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Latin America: financial systems and financing of investment.

Diagnostics and proposals

Luis Felipe Jiménez and Sandra Manuelito

This work examines the main characteristics of the financial systems of Latin America, in order to develop proposals for strengthening investment finance in the region. First, a diagnostic is given of the investment-supporting capacities of the region's banking systems, stock and bond markets, and flows of external financing. Next, an analysis is offered of the principal macroeconomic and microeconomic factors and a number of structural features that have had a hand in the region's shallow financial development and the system's failure to adapt to the needs of investment financing. Against this background, proposals are made for expanding the capacity of financial systems to support investment in firms of all sizes, and guidelines are offered for fostering access to long-term credit for smaller enterprises.

Luis Felipe Jiménez
Economic Affairs Officer
Economic Development Division,
ECLAC
✉ felipe.jimenez@cepal.org

Sandra Manuelito
Economic Affairs Officer
Economic Development Division,
ECLAC
✉ sandra.manuelito@cepal.org

I

Introduction

One of the key postulates of the Economic Commission for Latin America and the Caribbean (ECLAC) is the need to boost investment in Latin America, which is low in comparison both with the developed countries and with other developing regions. In 2008, the region achieved its highest investment rate since 1980, 23.4% of gross domestic product (GDP) measured in current dollars.¹ Comparatively speaking, Latin America's investment rate has been historically lower than that of other emerging regions, particularly developing Asia, whose investment rate rose from 27.8% in 1980 to around 35% in the mid-1990s and over 40% today.

The region has not, moreover, been able to produce sufficient national savings to finance investment nor, on occasion, enough foreign exchange to cover its imported component. The expansion of investment has therefore depended in great measure on external financing and the availability of resources in the international markets. The composition of Latin America's investment financing by national or external origin is much like that of Sub-Saharan Africa and Central and Eastern Europe. This contrasts with the steadily and fast-growing countries of developing Asia, whose investment has been financed basically from national savings, especially since the Asian crisis of 1997.

This lack of national savings has obliged Latin America to compete with other world regions for access to financial resources and to attract investment. So at times when access has been limited, investment rates have naturally fallen. An exception to this situation was the 2003-2008 period, when investment rose steadily in the region alongside a large increase in national saving. This change was chiefly a result of a sharp rise in national income on the back of high commodity prices and, especially in the case of the Central American countries, higher inflows of remittances.²

In modern economies, savings efforts are expressed as demand for financial assets, whose maturities and

risks depend on savers' preferences and needs. This demand also extends to a range of services designed to cater for a variety of contingencies (insurance in general, and especially insurance providing for the maintenance of income in retirement) and to meet the needs of increasingly complex economies.

Saving efforts will be frustrated unless the capacity exists to provide the type of instruments and services needed. Where these are lacking, savings are channelled instead into real assets or capital outflows, instead of greater financial saving within the country. Over time, this creates a vicious cycle and gradually erodes the capacity to mobilize savings possibilities, leaving effective saving below potential. At the same time, the absence of instruments for covering contingencies leaves individuals and enterprises open to greater risk than would be desirable, especially people who are not enrolled in formal social protection schemes and firms outside the financial system.

The decision to invest also generates, among other things, demand for resources and services for covering operational and investment-cycle risk. Where the institutional structure is not developed enough to provide these, investment will be constrained by firms' abilities to generate resources internally. So actual investment will fall short of potential and will be subject to firms' own capacities to absorb risk, such that they will take forward only the highest-profit or lowest-risk projects. Here, investments—and, as a result, growth—will be lower, and the enterprises with least access to external resources (typically smaller businesses) will face the greatest constraints.

Underdeveloped financial markets have negative systemic impacts and produce exclusions. Where financial intermediation is insufficient, large shares of financial resources remain in the sectors where they are generated; they do not necessarily move to sectors that could make more profitable use of them. When certain segments of the market are underdeveloped and the credit structure is oriented towards the short term, some important needs may not be fully met, especially those associated with housing loans, life insurance and pension schemes. Consequently, only high-income segments can aspire to adequately cover their financing and protection needs. At the same time, shortage of resources and the fact that less sophisticated banking systems demand greater real

□ The authors are grateful for comments received from Osvaldo Kacef, Chief of the Economic Development Division of ECLAC, and from an anonymous CEPAL Review referee.

¹ Measured in constant dollars at 2000 prices, gross fixed capital formation in 2008 was 21.9% of GDP, the highest figure since the early 1980s but still lower than the highs of the 1970s (around 25%).

² See Kacef and Manuelito (2008).

guarantees lead to the available credit going mainly to firms with privileged access.

This article sets out to analyse the main characteristics of financial systems in Latin America and formulate the groundlines for a strategy to build up their capacity to increase the region's investment rates, in order to better underpin economic growth.³

Section II examines the characteristics of the region's financial systems, identifying three main components

³ A highly relevant forerunner to this is the study headed by Barbara Stallings in 2006.

which, although largely present throughout, have reached different levels of development: the banking systems, the stock market and the bonds market. Then, given that no analysis of financing for investment would be complete unless it considered available sources of external financing, the composition of external financial flows is observed, as well.

Section III discusses microeconomic, macroeconomic and structural factors which condition the development of internal financial markets in Latin America. Section IV formulates a number of proposals for a strategy to develop those markets in the region. The article finishes with the study's main conclusions.

II

General characteristics of financing sources in Latin America

Latin America's financial systems are considerably less developed than those of more developed countries, and even those of other countries with similar levels of per capita income. They also lack the complex structure of financing generation and capture seen in the developed countries, although certain components are evident in some cases. Instruments for transferring and covering credit risk and financial risk in general (loan securitization, futures and other derivatives) and their related markets are, with few exceptions, fairly underdeveloped if they exist at all. Only a few countries have seen significant development of institutional investors. Financial markets in the region are dominated by commercial banks, whose portfolios retain much of the risk of their loans and are funded basically by deposits and bond issues; some of them also draw upon resources from the international financial system.

Financial underdevelopment has obvious costs in terms of investment financing, especially for smaller firms. The underdevelopment of institutions and markets able to shift long-term risk to others better prepared to hold them in their portfolios (insurance companies, pension funds and other long-term investment funds) effectively prevents the generation of sufficient longer-term financial resources. Risk is retained within the banks, which—given the short-termist nature of their funding—are at somewhat of a disadvantage and face certain weaknesses vis-à-vis holding risks of a longer horizon. As a result, such long-term financing as there

is has tended to go mainly to large and medium-sized firms which can provide better loan guarantees. Only in a few cases, in which large firms have begun to regularly source funding in the international financial market and therefore need less domestic credit, has an incentive been created for banks to find ways to broaden credit access for smaller firms.

1. Main features of financial systems in Latin America

(a) *Banking systems*

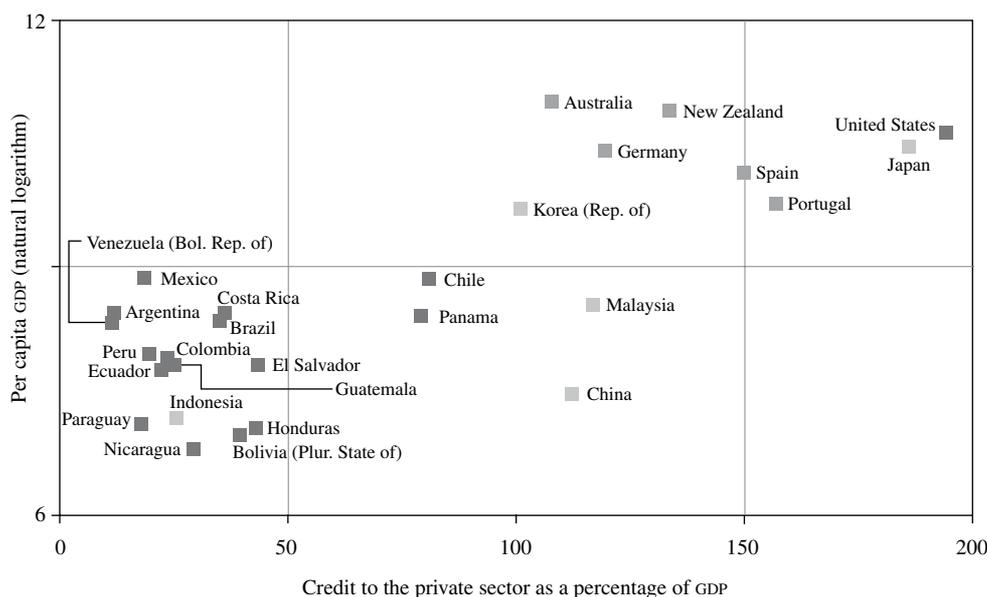
In most Latin American countries, the depth of the banking system—measured as credit as a percentage of GDP—is shallow compared with other countries and regions of the world. Some Latin American countries even have shallower systems than other countries with similar levels of per capita income (see figure 1). Chile and Panama⁴ are exceptions, with credit to the private sector at 100% of GDP in 2008. In the other countries, this figure is below 60% and, in some cases, even below 20% (Argentina and Haiti).

Although 2003-2008 was one of the longest stretches of growth in Latin America for the last 40 years, access to

⁴ In the case of Panama, the widespread presence of offshore banks distorts this figure and leads to overestimation of the penetration of the domestic financial system.

FIGURE 1

Selected countries: financial system depth and economic development, 2005
(Natural logarithm of per capita GDP in current dollars and credit to the private sector as a percentage of GDP)



Source: prepared by the authors on the basis of International Monetary Fund (IMF), *International Financial Statistics*.

GDP: gross domestic product.

banking services remained limited or actually narrowed in many countries, as is evident from the comparison between two distant years shown in figure 2.

Broadly speaking, the composition of the loan portfolio, despite some variation between countries, is leaning increasingly towards the short term, reflecting a surge in consumer lending (see table 1). Notwithstanding the jump in this type of lending, however, business lending is still the largest type. Longer-term loans, especially mortgage or housing loans, show very little development, with the exception of Chile.

Another important observation is that very little financial saving is transformed into financing for credit. Several countries have a deposit-to-loan ratio of over 1.5, indicating that a large portion of deposits is not being channelled into total credit (see figure 3).⁵ The other countries, again with the exception of Chile, have a deposit-to-loan ratio of between 1 and 1.5. This is due to several factors. First, capital markets are not extensively developed, so the money supply is regulated through reserve ratios. Gelos (2006) found that the median reserve requirement on demand deposits in 14 Latin

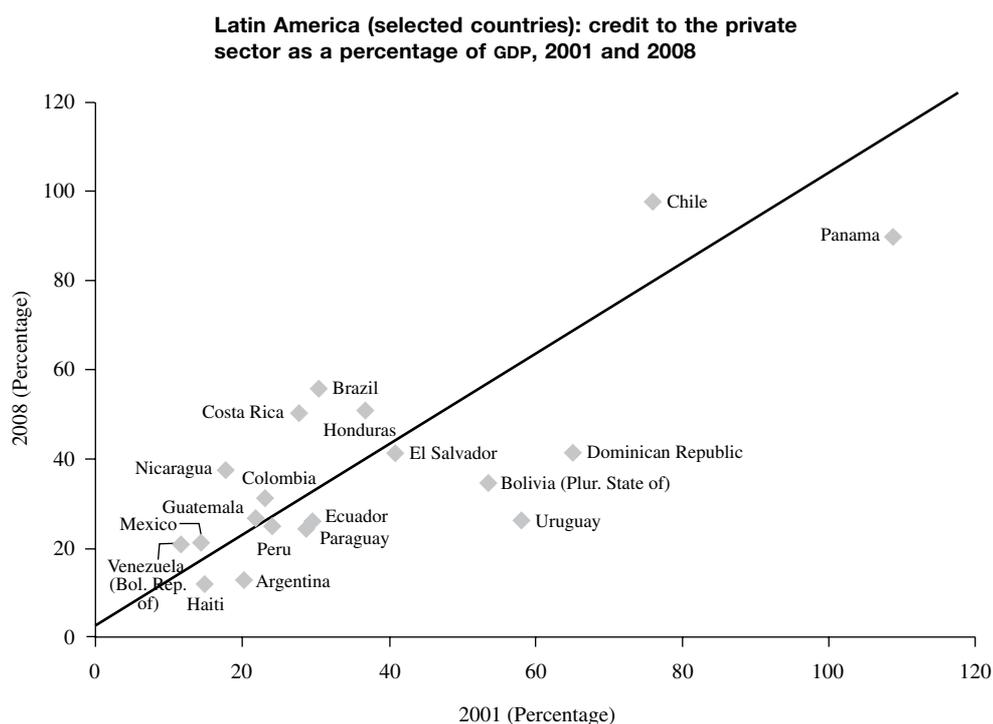
American countries was 13.8%, well over double the rate of 5% observed in other emerging countries. Second, the region has a history of financing public deficits by issuing domestic debt instruments which, owing either to regulatory factors or to their high yields and low risk, are favoured components of banks' investment portfolios. This raises no objections from the point of view of financing for investment, providing that these resources are going to public projects with high economic and social returns. If not, growth may be compromised.

With respect to funding, Latin America banks tend to prefer to take deposits on the domestic market, although they also issue bonds in both the domestic and international financial markets. In fact, from 1995 to 2004 deposits rose as a percentage of loans in almost all the countries. The exceptions were the Bolivarian Republic of Venezuela and Costa Rica, where this percentage nevertheless remained high (see figure 3). As will be discussed in more detail later, liabilities held with non-resident financial institutions play a small and decreasing role in funding. Both assets and liabilities are tending to become less dollarized, although dollarization remains very high in certain countries (see table 2).

With regard to the quality of the loan portfolio, and despite the range of definitions, some countries have

⁵ Total credit includes credit to both the public and private sectors.

FIGURE 2



Source: prepared by the authors on the basis of International Monetary Fund (IMF), *International Financial Statistic*, various issues.
GDP: gross domestic product.

TABLE 1

Latin America (selected countries): credit by sector as a percentage of private lending, 2000, 2005 and 2009
(Data at December of each year)

	2000			2005			2009		
	Consumer loans	Housing loans	Other loans	Consumer loans	Housing loans	Other loans	Consumer loans	Housing loans	Other loans
Argentina ^a	...	17.4	82.6	...	9.7	90.3	...	7.5	92.5
Brazil	20.3	18.0	61.7	32.2	5.0	62.8	34.1	6.8	59.1
Chile	9.1	19.4	71.5	13.0	22.0	65.0	12.6	25.5	61.9
Colombia ^b	15.9	21.6	62.5	25.7	10.0	64.3	29.0	8.0	63.0
Mexico	32.4 ^c	...	67.6	52.3 ^c	...	47.7	42.9 ^c	...	57.1
Peru	10.1 ^d	6.8 ^d	89.9 ^d	18.4	12.2	81.6	22.3	11.5	77.7
Venezuela (Bolivarian Republic of)	17.9 ^e	6.4 ^e	82.1 ^e	15.1	4.8	84.9	21.7	14.0	78.3

Source: prepared by the authors on the basis of official figures.

^a Includes loan advances.

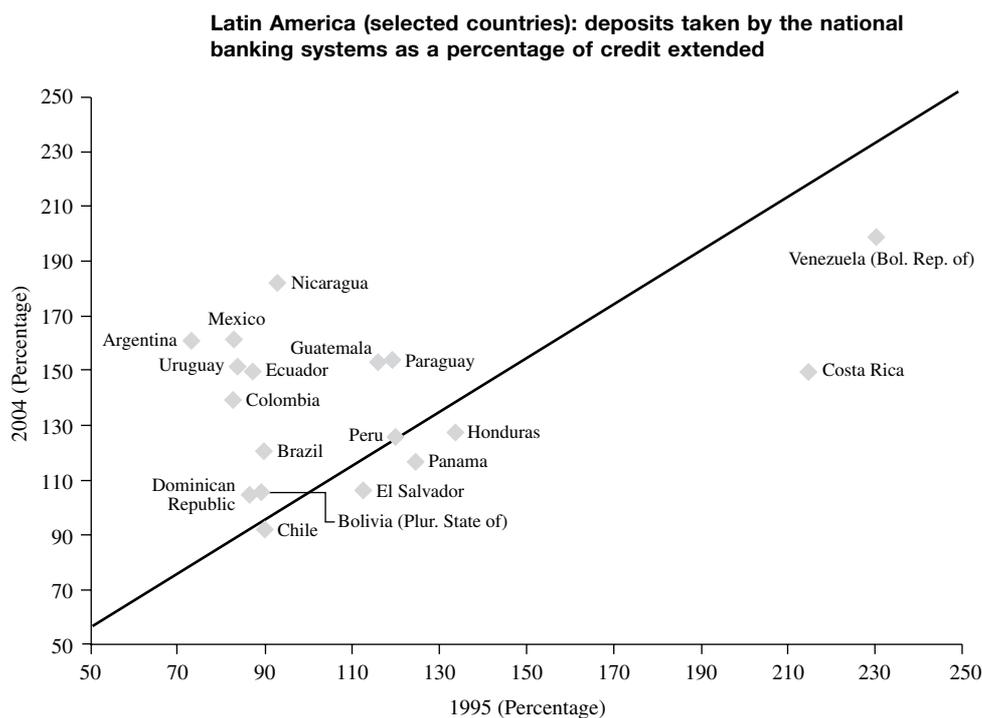
^b Data correspond to January 2003.

^c Corresponds to all loans to individuals.

^d Data correspond to January 2001.

^e Data correspond to December 2001.

FIGURE 3



Source: prepared by the authors on the basis of data from Latin Finance, *Latin Banking Guide & Directory*, various issues.

TABLE 2

Latin America (selected countries): loans and deposits in foreign currency as a percentage of total loans and deposits, 2000, 2005 and 2009
(Percentages)

	Loans in foreign currency as a percentage of total loans			Deposits in foreign currency as a percentage of total deposits		
	2000	2005	2009	2000	2005	2009
Argentina	69.6	14.0	13.0	58.9	9.0	16.1
Bolivia (Plurinational State of)	92.8	63.1
Peru	80.4	66.6	46.2

Source: prepared by the authors on the basis of official figures.

a very large non-performing or arrears portfolio (it is commonly assumed that if the non-performing portfolio exceeds 4% of the total portfolio, this is equivalent to over 50% of capital, which poses a high risk for a bank's financial stability). By this measure, the quality of the loan process is inadequate. The coverage of the arrears portfolio (through reserves and provisions) varies greatly and, in some cases, is less than 100%. Accordingly, if a large part of that portfolio had to be written off, the bank's capital could be compromised (see table 3). In certain cases, moreover, the criteria for defining arrears and non-recoverable loans are much more lax than those found in more modern portfolio

management practices. Consequently, the actual degree of coverage may be even lower.

Capital adequacy indicators have improved in many cases, thanks to the lessons learned from financial crises in earlier years, which made it advisable to reform the loan process and better match portfolio risk levels to capital. This process was aided by the arrival of foreign banks which were bound by more stringent rules in their home countries; in 2004, most of the countries showed a capital to risk-weighted assets ratio above the 8% required under the New Basel Capital Accord (see figure 4). Nevertheless, capital adequacy may not suffice to cover unexpected losses, given the

TABLE 3

Latin America (17 countries): arrears portfolio as a percentage of assets and reserves plus provisions as a percentage of the arrears portfolio in the national banking system, 1998 and 2004

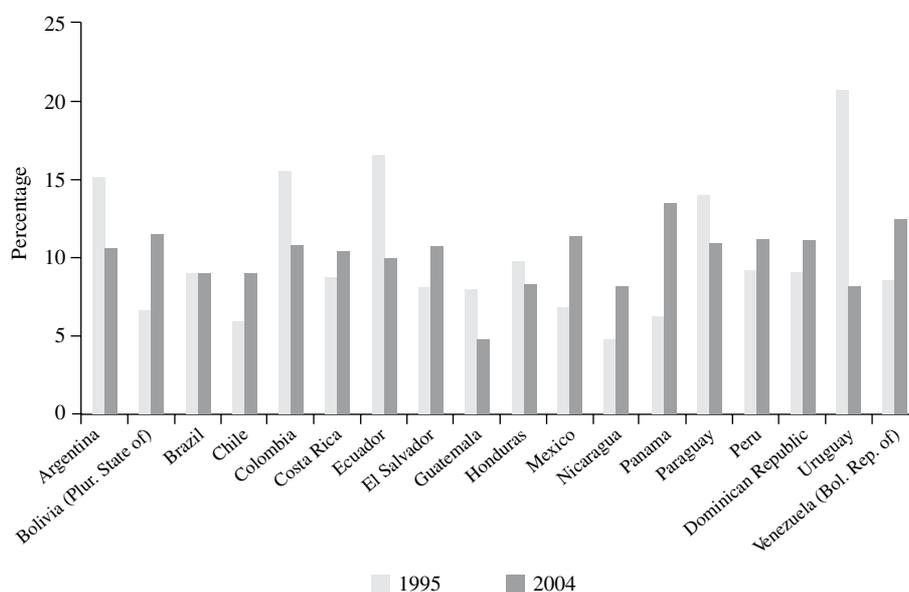
	Arrears portfolio as a percentage of assets		Reserves plus provisions as a percentage of the arrears portfolio	
	1998	2004	1998	2004
Argentina	5.8	4.0	65.2	89.7
Bolivia (Plurinational State of)	3.4	0.8	58.0	989.5
Brazil	3.5	1.3	113.3	161.9
Chile	0.9	0.9	133.9	165.2
Colombia	6.4	2.4	38.1	109.8
Costa Rica	1.2	4.1	131.4	30.1
Ecuador	2.8	3.4	138.5	119.0
El Salvador	3.5	1.4	85.8	132.5
Guatemala	2.4	3.1	46.6	78.4
Honduras	2.9	1.2	48.9	160.7
Mexico	7.0	1.3	67.4	203.2
Nicaragua	1.3	1.0	121.7	182.7
Paraguay	7.1	4.2	34.9	77.4
Peru	4.4	1.0	92.0	371.2
Dominican Republic	1.3	2.9	143.5	118.3
Uruguay	8.2	6.4	68.2	59.6
Venezuela (Bolivarian Republic of)	2.1	1.1	150.3	130.2

Source: prepared by the authors on the basis of data from Latin Finance, *Latin Banking Guide & Directory*, various issues.

FIGURE 4

Latin America (18 countries): capital adequacy of the banking system, 1995 and 2004

(Capital as a percentage of total risk-weighted assets)



Source: prepared by the authors on the basis of data from Latin Finance, *Latin Banking Guide & Directory*, various issues.

incomplete coverage of expected losses associated with the arrears portfolio.

At the same time, as occurs with regulation in other parts of the world, it is possible that not all risks are adequately covered. This is the case of operational risks, which are highly significant in countries which are prone to natural disasters (hurricanes, earthquakes, flooding and other phenomena), risks arising from market concentration⁶ (higher than in developed countries) and those associated with high macroeconomic variability.

Banking systems in the region also typically have considerable overheads, which a priori lead to high credit costs and, therefore, large spreads. This may be partly to do with their limited activity, which precludes the development of scale economies related, for example, to more intensive use of territorial coverage and the branch network. In several countries spreads are close to 10 percentage points and, in Brazil, over 30%. However, other factors have a hand in this scenario of diminished efficiency. In general, banking systems yield high returns

(see figure 5) amid limited competition, as shown by the market concentration indicators (see figure 6).

(b) *The capital markets*

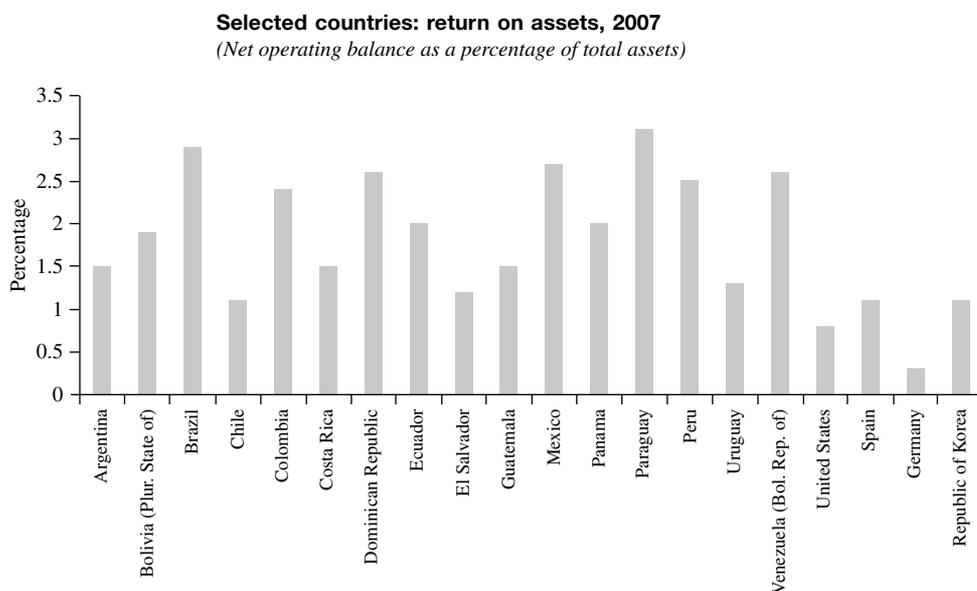
The experience in the developed countries shows that these markets have great potential to finance investment. An underdeveloped capital market leads to greater dependence on bank lending, which does not necessarily suit the nature of investment projects. By contrast, stock markets offer long-term capital resources at variable cost, and so are better suited to investment projects and reduce the possibilities of bankruptcy.

Debt markets offer broader possibilities for investment financing. First, because they help to materialize and generate long-term financial saving by meeting the needs of institutional investors who seek longer-term financial assets with risk that is different to or lower than stocks. Second, a market for tradable debt improves risk diversification in two ways: institutional investors are better prepared than banks to maintain and absorb long-term risk, because their funding is also long-term; and from the point of view of investment, these markets serve to diversify the liability structure, which helps to reduce risk on the financial side of projects.

Lastly, in modern economies, debt markets are the key channel for the transmission of monetary policy. Where no such market exists, more traditional methods

⁶ The market concentration indicator considers both public and private banks. Although public banks may play a role as an instrument of monetary policy, leading the authorities to prefer criteria other than profitability, the point emphasized here is the banking system's lack of competitiveness, which is illustrated by the market's capture by a small number of institutions.

FIGURE 5

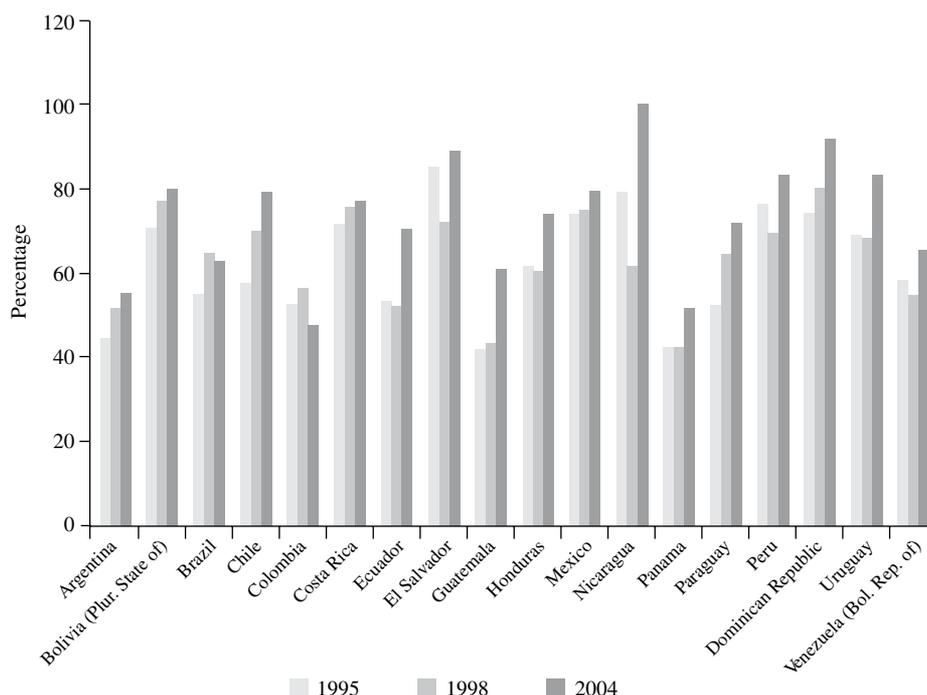


Source: prepared by the authors on the basis of data from International Monetary Fund (IMF), *Global Financial Stability Report*, Washington, D.C., 2009.

FIGURE 6

Latin America (18 countries): market concentration in the banking system, 1995, 1998 and 2004

(Credit extended by country's six largest banks as a percentage of total credit^a)



Source: prepared by the authors on the basis of data from Latin Finance, *Latin Banking Guide & Directory*, various issues.

^a Bank size is defined by total asset holdings.

must be used to regulate liquidity, such as reserve requirements. This type of measure directly affects the efficiency of banking systems by imposing an additional cost on credit.

(c) *Stock markets*

Figure 7 shows the ratio between the market value of the stock issued and GDP, as an indicator of market depth. In Latin America, despite the growth between 2003 and 2008, these markets still lag well behind those of developed countries and those of developing Asian and European countries. The figure also shows the heavy losses in stock market value in the United States and the European Union following the recent financial crisis. Figure 8 shows the recent evolution of share issues in emerging countries: in 2002 total emerging market issues began to rise rapidly, led by Asia (mainly the Republic of Korea). In Latin America share issues in international markets began to be significant as of 2005, with Brazil figuring as the main issuer.

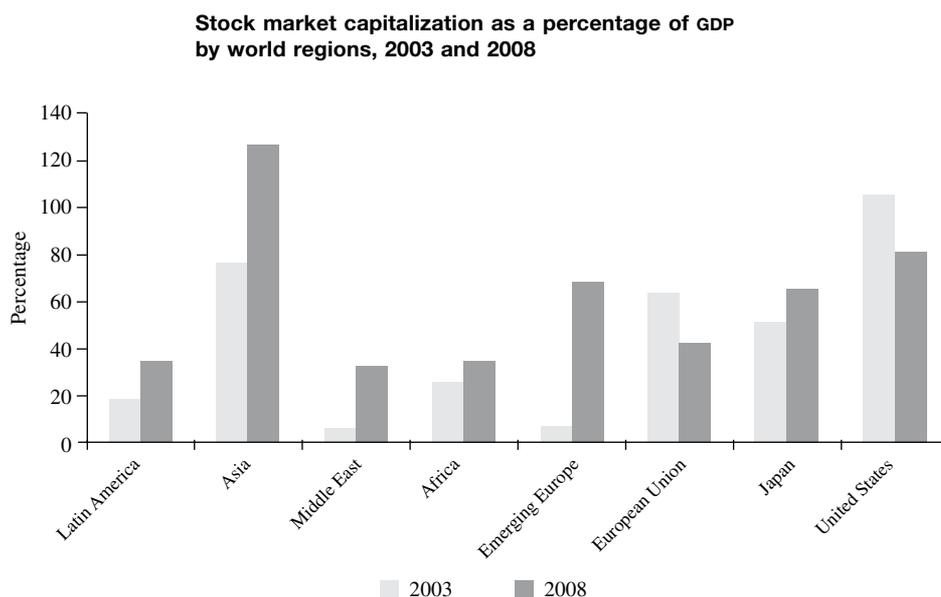
Within Latin America, only Chile shows market depth comparable with that of other regions; the other countries show a heavy lag or lack data, which is a symptom of a non-existent stock market (see figure 9). The most liquid market, by turnover coefficient, is that of Brazil; the other markets show limited liquidity (see figure 10).⁷

(d) *Bond markets*

Globally, debt markets were highly dynamic between 2003 and 2008, especially in the case of the most developed countries (see figures 11 and 12). Latin America evolved differently, owing to the reduction of public debt (both as a percentage of GDP and, in some cases, in absolute terms) on the back of strengthened

⁷ By way of comparison, the turnover coefficient of all stock markets which report to the World Federation of Stock Exchanges was 96.6% in 2007, 98.5% in 2008 and 78.4% in 2009.

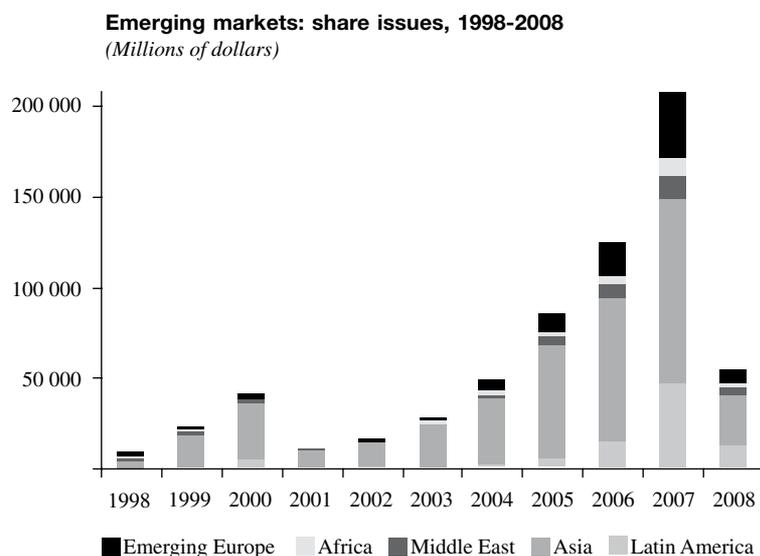
FIGURE 7



Source: prepared by the authors on the basis of data from International Monetary Fund (IMF), *Global Financial Stability Report*, Washington, D.C., several years.

GDP: gross domestic product.

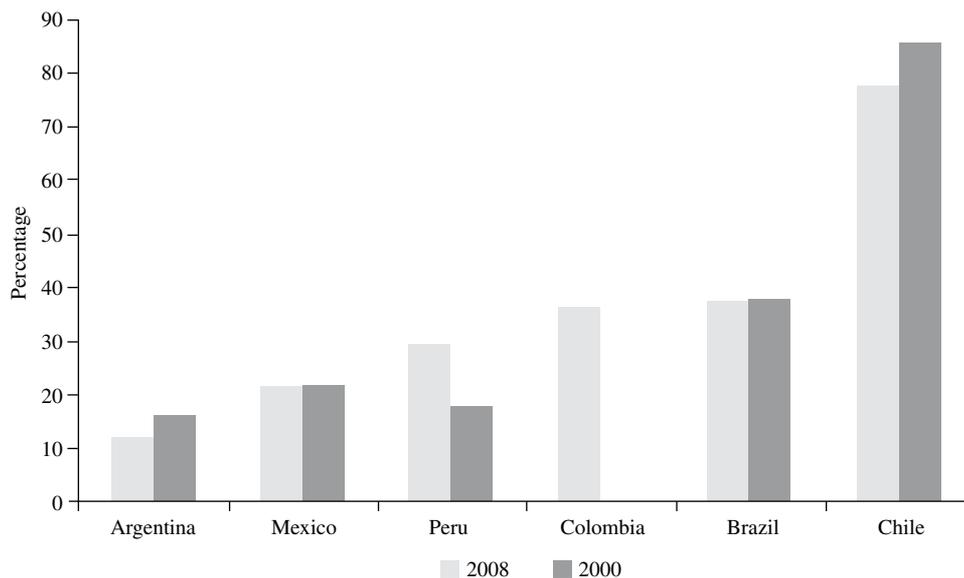
FIGURE 8



Source: prepared by the authors on the basis of data from International Monetary Fund (IMF), *Global Financial Stability Report*, Washington, D.C., several years.

FIGURE 9

Latin America (selected countries): stock market capitalization as a percentage of GDP, 2000 and 2008



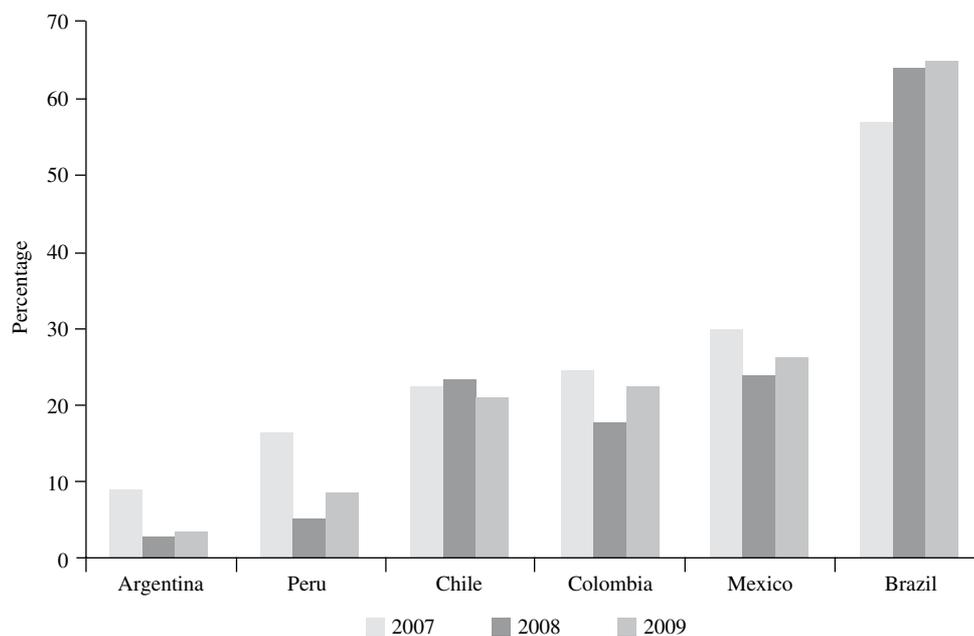
Source: prepared by the authors on the basis of data from the *World Federation of Exchanges*.

GDP: gross domestic product.

FIGURE 10

Latin America (selected countries): stock market turnover coefficient, 2007, 2008 and 2009

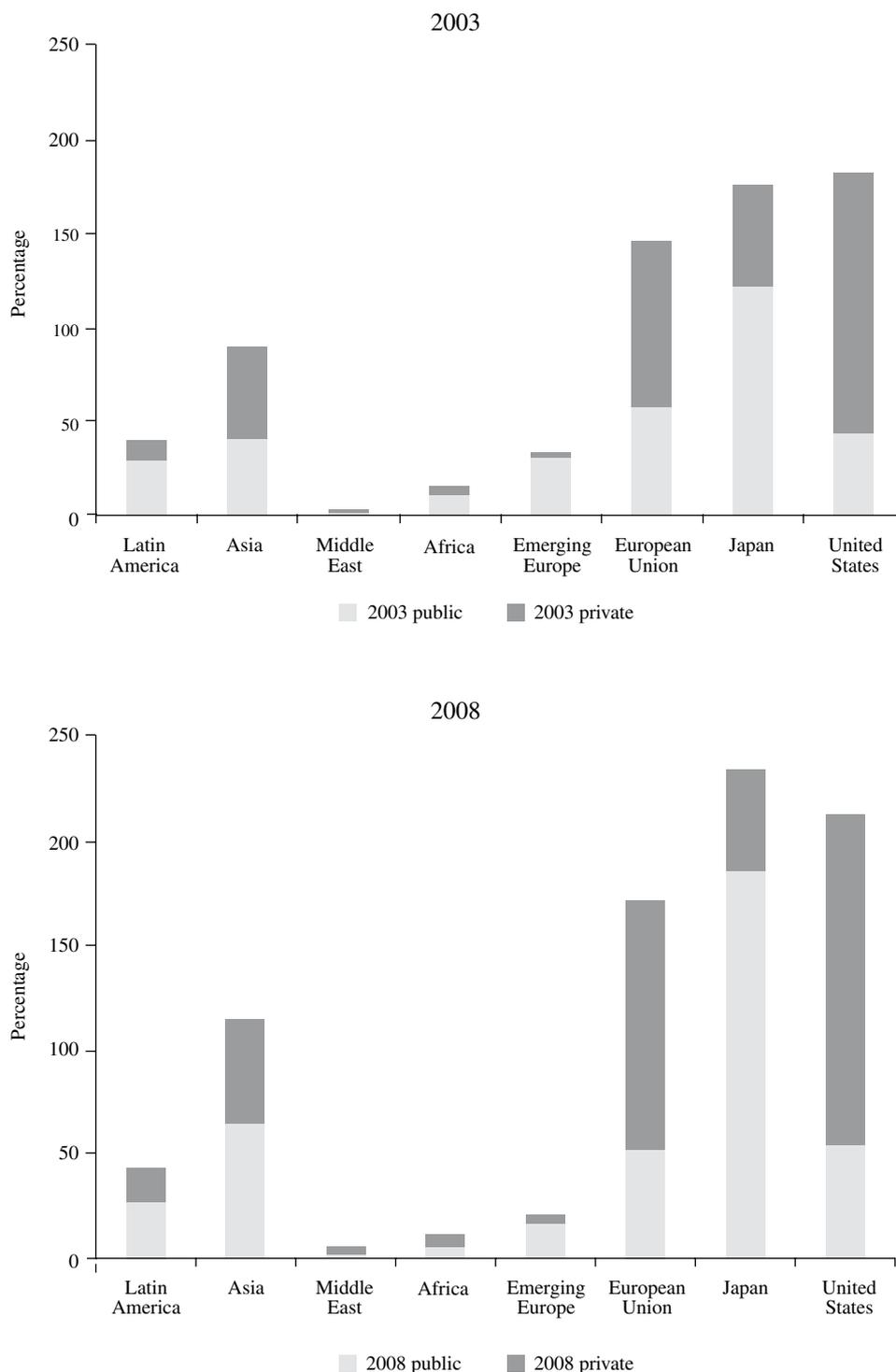
(Percentages of stock market capitalization)



Source: prepared by the authors on the basis of data from the *World Federation of Exchanges*.

FIGURE 11

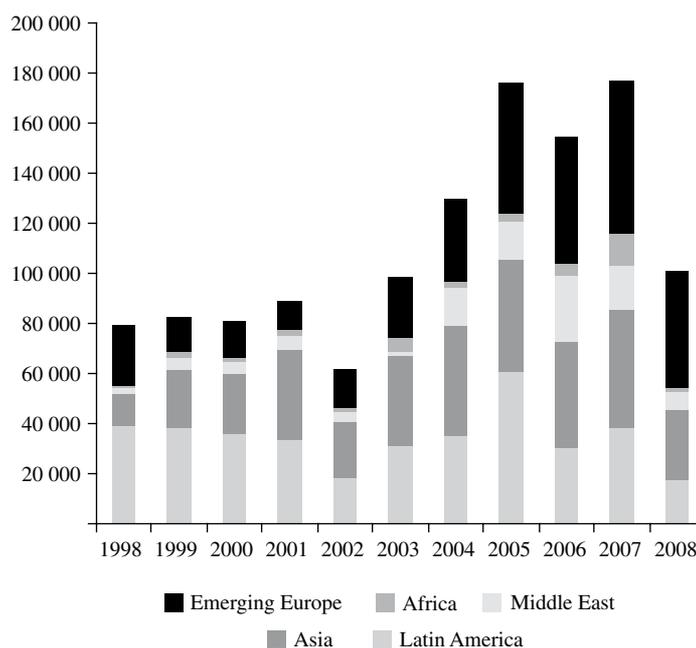
Global market by world regions: public securities and private debt, 2003 and 2008
(Percentages of GDP)



Source: prepared by the authors on the basis of data from International Monetary Fund (IMF), *Global Financial Stability Report*, Washington, D.C., several years.

FIGURE 12

Emerging markets: bond issues, 1998-2008
(Millions of dollars)



Source: prepared by the authors on the basis of data from International Monetary Fund (IMF), *Global Financial Stability Report*, Washington, D.C., several years.

fiscal and external positions thanks to improved terms of trade. Latin America showed one of the lowest rates of growth in bond issues, even compared to trends in these instruments in other emerging countries. As is evident in figure 11, public securities account for a large share of instruments in debt markets. In general, public securities are seen as necessary for the development of both local and international debt markets and for affording private issuers broader access to these markets because, as a safe or risk-free asset, they benchmark the cost of funds. They are, moreover, often used as guarantees in interbank and risk-management transactions, which also helps to broaden the market by fostering the development of new segments.

The large proportion of public securities in these markets therefore comes as no surprise. Nevertheless, public securities account for a greater share of the market in Latin America than they do in emerging countries in general or in developed economies (with the exception of Japan and emerging Europe); on average in 2008, public securities accounted for 63.8% of all bond issues in Latin America, much more than in the United States (25.7%), the European Union (30.4%), Asia (56.6%), Africa (46.9%)

and the Middle East (37%).⁸ This pattern became even more marked with the substitution of external debt with domestic debt in several countries following the upturn in their fiscal and external situations as of 2003.

The weight of public securities in the debt market should draw attention to two aspects of investment financing in the region. First, the degree to which the level of public debt may have exceeded what is necessary to provide a secure asset base for underpinning the development of the private debt market. Public debt could instead be crowding out private bond issues and restricting bank credit through holdings of public securities which are either compulsory or desirable for banks owing to their high returns.

Second, the heavy pressure of public debt in a small market (with, therefore, limited capacity to generate financial resources) may be one of the main factors in explaining high interest rates in certain countries. In markets which are financially integrated to some extent

⁸ According to figures from the International Monetary Fund, *Global Financial Stability Report*, various issues.

with the rest of the world, this may have boosted capital inflows, sharpening recent tendencies towards currency appreciation.

The problem is not, in either case, excessive public debt as a percentage of GDP as compared with other regions. Neither is it necessarily a problem of debt sustainability in the sense of the State's ability to fulfil its commitments. The problem is, rather, one of capacity to generate sufficient domestic financial resources in underdeveloped financial systems, and may, in fact, be worsened by the imposition of capital controls.

The evidence also suggests that the composition of bonds issued in the region (not including monetary regulation instruments) is not particularly conducive to investment financing. Compared with other emerging regions and with industrialized countries, Latin America has a disproportionately high percentage of inflation-indexed and floating rate instruments. Around 2009, in countries which had available data, on average 41% of bonds were variable rate and 35% were indexed, while only 31% were fixed rate. By contrast, fixed rate bonds represented 66% and 77%, respectively, of all bonds in emerging and industrialized countries.⁹ In most cases, this makes it more difficult to finance investment through bond issues, because to the normal risks of an investment project must be added those of interest rate fluctuations and inflation. The relative inexistence of instruments and markets to hedge those risks exacerbates the difficulty.

2. External financing flows

This section discusses separately the main features of external financing flows, given their importance in the financial policy debate. These flows, which mainly take the form of foreign direct investment (FDI), portfolio investment and net other investment assets,¹⁰ affect the evolution and characteristics of banking, capital and debt markets in general. A closer examination, however, gives a more precise picture of their contribution to financing in the region.

As the countries of the region gradually gained access to international markets and their bond issues increased, so did their capital inflows. FDI, for example, swelled

considerably in the 1990s, attracted by privatizations, market liberalization (in some cases) and the creation of guarantees for foreign investors.

In the early 2000s, FDI inflows were significantly down on the highs posted in 1999, but still above the levels of the first half of the 1990s. In 2007 and 2008, the region recorded a fresh record for FDI inflows, owing to voluminous flows into Brazil and Mexico (see figure 13).

Portfolio investment climbed strongly in the early 1990s—reflecting privatizations and the further opening of domestic markets to foreign investment—and remained relatively high until 1998, when the fallout of the Asian crisis hit the region. Later, flows of this investment practically disappeared or even turned negative amid defaults on external liabilities on the part of certain countries, the dot.com crisis and turmoil in the United States economy as of 2000. Net flows of portfolio investment did not become significant again for the region until 2007 and 2010, when several countries issued local-currency-denominated public securities, restructured external debt or substituted external with domestic liabilities. Domestic financial markets began to grow rapidly, especially in Brazil, Chile and Peru, and, more recently, improved credit quality led to an upturn in sovereign risk ratings.

Latin American countries began to increase their bond issues on the international market in the first half of the 1990s. This trend was interrupted by the outbreak of the Asian crisis in 1997, then stagnated following defaults by Ecuador (1999) and Argentina (2001)¹¹ and the crisis of 2000-2001 in the United States (see figure 14). Later, as market confidence recovered, issues of external bonds regained some momentum. Nevertheless, the boom in the prices of Latin America's main exports and improving fiscal situations reduced the need for external resources and led several of the region's countries to shift their strategies on public debt management towards domestic-market issues.

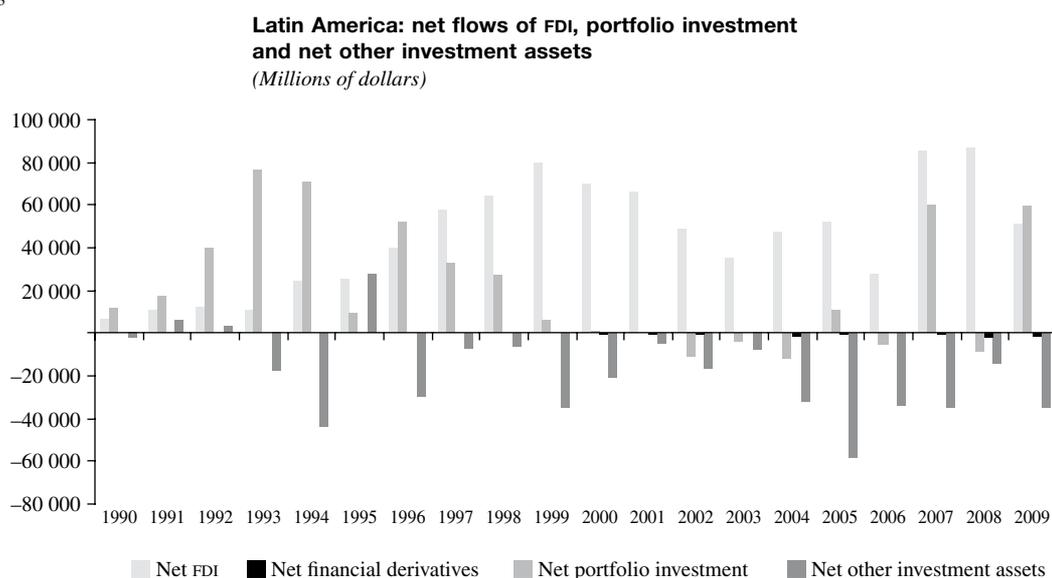
Several countries have enjoyed access to this form of financing, but Argentina, Brazil and Mexico have issued the largest amounts. Although at first bond issues on international markets consisted mainly of sovereign bonds, the proportion of those issued both by public enterprises and by the private sector has risen (see figures 14 and 15). Only a small group of countries has access to this market, however. In the case of private corporate

⁹ See BIS (2007) and the updated database at www.bis.org. The countries of the region included there are Argentina, Bolivarian Republic of Venezuela, Brazil, Chile, Colombia, Mexico and Peru.

¹⁰ "Other investment" forms a residual category that includes all financial transactions not covered in FDI, portfolio investment (shares, bonds and notes) or reserve assets. It therefore includes net external loans and deposits, among others.

¹¹ The amount of new issues by Argentina in 2005 basically reflects efforts to restructure (swap) external debt, more than a return to voluntary external financing.

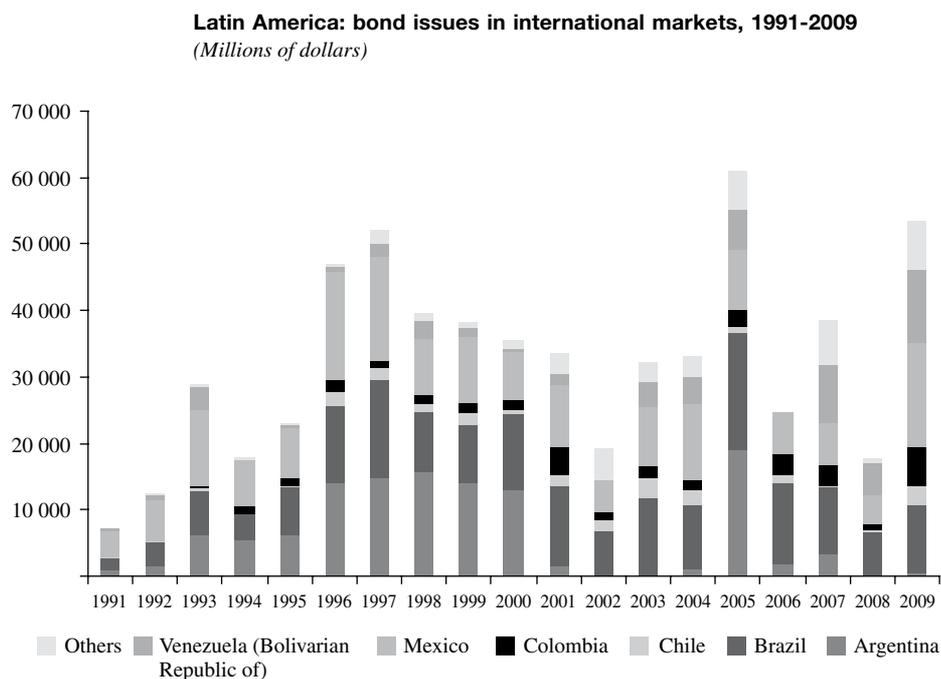
FIGURE 13



Source: prepared by the authors on the basis of International Monetary Fund (IMF), balance of payments statistics.

FDI: foreign direct investment.

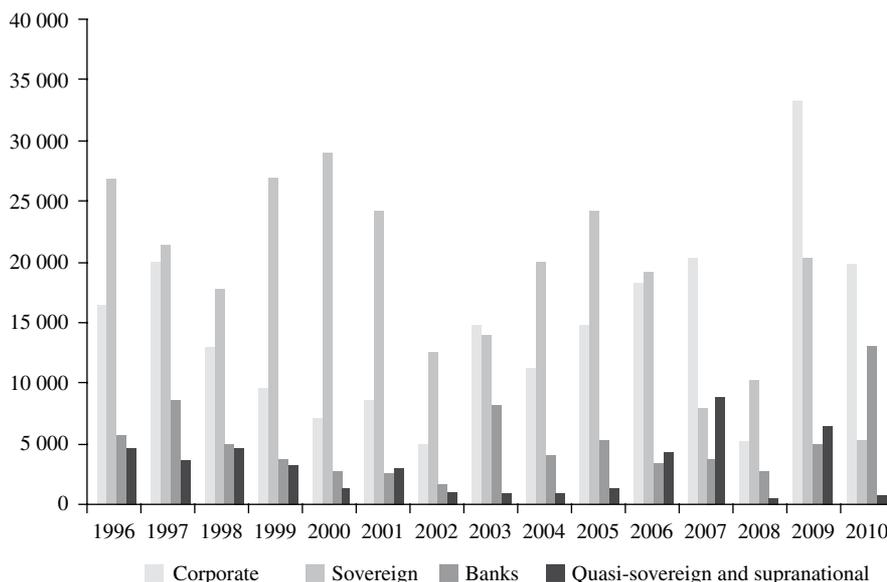
FIGURE 14



Source: prepared by the authors on the basis of Economic Commission for Latin America and the Caribbean (ECLAC), *Preliminary Overview of the Economies of Latin America and the Caribbean*, Santiago, Chile, several years; and International Monetary Fund (IMF), *Global Financial Stability Report*, Washington, D.C., several years.

FIGURE 15

Latin America: bond issues in international markets by type, 1996-2010
(Millions of dollars)



Source: prepared by the authors on the basis of Economic Commission for Latin America and the Caribbean (ECLAC), *Capital Flows to Latin America*, Washington, D.C., ECLAC Office in Washington, D.C., various issues.

Note: the data for 2010 correspond to January-June.

bonds, most issues have been made by firms from Brazil, Chile and Mexico. Lastly, recent evidence indicates that in 2010 private bond issues reached an all-time high, with issues by banks particularly dynamic.¹²

In turn, net other investment asset flows¹³ are negative, reflecting a net outflow of capital from the region to the rest of the world, with the exception of 1992, 1995 and 1997. The reasons for this, however, in aggregate terms for the region, lie in particular events in certain years (1994, 1999 and 2002, when some countries suffered financial and balance-of-payments crises) or in certain countries (several of which paid off loans from banks and international agencies between 2003 and 2006).

A rise in credit from external banks is evident starting in 2007.¹⁴ This lending has been concentrated in the non-financial private sector, which began to source more of its borrowing abroad in a context of low interest rates and high liquidity in the international markets (see figure 16). This is consistent with an increase in syndicated

lending and the tendency of banks in the region to reduce the external component their funding.

From a longer-term perspective, the tendency for banks to make less use of external financing began with Latin America's external debt crisis in the 1980s. The external liabilities of Latin American banks have grown much more slowly than those of other emerging regions and are actually the lowest in absolute terms (see figure 17). Until 2007 banks' external liabilities were standing still at an absolute level similar to that of the mid-1980s; at that point they embarked upon an upturn which was broken in 2008 by the global financial crisis, then edged back down, though without completely wiping out the previous rise. By contrast, other emerging regions posted much heavier falls in external liabilities during the recent crisis, precisely because they were much more exposed abroad.¹⁵

Another approach to this aspect is to look at the evolution of syndicated lending by foreign banks to emerging economies, in which the abovementioned trends are again in evidence (see figure 18). It may be concluded,

¹² See ECLAC (2011).

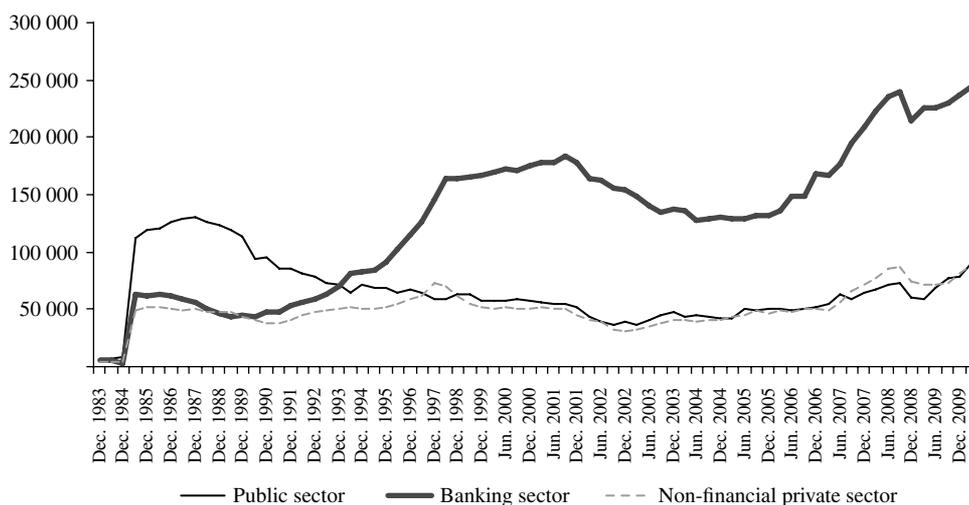
¹³ Refers to an item in the balance of payments.

¹⁴ BIS database.

¹⁵ See ECLAC (2009a and 2009b).

FIGURE 16

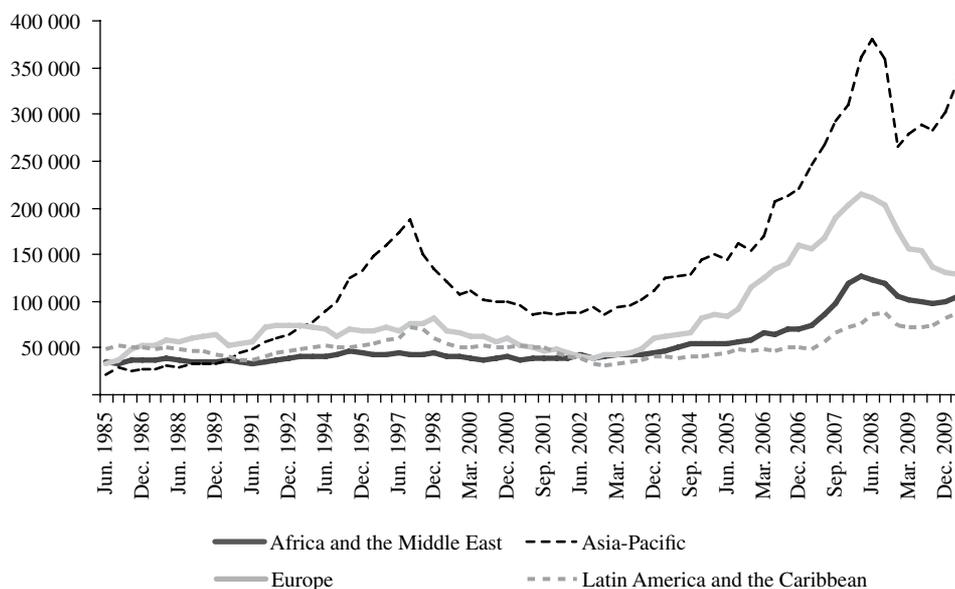
Latin America: external liabilities with BIS reporting banks by sector, December 1983-December 2009
(Millions of dollars)



Source: prepared by the authors on the basis of Bank for International Settlements (BIS).

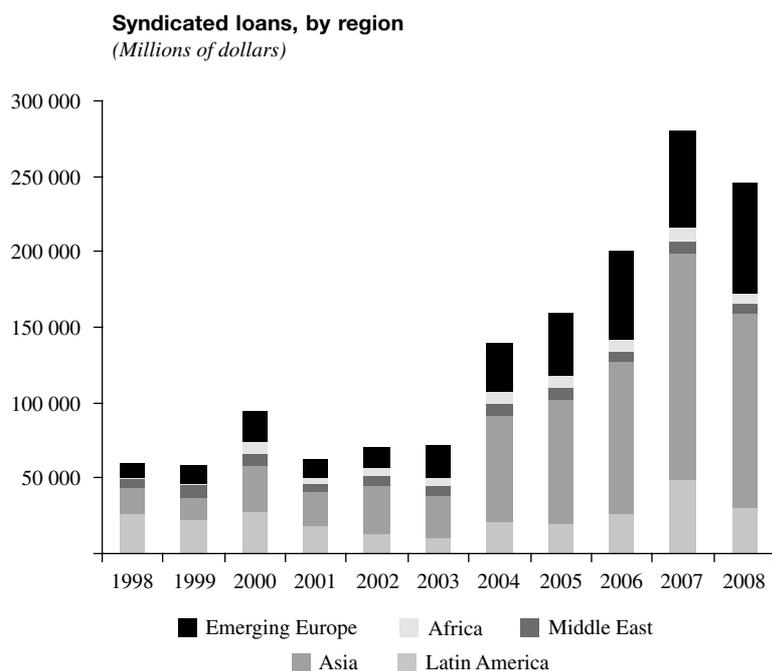
FIGURE 17

External liabilities of emerging country banks with BIS reporting banks by region, June 1985-December 2009
(Millions of dollars)



Source: prepared by the authors on the basis of Bank for International Settlements (BIS).

FIGURE 18



Source: prepared by the authors on the basis of International Monetary Fund (IMF), *Global Financial Stability Report*, Washington, D.C., several years.

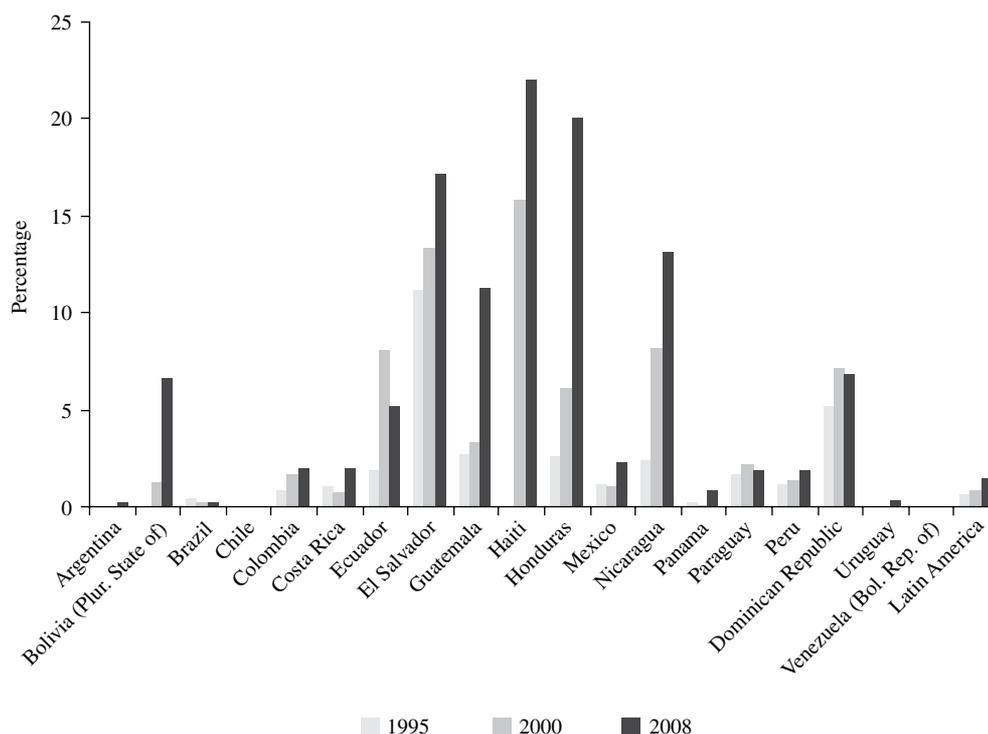
therefore, that Latin America and Caribbean banks show a long-term trend of reducing their indebtedness to non-resident foreign banks.

Another financial flow that has become more significant in the region since the 1990s is that of remittances sent home by migrants, as a result of growing emigration of Latin Americans to the United States, the European Union and even neighbouring countries (see figure 19). In addition, thanks to statistical progress, the

amounts received are more accurately recorded and better facilities —technologically speaking— have become available for sending money between countries. Although in aggregate terms remittances represent a small share of the region's GDP, at 1.4% in 2008, they have been increasing steadily. As a result, in several countries, especially in Central America, emigrant remittances have become very significant, reaching between 10% and 20% of GDP.

FIGURE 19

Latin America (19 countries): remittances from emigrant workers, 1995, 2000 and 2008
(Millions of dollars, as a percentage of GDP)



Source: prepared by the authors on the basis International Monetary Fund (IMF), *International Financial Statistics*, Washington, D.C.

III

Macroeconomic, microeconomic and structural factors in the underdevelopment of Latin America's financial markets

1. Macroeconomic factors

Macroeconomic volatility is one of the main factors leading to shallow financial development in the region. The Latin American economies have suffered many external and domestic shocks, which have on occasion led to crises in the banking system. Over the past 30 years, with the exception of the 2003-2008 period, the GDP growth rate has been highly volatile in Latin America. The region has also had historically high

rates of inflation, which dropped to single digits only in 1999. This, together with policies of regulating interest rates, has led to negative real rates and thus discouraged financial saving. At the same time, much of what limited financial saving there was tended to be funnelled into hefty fiscal deficits.

External variability has arisen mainly, though not exclusively, from large swings in the terms of trade. This in addition to the volatility of external financial inflows which, although caused partly by exogenous changes

in the external setting, have also led endogenously to internal disequilibria, prompting major shifts in exchange-rate regimes, stance on external liquidity management, or both.

In most of the countries, fiscal, monetary and exchange-rate policies have behaved procyclically, worsening the fallout from external shocks. This is because public revenues are highly correlated with export prices, with the result that volatility in raw material prices has usually been reflected, on the one hand, in public spending variations in the same direction and, on the other, in monetary and exchange-rate policies which —instead of softening international liquidity fluctuations— have passed them directly through to domestic financial flows.

The various crises experienced by the region in recent decades have been expressed in different factors which have dampened support for investment. For example, bouts of high inflation and hyperinflation in a number of countries shortened the maturities of the scarce available savings and increased systemic risk. The external debt crisis and severe devaluations of the 1980s induced the dollarization of much of the limited financial saving. This worsened the shortage of funds for investment and sharpened currency and maturity mismatches between assets and liabilities, exacerbating the risks of long-term financing. To these features is added the large proportion of public debt in domestic markets, as a result of cumulative deficits.

2. Microeconomic factors

(a) *In the banking system*

Latin American banking underwent significant changes in the 1990s with the entry of foreign banks to the market. This led to the adoption of modern practices of financing and risk management, but still fell far short of producing levels of uptake of banking services similar to those of countries with similar per capita GDP.

Several studies have identified the problems facing banks in catering for smaller clients, including failings in guarantee schemes and high transaction costs compared with the volume of financial services demanded.

Attention should also be drawn to the banks' high rates of return. This could indicate the existence of monopoly rents, which discourage the expansion of financing for small, medium-sized and micro-enterprises. The great concentration of the banking industry could be a symptom of insufficient market competition and the prevalence of quasi-monopolies and result in suboptimal service provision. Credit provision by retail

stores has expanded hugely, which is indicative of an unmet demand that could reasonably be covered by banks in terms of cost and loan risk. The experience of developing microcredit in a number of South American countries, such as the Plurinational State of Bolivia, Peru and Chile, and in Central America, also speaks of the potential to expand investment in sectors hitherto inadequately catered for by banks.

(b) *In stock markets*

Several microeconomic factors limit the development of stock markets. First, a family control structure still persists, along with resistance to allowing external investors to hold equity. Second, the large conglomerates prefer international market finance over local market issues, partly because of the high costs of issuing paper. This is in addition to the limited demand for such instruments, owing to weak protection for minority shareholders, which leaves them exposed to the risk of rent extraction by controlling shareholders: among other factors, there are few independent corporate board members and legislation on the use of privileged information and related-party transactions is weak. The development of these markets also suffers from constraints on the participation of private firms —local or foreign— in certain areas of the economy, accounting and financial disclosure rules that fall short of international standards, a lack of independence of external auditors and the absence of schemes that would foster opening to medium-sized enterprises (such as risk capital).

(c) *In bond markets*

Some of the factors underlying the shallow development of this market are also applicable to the stock market, but others are more specific. First, issuing costs are high compared with international markets, owing to higher taxes and the small size of local markets, which prevent the generation of economies of scale or of sufficient infrastructure for trading and securities custody, clearing and settlement.¹⁶ Second, bankruptcy processes are more complex and take longer than the international standard. Third, the public sector, notwithstanding its important role as a benchmark, absorbs what is a probably an excessive proportion of the financial savings available in some countries. In addition, the scant development of institutional savers limits both the quantity of resources available and their

¹⁶ Zervos (2004), De la Torre and Schmukler (2004).

turnover in the local markets, with the exceptions—to some extent— of Brazil and Chile.

3. Structural factors

Lastly, there are factors in the economic structure which lean heavily towards underdevelopment of financial systems and which erode the effectiveness of policies aimed at strengthening investment financing among smaller firms. These factors are:

First, high levels of informality in the economy, which limit access to banking services, since normal financial practices are based on contractual relations and prior records which demonstrate the ability and willingness to pay of potential credit customers. Those lacks also reduce the effectiveness of public policies channelled through support schemes based on formal instruments.

Second, public institutions, including banks and development agencies, are too weak to direct sufficient policy efforts towards market segments in which they could act as pioneers or catalyse later engagement of the private financial sector (for example, support for microenterprises, development of guarantee schemes and financial leasing).

Third, modern practices in financial systems depend heavily on the intensive use of information and communications technologies. Differences in the availability of these technologies and the lag in the communications infrastructure cause, in turn, inequitable access to the financial system's resources and services, which are uneven across income levels and geographical areas (differences between regions, difficult access from more remote and less populated regions).

IV

Aspects of a strategy for strengthening investment financing in the region

Regardless of its particular characteristics, a financial development strategy for boosting investment cannot be successful unless it is preceded by a macroeconomic policy regime that is conducive to stability and can absorb external shocks as well as possible. Although the specific aspects depend on the situation in each country, four general traits warrant mention. First, a fiscal policy which—depending on the needs of the country— promotes sustainable public finances on the basis of a multi-year vision and the creation of countercyclical capacities. Second, a monetary policy that seeks stability and a balance between nominal aspects (inflation) and levels of activity (growth and employment). Third, an exchange-rate policy which, in a framework consistent with the first two aspects, avoids unsustainable real appreciation and the resulting external disequilibria. Exchange-rate policy should also afford a degree of flexibility in order to soften the transmission of external fluctuations. Key factors for this are the degree of integration with international financial markets and the capacity of the domestic financial system to hedge those fluctuations. Fourth, prudential regulation directed at both the solvency of financing institutions and the control of systemic risks.

A strategy for achieving higher growth rates must deal, among other things, with two key challenges: (i) to expand the capacity of the financial system in general and of its various subsystems to finance long-term projects, and (ii) to improve access to capital resources and long-term lending for small and medium-sized enterprises.

These two objectives are complementary and they also need the system to build its capacity to satisfy other development-related needs, such as financing for consumption and housing, working capital, insurance and modern financial services.

In fact, measures for promoting the financial development of smaller firms actually form part of a broader strategy of strengthening capacities to finance investment projects of all sizes, because of two characteristics which are necessary for the development of financial markets: liquidity potential and risk control and diversification. This is why segments with greater liquidity and lower risk are usually those which grow first. In the right conditions, those segments can serve as a platform for the expansion of credit towards segments which have less liquidity, higher risks, or both. So, the strategy here would be to start by consolidating the safer, more liquid segments, then gradually start to

provide private loans and other financial services for emerging segments with less initial liquidity and risk that is harder to control and diversify. In the meantime, public banks, both commercial banks and development banks, must provide financial resources and services for segments for which the private banks do not cater. It would be unrealistic to expect expansion into these other segments—which are initially less attractive for traditional banks—to occur spontaneously, mainly because of information externalities¹⁷ and the need for specific mechanisms to overcome the credit access difficulties of smaller firms: especially long-term credit lines and guarantee schemes.

The specific features of a strategy and the sequence of policies and measures depend to a great extent on the progress already made and on potential market size. A number of core internal aspects that should be included in a financial development strategy are discussed below. External aspects are not discussed, such as the promotion of FDI, strategies for positioning in international capital markets and the specific role of foreign investors in the development of certain domestic markets, among others.

1. Banking systems and financing for investment

The two main problems involved in supporting investment through the banks are funding limitations and risk coverage mechanisms. In terms of the nature of funds, the main symptom of economic instability in the region is the shortage of long-term resources and the predominance of short-term deposits. The main obstacle medium-sized and, especially, small firms have faced in securing bank financing has been the lack of mechanisms to mitigate debt repayment risks.

These two problems have been tackled in various ways, by introducing savings and loans schemes, instruments that are inflation-indexed or inflation-protected, long-term credit lines for small and medium-sized enterprises (SMES), often brokered by commercial banks and backed by State guarantee schemes, promotion of leasing-type loan modalities, securitization, factoring and microcredit. To a large extent, this is undoubtedly still the right road and significant progress has been reported in several cases, often led by public institutions. Yet the

negative impacts of economic variability have persisted, which has kept bank intermediation fairly limited in most of the countries. It seems necessary, therefore, to intensify the role which the public banks—particularly development banks and development agencies—are playing as catalysts in the establishment and expansion of long-term credit segments.

Public development banks are especially influential in countries whose economies are too small to expect other financial subsystems to emerge spontaneously. In fact, in both stock markets and debt markets, liquidity potential, opportunities for risk diversification and competitiveness are crucial in determining transaction costs.¹⁸ All these aspects are a direct function of the scale of operations and, therefore, of the size of the economy. Consequently, several countries will have to rely on development banks as a mechanism for channelling long-term loans and capital.¹⁹

This implies additional challenges which are abundantly illustrated by the experience in Latin America, the lessons from which have helped to reformulate the operating methods of development banks and agencies.²⁰ A few of the main challenges are mentioned here.

First, in order to ensure transparent and accountable results-based management, it is essential to avoid confusing productive and financial development policies and programmes with other social programmes, since they usually have very different target groups and methods of operation.

Second, even within productive and financial development programmes, the components of fund provision and support for access to long-term resources must be clearly and explicitly differentiated from subsidy components, so that the latter effectively target the desired beneficiaries and not groups and firms which do not lack payment capacity.

Third, development banks and agencies are not always specialists in risk evaluation, meaning that private intermediaries must also be engaged in the process. These agents must retain part of the risk as well, in order to ensure proper alignment of incentives.

Fourth, it is important to prevent these entities from being captured by their debtors or by other interest groups. This, together with the point made above, led

¹⁷ Information externalities arise here because the quality of a loan applicant is determined on the basis of an estimate of ability to pay. But the existence of a previous loan to the individual or firm facilitates the evaluation process for the rest of the banking system.

¹⁸ Transaction costs, in this case, refer to those incurred for issuing securities, trading them on the stock market, listing, clearance, settlement and custody.

¹⁹ The most notable case in the region is the experience of the National Bank for Economic and Social Development (BNDES) of Brazil which, unlike other development banks, provides both loans and capital.

²⁰ See ALIDE (1993).

to a major change in the modality of engagement of development banks and agencies in the financial system: instead of providing direct credits, many of them now act as second tier banks.

Fifth, the action of the public sector must not crowd out other, private-sector solutions. This can happen when the provision of financing and guarantees is accompanied by large subsidy components, which ultimately distort relative prices so much that it is not competitive for private agents to enter the market.

2. Stock markets and debt markets

Two conditions which must be met if these markets are to provide long-term resources for investment are the development of institutional investors (pension funds, life insurance companies, mutual funds and investment funds in general), and that their financial saving capacity must not be filled up with public debt securities.

Several countries have institutional investors with long-term financial saving capacity. However, their impact on financing for investment is limited by regulatory provisions which oblige them to buy public debt, or by the high rates of interest these instruments offer.

Progress needs to be made on adequate structuring of the type of instrument offered, especially in the case of public debt. Insofar as economic stability is consolidated, it should be possible to move more towards fixed rate instruments with standard characteristics. These are the type best suited to the financing needs of investment projects and allow the creation of a broad, liquid market, unlike a bond market with different rates and denominations and variable maturities.²¹

The stock market needs to gradually move away from traditional ownership structures and counteract the disincentives of low market liquidity and high transaction costs. On the demand side, efforts must be made to eliminate the disincentive arising from the scant protection offered to potential minority investors. These risks have been poorly understood in the region and their legal treatment is inadequate.²² Nevertheless, they have become increasingly important as the countries have become more integrated into international financial flows.

One alternative for tackling this array of problems is illustrated by the pioneering experience of Brazil, which

shows that proper treatment of these risks can lead to stock markets having a more significant role as sources of financing for investment and for innovative firms.

The rules for participating in the market segments of the São Paulo Stock Exchange (BOVESPA) empower minority shareholders by requiring that all shares carry voting rights and that at least 20% of board members be independent. There are also disincentives to using majority control to extract value from the firm, and minority shareholders have the right to receive the same price for their equities as the controlling investors. Requirements have also been substantially tightened with regard to the presentation of financial statements, disclosure of related-party transactions and the use of privileged information. In order to avoid lengthy legal disputes between firms and their shareholders, such disagreements must be settled in an arbitration forum created especially by BOVESPA.²³

Something which generates intense debate is the impact that certain taxes, particularly capital gains tax, have as a disincentive to demand for financial securities. In the case of shares, a number of approaches suggest that capital gains taxes lead to suboptimal market performance.²⁴ Yet most of these approaches suppose the existence of an unflawed, neutral tax system and a process of share price formation that reflects firms' true value. The first supposition is—in most of the countries of the region—somewhat unrealistic, and “second best” solutions are often needed to work with a system that allows various forms of evasion and avoidance. At the same time, for shares that are illiquid or seldom quoted, asset price formation is not necessarily accurate. This leaves open opportunities to manipulate prices (for tax purposes or to influence the controlling value). These two factors and the obstacles which commonly stymie tax reform attempts have until now discouraged the elimination of capital gains tax, and in general only securities with a large market presence are exempted.²⁵

Lastly, in several countries of the region, increasing importance has been afforded to investment financing for medium-sized enterprises, especially those engaged in innovative activities. This has taken the form of support for risk capital schemes and policies to facilitate the listing of medium-sized enterprises in stock markets.

²¹ See World Bank/ International Monetary Fund (2001) and BIS (2002).

²² See the reports of the Financial Sector Assessment Program of the International Monetary Fund (IMF) at <http://www.imf.org/external/np/fsap/fsap.asp>.

²³ São Paulo Stock Exchange (BOVESPA, 2006a, 2006b, 2006c and 2006d) and Santana (2007).

²⁴ This is based on the general argument of double taxation of income, particularly in non-integrated tax regimes, i.e. those which do not consolidate all sources of personal income into a single tax.

²⁵ Typically gains from public debt securities and those issued by the central bank are tax-exempt.

Two key issues to be faced in providing capital for medium-sized enterprises and innovative firms are moral hazard and information asymmetries between investors (or risk capitalists) and the company's management. The type of organization introduced in the United States, after a number of trials, to provide risk capital to medium-sized and innovative firms has been gradually adopted in several countries, and has become fairly widespread in France, Germany, India, Israel, Taiwan province of China and the United Kingdom, among others. The most developed risk capital schemes in Latin America are seen in Brazil and Chile, but efforts to set up this sort of capital financing have been made in several countries, including Peru, Mexico and Colombia.²⁶

This is a segment of the market in which public development banks and agencies can play a key role, both as providers of funds through intermediaries, in the case of risk capital, or directly as minority shareholders.

With respect to bond markets, recent studies have concluded that 25% of this market's underdevelopment in Latin America as compared with the developed countries has to do with factors related to economy size (magnitude of GDP) and income level (per capita GDP).²⁷ This would tend to confirm the importance of scale effects. As well, as discussed in the literature on the influence of institutional factors on economic growth, it is possible that the significance of per capita GDP reflects its positive correlation with institutional development.²⁸ In other words, greater institutional development leads, through different channels, to higher per capita GDP and generates better conditions for the expansion of debt markets.

Another 15% of the underdevelopment of the bond market in Latin America is accounted for by the

low rate of access to banking services, which tends to confirm the hypothesis that the two subsystems are complementary, rather than substitutes or competitors as resource providers.²⁹

Historical and geographical factors explain a further 15% of bond market underdevelopment. The only policy variables which are significant are macroeconomic stability, degree of economic openness, protection of creditors' rights and the costs of contract enforcement. Even so, these variables account for no more than 25% of underdevelopment.³⁰

Concerning the effects of public debt on corporate bond markets, estimates suggest that the crowding-in effects of public bonds—since they help to create a liquid market with a reference yield curve—outweigh the crowding out of private financing. This finding's applicability to Latin America must be carefully weighed, however, since for much of the period examined, only Brazil, Chile and Mexico registered significant private bond issues, followed at some distance by Argentina.³¹

Institutional factors leading to deeper bond markets are similar to those that underlie the expansion of stock markets, so the related policies are largely complementary. In these areas, Latin America is similarly placed to the economies of Eastern Europe, but lags behind the emerging Asian countries and the developed economies.³² In most cases,³³ institutions and practices which could reduce information asymmetries between debtors and creditors are still incipient.

²⁶ See Jiménez (2008) for a more detailed account of the characteristics and operation of this type of capital.

²⁷ Borensztein, Eichengreen and Panizza (2008).

²⁸ Concerning the link between economic growth and institutional development, see Acemoglu and others (2003), and Easterly and Levine (2003).

²⁹ Claessens, Klingebiel and Schmukler (2003) and Eichengreen and Luengnareumitchai (2004) also report complementary links between the banking system and the bond market.

³⁰ Borensztein, Eichengreen and Panizza (2008). Other policy variables are also statistically significant, but make a much smaller contribution to explaining the development of bond markets in Latin America than those mentioned.

³¹ See IMF (2005a, table 4.2).

³² See IMF (2005b, table 4.3).

³³ Brazil and Chile are usually cited as exceptions, since their institutional frameworks are advanced in comparison with the rest of the countries of the region, yet they are still less developed than those of emerging Asian countries.

V

Conclusions

This paper has examined the characteristics of the main components of financial systems in the region, from the point of view of financing for investment. The analysis was based on three observations: first, the investment rate in the region has been systematically lower than that of other economies which have recently achieved a sustained rise in their growth rates; second, except for the 2003–2008 period, national savings have been insufficient to finance investment, such that growth—and its variations—have been highly dependent on external financing and its variability; third, it is argued that failings in the financial system play a crucial role in determining real levels of saving and investment, and the capacity of individuals and firms to deal with risks. These failings result in tighter constraints on smaller firms, which not only lack access to the resources of the external capital market, but also experience difficulties in accessing the domestic financial system, owing to its shallow development.

The analysis finds that, although the situation is heterogeneous from one country to another and some are further ahead, financial systems in the region are undeveloped and do not serve the needs of investment. Banking services are, with few exceptions, more limited than in other countries with similar per capita GDP and lean towards short-term lending. Conversion of bank deposits into lending is relatively limited, which has to do with outdated monetary regulation practices, combined with banks' and institutional savers' strong preference for public securities.

In terms of funding, banks are tending to de-dollarize their net liabilities and rely less on external loans. Portfolio quality varies between countries and in some cases a large non-performing portfolio points to failures in credit processes. Provision for portfolio risk is, in certain cases, insufficient. Capital adequacy indicators seem to indicate a good level of solvency, although doubt remains over the proper measurement of all risks and their inclusion in coverage. What is more, inadequate loan-loss provisions could cast doubt over capital sufficiency.

Interest rate spreads are large in the region, which is associated with large overhead costs and small market size. The combination of high returns and concentration makes for little competition in the banking industry, which has few incentives to expand into segments that are excluded from credit.

Stock markets lag well behind those of other regions, with low capitalization levels and little liquidity. Bond markets, which experienced a global boom in the 2000s, expanded somewhat in the region as well, although to a lesser extent than in faster-growing emerging countries. Unlike in other regions, Latin American bond markets are dominated by public securities, placing strong pressure on domestic interest rates in some cases. This does not reflect public overindebtedness in relation either to GDP or to capacity to serve these debts. On the contrary, several indicators show that public debt declined during the decade and does not represent an excessive burden in comparison with public revenues.

When it comes to the system's ability to generate financial savings, however, the public sector's heavy demand for resources seems to lead to high interest rates and constraints on private-sector access to investment finance resources. The crux of the problem is the underdevelopment of the financial system and its limited capacity for mobilizing savings.

The sorts of bonds issued and their maturity structure do not serve the purposes of investment financing. Variable rate and indexed bonds account for a disproportionate percentage of instruments, which poses additional difficulties for investment financing, since there are too few instruments or markets to cover the risks of fluctuations in interest rates and inflation.

External financing flows were also examined, which confirmed the tendency towards a reduction in bank funding from external resources and an increase in issues of bonds—both sovereign and private corporate—in international markets. Access to these resources has been tied to fluctuations in the global economy and affected by specific junctures associated with payment suspensions and renegotiations of external commitments. Nevertheless, after the financial crisis of 2008 external bond issues resumed a brisk upward trend.

Three groups of countries were distinguished in relation to external financing. One group is formed by the countries which have integrated to a greater extent in voluntary markets for external financing and have engaged with the global expansion of these flows. They have a more complex external financing structure and their investment financing is more internationalized than in previous decades. The second group has certain difficulties in gaining access to private financial markets

aboard, so their external financing continues to depend mainly on the balance of payments current account and on access to multilateral loans.

Lastly countries in the third group have even greater difficulties in securing voluntary external resources, although FDI may be relatively significant in relation to the small size of their economies. These countries are also subject to greater conditionalities when they seek multilateral support; owing to their internal difficulties they rely largely on remittances and, in some cases, grants.

Correspondingly, the structure of investment financing also differs among those three groups of countries. Generally speaking, notwithstanding their lag, the countries in the first group have more developed domestic financial markets, while the other two groups find it hard to finance growth.

Three factors seem to underlie this situation. First are macroeconomic factors, including, in particular, the lasting impacts on financial saving and real investment of previous episodes of instability and crises. Second are microeconomic factors, such as limited banking sector competency, shallow development of institutional investors, weak protection for minority stakeholders and creditors, high transaction costs associated with small markets and, possibly, demand for resources by the public sector that exceeds the system's capacity to supply them. Third are structural factors, including very substantial informal sectors and the weakness of public institutions which should be playing a key role in breaking down microeconomic barriers.

On the basis of these observations, consideration was given to the workings of a financial development strategy for boosting investment across the spectrum of firms of different sizes. Two complementary approaches were proposed:

- Increase the overall capacity of the system to finance long-term operations and pursue policies to afford small firms broader access to the system's resources. These two lines of action are complementary, first, because the nature of the financial markets is such that the first segments to develop are those with greater liquidity and capacity to control and diversify risk. Second, given the information externalities and risk coverage mechanisms available in the

small business segment of lending, it is unrealistic to expect that market to develop spontaneously. But it is also unrealistic to expect any growth in lending to those businesses unless the more liquid markets, which are better able to control, cover and diversify risk, expand first.

- For increasing access to banking services, the main line of action proposed is to make more effective use of public development banks and development agencies to establish sources of long-term financing, develop guarantee schemes and create new financing markets. In light of the experience in the region, proposals are made concerning the way banks participate in the market, with a view to avoiding their capture and boosting lending. As a complement to this public effort, steps need to be taken to increase competition in the banking industry.

In relation to capital markets, attention was drawn to the need to develop institutional investors and improve corporate governance in order to better protect minority shareholders and creditors rights. It is also necessary to examine the role played in development by the domestic public securities market, which has reached such a magnitude that it may be exerting pressure on the system's limited capacity to generate domestic financial savings. This, in turn, pushes up interest rates and crowds out SMEs from credit markets. Lastly, the capital markets have the potential to meet the long-term financing needs of medium-sized firms and innovative businesses. Globally speaking, the experience—which, albeit to different extents, is beginning to be replicated in the region—is that risk capital represents these firms' gateway to markets for other capital resources. Furthermore, the development of stock-market-type institutions has sometimes paved the way for the creation of other markets, such as exchanges for agricultural products, which can finance working capital for small producers.

To sum up, it will take efforts on multiple fronts to strengthen financing for investment in the region. This article has attempted to draw attention to the main domestic problems underlying the financial system's failure to generate and broker adequate financial resources for investment in businesses of all sizes: small, medium-sized and large.

(Original: Spanish)

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