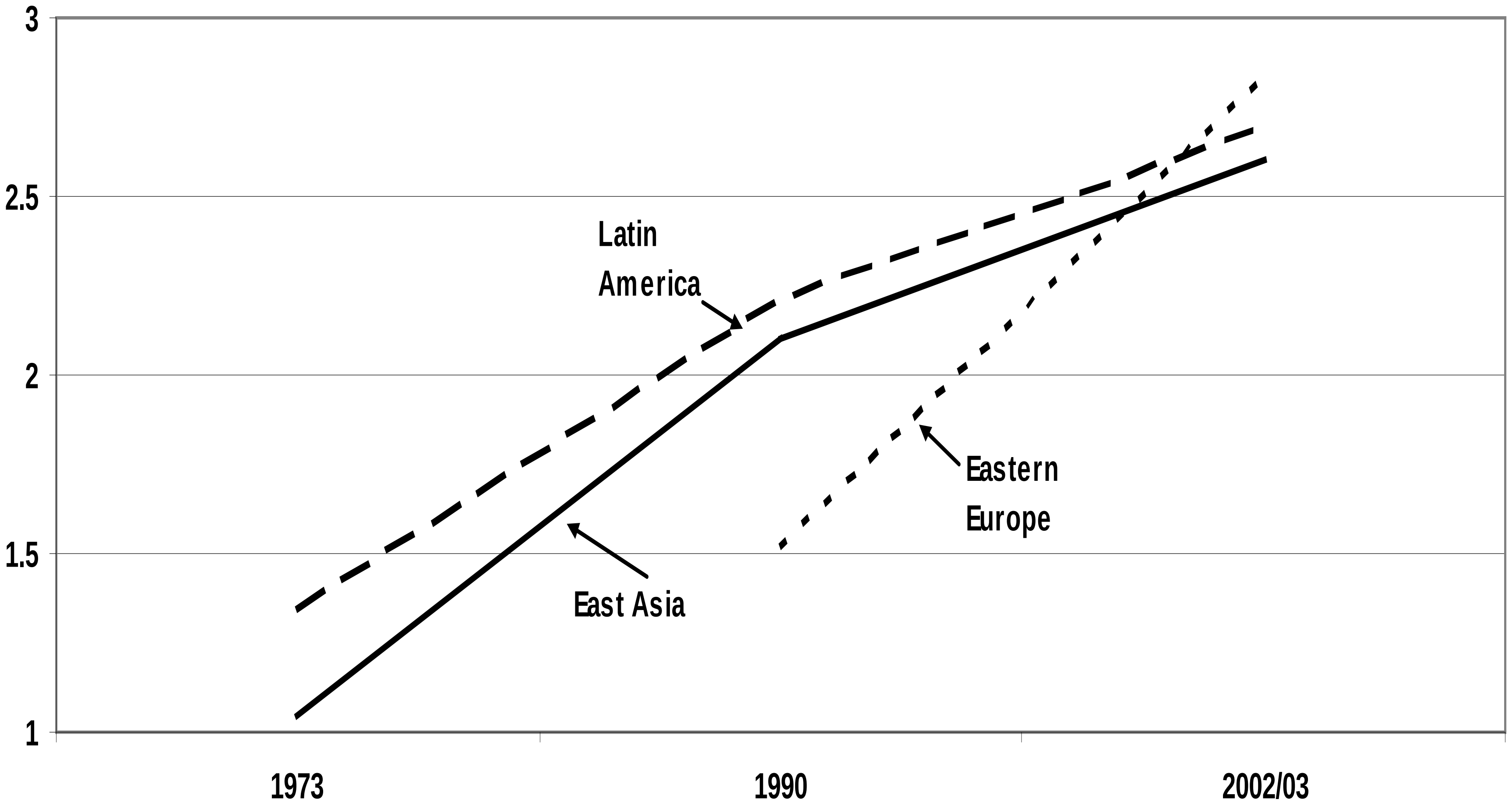
Country differences (% GDP)

Country/region	Bank credit to private sector	Private sector bonds	Stock market capitalization	Total
East Asia	80.1	26.1	125.5	231.7
Indonesia	25.4	2.1	48.9	76.4
Korea	107.8	63.0	115.9	286.7
Malaysia	105.3	58.2	174.4	337.9
Philippines	28.8	1.1	71.7	101.6
Singapore	99.9	18.1	219.1	337.1
Taiwan	101	23.1	168.3	292.4
Thailand	92.4	16.9	79.9	189.2
Latin America	36.0	9.0	65.5	110.5
Argentina	14.5	4.8	33.0	52.3
Brazil	49.8	19.7	104.3	173.8
Chile	88.5	17.2	129.9	235.6
Colombia	32.7	0.4	49.1	82.2
Mexico	22.0	15.7	38.9	76.6
Peru	21.0	4.3	98.8	124.1
Venezuela	23.6	1.1	4.5	29.2

Liberalization process

- Liberalization was more gradual in East Asia and Latin America (than in Eastern Europe)
- East Asia ended up with least liberalized markets (but difference re is LA not great)
- Liberalization was more rapid in Eastern Europe (after 1989); markets are now somewhat more liberalized than EA or LA

Financial Liberalization Index



Change in bank ownership

- East Asia: not much change, but dates are misleading because of 1997 financial crisis; renationalization, then more foreign ownership
- Latin America: substantial move away from government and toward foreigners
- Eastern Europe: most dramatic move toward foreign ownership

Change in bank ownership (%)

	1990			2002		
Region	Government	Private	Foreign	Government	Private	Foreign
East Asia	17.8	60.0	22.2	34.0	42.7	25.9
Latin America	46.2	46.8	9.7	21.7	30.7	46.5
Eastern Europe	83.4	10.0	4.6	11.0	10.8	76.3

Explanations for EA strength

- In comparison with Latin America, explanation is over-determined:

  -- Macroeconomic performance

  -- Institutions

  -- International financial relations

Explanations (1): Macro

- EA has had strong macroeconomic performance, which promotes financial development

  -- High and stable growth rates

  -- Low inflation

  -- High savings rates

  -- Current account surpluses

Macroeconomic performance

Indicator	East Asia	Latin America	East Europe
GDP growth			
1990-2000	8.5	3.2	-0.8
2000-2007	9.0	3.6	6.1
Inflation			
1990-2000	8.6	98.4	60.1
2000-2007	3.3	7.2	11.9
Savings			
1990	36	22	28
2000	36	19	24
2007	46	24	24
Current account			
2000	2.0	-2.4	-5.3
2007	6.7	0.5	-6.6

Explanations (2): Institutions

- In comparison with LA, EA has strong institutions, which also promotes financial development
- Definition of institutions
- Problems with measurement
- World Bank indicators

Institutional quality index (2007)

Indicator	East Asia	Latin America	East Europe
Institutional index	0.47	-0.14	0.55
Govt effectiveness	0.79	-0.13	0.60
Regulatory quality	0.56	-0.05	0.95
Rule of law	0.35	-0.34	0.42
Anti-corruption	0.17	-0.13	0.24

Explanations (3): International

- LA made greater use of international finance in the past, which has both positive and negative aspects

  -- Greater volume at cheaper price

  -- But also greater volatility

  -- Evidence that foreign borrowing may undermine domestic markets

International finance (% GDP)

Indicator	East Asia	Latin America	East Europe
Private flows			
1997-1999	-0.1	4.0	4.8
2007	4.4	2.8	9.4
Direct investment			
1997-1999	3.4	3.3	2.7
2007	2.1	2.1	4.03
Equity			
1997-1999	1.3	1.1	0.6
2007	0.4	0.9	-0.4
Loans			
1997-1999	-4.8	-0.5	1.5
2007	1.9	-0.2	5.7

Eastern Europe comparison

- Adding Eastern Europe complicates the analysis

  -- Macroeconomic explanation remains

  -- EE has stronger institutions than EA or LA

  -- EE also has largest share of foreign capital

Eastern Europe comparison

- My explanation for both institutional advantage and more foreign capital in EE is membership in European Union
- Institutions: EU rules (*acquis)* required institutional development
- Foreign capital: came in because new members were regarded as both safe and a new opportunity

Implications for the future

- Lack of finance undermines growth
- Crowding out private sector negative for growth, especially after liberalization
- Need for international finance brings associated problems (including crises)
- Perhaps EA has lessons for Latin America and Eastern Europe

Policy implications

- No return to dominance of state-owned banks, but there are important roles for government in the financial sphere
- Regulation is clearly necessary
- Government needs to provide appropriate environment for financial deepening: prudent macro management, institutional development, curbs on foreign capital?