Financial Reforms and Emerging Markets

By Silvina Vatnick

In this discussion chapter, the author summarizes the main features of recent financial developments in emerging markets, including market development, governance and regulatory issues. In light of the financial crises that have taken place in those markets, emphasis is made on the actual path of reforms, main policy lessons and issues of concern from the country cases presented in the panel.

I. INTRODUCTION

A number of significant financial reforms have been implemented in emerging markets (EM) during the last decade and the first half of the current one. These reforms, which were conceived to pursue sustainable economic growth, aimed to improve the efficiency in capital allocation, the identification of better investment projects and the promotion of risk hedging mechanisms.

The financial crises that took place in the late 1990s and early 2000s in Asia, Russia and Latin America, have risen widespread doubts about the path and sequence of reforms and highlighted the impact of related risks, including increasing instability in nominal and real variables and other undesired phenomenon such as market concentration.

Since then, policy makers have stressed lessons from the past experience and selected issues to be taken into account. Among others, the following issues have been singled out: the importance of examining the close link between real and financial sectors, the relevance of initial conditions (i.e. the composition of the financial system portfolio), the creation of benchmarking instruments, the development of institutional investors, the fostering of disclosure mechanisms, the compliance of corporate governance standards and the importance of internal incentive systems. Academics as well as policy makers have concluded that different financial instruments should receive different treatment and that the sequencing in their implementation does matter too.

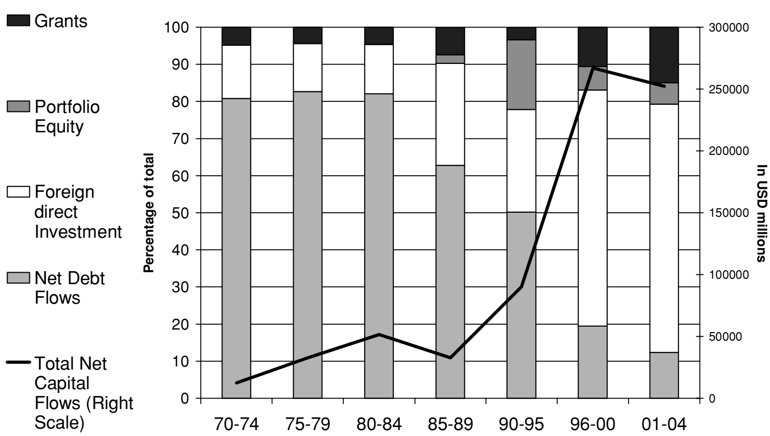
As a discussant of this panel, I would like to take the liberty of first highlighting some of the main features of current financial developments in emerging markets to shed some light on the actual outcomes of the reforms that have already been implemented. I will then continue with a brief reference to Governance and Regulation issues in those markets to then focus and comment on the thrust of the presentation by Mr. Luo Ping.

II. MAIN FEATURES OF FINANCIAL DEVELOPMENT IN EMERGING MARKETS

Capital flows to Emerging Markets (EM) have increased sharply in the last decade and its composition changed significantly (See Figure 1). Total net capital flows have multiplied by more than 2.5 in the period 1996–2000, reaching 260 billion dollars. This tendency was mostly explained by a pronounced increase in Foreign Direct Investment. Equity Markets have lost relative importance in terms of capital flows to EM and net debt flows have reduced dramatically.

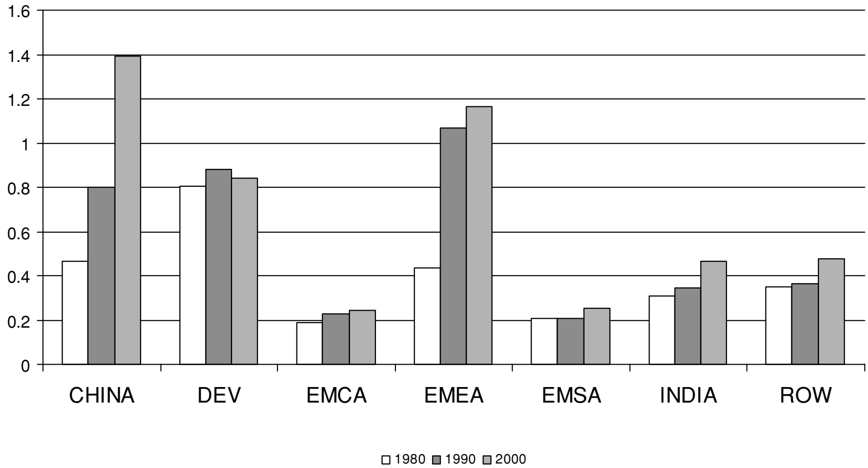
EM financial deepness measured as total deposits in the financial system as percentage of GDP has also increased in the last decade (See Figure 2). East Asian countries have reached financial deepness levels similar to that of high income countries. China has also exhibited a strong increase during the early years of the present decade. Deposits in the Chinese financial system nearly doubled in the period 2000–2003 with respect to the average of the nineties. In contrast, Latin America's financial deepness is relatively limited.

Governments have kept a relatively high share of financial intermediation. In the case of banks, for example, the percentage of government shares in assets ownership reached nearly 90% in China and 80% in India (See Figure 3). Although East Asian and Latin American economies present lower figures, between 20–25%, these are still relatively high compared to the average for High Income Countries which is lower than 5%. On the other hand, the pattern of concentration in the EM banking system is improving. Figure 4 shows that the percentage of assets held by the three largest banks in the system as percentage of all commercial banks, as a measure of concentration, has decreased in the last decade in all EM regions with the exception of India.



Source: Global Development Finance, World Bank, 1997 and 2005

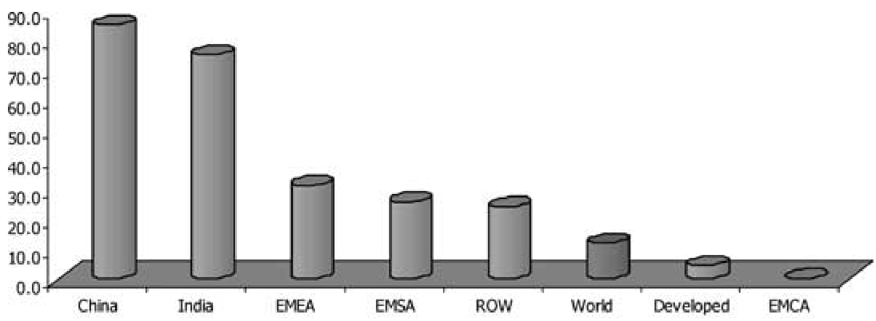
Figure 1: Composition of Net Capital Flows to Developing Countries, 1970–2004.



Note: 2000´s decade include period 2000-2003. EMCA: Emerging Markets from Central America. EMEA: Emerging Markets from East Asia. EMSA: Emerging Markets from South America. DEV: Developed Markets. ROW: Rest of the World.
Source: IMF's International Financial Statistics

Figure 2: Financial System Deposits to GDP (Decade averages).

At the same time, non-bank financial intermediation in EM is relatively limited. Countries that experienced the higher increase in financial system deposits have done it almost exclusively through the banking sector (See Figure 5). One example is the East Asian financial system. Banking assets as a percentage of GDP is higher than the average of emerging economies, however the percentage of other financial institutions is much lower. Similar patterns of low non-bank intermediation can be observed in other emerging economies. This is a major issue, since the complementary development of capital markets has not taken place. A number



Note: EMCA: Emerging Markets from Central America. EMEA: Emerging Markets from East Asia. EMSA: Emerging Markets from South America. DEV: Developed Markets. ROW: Rest of the World.
Source:World Bank Regulation and Supervision Survey (2003) and Barth, Gan and Nolle (2005)

Figure 3: Percentage of Bank Assets Government Owned (2003).

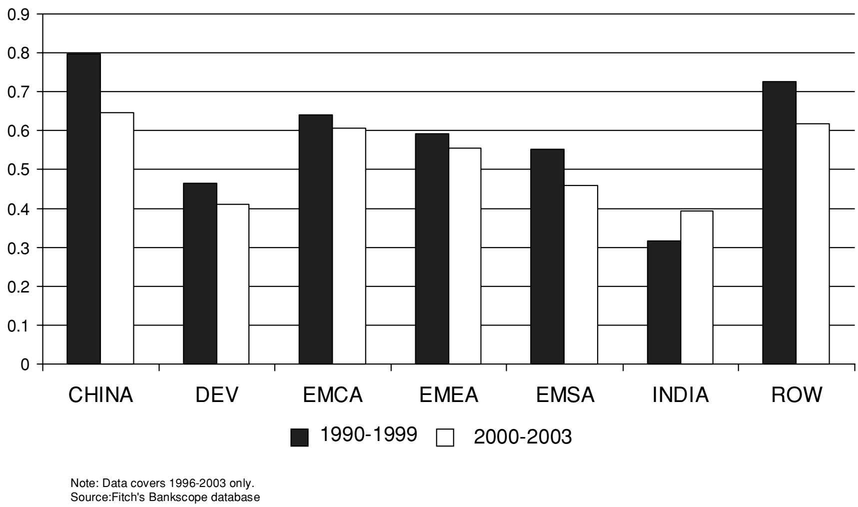


Figure 4: Assets of the three largest banks as a share of assets of all commercial banks in the system.

of new studies focused in emerging markets have shown that credit rationed firms that succeed in accessing bank credit are also better able to access to financing from other financial sources (i.e. obtaining a lower cost of financing in equity markets)[1].

The development of equity markets as an alternative source of funding to banks has been influenced by both global and local markets trends. Their performances have differed substantially across markets.[2] Latin American stock markets' experience, in particular, has been disappointing. Growth rates in stock market capitalization reached significant levels in the early 90's. However, as these markets became increasingly volatile with financial crisis episodes, growth rates decreased, volume trades fell and markets became increasingly illiquid. As a result, the development of Latin American stock markets has been substantially lower than the observed for East Asian economies.

Moreover, last decade witnessed a significant decrease in the number of listed companies across Latin American stock markets. In these economies, patterns of cross-listing ending in complete migration to developed markets have been common between bigger firms (See Figure 6). The opposite situation is observed across Asian Economies, especially in the case of China, South Korea, and Malaysia, where the number of listed firms increased intensively in the last decade.

With the notable exception of East Asian bond markets, EM are still dominated by sovereign bonds. In the case of Asia, for example, the period after the crisis

[1] See Grandes, Panigo and Pasquini (2007).
[2] See De la Torre and Schmukler (2004).

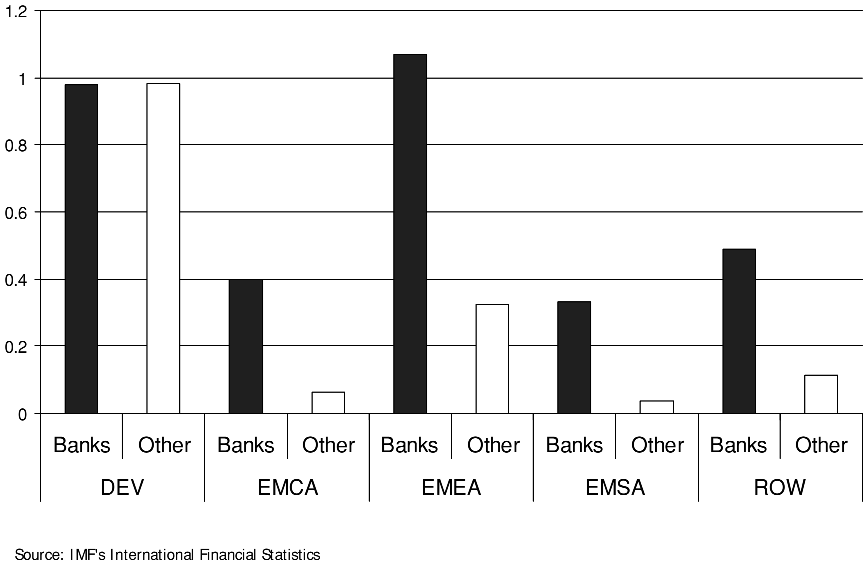


Figure 5: Assets to GDP ratio for Banks and Other Financial Institutions. (Average 2000–2003).

was characterized by an increasing need to recapitalize the banking system. The lack of banking credit stimulated corporate bond issuance. More recently, the growth of local bond issuance has also been stimulated by the need to finance expansionary fiscal policies. In Latin America, the fast growth of institutional investors, such as the new privatized pension system, increased the demand for higher rates of return investments and longer duration assets, which stimulated local bond issuance. However, in many cases these new demands have only been fulfilled by the government sector.[3]

Volatile equity and bond markets, as it has been the case of Latin American markets, have contributed to the relatively high levels of the cost of capital in these economies. The cost of capital is an important determinant of economic growth in emerging economies. A lower cost of capital implies rising investment in both physical and human capital, hence inducing a higher rate of capital accumulation and faster economic growth. Reducing the cost of capital does also create more opportunities for new firms to raise funds at more affordable costs than other sources of finance such as banking loans. Therefore, economic policies aiming to reduce the overall cost of capital should be high on the agenda of policy makers considering the effect over investment and long run economic development.

Studies of EM at the Center for Financial Stability (CEF) suggest that the increases in the cost of capital in these economies have been mainly due to the

[3] See Hausler, Mathieson and Roldos (2003).

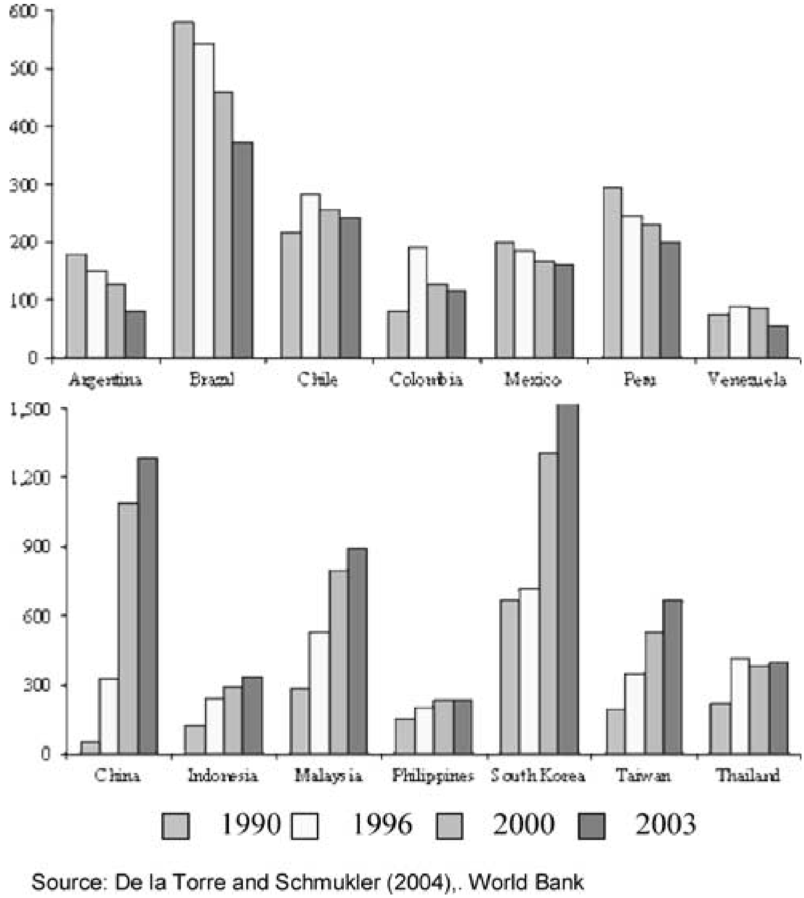


Figure 6: Number of Firms Listed in Domestic Stock Exchanges in Latin America and South East Asia.

inability of these countries to deal with systematic volatility. This source of risk cannot be diversified away by EM participants and therefore reduces the risk adjusted return below the level of developed markets. Then, the cost of capital increases and reduces available capital market financing for emerging countries firms.

It follows that a crucial objective for policy makers in emerging countries relies on the reduction of systematic volatility (i.e. the implementation of fiscal and trade policies such as sustainable budget and current account surpluses, decreasing inequality, short-term capital controls, production diversification, lower monopoly degrees and financial stability, among others). This is particularly the case of the cost of bond financing, where corporates in emerging markets can achieve a lower cost of debt when sovereign risk decreases. This is the more critical as the country has a relatively low creditworthiness (speculative grade sovereign ratings, higher and volatile sovereign spreads). Policies to improve the sovereign's creditworthiness (fiscal sustainability, positive and stable economic growth, sound institutions, low vulnerability to external shocks, more open and diversified economies, elimination of balance sheet mismatches) may have a positive impact on the corporate cost of bond financing.

III. GOVERNANCE AND REGULATION

There have been different approaches of the impact of regulation in the development of financial markets. As an example, consider those arguing that regulations might be harmful for securities' market development or might increase the cost of capital financing in those markets. Those approaches generally assume that the existence of information asymmetries in trading should not be a big concern. Based on this perspective, issuers of securities are perceived as having an incentive to disclose all available information; then, adverse selection problems are eliminated. On the other hand, the theories that support the role of regulation as a way to reduce the cost of capital recognize that the supply of securities might suffer from potential conflicts of interests. Adverse selection and moral hazard problems are potentially severe, and if not addressed can undermine and possibly stop fundraising in the stock market.

There is a generalized consensus that the institutional aspects related to the legal and regulatory framework, legal certainty, transparency and protection of creditor and minority shareholder rights account for a significant share of the relative underdevelopment of financial systems. The strengthening of such institutions would allow restoring trust in the capital market as a mechanism to allocate savings. Empirical evidence shows that a legal framework which fosters transparency and defines clear-cut accountability rules do foster capital market expansion.

Table 1 provides some basic statistics on regulation in the banking sector in the world. It covers banks reported perceptions on restrictions on their activities and, on the other side, enforcement, disclosure and independence indices covering issues related to the capabilities and limitations of regulatory and supervisory agencies.[4] In general, banks reporting higher restrictions on their activities are Asian ones. In particular, China's prominent figure reflects clearly the rules-based approach to supervision prevalent in the country. In the case of South American or Central American countries, banks' reported perceptions of restrictions are similar to the ones reported by banks in developed economies. Countries like China and India are also the ones displaying the highest values for the indices of enforcement and disclosure, and Latin American ones displaying the lowest.

A key regulatory issue today is Corporate Governance (CG). CG refers to incentive mechanisms developed for the operation of business firms, with the purpose

[4] The description of the indices are reported in the Appendix.

Table 1: Banking System Indicators (2003)

Region	Operation: Index of Restrictiveness	Supervision and Regulation: Enforcement	Disclosure	Independence
China	9.20	4.00	1.87	0.13
Developed	6.93	3.62	1.67	0.90
World	7.02	3.67	1.63	0.76
EMEA	7.85	3.93	1.17	0.00
ROW	6.42	3.69	1.38	0.53
EMSA	6.91	3.47	1.08	0.00
India	8.00	4.00	2.00	1.00
EMCA	6.12	4.80	1.94	0.00

World Bank Regulation and Supervision Survey (2003), Global Survey 2003, Institute of International Bankers, Office of the Comtroller of the Currency and People's Bank of China Annual Report. Note: China includes Hong Kong, while EMEA, ROW, EMSA and EMCA stands for Emerging Market East Asia, Rest of the World, Emerging Market South America and Emerging Market Central America, respectively.

of protecting the interests, actions, rights, and duties of various participants having a legitimate corporate interest or stakehold. The best CG practices include a legal and regulatory framework that properly addresses investor rights by promoting equitable treatment, encouraging and demanding transparency in the decision making process and, in turn, assuring effective enforcement. Along these lines, the set of common rules concerning good CG practices determined by the legal system and the institutions inherent to each country is known as Institutional CG. Private-sector initiatives and efforts -especially, commitments undertaken by companies on a voluntary basis- are referred to as "Contractual CG". Thus, it does not only involve "direct" participants in the business firm (shareholders, managers, directors), but also investors or bond-holders, employees, suppliers, customers, tax authorities and the community at large.

Empirical evidence shows that improvements on Institutional CG have a positive impact on the development of capital markets and, through the latter, on economic growth. On the other hand, the correlation between contractual governance and shareholder value or other return on investment indicators is stronger in EMs than it is in developed markets.

Figure 7 exhibits a comparison of CG standards implementation across banking systems in emerging markets. East Asian countries display the highest values for the corporate governance index. This is not surprising since empirical studies have shown the benefits of higher corporate standards in these markets. Those East Asian listed companies within the top quartiles of CG standards

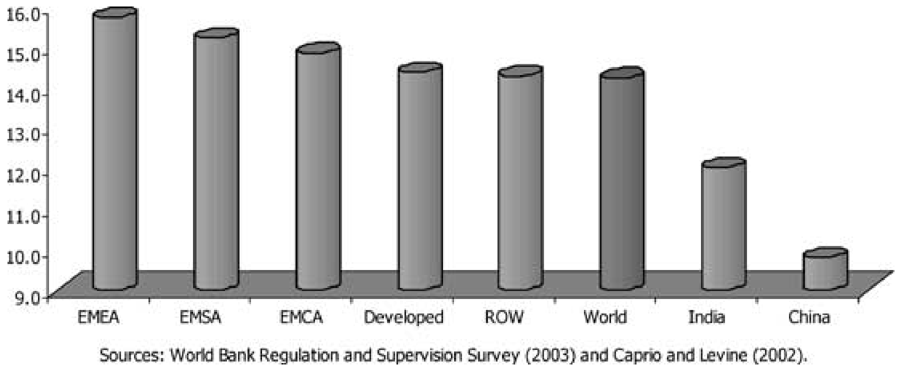


Figure 7: Corporate Governance Standards.

implementation have been found to display consistently higher returns than its counterparts.[5]

On the opposite side of the corporate governance ranking we find India and China. Note that, as shown above, these countries do also present a higher participation of the government in the financial sector. This is an important issue and somewhat distorting factor in the implementation of CG. In this context, I would like to stress the need for an appropriate assessment of degrees of implementation of CG standards across non-bank financial institutions. A better understanding of levels of transparency and disclosure in institutions such as pension funds, insurance companies and mutual funds would bring about tangible benefits to financial intermediation.

I would like now to relate my comments directly to the presentation made by Mr. Luo Ping. Regarding the development of financing sources in China, I have previously stressed that the experience in the country has been characterized by bank intermediation and, in particular, by a high concentration in the hands of the Government. In the case of banks, for example, I mentioned that the percentage of government shares in assets ownership reaches nearly 90%. Therefore, although the banking system appears to be robust and profitable, this phenomenon would imply abnormally elevated levels of exposure to systematic (non-diversifiable) risk. A question arises then, and it is related to whether this outcome is in fact an indicator of over-regulation or not, and whether increasing liberalization is still needed. Moreover, I would like to ask Mr. Ping about his view on how this process could be managed and how to avoid a process of internationalization.

Another characteristic of this market is the relatively low degree of compliance with international standards in regulation and supervision (in line with other developing economies). This raises concerns about the potential benefits from

[5] See Gill (2003).

bank privatization and to the implications of the upcoming implementation of a Basel II related framework. In particular, Basel II's third pillar relies on the implementation of increasing disclosure mechanisms to foster a process of increasing market discipline and therefore capital market development. In light of the particular characteristics of China, then, which should be an adequate sequencing for this implementation?

Third, in strict relation with my previous discussion on the important role of corporate governance and the relatively limited implementation of corporate governance standards in China, how can this situation be addressed over time?

Finally, a question on the relationship among financial concentration, government ownership, financial intermediation and efficiency. Could the commitments made under the WTO and the autonomous liberalization process reduce the concentration level of the Chinese banking system?

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V. NOTES ON CONTRIBUTOR/ACKNOWLEDGMENTS

Silvina Vatnick is Director General, Board Member and Co-Founder of the Center for Financial Stability (CEF), an independent think tank with a strategic and integrated approach to financial services in Latin America (www.cefargentina.org). She also served in Argentina as Senior Advisor to the Central Bank's Chairman in 2002 and to the Deputy Minister of the Economy and Finance Secretary in

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At an international level, as a career officer at the World Bank, she worked in Russia during the post-crisis financial reform (1998–2000), negotiated economic reforms in the former Soviet Union and Uzbekistan (1992–96) and advised on the debt rescheduling of Brazil, Venezuela and Nigeria. During a secondment to Fannie Mae -Federal National Mortgage Association- (1996) she defined a debt marketing strategy for Latin America and Central Europe and a strategy on secondary markets in mortgages for developing countries.

Silvina Vatnick obtained a Bachelor's Degree in Economics from the University of Buenos Aires, with postgraduate studies at CEMA (Center for Macroeconomic Studies of Argentina) and Columbia University, New York, and PhD respectively. In 1996 she also received the Advanced Professional Certificate in Finance and Management of Financial Institutions from New York University. I would like to specially thank the contribution made to this discussion chapter by Ricardo Pasquini, Research Analyst from the Center for Financial Stability (CEF).

VI. APPENDIX

Activities Restrictiveness Index

Unrestricted = a full range of activities can be conducted in the bank. Takes an index value of 1.

Permitted = a full range of activities can be conducted, but some or all must be conducted in subsidiaries. Takes an index value of 2.

Restricted = less than a full range of activities can be conducted in the bank or subsidiaries. Takes an index value of 3.

Prohibited = the activity cannot be conducted in either the bank or subsidiaries. Takes an index value of 4.

Corporate Governance Index

The Corporate Governance Index is the sum of the component indexes, Strength of External Audit, Financial Statement Transparency and External Ratings and Creditor Monitoring. The Strength of External Audit index adds one for an affirmative answer to each of the following questions: 1) Is an external audit required?; 2) Are specific requirements for the extent or nature of the audit spelled out?; 3) Are auditors licensed or certified?; 4) Do supervisors receive a copy of the auditor's report?; 5) Can supervisors meet with auditors without prior approval by the bank?; 6) Are auditors required by law to communicate directly to the supervisory agency any presumed involvement of bank directors or senior managers in illicit activities, fraud, or insider abuse?; 7) Can supervisors take legal action against external auditors? The Financial Statement Transparency index adds one for an affirmative answer to each of the following questions: 1) Does accrued, though unpaid, interest/principal enter the income statement while the loan is still performing?; 2) Are financial institutions required to produce consolidated accounts covering all bank and any nonbank financial subsidiaries?; 3) Are off-balance sheet items disclosed to supervisors?; 4) Are off-balance sheet items disclosed to the public?; 5) Must banks disclose their risk management procedures to the public?; 6) Are bank directors legally liable if information disclosed is erroneous or misleading? In addition, this index adds one for a negative response to the following question: 7) Does accrued, though unpaid interest or principal enter the income statement while a loan is still nonperforming? The External Ratings and Creditor Monitoring index adds one for an affirmative answer to the following question: 1) Is subordinated debt allowable as a part of capital?; 2) Is subordinated debt required as a part of capital?; 3) Do regulations require credit ratings for commercial banks? The index also adds one if the top 10 banks in the country are rated by an international credit rating agency and domestic credit rating agency.

Regulation and Supervision

The Enforcement index adds one for an affirmative answer to each of the following questions: 1) Are there any mechanisms of cease and desist-type orders, whose infraction leads to the automatic imposition of civil and penal sanctions on the banks directors and managers?; 2) Can the supervisory agency order the bank's directors or management to constitute provisions to cover actual or potential losses?; 3) Can the supervisory agency suspend the directors' decision to distribute: Dividends?, Bonuses?, Management fees? The Disclosure index adds one for an affirmative answer to each of the following questions: 1) Are bank regulators/supervisors required to make public formal enforcement actions, which include cease-and desist orders and written agreements between a bank regulatory/supervisory body and a banking organization?; 2) If an infraction of any prudential regulation is found by a supervisor, must it be reported? The Independence index is one for negative response to the question: Are supervisors legally liable for their actions?