This book has analyzed the domestic financial system in Latin America and how it has changed since the early 1990s. Expanding finance is one of the major challenges facing governments of developing countries, as they try to speed up economic growth and reduce poverty to improve the welfare of their citizens. A large body of literature now provides evidence that access to finance, through domestic banking systems and local capital markets, is an essential element for promoting growth. Our evidence indicates that the relationship runs in the other direction as well, but finance and growth are clearly intertwined. A smaller body of research suggests that there is also a positive relationship between finance and poverty reduction. Financial stability plays an important role in both relationships, since financial crises are highly damaging to growth prospects, and they are particularly harmful to the most vulnerable groups in society.

We focus on the domestic financial sector, but we make it clear throughout the book that it is necessary to take account of the multiple links between domestic and international finance. First, increased financial liberalization allows a greater volume of foreign portfolio investment to enter developing economies, through both domestic banking systems and capital markets. Second, foreign banks and capital markets provide an alternative source of finance for some borrowers from developing countries, especially governments and large corporations. Third, foreign ownership of banks and other financial institutions
in developing countries has increased substantially. Fourth, international rules and regulations are having a growing impact on the operation of domestic financial systems. One of the crucial tasks of our analysis is to assess these relationships and suggest ways to take advantage of the positive aspects of financial globalization while avoiding the negative ones.

In addition to domestic-international links, we also highlight connections between the public and private sectors. We agree with the general thrust of financial liberalization. The economies of Latin America, and most other developing countries, have become far too complex for governments to micromanage their financial systems, but this does not mean that governments no longer have any role to play. While particular circumstances vary from country to country, we can suggest a minimal list of required government functions. Governments need to provide a stable macroeconomic environment; they must provide a strong institutional framework, including prudential regulation and supervision; and they should engage in market-enhancing policies to deal with problems of missing or incomplete financial markets. We discuss the precise meanings of these various roles more fully below.

This concluding chapter has two goals. One is to summarize the main findings of the book. The summary is divided into three parts. The first two review Latin America's lagging behavior with respect to banking and capital markets. The third compares the country experiences we have presented—the three Latin American case studies and some of the material on East Asia. We want to explain the reasons for Latin America's disappointing performance, but we are also interested in identifying lessons from the successes of the different countries and the problems they have encountered. The other goal is to outline a set of policy recommendations, based on the results of our research. They are organized according to five policy areas: macroeconomic environment, institutional development, regional and international context, finance for investment, and access to finance for small firms.

Banks and Capital Markets since 1990

Banks and capital markets are the main components of domestic financial systems in Latin America. They share a number of features, especially the context in which they operate. The main contextual factors in which we are interested include macroeconomics, institutions, and international financial linkages. Nonetheless, banks and markets are also different enough in their operations and their prerequisites that we need to discuss them separately. We concentrate first on Latin America and then bring in our analysis of East Asia when we compare our country-level findings on an intra- and interregional basis.

The Weakness of Latin American Banks

Financial liberalization began in Chile in the 1970s and was widely adopted throughout the region in the 1980s and 1990s. Government control of interest rates, high reserve requirements, and directed credit are largely—though not completely—a thing of the past. These changes transformed the operation of Latin America's banking systems, establishing new rules for their operation, new ownership patterns, and new roles for governments. Some of the changes were inherent in the liberalization process itself, while others stemmed from the crises that frequently followed liberalization.

We defined financial liberalization as the deregulation of the domestic financial sector. Our main hypothesis, which was supported by various types of evidence, suggested that whether liberalization resulted in crises was determined mainly by the policies that accompanied it. We focused on three kinds of policies. First was macroeconomic policy. Far too many countries instituted financial liberalization under very adverse macroeconomic conditions: low and volatile growth; high inflation and significant budget deficits; and exchange rate regimes that led to trade deficits, large capital inflows, and increased financial fragility. A second policy that often accompanied reforms was capital account opening before domestic banking systems were strong enough to deal with the new challenges arising from international integration. This increased vulnerability and created channels for contagion. A third policy, whose absence frequently contributed to crises, was adequate prudential regulation and supervision. The tendency among the cases studied was to implement minimal regulation after the initial liberalization, which often resulted in lending booms, lack of proper risk management, and ever larger volumes of nonperforming loans.

Successful policies with respect to macroeconomic performance, capital account management, and regulation and supervision depended on the existence of strong institutions. Without good institutions in place, good policies could not be carried out, and crises were likely to be the outcome. By institutions, we refer throughout the book to the broad definition of the term: the formal and informal rules that shape the behavior of individuals and organizations by reducing uncertainty. Institutions in the more concrete sense—such as capable finance ministries and central banks, together with strong regulatory agencies and well-paid and skilled supervisors—were also essential for good performance.

One of our major findings was the tremendous cost of financial crises. Analysts usually focus on the fiscal costs, but crises also result in lost GDP, high interest rates, and falling asset prices. While it is difficult to sum these amounts, the fiscal cost and lost GDP in the first year alone averaged nearly 40 percent of GDP across the countries we studied. Moreover, these costs linger for a very long time. Our evidence, for example, suggests that it may take at least a decade.
for countries to return to the credit-to-GDP ratios that prevailed in the precrisis period.

Partially because of the lingering effects of crises, the domestic financial systems in Latin America are not working well today. With the exception of Chile, most standard indicators are weak in comparison with other emerging market countries, by which nothing of industrial economies. For example, the average ratio of credit to GDP in Latin America was only 41 percent in 2003, while it was 96 percent in East Asia and 94 percent in the G-7 countries. A much smaller share of available credit goes to the private sector in Latin America than in East Asia (just over 50 percent versus 85 percent, respectively), and nonperforming loans and financial inefficiency are high. Margins between active and passive interest rates are therefore high to cover the cost of these inefficiencies, which limits demand for credit while still providing the high returns that make banking a lucrative business.

Many experts argue in recent literature that the main reason for the poor performance is the continuing presence of state-controlled banks, even after liberalization. While we found evidence that supports this argument in many cases, we also found exceptions—most notably where strong institutions are present. Regulation and supervision are very important, but so are control of corruption, strong judicialities, transparency, and general support for the rule of law. Type of ownership becomes less important when public sector banks are treated the same as their private sector counterparts, without regulatory forbearance. Likewise, if the institutional context is weak, even foreign banks will be hobbled.

In addition to bank performance, we have also addressed two economywide problems that result from the incentive structure that banks face in Latin America: the lack of long-term finance for investment, which constrains growth, and the lack of access to any kind of finance for smaller enterprises. The two are closely related. The long-term finance problem is typical of economies that are heavily reliant on commercial banks, which normally restrict themselves to providing short-term loans as a means of controlling credit risk. It also enables them to monitor their clients more closely. At the same time, however, it means that firms must finance long-term projects by rolling over short-term credit, using retained earnings, or entering the capital markets if they can obtain access. This problem led development banks in both Latin America and East Asia to provide long-term credit in the early postwar years. As a result of poor management, however, most of those banks have since been closed or turned into second-tier institutions. Brazil is the main example in Latin America where development banks continue to play an important role in the financial sector.

The problem of access for small and medium-sized firms is the other challenge that we highlight with respect to the region’s financial systems. Large firms are not financially constrained. Research shows that they move from one type of finance to another, depending on the state of global markets. When access to international finance is limited, they move into domestic markets—including credit markets—thereby displacing smaller firms from the latter. Small firms, by contrast, do not have access to either international finance or domestic capital markets. The (very) partial exception may be a few medium-sized firms in domestic stock markets. This means that small firms are limited to bank credit, retained earnings, family resources, and suppliers’ credit. Given this panorama, the gap between large and small firms continues to widen. The reasons that banks are reluctant to finance small firms are well known—namely, lack of information and high transaction costs. Public sector banks in some countries have helped to tackle both problems through first- and, especially, second-tier operations. Nonetheless, survey evidence demonstrates that small firms continue to lack credit, which prevents their growth and hinders employment expansion.

The Underdevelopment of Latin American Capital Markets

Financial liberalization focused mainly on the banking sector, but spillover effects also helped the capital markets since liberalization signaled that a country wished to attract private funds, both domestic and foreign. The privatization process was important as well. Newly privatized enterprises no longer had access to government funding, so they began to seek private sources that included domestic capital markets. At the same time, newly privatized pension funds needed assets to match the maturity of their liabilities and thus became a source of demand in those cases where they were not restricted to holding government debt. Over time, reforms took place in the financial sector itself as regulation and supervision were modernized, corporate governance was improved, and transparency was increased.

Nonetheless, these changes have had a limited impact, and Latin American economies remain bank based. Only a small number of countries have active stock and bond markets. Among the seven largest economies, the average ratio of bonds outstanding to GDP was 37 percent in 2003, while stock market capitalization averaged 34 percent. This compared with 60 percent and 80 percent, respectively, in East Asia, and 141 percent and 100 percent among G-7 countries. Chile and Brazil are the leaders in Latin America with respect to both bonds and equities, but their markets are much smaller than those of their Asian counterparts. As with the banking sector, most of the Latin American bond markets consist of government issues; only 22 percent of bonds outstanding were issued by the private sector in Latin America, compared with 63 percent in East Asia.

Bonds outstanding and stock market capitalization both increased substantially after 1990 in Latin America, but they peaked late in the decade. The number of firms listed on local stock markets declined significantly, therefore, as delisting exceeded new entrants. Delisting occurred for two main reasons: the
reluctance of firms to provide the information required by new corporate governance standards, and the preference of new foreign owners to list in their home markets. The process exacerbated already existing problems of illiquidity in the markets, which, in turn, made investors more hesitant to participate.

In assessing whether capital markets will flourish in the future, we found support for several hypotheses that have much in common with our analysis of banks. First, poor macroeconomic performance (that is, low savings rates, low and volatile growth rates, and high inflation) made investors in Latin America reluctant to put money into domestic capital markets. Second, structural reforms (such as financial liberalization, privatization, and pension reform) helped promote capital markets, but many were carried out in ways that undermined the intentions of their supporters. The cases in which financial liberalization resulted in crises were dramatic examples. Third, generally low-quality institutions, both at the societal level (role of law and adequate judicial systems to enforce it) and the market level (good corporate governance), hindered the development of stock and bond markets. Fourth, the availability of international financial opportunities frequently diminished the urgency with which governments and private sector actors pursued the development of capital markets. In addition, the delistings noted above have had negative implications for the already low levels of liquidity in Latin American markets.

Our discussion of banks identified two problems that their weakness poses for economic growth in Latin America: lack of long-term finance for investment and lack of access to finance for small firms. The capital markets present similar instances of market failure. Although the stock and bond markets, by definition, provide long-term finance, the indicators typically used to measure their size focus on market capitalization and bonds outstanding, rather than on new issues that provide investment financing. (For lack of alternative data, we use these measures as well.) In all developing countries, especially in Latin America, new issues on stock markets have largely dried up since the late 1990s. Bond markets have been more active, but most new issues have been for government borrowers. While some changes are beginning to occur, most notably in Chile and Mexico, private sector issues remain a small minority throughout the region. Access, of course, is more restricted in the capital markets than in the banking system. Only a few private firms, together with governments and state-owned enterprises, are large enough to participate.

**Explaining Latin America's Poor Performance**

The diagnoses featured in the literature to explain poor performance emphasize inefficient public sector banks, overly burdensome regulation of both banks and capital markets, and the limitations that small economies pose for capital market development. These arguments certainly have merit. We argue, however, that they need to be expanded to include the context in which financial systems operate.
Table 9.1: Latin America and East Asia: Determinants of Financial Deepening, 2003

<table>
<thead>
<tr>
<th>Country</th>
<th>Total</th>
<th>Local</th>
<th>Equity</th>
<th>Domestic financial sector</th>
<th>Contained factors</th>
<th>Per capita GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GDP%</td>
<td>%</td>
<td></td>
<td></td>
<td>Contained factors</td>
<td>$/year $/year</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>Local</td>
<td>Equity</td>
<td>GDP%</td>
<td>Per capita GDP</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2003</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>21.941</td>
</tr>
<tr>
<td>Singapore</td>
<td>354.2</td>
<td>12.2</td>
<td>9.5</td>
<td>5.5</td>
<td>2.05</td>
<td>50.5</td>
</tr>
<tr>
<td>Chile</td>
<td>350.2</td>
<td>9.5</td>
<td>9.5</td>
<td>5.5</td>
<td>2.05</td>
<td>50.5</td>
</tr>
<tr>
<td>Korea</td>
<td>287.7</td>
<td>9.5</td>
<td>9.5</td>
<td>5.5</td>
<td>2.05</td>
<td>50.5</td>
</tr>
<tr>
<td>Thailand</td>
<td>214.8</td>
<td>9.5</td>
<td>9.5</td>
<td>5.5</td>
<td>2.05</td>
<td>50.5</td>
</tr>
<tr>
<td>Brazil</td>
<td>155.5</td>
<td>9.5</td>
<td>9.5</td>
<td>5.5</td>
<td>2.05</td>
<td>50.5</td>
</tr>
<tr>
<td>Mexico</td>
<td>96.7</td>
<td>9.5</td>
<td>9.5</td>
<td>5.5</td>
<td>2.05</td>
<td>50.5</td>
</tr>
</tbody>
</table>

Sources: Table 9.2; for table 9.3, for bonds, table 9.4; for equity, table 9.7; for institutions; table 5.6 for international, World Bank, World Development Indicators.

Notes: Table 9.2, for table 9.3, for bonds, table 9.4; for equity, table 9.7; for institutions; table 5.6 for international, World Bank, World Development Indicators.

financial markets, the government still promotes local capital markets. Singapore's political system, however, provides little space for contestation and accountability. Indeed, its score on that factor in the World Bank's governance index is negative.

Korea, a large economy with high per capita income, and Thailand, a medium-sized economy with mid-level income, are examples of more partial success. A superficial lesson from these cases is that if macroeconomic performance is strong enough, institutions become less important. In both cases (especially Thailand), institutions leave much to be desired, but this did not seem to hinder financial development overall. Nonetheless, while banks provide large amounts of finance in both countries, capital markets are less developed than in other cases presented in the table, with only around half of total finance coming from the markets. Institutional deficiencies may well be a drag in this respect.

In Chile, however, that offers the most important lessons for Latin America. First, it is part of the region and so shares a number of characteristics with its neighbors that the Asian countries do not. Second, it is a small economy with only a mid-level per capita income. Third, Chile has not always had a good performance on the various indicators we are studying. Rather, it made very significant improvements in both its macroeconomic management and its institutions over the last two decades. These have enabled the country to support capital markets that are large in comparison to its bank claims, which is unusual in emerging market economies. Moreover, the availability of international finance has not stood in the way of the development of domestic capital markets. Finally, given its lack of fiscal deficits, the bond market has space for private sector initiative, rather than serving merely to finance government shortfalls. Latin American countries would do well to study the steps taken by the Chilen government and the financial sector to achieve such a strong performance.

Brazil and Mexico, the two largest economies in Latin America, are the laggards among the six in all aspects under consideration. They have the smallest financial sectors, matched by higher inflation, lower growth, and lower savings than the other four, and they also have lower-quality institutions. At the same time, the two countries display significant differences. Most important is the fact that Brazil's capital markets are nearly as large as those of Korea and Thailand. The vast majority of bonds outstanding consist of government debt, however, as the private sector is crowded out. Both countries need to consider ways to improve macroeconomic management and strengthen their institutions. In addition, international options for obtaining finance may be hindering domestic financial market performance, especially in Mexico with its close proximity to the United States.

LONG-TERM FINANCE. Having identified potential sources of lessons for Latin America in terms of finance in general, we now turn to our two particular concerns: long-term finance and access for small firms. Table 9.2 provides ele-
Table 9-2. Latin America and East Asia: Long-Term Finance and Access, 2003

<table>
<thead>
<tr>
<th>Country</th>
<th>Investment rates</th>
<th>Long-term credit constraints</th>
<th>Capital markets</th>
<th>Government activism</th>
<th>SME credit constraints</th>
<th>Government activism</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>32.5</td>
<td>15.9</td>
<td>182 Medium/High</td>
<td>12.8</td>
<td>Medium</td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>23.0</td>
<td>41.7</td>
<td>147 Low</td>
<td>51.1</td>
<td>Medium</td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>32.2</td>
<td>n.a.</td>
<td>109 High</td>
<td>n.a.</td>
<td>High</td>
<td></td>
</tr>
<tr>
<td>Thailand</td>
<td>27.9</td>
<td>76.1</td>
<td>101 Medium</td>
<td>43.9 Low/medium</td>
<td>43.9 High</td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>20.7</td>
<td>63.8</td>
<td>59 High</td>
<td>30.0</td>
<td>High</td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>19.5</td>
<td>87.6</td>
<td>23 Low</td>
<td>64.7 Medium/High</td>
<td>64.7 High</td>
<td></td>
</tr>
</tbody>
</table>

Sources: World Bank, World Development Indicators (onlifex) for investment ratio tables 2.3 and 2.4 for capital markets: World Bank website (http://data.worldbank.org/governance/wibs) for scores on credit constraints, market access, and government policies. a. Not available.

2. Percentage of all firms that report lack of long-term finance to "major or moderate obstacle" in business environment.
3. Market capitalization and private sector domestic bonds outstanding as share of GDP.
5. Percentage of small firms that report financing as "major obstacle" in business environment.
6. Government support programs for SMEs.

vant data. The first column presents the ratio of investment to GDP. The second shows survey data on the extent to which lack of long-term finance is a major or moderate obstacle to business operations and growth. The third and fourth indicate two ways to satisfy the need for long-term finance: capital markets and government programs. The fifth column turns to SME credit, also presenting survey data about whether lack of finance is a major obstacle to the operations of small firms. The final column estimates government efforts in this area.

The World Business Environment Survey (WBES) provides a source of data on whether long-term finance is a "major or moderate problem" in individual countries. A large majority of firms in Brazil (64 percent), Thailand (76 percent), and Mexico (88 percent) said it was. Very few firms in Singapore agreed (16 percent). Chile fell in the medium (42 percent). Comparing these responses to the availability of long-term finance from the domestic bond and stock markets yields interesting results. In Singapore, which has the most finance available through bonds and equity (nearly 200 percent of GDP), few firms complain about finance. In Mexico and Brazil, by contrast, where capital market finance is scarce (between 20 and 60 percent of GDP), entrepreneurs predictably see great difficulties. Chile lies in the middle, as would be expected. The surprise is that long-term finance is also cited as an obstacle in Thailand, despite what appears to be an ample supply. (Korea is not included in the survey.)

In the face of a perceived market failure, some governments have tried to supplement private sector finance through long-term loans from public sector development banks. Brazil's National Bank for Economic and Social Development (BNDES) is the most prominent example. The bank currently lends nearly $14 billion a year, which is nearly 15 percent of Brazil's annual gross domestic investment. The vast majority of the funds go to the private sector, including foreign firms; priority areas include infrastructure, basic inputs, exports, national technology development, and SMEs. The survey data, however, suggest that the BNDES loans are not sufficient to meet the demand, and investment rates are extremely low despite the availability of finance.2

Korea also has powerful public sector banks. Korea Development Bank (KDB) is the largest and, like BNDES, specializes in long-term finance for investment purposes. The biggest share of its loans goes to the industrial sector, followed by gas, electricity, and water and then by transportation and communications. In 2003, loans totaled around $10 billion (6 percent of the country's industrial output that year). The Export-Import Bank complemented KDB on financing exports; it lent nearly $8 billion in 2003. Unfortunately, Korea is not included in the WBES, so we do not know the opinion of Korean entrepreneurs. Nonetheless, Korea has long had a high investment rate, and some experts argue that government finance has been a significant factor.3

Singapore and Thailand focus more on public-private partnerships to support investment, but they do so in rather opaque ways. Singapore's government accounts for a large share of the country's very high investment rate, operating through the Government Investment Corporation and Temasek, which together manage assets representing more than 150 percent of GDP. Much of this investment, however, is carried out overseas. One of the sources of funds is the Central Provident Fund, the government-controlled pension system, whose assets are about 65 percent of GDP.4 Thailand has a number of so-called specialized financial institutions. The joint public-private Industrial Finance Corporation of Thailand (IPCTC) appears to have been most analogous to BNDES and KDB, although on a much smaller scale. Its loan book, as of early 2003, was nearly $4 billion, although annual flows were much lower. In 2004, IPCTC merged with the Thai Military Bank and DBS-Thai Dai Bank, a subsidiary of the large Singapore bank. It is not yet clear what the role of the new institution will be.5

Unlike the other cases, Chile and Mexico rely mainly on the private sector to finance business investment today, although both had prominent development banks that played an important role in the industrialization of the two countries.

1. See chapter 8. The BNDES annual disbursements are more than the World Bank lends annually on a worldwide basis through the IDB window.
2. See discussion of Brazil in chapter 8.
4. On Singapore's financial system, see Mestres and Gipf (1999); Hew (2002); IMF (2004a); Fitch (2002b).
5. On finance in Thailand, see Vajragupa and Vichyanond (1999); Vichyanond (2002); IMF (2004f); War (2004a); Fitch Ratings (2005).
tries. Now those two institutions—the National Development Corporation (Corfo) and Nacional Financiera (Nafin), respectively—have become second-tier banks that primarily serve SMEs. Having moved away from public funding of investment, Chilean governments have sought to provide incentives to enlarge both the banking sector and the capital markets. The data in table 9-2 on the investment ratio and the availability of long-term finance reflect their success relative to neighboring countries—although much remains to be done. Mexico still has a development banking sector, but most of it is being phased out or turned toward social goals. At the same time, the private sector has not stepped in to fill the gap in terms of investment finance. Bank credit to firms is very limited and almost exclusively for working capital, while the capital markets remain very small despite recent expansion. These problems are reflected in both the low investment rates and the fact that entrepreneurs signal that long-term finance is a more serious problem than in our other cases.\(^6\)

In summary, table 9-2 suggests that lack of long-term finance is a serious constraint on investment and growth in most of the countries we are following in this chapter. The countries with large capital markets, which specialize in long-term finance for a limited sector of the corporate population, complain less about this problem and have higher investment rates. This includes Singapore and Chile. Chile relies exclusively on private sector finance, but Singapore complements its capital markets with a direct government role in investment. Brazil and Korea have large public banks whose mission is to provide long-term finance. While Brazil's bank is larger than Korea's, it has not had the same impact in terms of increasing the investment rate. Mexico is in the worst position, since it has neither strong capital markets nor an active development bank. Businesses note the lack of long-term finance, which is correlated with low investment. Thailand's situation is unusual since it has had a relatively high investment rate, but there are serious complaints about the lack of finance. This apparent anomaly may have to do with the aftermath of the country's 1997 crisis (the survey was taken in 2000).

ACCESS FOR SMEs. SME credit displays both similarities and differences with respect to the country responses on long-term credit. That is, in Singapore, owners of small and medium-sized firms indicate little difficulty with access to finance (less than 13 percent report it is a major problem), while in Mexico they report a great deal of trouble (nearly 65 percent see it as a major constraint). The other three countries fall in between; again no information is available for Korea. While private sector institutions have expressed some interest in expanding SME finance in recent years—as a result of both the higher margins in that area and the migration of larger firms to the capital markets and international finance—they have yet to make much of a dent in the existing demand. Governments have

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\(^6\) See discussion of Chile in chapter 6.  
\(^7\) See discussion of Mexico in chapter 7.  

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As discussed earlier, the provision of finance for SMEs is one of the priorities of Brazil's BNDES. Some, but not all, of this lending is done through second-tier operations with the government-owned Banco do Brasil, the largest commercial bank in the country, and with various private institutions. Banco do Brasil does some of its own lending in addition to participating in BNDES activities. In both cases, lines of credit for working capital and investment goods are provided together with guarantees, technical assistance, and innovative approaches to SME finance through the use of credit cards. Between the two, some $5 billion was provided in 2003.\(^8\)

The main government agent for SMEs in Mexico is Nafin, the former development bank, which now targets small firms as one of its principal activities. (It also acts as the government's fiscal agent and makes direct loans to public sector firms.) Nafin provided loan and guarantee disbursements of around $8 billion in 2003, almost all of which was channeled through second-tier operations; its financial support programs thus reached 90,000 companies and its technical assistance efforts another 250,000. One of its most successful techniques is an Internet-based network of private firms that are interested in providing factoring services to SMEs.\(^9\)

Chile has established a partnership between its former development bank, Corfo, and the state-owned commercial bank, BancoEstado, to support SMEs. Working together, they have designed a successful program (Pogape) to offset transaction costs for private sector banks that are willing to finance SMEs. They also engage in direct lending to small firms and provide guarantees so such firms can borrow from private banks. The amounts involved are much smaller than in Brazil and Mexico, with only around $300 million a year from Corfo and Pogape combined in 2003. However, BancoEstado lends another $2–3 billion annually to small firms. If this amount is included, then the public sector in Chile provides far more on a per capita basis than do Brazil and Mexico, but it is done on commercial terms.\(^10\)

Korea and Thailand, by contrast, have state-owned banks that provide direct finance to SMEs. In Korea, the Industrial Bank of Korea (IBK) fulfills this function,
Specifically called the SME Bank, Korea's SME finance is for small firms in that country. It is the loan book to SMEs, some $4 billion in addition to traditional types of lending, similar to that at Nafin, and it has helped and market through an issue jointly guaranteed by the four International Cooperation. It also engages in a number of SMEs. Thailand's SME Bank targets older and less sophisticated level. Total loan, involving 6,000 small and medium-sized companies, is six, Singapore's efforts with respect to entrepreneurship and innovation. Some government agencies, such as the Economic Development Board, are carried out in conjunction with private sector initiatives. Many programs are geared for technology available for firms in more traditional sectors and variable-rate loans, insurance, equity participation through hiring external experts, etc. Binghamton says, in particular, are changing world because of their potential for employment generation. Unfortunately, it is uncertain whether the experiences that we have reviewed—direct investment in Asia versus second-tier finance in Latin America, for example—will be an example. It is not clear whether the area could be more powerful, or by both public and private sector practices, as a first step to policy initiatives need to be considered and improve the sector's performance. The World Bank has reported recently by the World Bank and others (2004); Cull and others (2004); and..

A Policy Agenda for the Financial Sector

Even those who believe that finance is basically a response to growth realize that the proper financial infrastructure must be in place for a smooth transition to occur. The issue of what should be done, however, is not clear-cut. Moreover, the different characteristics across countries complicate the policy discussion enormously. Initial conditions are obviously central to policy choice. These vary widely, as we have shown throughout the book, which implies that a one-size-fits-all solution is not appropriate.

Our aim in these final pages is to suggest a set of mid-level policy recommendations. We identify areas that require reform and suggest some general approaches, based on best practices found in our research. Aligning them with specific policy instruments must be the task of public and private sector actors in each individual country. We argue that five areas constitute the central core of a policy agenda to promote a robust financial system that will promote growth and equity. They include good macroeconomic management, development of strong institutions, cautious integration into the international economy, support for a long-term segment of the financial markets, and a major thrust toward expanding finance for small firms.

Macroeconomic Management

A first policy area that we have identified as crucial for the development of both banks and capital markets is sound macroeconomic management. It is virtually impossible to foster healthy banks and especially robust capital markets in the midst of high inflation and volatile growth. Brazil in the late 1980s and early 1990s shows that banks can adjust so as to be highly profitable, even in Latin America. They will do so through speculative activities rather than lending to support private sector investment or consumption. Argentina provides a different model, in which a strong regulatory environment proved to be a match for serious macroeconomic failure. Bond markets are much more fragile than banks. Under poor macroeconomic conditions they will—at best—provide finance for governments, while corporate issues dwindle and stock markets remain thin and volatile.

Many aspects of macroeconomic policy are important, and they are closely interrelated among themselves and with finance. Stable growth, low inflation, fiscal discipline, and high savings are all essential components of an environment in which financial markets can flourish. Of these elements, Latin American countries have made the most progress in controlling inflation. Brazil's 'Plano Real was the final step that returned the region to single-digit levels in the mid-1990s. In many cases, these inflation gains were purchased through fixed exchange rates that ultimately fed into financial crises. Now a new approach seems to have taken hold, involving flexible exchange rates and the slow, but steady, use of monetary and fiscal policy to bring inflation down further in those cases where it is necessary. Chile, throughout the 1990s, was an example of this...
while Thailand has an institution specifically called the SME Bank. Korea’s Industrial Bank is the leading source of finance for small firms in that country and devotes 5 percent of its 3.5 trillion won loan book to SMEs; some $4 billion in new loans were disbursed in 2003. In addition to traditional types of lending, IBK has introduced a factoring system similar to that at Naino, and it has helped smaller firms enter the international bond market through an issue jointly guaranteed with Japan’s Bank for International Cooperation. It also engages in venture-type financing for a select group of SMEs.11 Thailand’s SME Bank carries out similar activities, but on a smaller and less sophisticated level. Total loans in 2003 were around $680 million, involving 6,000 small and medium-sized firms.12

As the highest-income country of the six, Singapore’s efforts with respect to SMEs are heavily focused on fostering entrepreneurship and innovation. Some programs are directly administered by government agencies, such as the Economic Development Board, and others are carried out in conjunction with private institutions and individuals, “angels.” Many programs are geared for technology start-ups, but opportunities are also available for firms in more traditional sectors. Instruments include fixed- and variable-rate loans, insurance, equity investments, tax incentives, technical assistance through hiring external experts, and support for developing overseas markets.13

The problems of SMEs in general, and their financial needs in particular, are a high priority throughout the developing world because of their potential impact on poverty reduction and employment generation. Unfortunately, it is hard to evaluate the two types of experiences that we have reviewed—direct lending by government banks in East Asia versus second-tier finance in Latin America—because of the lack of comparable information. It is also unclear whether successful experiences can be replicated, but the area calls out for more comparative research. We need to identify best practices by both public and private sector institutions, and the prerequisites for their implementation, as a first step to providing solutions.14

Toward a Policy Agenda on Finance

Latin American governments generally agree that policy initiatives need to be undertaken in the areas of finance. Those who regard finance as an important determinant of growth are eager to deepen and improve the sector’s perform-

14. Interesting work on SMEs, finance, and poverty has been reported recently by the World Bank. See, for example, Berger and Udell (2004); Beck and others (2004); Call and others (2004); Hanoun (2004, 2005).
kind of approach, in contrast to the Argentine, Mexican, or Brazilian style of stabilization. These hard-won gains must be protected and, in some cases, extended, but within a context of substantial exchange rate flexibility.

A key aspect of stabilization must be fiscal discipline, despite political pressures to the contrary. Fiscal discipline is important because deficits must be financed—whether through printing money, issuing domestic bonds, or tapping the international markets. Each mechanism has its costs for financial development. Inflation and the resulting uncertainty are one cost, together with the need to compensate with tight monetary policy and high interest rates. Crowding out in local bond markets is another, as can be seen in many Latin American countries where the large majority of bonds consist of government debt. Finally, careless use of international finance, with mismatches of various kinds, has proved to be a powerful element underlying financial crisis. While fiscal deficits declined sharply in the early 1990s, they have been creeping up again, which constitutes an obvious area of concern throughout the region. They must be controlled, but the target level of deficit (or surplus) has to be decided according to political and economic circumstances in individual countries.

Growth, savings, and finance are an interrelated triad in the macroeconomic sphere. Economic evidence suggests that finance is the independent variable in the relationship with growth, but the latter will always generate some type of finance when necessary. The question is how stable and robust the finance will be. The situation in Mexico since 1995 is an interesting example. Despite a continuous decline in bank lending and minuscule domestic capital markets, growth and investment were buoyant in the second part of the decade, supported by international finance for large firms and nonbank finance for SMEs. While the steep fall in Mexico’s growth rate in the early 2000s was mainly due to the drop in U.S. economic growth, the lack of finance for the majority of firms meant that the domestic economy was not able to buffer the external slowdown.

Savings are also primarily a result of the growth process, although tax and other policy measures can have a positive effect on saving propensities. Some portion of available savings will then be recycled through the domestic financial system. The deep financial systems in East Asia are clearly a reflection of the high savings rates in that region. The situation in Latin America is weaker than that in Asia for two main reasons: the savings rates are lower per se, and skewed income distribution and macroeconomic instability create incentives for capital flight, moving existing savings out of the country rather than channeling them into domestic capital markets to finance investment. Each individual country needs to design instruments and incentives to help channel savings into the financial system and into productive use, but this must take place within a context of stable growth.

**Institutional Development**

Institution building constitutes a second policy area that is crucial for strengthening the financial sector. Political stability is a prerequisite for any program to develop societywide or sector-specific institutions. In particular, continuity of political-economic approach is a sine qua non. Too often in the past, Latin America has gone through large pendular swings in policy orientation, which has the effect of undermining any kind of institution building. One of the most positive aspects of recent years is the increased tendency toward economic policy continuity, even when governments of different political persuasions replace each other. Governments and the private sector alike are coming to realize that institutions take a long time to create, but can be destroyed very rapidly.

Given an appropriate political context, institution building must take place in two distinct areas. The first is the area we have emphasized in the book: the rules and norms that govern societal interactions by controlling uncertainty. We have focused on two types of rules and norms, both of which are essential for fostering financial development. At the societal level, the World Bank has helped to define and measure a set of governance institutions. Of their six elements, we worked with four: government effectiveness, regulatory quality, rule of law, and control of corruption. We found a strong relationship between these indicators and both bank performance and capital market size, which suggests a fruitful—if difficult—area where governments should try to make progress in the near future. At the financial sector level, a more specific set of institutions is important. Both corporate governance in firms that are potential borrowers and governance of the financial sector itself must be strengthened. Examples that we and others have found to be related to capital market development include disclosure of financial information, general transparency, contract enforcement, protection of minority shareholders, bans on insider trading, and simple and expeditious bankruptcy procedures. These practices have a strong impact on whether bankers are willing to make loans and investors are willing to put money into capital markets. The relationship is especially important with respect to finance for the private sector. Governments may be able to get resources for themselves through various means, but private sector finance is much more fragile.

A second area for developing institutions is more concrete, involving specialized agents and markets. With respect to banking, perhaps the most important is the regulatory and supervisory system. Opinions differ on the best type of regulation and supervision for both banks and capital markets. The prevailing view is that a strong government role is essential, but a few experts have recently begun to argue that private sector monitoring is preferable. Our view is that it would be a mistake to rely exclusively on the latter, given the problems of macroeconomic shocks, contagion, and procyclicality that characterize today’s open economies. Nonetheless, activities such as increasing information disclosure
and transparency and introducing external ratings and audits can be useful supplements to government regulation and supervision. Government-based supervision and private monitoring should be viewed not as substitutes, but as complements. Important attributes of supervisors must include high skill levels, pay scales that prevent them from being bribed or hired away, and adequate training. Training can usefully be carried out in connection with regulatory agencies of industrial countries, which is especially important when foreign banks control the dominant share of local markets (as in Mexico). Information sharing and perhaps joint supervision are additional topics that need much more attention than they have received to date.

With respect to capital markets, the key requirements include fostering the development of new actors and strengthening market infrastructure. On the demand side, we have described the importance of institutional investors, including pension funds and insurance companies. At the same time, we found a degree of contradiction between institutional investors and the liquidity that is necessary to attract other participants to the stock and bond markets. One answer is to promote another kind of institutional investor—mutual funds—that tends to specialize in short- to medium-term investments because of client requirements. On the supply side, a central issue is attracting enough firms to list on local exchanges. Among others, two interrelated problems need government attention. On the one hand, strong corporate governance must be promoted if markets are to flourish. On the other hand, some firms are unwilling to engage in the disclosure and transparency that are the essence of corporate governance. Convincing them that it is in their long-run interest to do so is an ongoing task of financial authorities in all emerging market economies.

International and Regional Context

While the international context in which Latin American banks and capital markets operate is clearly important to their performance, policy in this area is complicated. Some experts emphasize the need to reform the international financial architecture. Developing countries do not have much leverage, however. Moreover, the interests of developing countries do not always coincide, which hinders the creation of alliances that could increase their influence. For example, the richer countries are more concerned with access to private flows, whereas the poorer ones are more interested in aid. Those with access to private capital are concerned about measures to enhance the stability of international debt instruments; those who rely on public sector flows tend to be more interested in conditions for debt relief.

Given this panorama, we recommend that Latin American countries devote their main efforts to decreasing their own vulnerability, yet without abandoning the discussion of international financial policy. In large measure, this means

pursuing sound macroeconomic policy, as discussed earlier. For example, higher savings rates and lower fiscal deficits both decrease the need for external finance. Similarly, conservative debt management strategies can help countries avoid being caught out when conditions change in international financial markets. Within the context of sound macroeconomic management, judicious use of controls on capital inflows may help to prevent capital surges from undermining domestic stability. Maturity, currency, and interest rate mismatches should be avoided when engaging in international transactions. Finally, decreasing a country's international vulnerability is a strong reason for developing local capital markets.

A powerful argument against the last point involves the relatively small size of most Latin American economies, with the exception of Brazil and Mexico. Small market size does indeed affect the ability of local capital markets to provide for the financial needs of governments and large firms. Some World Bank economists, among others, have recently argued that because of size constraints, the best approach is to push forward with international financial integration and forget about local markets. We do not believe this recommendation is helpful except, perhaps, for the largest borrowers. Medium-sized firms will not be able to tap international markets, but they could participate locally. In addition, local markets could supplement international offerings by larger borrowers. We suggest that governments continue their efforts to expand domestic markets through market-enhancing policies, such as promoting improved corporate governance and expanding the types of actors who can participate. The latter might include the introduction of equity markets for new or small firms, as has been done in Brazil, Chile, and Korea.

An alternative that the World Bank rejects, but that we think deserves more exploration, is the creation of regional capital markets. East Asian governments have taken the lead in this area and have already set up some relevant institutions. For example, a small regional bond market has been established, and central banks have negotiated swaps. On the private sector side, banks have begun investing across borders, increasing the demand for regionally based brokerages, investment banks, and other such institutions. Latin American countries would do well to follow the results with care to see what can be accomplished. Within Latin America itself, harmonization of macroeconomic policies is a first step, but others could be taken as well. Regional and subregional development banks should take a leading role in these activities.

Long-Term Finance for Investment

The lack of long-term finance for investment is one of two major failures that we highlight in the book. The lack of such finance is arguably one cause of the low investment ratios found in Latin America, although some approaches have been more successful than others in addressing the problem. For example, Brazil
one of the lowest interest rates in the region. Chile, by contrast, offers no long-term government finance, but it has promoted capital markets with greater success as measured by investment ratios. Mexico has little finance of either kind, relying instead on nonbank and international finance together with retained earnings. Again, however, the investment ratio is very low. Market-enhancing policies could play a useful role in stimulating the development of both public and private institutions.

Three forms of market enhancement offer the potential to increase long-term finance. A first approach centers on banks, since they are the single largest source of finance in the region—despite the poor performance in recent years. The maturities of bank loans that are to be used for investment need to be extended. One possibility would be to establish carefully designed guarantees from national or regional public sector banks. Another would be to encourage a system for the securitization of long-term loans for investment, along the lines of the mortgage market in a number of countries. While the U.S. system is the best known, Chile has long securitized its mortgage debt, and Mexico and Brazil have also begun to use this approach. In the U.S., the institutions involved are quasi-public, but regional development banks could play this role, as could private firms with sufficient resources. This would allow banks to make long-term loans, but then get them off their books so as to continue making new finance available.16

A second approach is to promote capital markets in countries where the market is large enough to support them. Brazil and Mexico are clearly candidates, and the Chilean markets are already active in a relatively small economy. A key factor is fiscal restraint, so that available funds are not monopolized by the public sector. Based on our review of various experiences, we identify three additional requirements: namely, good corporate governance, the presence of institutional investors, and sufficient liquidity in the secondary markets to give investors confidence. While some conflict may arise between the second and third items, it is most likely to occur with pension funds and insurance companies, given their long time horizons. Other institutional investors, such as mutual funds, are more active traders. As mentioned above, the possibility of regional capital markets should also be explored as a way to resolve the size problem.

A third approach involves a direct government role in providing long-term finance. The negative experience with government development banks in many countries has frequently led to the closure of these banks or their conversion into second-tier institutions. It is worth studying the relatively successful cases, however, to see if any mechanisms could be adapted to other locations. Korea's KDB is a case in point, as is Brazil's BNDES, although the issue of why BNDES has been unable to raise investment rates needs to be thoroughly explored. A number of regional and subregional development banks have also played a positive role in financing investment. The Inter-American Development Bank, the Andean Development Corporation, and the Central American Bank for Economic Integration are all important examples within Latin America. The World Bank provides an example on a global scale. These regional and global institutions could also usefully be examined for lessons on how well-managed development banks can contribute to long-term finance for investment. The poor experience with public sector banks in the past should not be grounds for automatic elimination of this option.

Access to Finance for Small Firms

The other market failure that we have been following is the lack of finance for small firms. The two most important reasons that SMEs have difficulties obtaining finance are lack of information about the firms (because of poor record-keeping or insufficient history) and high bank transaction costs (the unit administrative costs of making small loans are much higher than for large ones). The challenge, then, is to design instruments to deal with these problems. The solution must take into account some important differences between two types of small firms, since they may require different solutions to their financing problems. Small firms in traditional sectors can be supported by existing institutions (banks and nonbank intermediaries), but high-tech start-ups may need finance more akin to venture capital in developed countries. Again, market-enhancing policies are required.

The countries we have studied have tried four approaches to increase finance for small firms, with differing degrees of success. Governments in other countries can gain useful insights from their successes and failures. The first approach is the traditional way of providing finance to small firms: direct loans from government-owned commercial or development banks. These experiences have generally been quite negative, in terms of both managing the banks and getting the money to the intended recipients. Nonetheless, some relatively successful cases are worth reviewing, such as Chile's BancoEstado, Brazil's BNDES and Banco do Brasil, and Costa Rica's public banks. Several banks in East Asia, such as Korea's Industrial Bank, may also offer some useful experiences. After suffering serious problems in the past, these institutions have restructured operations and improved internal bank management. Tough regulation, which put the public banks on the same level playing field as their private competitors, has also been essential in turning around performance and making the banks potentially useful instruments for supplying finance to SMEs.

The second approach involves second-tier banks. These have been much more common than direct lending in recent years in Latin America. These are

16. Securitization is easier for mortgages than for investment loans because of the standardization of the underlying asset and the ability to repossess in case of default. Greater institutional creativity would be required for investment loans.
government-owned institutions that provide funds to (usually private) commercial banks to on-lend to small and medium-sized firms. Two of the most successful instruments used by second-tier banks have been guarantees for loans that private banks make to small firms and subsidies for transaction costs. Chile’s BancoEstado, in collaboration with Corfo, has used both methods with fairly good results. Mexico’s Nafin has a large program that offers guarantees to banks for the loans they make to small and medium-sized firms. Brazil’s BNDES also does much of its lending to SMEs via second-tier operations with both public and private commercial banks, which are responsible for the analysis and approval of both credits and guarantees. BNDES officials argue that the latter are closer to the customers and thus can make better-informed decisions than the large development banks themselves.

Third, new institutions and techniques to support lending are being introduced in Latin America. Credit bureaus have lowered the information costs for SME lending, while credit scoring has lowered transaction costs. Leasing and factoring have also become important sources of finance for small firms. Leasing enables them to obtain equipment without having to make a large initial outlay, while factoring makes it possible for them to get access to funds before they are paid for the products they produce. Indeed, factoring has become the technique of preference at Mexico’s Nafin, where a second-tier arrangement has been devised to link large purchasers and private factoring firms with small subcontractors. Likewise, studies show that a substantial amount of investment by small firms in Chile is carried out through factoring and leasing. In Brazil, both BNDES and Banco do Brasil have introduced credit cards for SMEs, which provide preapproved medium-term credit for working capital and investment, and BNDES administers a lending and technical assistance program for SME exporters. New actors have also appeared to support SMEs. In Mexico, the absence of lending from commercial banks led to the formation of a group of nonbank institutions (sobases). Since they cannot take deposits, the sobases get money from the banks and the capital markets. They have lent mainly for consumer and housing purposes, but they have also made loans to SMEs. A mark of their success is the fact that several have been purchased by the large banks.

Finally, a select group of small firms needs large amounts of money to undertake substantial investments in high-technology areas. Such firms have gained access to venture capital funds in developed countries and in some Asian countries. Taiwan has perhaps the most developed set of venture capital firms, but Korea and Singapore are also moving in this direction. Mexico has incipient venture capital firms (Sincap, a type of mutual fund), although they have not yet taken off, while the latest capital market reform in Chile contains provisions to stimulate venture capital. This is clearly an area for future activity, probably though a partnership between public and private sectors. It may also involve a special stock exchange for new firms so as to provide an exit for venture partners and an ongoing source of finance for the firms at a later stage. A study of the Asian experiences would be a useful first step.

Final Comments

To close our analysis of Latin America’s financial systems at both the regional and national levels, a few simple messages are worth emphasizing. First, finance is an important determinant of growth and welfare. It thus merits receiving the highest priority on the policy agenda of the region. Second, the financial systems in most Latin American countries work poorly, including both the banking systems and the capital markets. They are not providing either the support needed for higher growth or the access required to expand opportunities to less privileged groups in society. Most Latin American governments have declared growth with equity to be their overarching goal; finance is a key instrument—one that can assist them or undermine them. Third, changes must be made. Financial liberalization resolved some problems, but it created many others. It is now time to push forward with a new reform agenda that will address existing deficiencies. We have put forward one set of proposals; others have made their own suggestions. Ultimately, individual governments and private sector actors in each country must choose broad strategies and select specific policies that will work in their particular case. Even with a clear and coherent agenda, however, strengthening the region’s financial systems will be a long-term process full of difficulties. It is urgent to start now.