

PART II



Financial Market Development to Promote Business Growth

Summary

The major problem faced by businesses in Latin America and the Caribbean is accessing financial markets. In 18 of the 20 Latin American countries covered by the World Business Environment Survey, access to credit was reported by entrepreneurs as their most serious concern. Figure 1 shows that financial markets in Latin America are in fact very small, so the concerns of business communities would seem understandable. On average, the ratio of credit to the private sector to GDP in the 1990s was close to 33 percent, roughly a third of the size of the average credit markets in East Asia and the developed countries. In countries where credit constraints are tighter, firms are unable to grow. Estimates suggest that, on average, a large firm can increase its assets by nearly 5 to 8 percent for every 10 percent increase in the financial depth of its host country. Therefore, companies in countries with tight credit constraints face severe impediments to expansion.

The importance of well-functioning financial systems for economic growth has been amply explored in the literature.¹ The size and stability of a country's financial system play a key role in ensuring high and sustained levels of economic growth. Entrepreneurs take the initiative on potentially profitable investments only if they are able to obtain the funding required. The ability to mobilize financing and allocate it productively depends on the efficiency of the domestic financial system. Investment intentions of entrepreneurs generate demand for funds in financial markets, and the response of both domestic and foreign financial intermediaries to those demands is what determines the pattern of domestic investment, competitiveness and economic growth.

Beyond financial depth, however, financial *stability* is crucial for competitiveness. Systemic crises in the

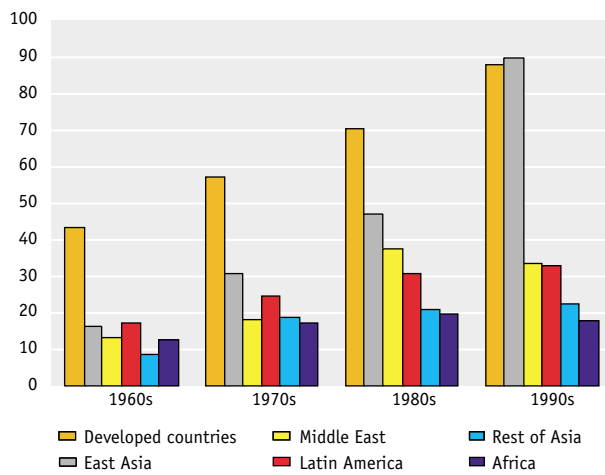
financial sector invariably disrupt the real economy (through their effects on the supply of credit and the payments mechanism), increasing the risk associated with real investment. Moreover, generalized insolvency in the financial sector is likely to interact with other risk elements in the macroeconomic environment, increasing the severity of other risk factors. For example, financial sector weakness may increase the probability of a currency crisis when the currency is overvalued. It may be associated with potential fiscal insolvency as well, if the government backs the liabilities of the financial system.

There are many facets as to why financial constraints are more pronounced and financial crises more frequent in some countries than in others. Macroeconomic issues such as international, monetary or productivity shocks are particularly relevant.² A stable environment can facilitate international capital inflows, expand the coverage of financial services, ease the information gathering and processing functions of the financial sector, and allow scope for the emergence of a wider range of financial instruments. In short, it can promote an efficient allocation of financial resources, and reduce borrowing costs for domestic firms, therefore promoting economic growth.

Most Latin American countries have had to address the aftermath of severe macroeconomic problems in the 1980s and early 1990s. Inflation in the region has been reduced dramatically to a nearly one-digit figure aver-

¹ See King and Levine (1993), Levine and Zervos (1998), and Levine, Loayza and Beck (2000).

² See Bernanke and Blinder (1988) and Frexias and Rochet (1997) regarding monetary shocks, and Kiyotaki and Moore (1997) regarding productivity shocks.

Figure 1. Private Credit*(Percent of GDP)*

Source: World Bank (2000).

age, and countries have engaged in profound reforms to stabilize public finances. There are, however, several institutional and regulatory issues that still constrain development of the financial sector.

In general, Latin American countries have relied much more than other regions of the world on banking finance rather than equity-based finance. On average, stock market capitalization in the region during the 1990s was nearly 3 percent of GDP. Recent studies have analyzed the impact of the legal environment, the regulatory framework, the presence of tax distortions against dividends, and several macroeconomic events on the development of stock markets.³ This section explores several institutional issues that have constrained development of the major source of funding, namely, banking credit.

Institutions that support financial contracts provide an operational framework for financial intermediaries, and therefore are crucial to explaining the size of the financial sector and the way that each country accommodates macroeconomic shocks. Inadequate supervisory and regulatory regimes can increase the vulnerability of the financial system and magnify the impact of shocks on credit markets, causing severe volatility and damaging a country's competitiveness.

The appropriate functioning of the financial sector requires an adequate institutional environment and regulatory and supervisory capacity in order to restrict the scope of information asymmetries, adverse selection,

moral hazard, contract enforceability and time inconsistency common to financial contracts.

Regulations that govern credit markets must ensure that financial intermediaries can respond to incentives to direct financial resources toward the most profitable sectors of the economy within a reasonable context of risk management. Policies that force lenders to direct credit towards particular sectors, that impose caps on interest rates, or that excessively tax financial activity inhibit proper risk management and effective risk-taking decisions and misallocate credit. Properly conducted financial liberalization encourages the growth of the financial sector and promotes the development of entrepreneurial activity.

Properly established prudential regulations are intended to address moral hazard considerations associated with lending activity. Restricting lending to related parties, excessive portfolio concentration, and requiring appropriate loan evaluation procedures are examples of regulations aimed at restraining banks from engaging in excessive risks that can be translated into costly crises. When regulation and supervision are weak, the financial sector's ability to allocate investment resources efficiently and broadly is seriously impaired.

Regulations that shape the incentives of the different actors in credit contracts in order to encourage them to abide by the rules are also extremely important to the healthy development of credit markets. In particular, rules that protect creditors and provide a proper legal and judicial apparatus to enforce that protection reduce moral hazard on behalf of borrowers who pledge collateral, and also contribute to financial depth by using the benefits of collateral to reduce informational asymmetries that can constrain credit expansion.

Chapter 5 analyzes the status of prudential regulations, financial liberalization, lender protection, and other regulations that explain the lackluster development of credit markets in Latin American countries. Insufficient regulation to protect creditors and excessive regulation of financial contracts are shown to have negative impacts on the size and stability of credit markets.

Excessive government involvement in banking has a negative impact on credit markets. Public banking induces inefficiencies that can spread throughout the financial system and undermine the financial sector's role in facilitating economic prosperity.

³ See Demirguc-Kunt and Levine (1999).

Chapter 6 looks at this issue, as well as the effects of limiting the scope of action of banks, or what has been called universal banking, as well as at the role of the internationalization of the banking industry. Latin America's longstanding tradition of publicly owned banks, and the large number of restrictions that banks face in terms of expanding their scope of action, are part of the reason why the region's credit markets are smaller than those of other parts of the world.

Chapter 7 examines the microeconomic issues related to information asymmetries and the degree of development of information-sharing institutions like credit bureaus, credit registries and credit-rating agencies.⁴ Properly established institutions to promote information-sharing help to reduce adverse selection and

expand the scope of financial services. These institutions play an important role in counteracting several regulatory deficiencies that explain the limited financial depth of some Latin American countries.

In countries where there are financial constraints, the smallest firms are usually those that suffer most, particularly in terms of credit.⁵ Latin America is no exception. Chapter 8 shows that when the institutional set-up is adverse enough to restrict financial intermediation, economies tend to develop mechanisms to expand financial services to the smallest entrepreneurs. The chapter thus discusses the evolution of microlending in Latin America and suggests several regulatory and supervisory considerations to help ensure a stable and deep microcredit market.

⁴ See Pagano and Japelli (1993 and 1999).

⁵ See Laeven (2000), Love (2000) and Winker (1999).

