

Financial Sector Reforms: Dealing with Financial Development and Risk

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**Understanding Reforms
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Dealing with Financial Development and Risk: The Latin View

- ✚ Why does financial development remain elusive, despite the intense crises-prevention efforts and financial sector reforms?**
- ✚ Why do currency and maturity mismatches continue to be widespread, despite their effects on crises and the reform efforts to try to avoid them?**

Dealing with Financial Development and Risk

- ✚ No shortage of reforms for development (of capital markets)

 - ✱ The logic of reforms

- ✚ No shortage of reforms for risk management (and crisis prevention)

- ✚ But results not as expected

- ✚ Were financial reforms misconceived?

 - ✱ Wait

 - ✱ Getting sequencing (and structure) right

 - ✱ Revisit basic issues and reshape expectations

 - ✱ Comprehensive policy approach with lower systemic risk

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No Shortage of Capital Market Reforms

Sweeping financial liberalization since the late-1980s

-  Domestic market

-  Stock markets

-  Capital account

Promotion of securities markets peak in the 1990s

-  Rules: legal and regulatory innovations

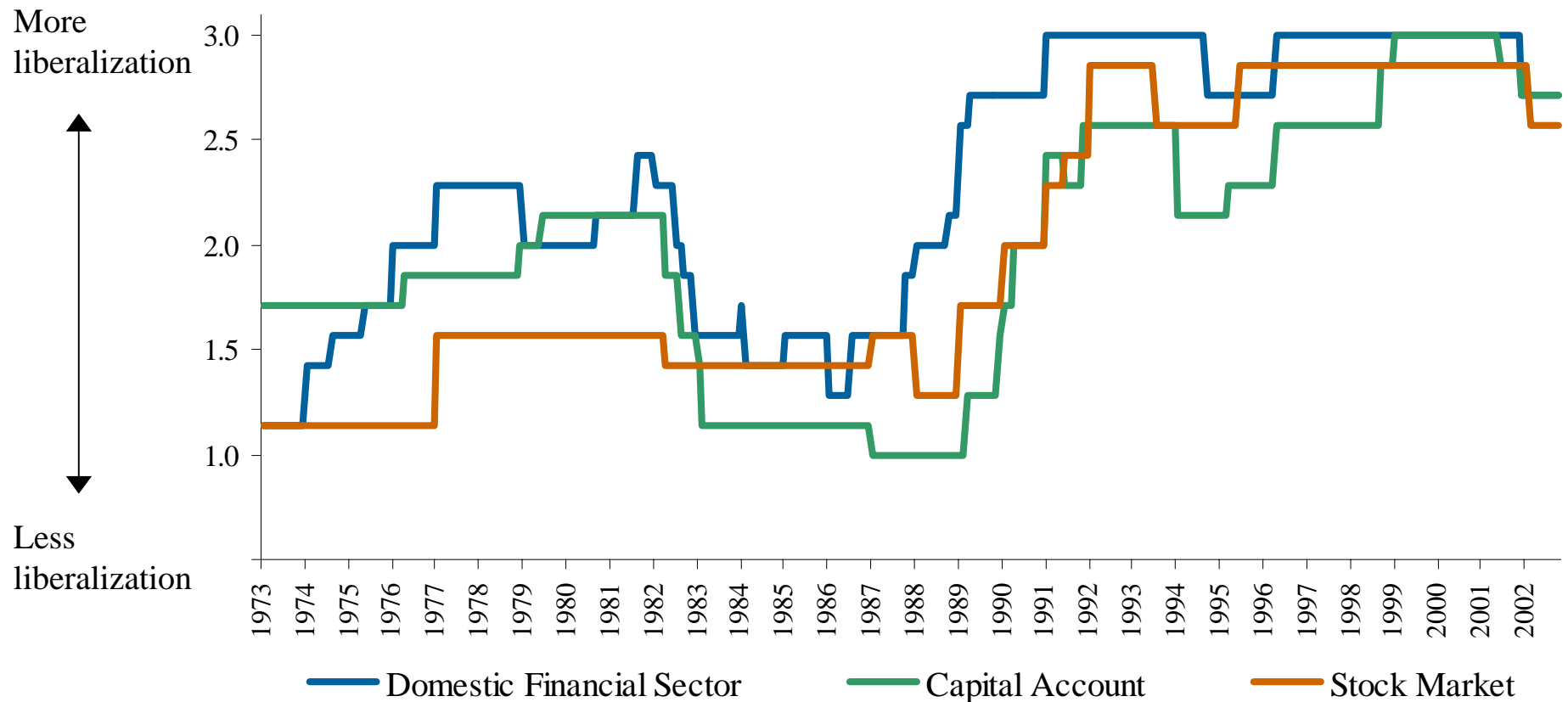
-  Infrastructure

-  Demand: institutional investors

-  Supply: privatizations

Financial Liberalization Increased Since the Late-1980s

Latin America: Indices of Financial Liberalization by Sector

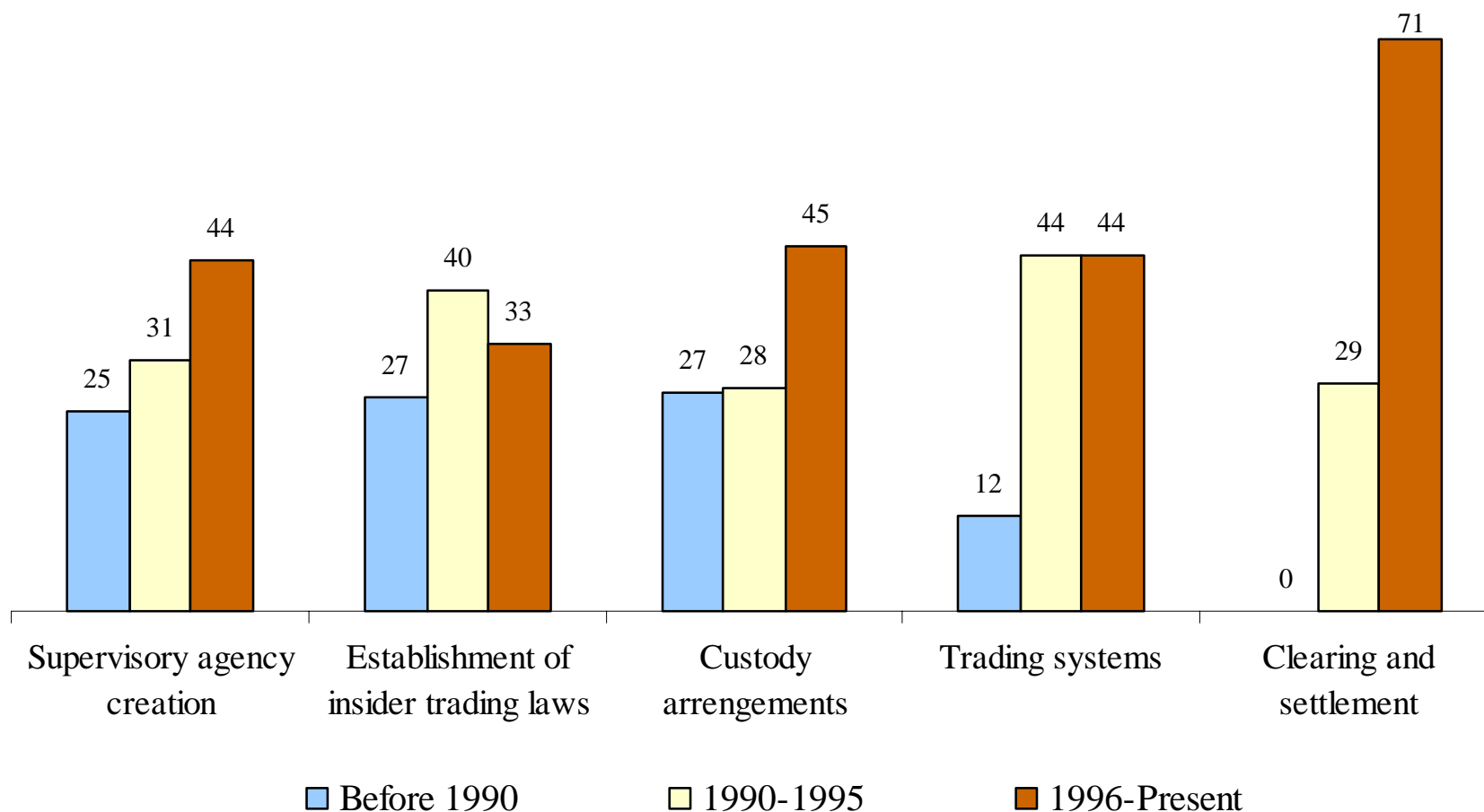


Latin American countries: Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. The value 1 means repression, 2 partial liberalization, and 3 full liberalization. Figures correspond to end-of-month values.

Source: Kaminsky and Schmukler 2002

Securities Markets Supervision, Regulation, and Infrastructure Were Improved in the Last Decades

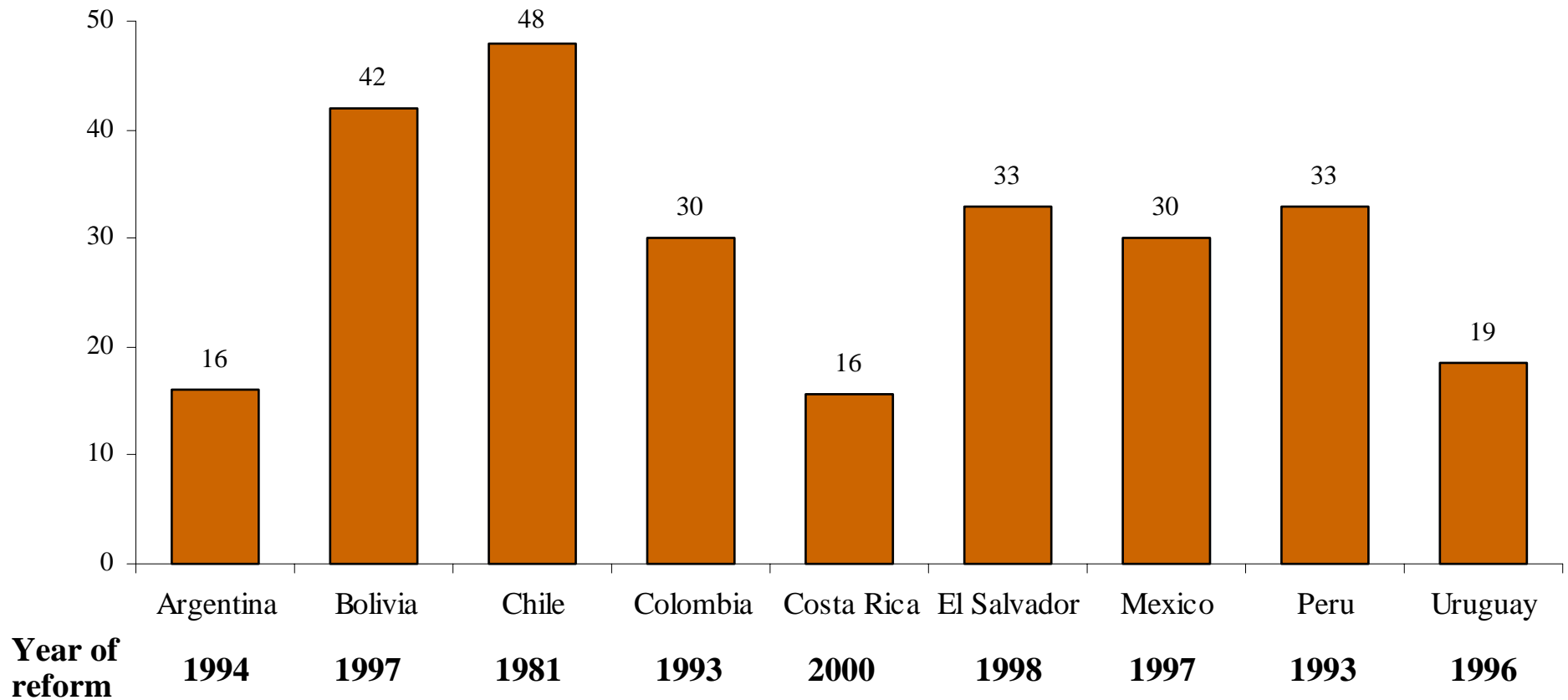
Percentage of Latin American Countries Implementing Reforms



Sources: Local data, The Handbook of World Stock, Derivative & Commodity Exchanges 2001, and Bhattacharya and Daouk 2000 7

Many Latin American Countries Also Implemented Comprehensive Pension Reforms

Extent of Privatization*



* The share of the total amount workers contribute to social security that accumulates in a private individual account is taken as a measure of how much a country “privatized” the provision of social security (IRA contribution – net of fees and insurance premia – as share of total payroll deductions).

Source: Gill, Packard, and Yermo 2002

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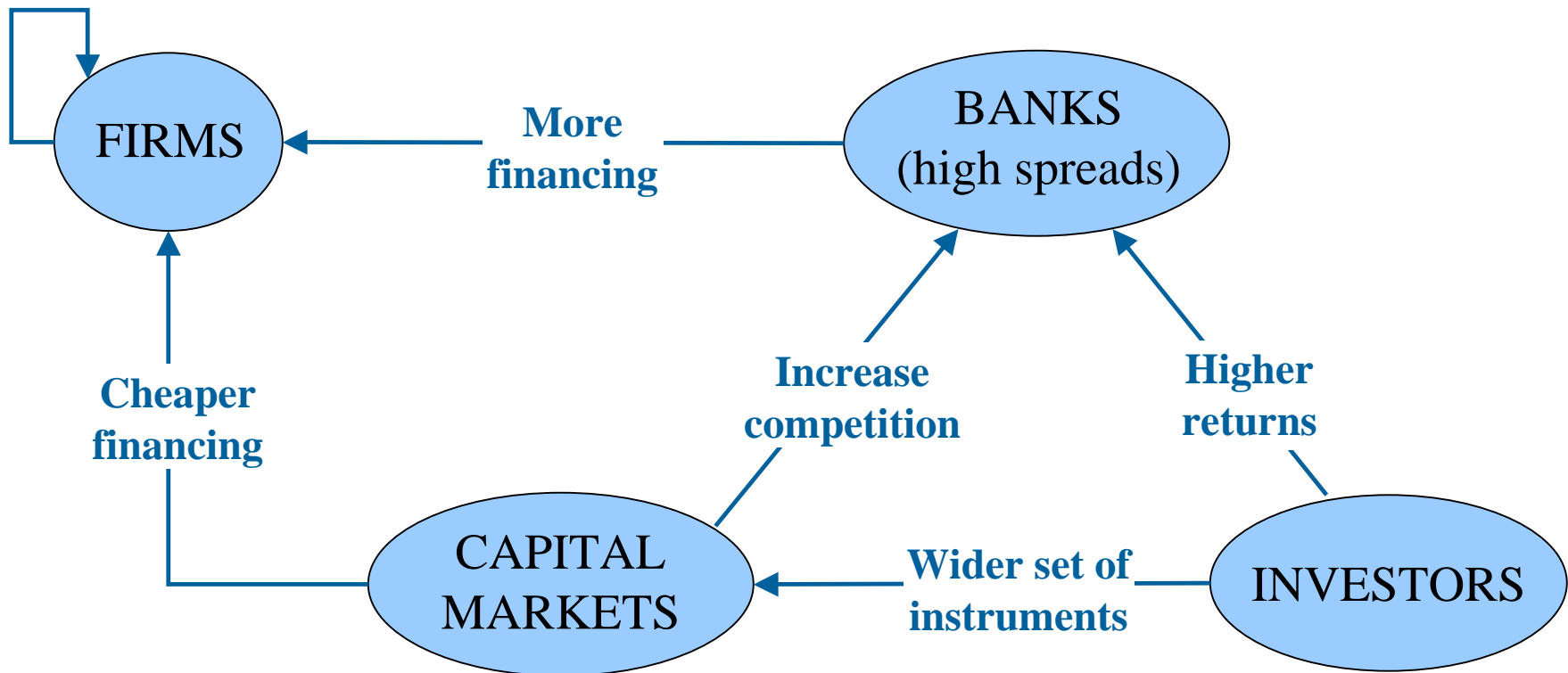
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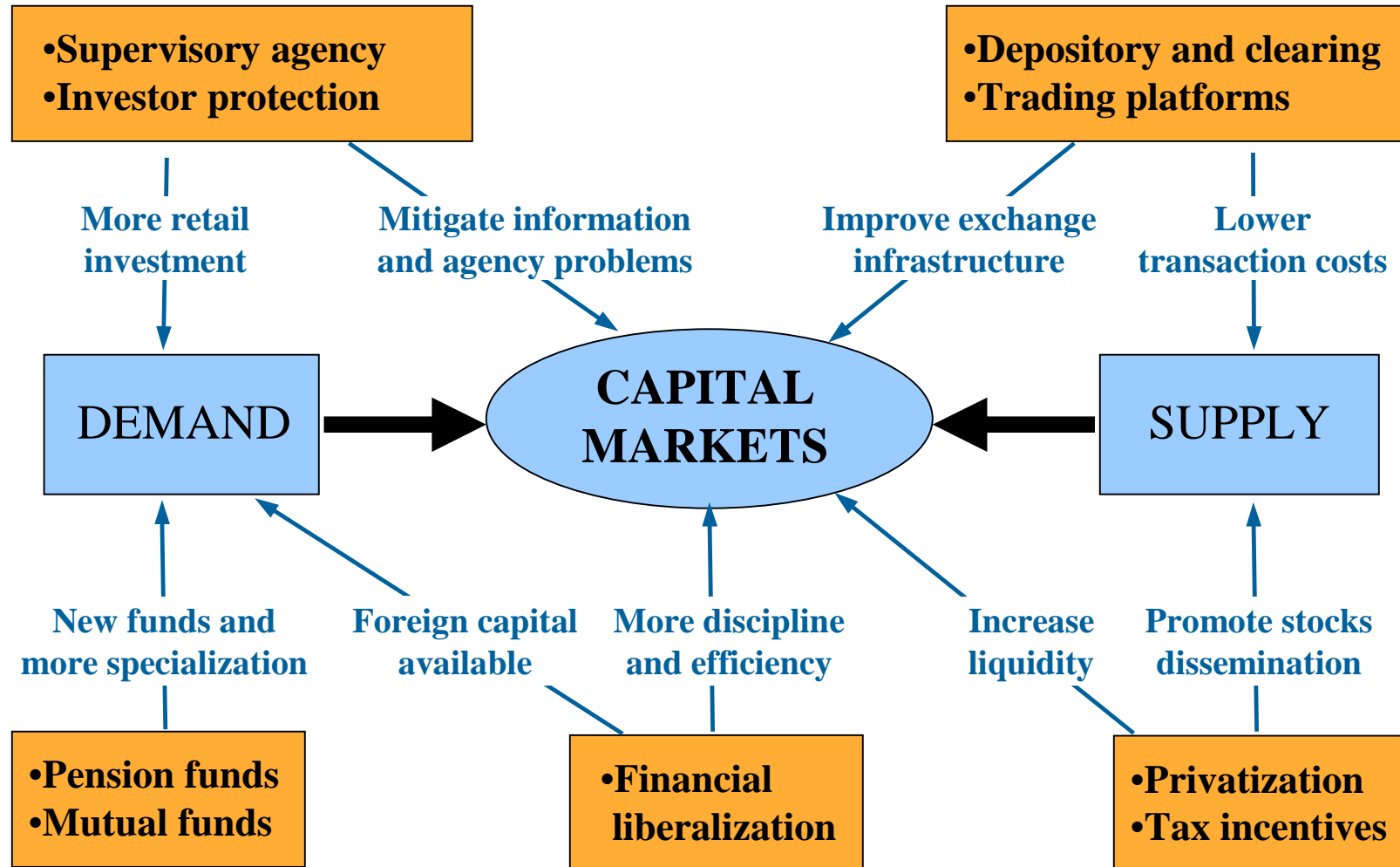
 - ✱ Revisit basic issues and reshape expectations

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Countries Promoted Capital Market Development to Generate More and Cheaper Financing



Many Reforms Were Introduced to Develop the Domestic Securities Markets



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No Shortage of Reforms for Risk Management

- + **Consensus on policy prescription**

 - * **Avoid undue risks**

- + **Followed by efforts to**

 - * **Choose right exchange rate regime and consolidate it**

 - * **Eliminate currency and maturity mismatches**

 - * **Enhance regulation and supervision**

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Results Not as Expected

✚ Equity markets

- ✦ Visible growth (market cap) but not as in OECD
- ✦ Rising concentration
- ✦ Migration abroad and illiquid domestic markets

✚ Bond markets and bank contracts

- ✦ Prevalence of government paper
- ✦ Dollarization and short-duration peso contracts
- ✦ Cyclicity

✚ Pension and mutual funds

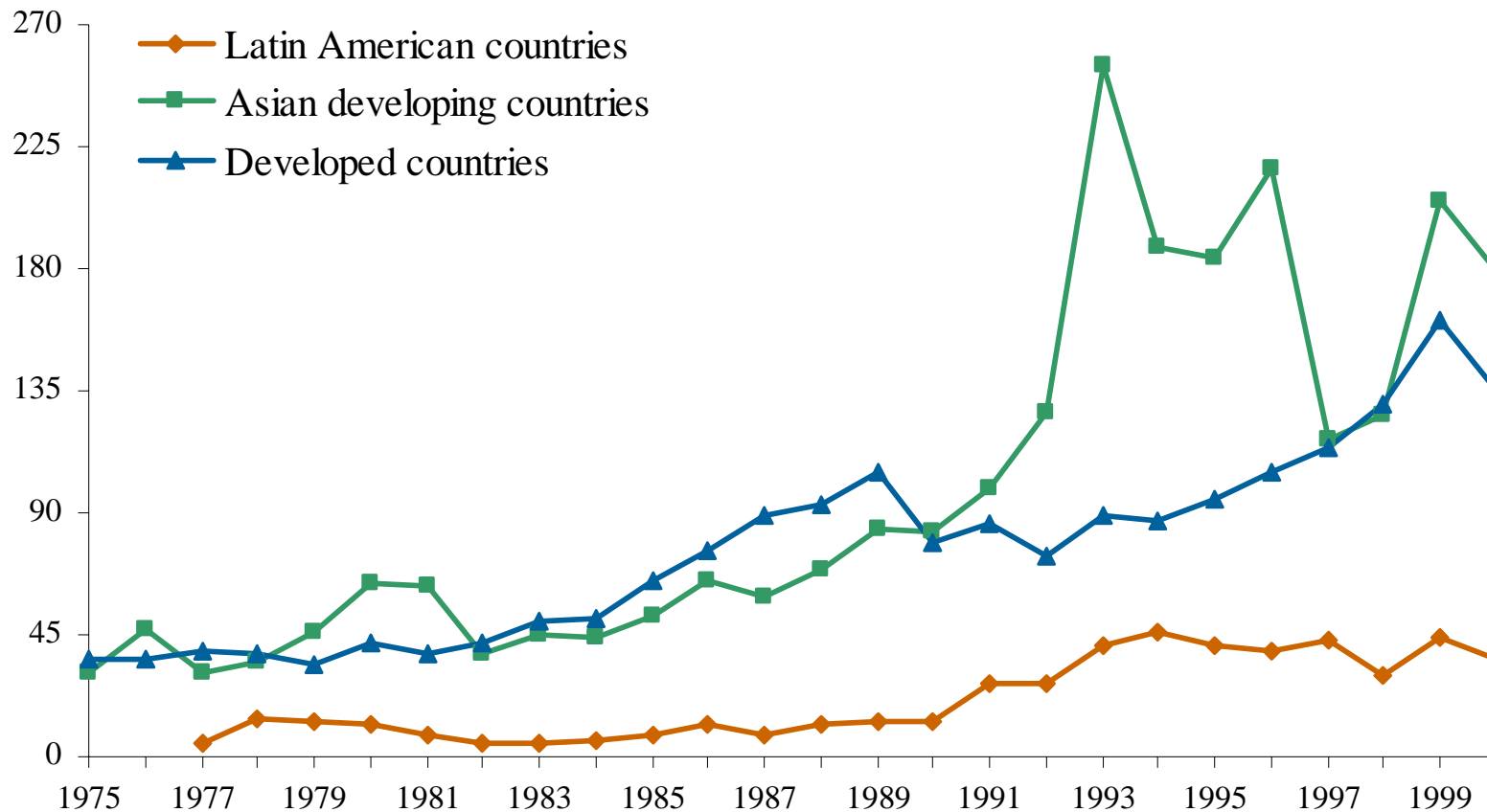
- ✦ Fast growth but tapped by governments

✚ Currency, banking, debt crises

Latin America Equity Market Growth is Poor Compared to Other Regions

Stock Market Capitalization

Percentage of GDP

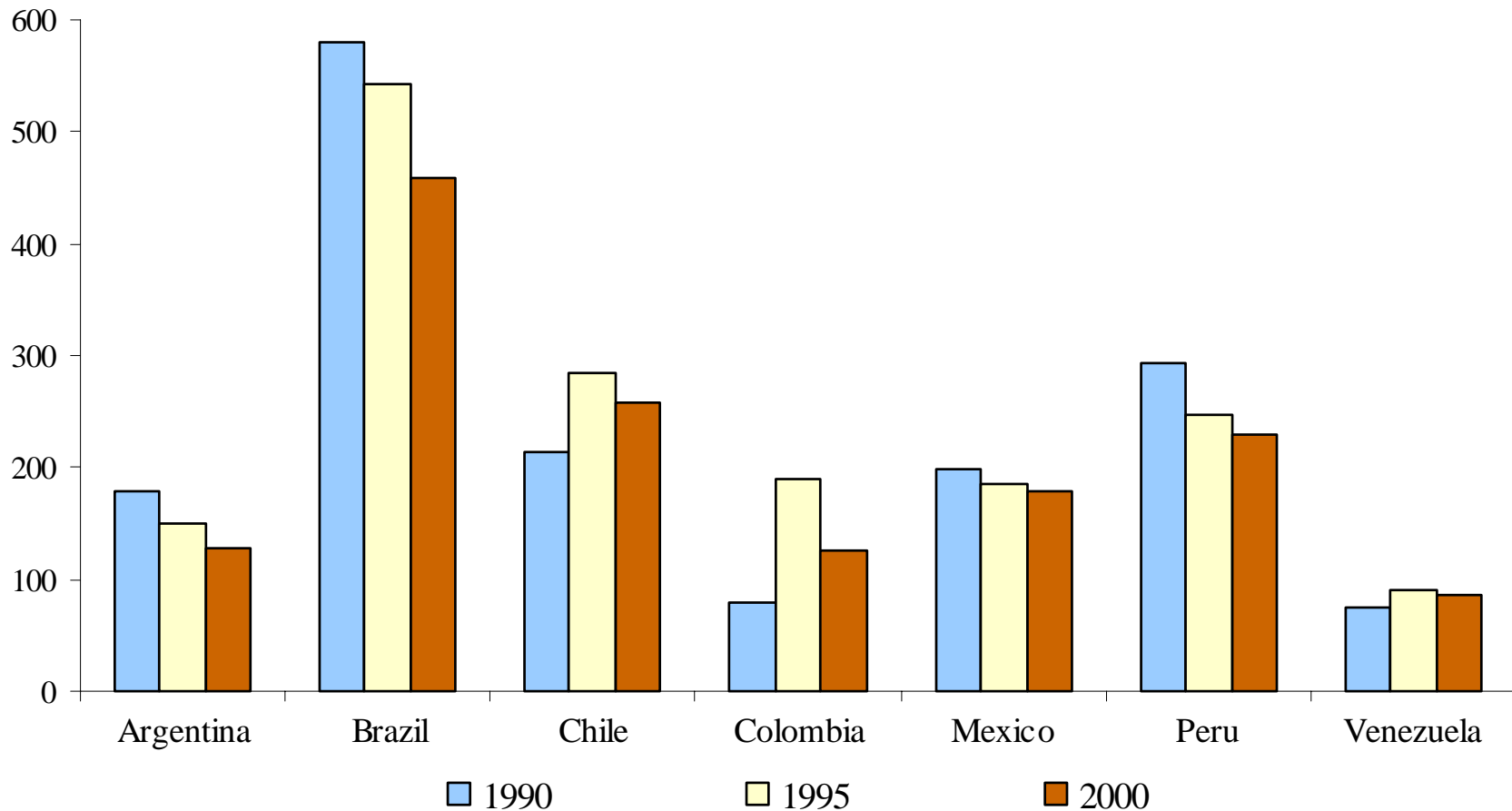


Latin American countries: Argentina, Brazil, Chile, Mexico, and Peru. Asian developing countries: Hong Kong, Malaysia, and Thailand. Developed countries: Japan, U.K., and U.S. Figures correspond to end-of-year values.

Sources: IFC's Emerging Markets Database, World Federation of Exchanges (FIBV), and The World Bank

Stock Exchanges Are Affected by Increasing De-listing

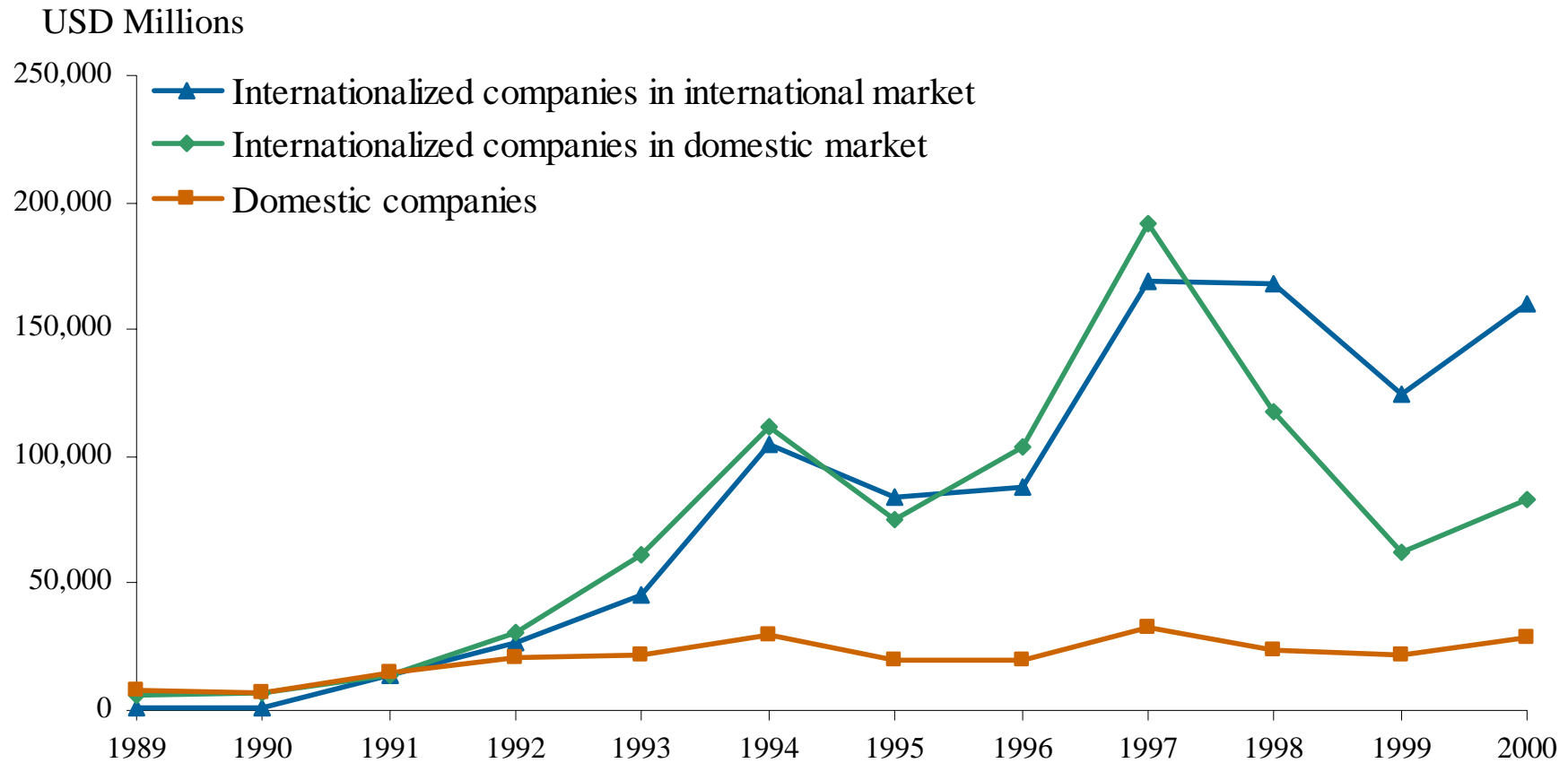
Domestic Stock Exchanges: Number of Companies



Source: IFC's Emerging Markets Database

Large Companies Migrate to International Markets

Latin American Companies: Value Traded

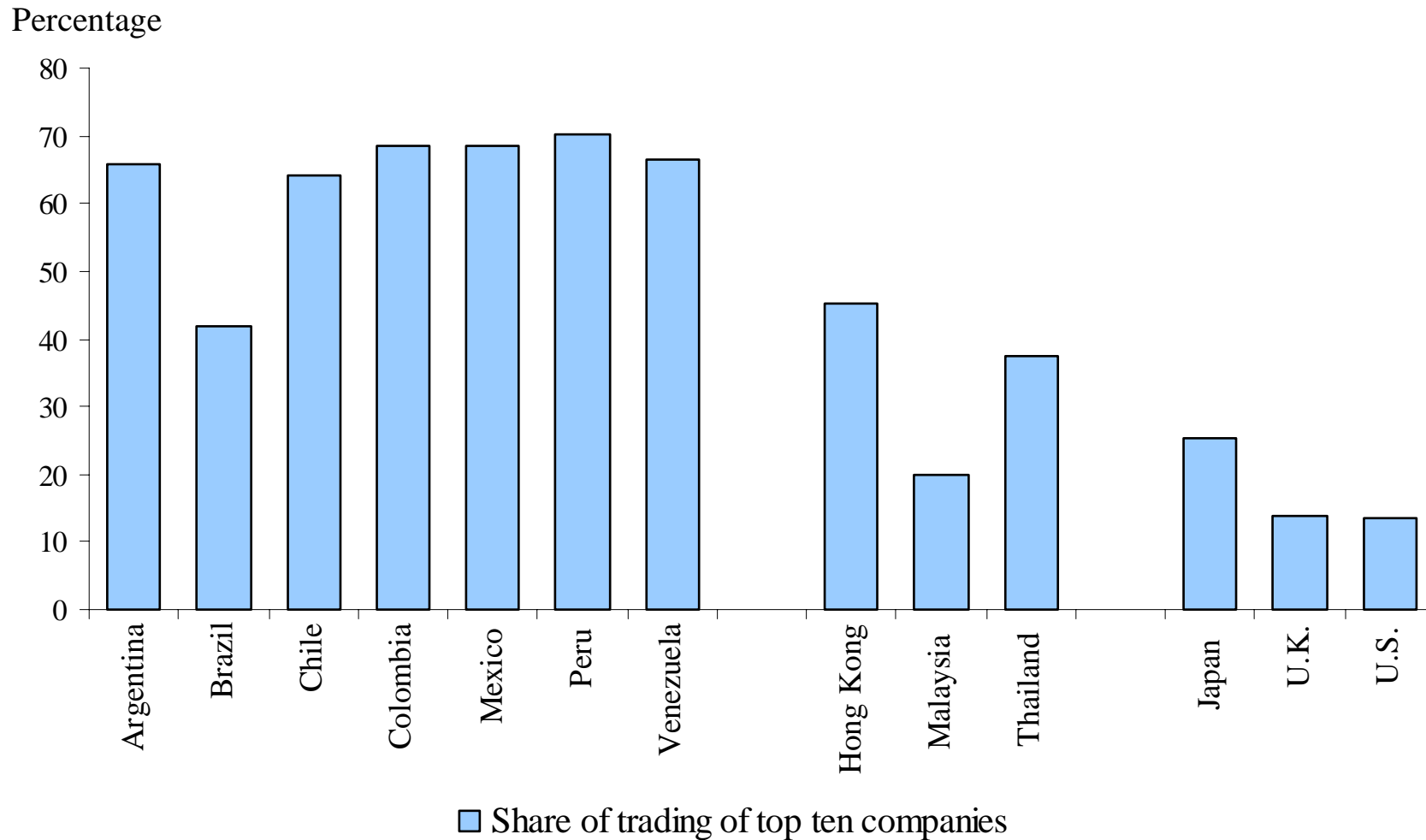


Latin American countries: Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. Internationalized companies are defined as companies that cross-list or raise capital in international stock markets at some point in time. Figures correspond to end-of-year values.

Sources: The Bank of New York, Euromoney, and IFC's Emerging Markets Database

Equities Traded Belong to a Handful of Large Companies

Stock Market Concentration (end-2000)

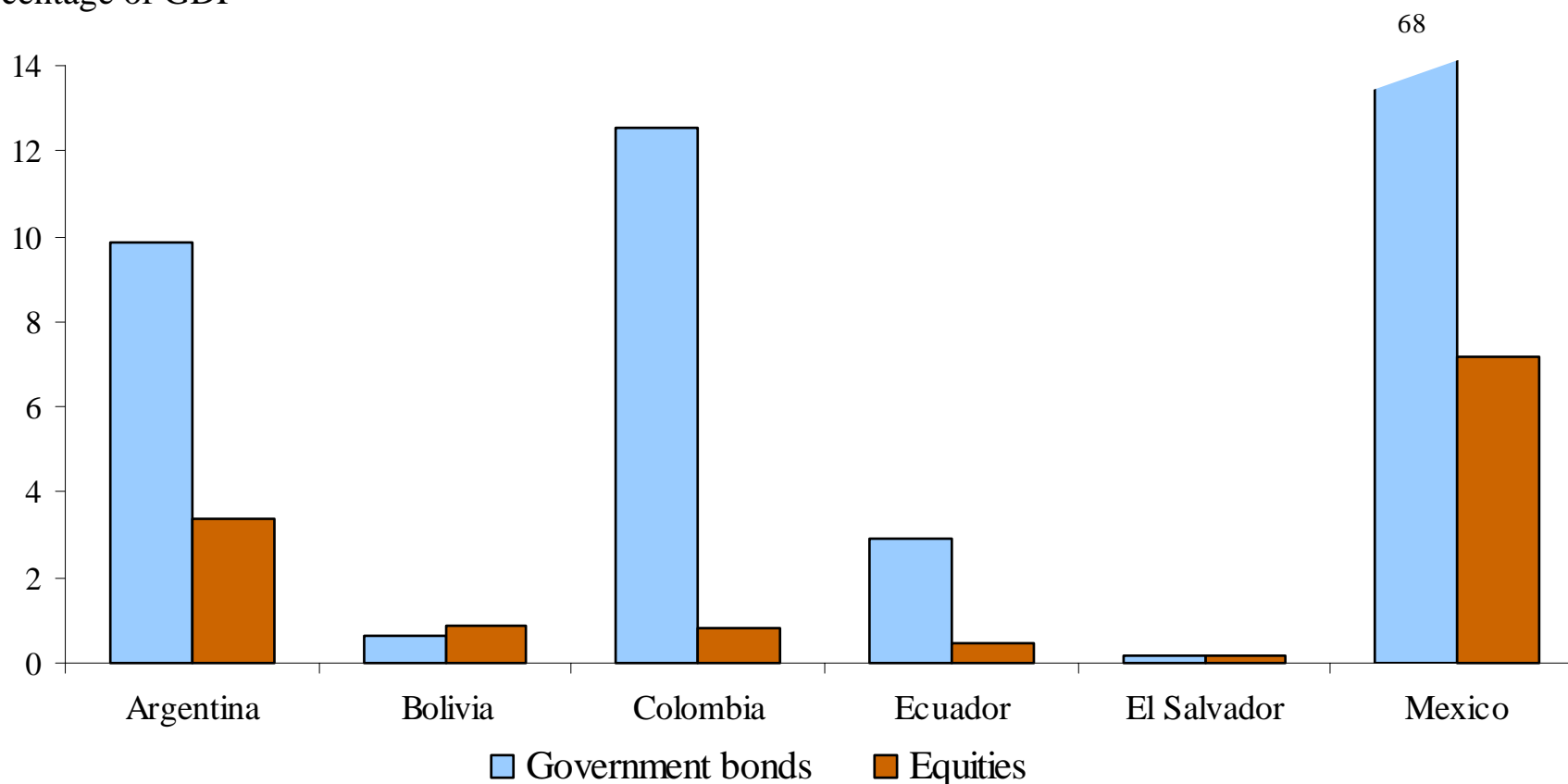


Source: IFC's Emerging Markets Database

Trading in Government Securities Outweighs Trading in Equities

Value Traded in Domestic Markets (2000)

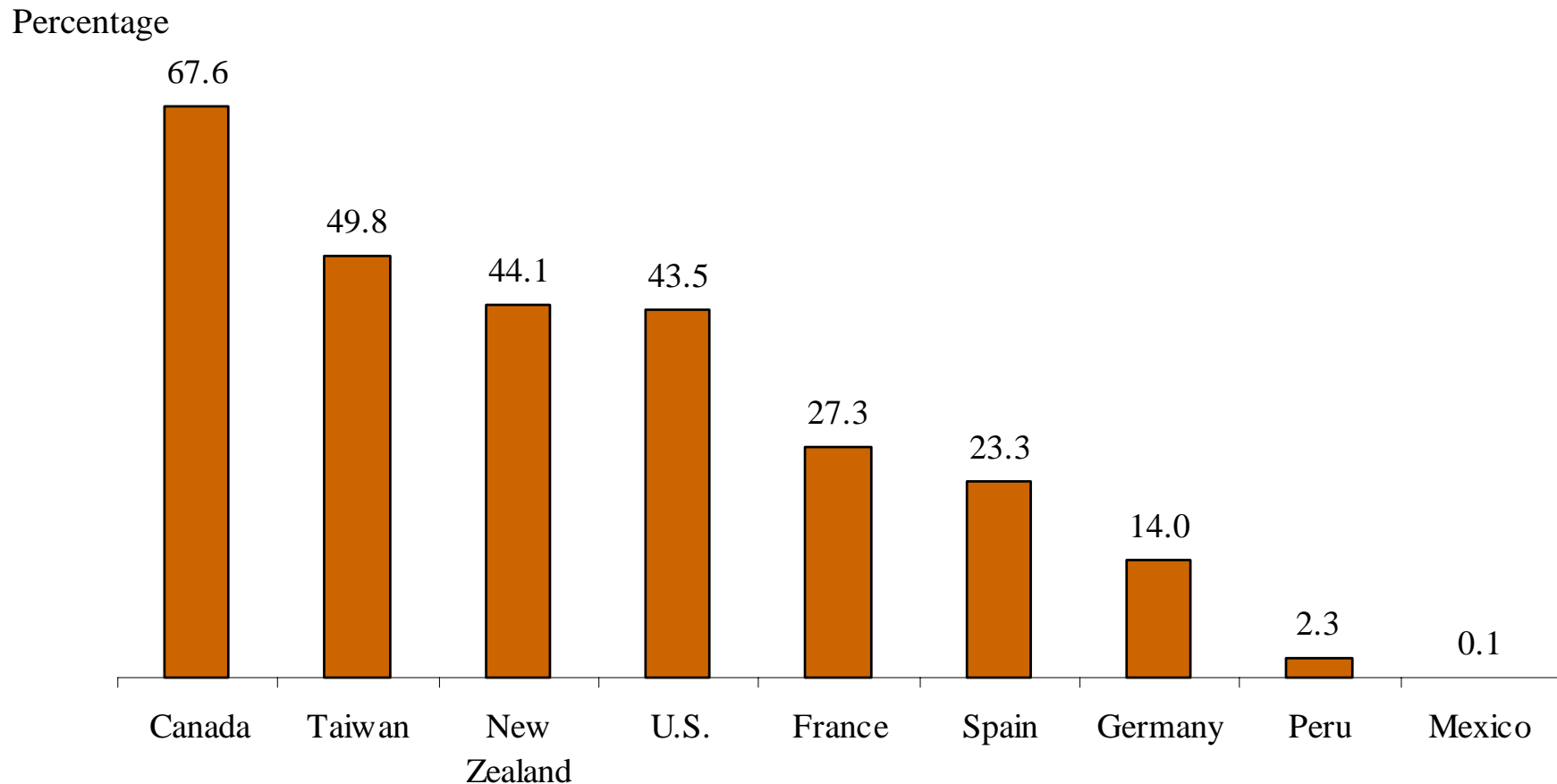
Percentage of GDP



Sources: Local data, The Handbook of World Stock, Derivative & Commodity Exchanges 2001, Federacion Iberoamericana de Bolsas de Valores (FIABV), and The World Bank

The Retail Investor Base Is Very Small in Latin American Countries

Investor to Population Ratio (end-1999)

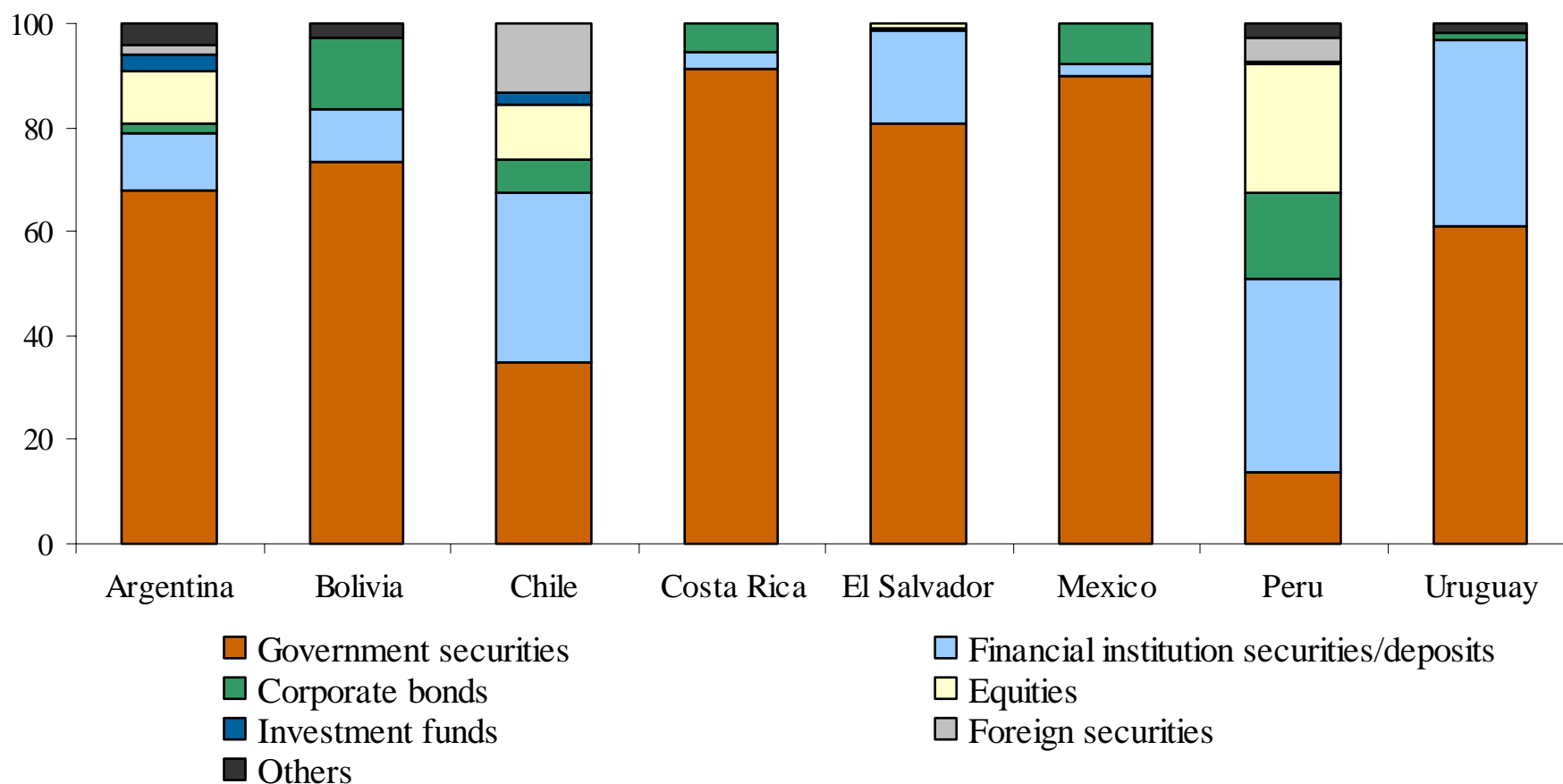


Source: Comision Nacional Bancaria y de Valores de Mexico

But Their Assets Are Invested Mainly in Government Securities

Pension Fund Investment Portfolio (end-2001)

Percentage



Source: Asociacion Internacional de Organismos de Supervision de Fondos de Pensiones (AIOS)

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Wait for the Fruits of Reform

- ✚ The dividends from reforms have long gestation periods
 - ✱ First generation reforms were right, are mostly completed
 - ✱ But there are inevitable costs, even crises, along the way
- ✚ Opening and competition expose weaknesses, constitute a cleansing process that strengthens defenses
 - ✱ Over time, learning takes place and incentives are set right, yielding durable results (e.g., Chile after 1982 crisis)
- ✚ What to do?
 - ✱ Let market discipline work; or,
 - ✱ Complement market discipline with regulatory discipline; accelerate institutional reforms
- ✚ *Qualifier:* in the long run we may all be dead

Getting Sequencing (and Structure) Right

- ✚ **Financial integration: was it too fast?**
 - ✚ Was the financial system ill prepared for openness?
 - ✚ Good regulation and supervision takes time to develop. Should institutional reforms have come first?

- ✚ ***Qualifier:* are there sufficient incentives to reform institutions without the discipline from openness and crisis?**

- ✚ **Solid banks or deeper capital markets should go first?**
 - ✚ Is it structure or infrastructure?
 - ✚ Do you need solid banks with deep pockets before you develop a sound capital market?

- ✚ ***Qualifier:* financial structure does not seem to matter**

Revisit Basic Issues and Reshape Expectations

✚ Reforms did not tackle well some basic issues for emerging markets

- ✚ *Liquidity* – Needs minimum size and network and agglomeration effects (external economies of scale).
- ✚ *Asymmetric information / Information cost*–It only pays to invest in large markets (and large firms). Thus, segmentation.
- ✚ *Contract enforcement* – Weak judiciaries and expropriation risk undermine finance.
- ✚ *Risk diversification* – Difficult to diversify risks within small economies. Plus governments resist cross-border diversification.

✚ What to do?

- ✚ Try to address these basic issues, and revise expectations

✚ *Qualifier*: these issues are intrinsic to emerging markets and solving them is a daunting task

Comprehensive Approach with Lower Systemic Risk

- ✚ **Short-duration, dollarization, and use of a foreign jurisdiction are rational, endogenous, and jointly determined risk-coping devices**
 - ✳ **Symptoms rather than underlying causes**
 - ✳ **Symptoms to deal with systemic risk**
 - ✳ **Solutions at least as much as problems (solutions with bad side effects)**
 - ✳ **Not necessarily the result of market distortions**

- ✚ **One-sided, “consensus” policies might not work**
 - ✳ **Efforts to reduce the use of a particular coping mechanism may only result in risk balancing and risk displacement (rather than risk reduction)**

Comprehensive Approach with Lower Systemic Risk

✚ What to do?

- ✚ Reduce aggregate systemic risk through comprehensive policy agenda

✚ For dedollarization

- ✚ Macroeconomic policy (exchange rate flexibility cum inflation targeting)
- ✚ Prudential policy (e.g., higher capital requirements for dollar loans to debtors in the non-tradable sector)
- ✚ Financial policy (e.g., promotion of CPI-indexed peso contracts)

✚ *Qualifier:* but very difficult thresholds must be crossed




- ✚ Require resilient fiscal viability, low initial dollarization level, K requirements for dollar loans that do not cause shift to short-duration peso loans or to seedy offshores, CPI-indexed peso contracts that “stick”

Conclusion

Some truth

-  More patience needed
-  Sequencing might need to be adjusted

More (?) truth

-  Reforms need to be rethought
-  Expectations need to be adjusted
-  Comprehensive approach to deal with systemic risk is needed

Unquestionable truth

-  Challenges ahead are not easy

End