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Promoting global financial development: vive la différence!

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During their June 2000 Summit, the Group of 15 (G15) Heads of State emphasized the importance of 'stable financial markets through reform'. At that meeting, the Committee on Trade, Investment and Technology requested the Cairo and Alexandria Stock Exchanges to coordinate the efforts of the G15 countries in the area of capital markets. In March 2001, experts from the G15 Stock Exchanges met to emphasize cooperation in capital market development. The conference was aptly named 'Challenges & opportunities in the new world'. Their topic applies to developed and transition economies as well as developing countries. Around the world, financial institutions are facing challenges to their skills and opportunities to display their ability to meet those challenges.

Financial services are the first truly global products. Most other products and services sold around the world are multinational, but not global. For example, the salt sold in Cairo is basically the same product as salt sold in Algiers. Perhaps the label contains the word 'salt' in a different language, but the package contains the same product and is used for the same purpose. Financial services are different. A share of stock in Paris has different rights, a different meaning, than a share of stock sold in Buenos Aires. For this reason, there is no one solution for the banks, brokers and stock exchanges in every country.

I Determinants of implementation

It can't be said enough that there is no one-size-fits-all solution to developing financial markets. Eatwell (2001) acknowledges that the consequence of uniform financial regulations is that they often have quite different practical effects. These differences can be applied to developed nations, too, in the arena of capital markets. Eatwell (Cairo, 2001) points to the differences across the EU mortgage markets, where standard terms

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are from less than 10 years to up to 30 years, a difference that exists between Germany, France and the UK right now. Hooper (2001) and others at the Cairo meeting lament the 'Washington Consensus' (Williamson, 1990) on development, which included ten recommendations that resulted in virtual requirements for International Monetary Fund (IMF) and World Bank support in developing countries. This is the most prominent example of an attempt to use one set of guidelines to develop capital markets across highly differentiated economies. Ten years later the consequences of that one-size-fits-all development programme are widely debated. Naím (2000) provides a comprehensive review.

There are some aspects of promoting financial development that have been tested in a variety of economies, small and large, robust and emerging, that can be applied generally. The four primary policies (summarized in Barth *et al.*, 2001) shown to promote stable national financial systems are: (1) having private, independent rating agencies; (2) having some safety net, but not so extensive that banks and brokers are not held accountable; (3) having less government ownership or control of national financial assets; and (4) allowing capital market participants to offer a wide-range of services so they can reduce the volatility in returns.

Empirical results presented in Barth *et al.* (2002a) suggest that an overall approach to bank regulation that stresses private-sector incentives, such as having independent rating agencies and minimizing government control of national financial assets, is associated with greater banking-system success than an overall approach to bank regulation that emphasizes official government oversight and regulation of bank activities. They report statistically significant correlation coefficients with bank development (measured by bank credit to the private sector as a percentage of GDP) for independent rating agencies (0.48), government ownership of banks (–0.29) and restricting financial institution activities (–0.39). These results are confirmed in regression analyses that control for the ethnic diversity factors shown to be important in Easterly and Levine (1997), the legal tradition suggested by La Porta *et al.* (1998), the cultural factors used in La Porta *et al.* (1999), media openness suggested by Djankov *et al.* (2002), etc., etc. Finally, while they present strong evidence that generous deposit insurance schemes tend to destabilize banking systems, their results dispel the myth that strong regulation and supervision can mitigate the moral hazard they produce.

Yet, even the policy tools that promote stable national financial systems cannot be applied blindly like some rigorous methodology. Rather it is the spirit and intention of these tools that can be directed to virtually any economy. That is, the underlying purpose of financial development will be the same everywhere: to make the capital markets robust and stable. But the methods used to stimulate financial development will vary across national borders.

The implementation of those tools will vary depending on four factors. The first is the strength of the market participants to finance the operations of the infrastructure. If the banks, brokers and exchanges are struggling, then it will be very difficult for them to fund the necessary institutions, such as clearing, settlement and depository. Next, one has to consider the sophistication of the domestic financial market participants. Not only the bankers and brokers, but also the investors must be knowledgeable about the risks associated with the potential rewards of robust capital markets. The banking system must be able to handle the rapid movement of funds for delivery versus payment, which can't be overlooked. Likewise, however, the sophistication of domestic investors cannot be ignored. They are a source of funds and liquidity for financial markets. Thirdly, while there are some regional commonalities in the legal framework, across regions there are important differences that will affect the regulatory structure of the capital markets.

Here is a specific example of the difference between the spirit of a financial market development tool and the direct application of a set of regulations. One area where the USA excels in capital markets is in having a comprehensive, functioning legal structure for securities market activities. But this is an important area where one size definitely does not fit all, and it does not fit in ways that go beyond the 'legal tradition' studies carried out by empiricists in finance and economics. Laws come about in an evolutionary way. First, there is a generally accepted good business practice, which all market participants follow. Developed over a period of time, these good business practices serve the community and the markets very well. Over time, good business practices become generally accepted. Then one or more participants find a way to advance their position by cheating. When they get caught, new laws are usually created to codify the original 'good business practice'. What was once considered just a good way to conduct a transaction now becomes a legal business requirement. Whether one legal framework for clearing and settlement and financial services will serve the capital markets in another country is akin to asking if they will 'cheat' the same way everyone else does. So, the underlying question is: how tight are the cultural and social foundations upon which business is done? The Protestant work ethic is the foundation for capitalism in the USA, UK and many other countries; the cultural concept that hard work brings rewards, material rewards that somehow symbolize spiritual good. Capital markets can work anywhere in the world, but the social and cultural foundations of the system that supports these markets may be quite different.

The fourth and final factor affecting the implementation of capital market infrastructure is the set of existing laws, whether or not they can be changed, and how quickly or easily changes can take place. For example, in 1994 Russian law gave no legal status to 'registrar extracts', the printed statements acknowledging share ownership. However, in practice, these extracts were treated as stock certificates, as though they had intrinsic value. In fact, the Russian word for 'securities' is *tsyeni bulmagi*, literally 'valuable paper'. In that context, it was impractical to design a paperless clearing and settlement system. In this example, not only did the laws have to be amended, but the business practice of requiring paper to represent ownership also had to be changed.

II The world we occupy

In 1940 there were about 70 countries in the world. There are over 200 now, 60 years later. So, although we think we are integrating through globalization, politically the world is actually becoming more fragmented. We are also becoming financially fragmented. The number of currencies today is nearly triple what it was in the early 1940s. And with over 200 financial regulatory agencies around the world, the potential for procedures to be less integrated, less compatible rather than more compatible is increasing nearly beyond control. Hooper and Heaney (2001) report a high correlation between political risk and capital market segmentation. Political risk will have an impact on financial markets. But financial instability could be the final factor that pushes an at-risk country into political turmoil.

III Globalization through technology

The advancement of technology in promoting global financial services has been tremendous. Time, distance and location are largely irrelevant, as investors now have the potential to move their net worth to whatever jurisdiction offers the highest reward with the lowest risk. Brick and mortar no longer bind financial services. Investors around the world have been comfortable moving large net worth positions by electronic means for nearly a decade. The injection of the digital element into world capital markets has also dramatically reduced the transaction cost of financial services.

The Internet and other technology advancements have played a tremendous role. Around the world, we are seeing that investors and customers are becoming more comfortable every day with the ability of financial service providers to protect their privacy. The number of telephone trunk lines available was once considered to be the only indicator of how much communication a country could have (Table 1). It is still a good indicator, but some countries and regions are leap-frogging hard-wire infrastructure and going straight to wireless. Wireless access to digital finance is available for

Table 1 Infrastructure available to G15 countries

Country	Telephones – main line (millions)	Wireless phones (000)	Internet service providers
Algeria	1.176	33.5*	1
Argentina	7.5	1800	47
Brazil	19	4000	197
Chile	2.603*	197.3	26
Colombia	1.89 (est.)	NA	NA
Egypt	3.168	380*	31
India	18.95*	1900*	3
Indonesia	3.291	1200*	24
Iran	7* (est.)	265*	1
Jamaica	0.292	45	6
Kenya	0.290*	6*	7
Malaysia	4.4*	2170*	8
Mexico	9.6*	2020*	167
Nigeria	0.405	10*	5
Peru	1.509*	505*	15
Senegal	0.82	0.122	4
Sri Lanka	0.495*	229*	4
Venezuela	2.6*	2000*	11
Zimbabwe	0.232	70*	10

Source: Central Intelligence Agency (2002).
Notes: Telephones: main line and wireless phones are 1995, 1996 or 1997 data except where marked with an asterisk.
*Indicates 1998 or 1999 data.
ISPs are 1999 data.
NA, not available.

information and transactions. Furthermore, according to Mrs Madhabi Puri Buch, Chief Executive Officer, ICICI Capital Services Ltd in India (Cairo, 2001), communal access is making obsolete the 'counting' system of measuring progress. If you ask how many Indians have long distance service, the response will be very low. But if you ask how many *use* it, the answer is about 80%. Though telephones have very low home penetration, most people use shared phone booths. Mrs Buch suggests the same thing is happening with Internet access. Cyber Cafes are available in neighbourhoods even where there is no home PC. It is estimated that the number of online-trade customers in India increased from 24 000 to 91 000 between October 2000 and February 2001 – nearly quadrupling in just four months.

'Global and digital' can't be separated from 'robust and safe' when discussing capital markets. Developing nations need to prepare their financial market infrastructure while transaction volumes are still relatively low. For example, one mistake made in the USA was in not anticipating in 1960 the volume of stock market activity that was coming in 1970. In the late 1960s, the USA experienced what is commonly known as the 'paper crisis'. Every trade had to be settled by passing around pieces of paper: paper representing stock ownership and paper representing payments. Wall Street's paper crisis virtually halted stock market activity. Immediate, emergency processes had to be put into place to keep the capital markets functional. This, in fact, was the birth of the Depository Trust Company and the National Securities Clearing Corporation. Once the regulatory and technological infrastructure was in place, the markets were able to function and to grow.

For all these advances, technological gaps remain a serious concern for back-end processing. In global financial services today, we find a patchwork of protocols. In some cases, multiple netting of trades simply means having multiple fax machines because the computer system of one country can't talk to the computers in another. Every gap in this technology has the potential to stop the progress of financial services dead in its tracks. A headline in *Business Week* was close to the truth when it said that if the problem isn't fixed, the global financial system could implode (29 January, 2001).

IV Fundamental differences

Bank assets have dominated the value of financial market assets over the last decade. However, as Figure 1 shows, equity markets are quickly catching up, having total value about equal to bank assets as a percentage of worldwide gross domestic product. As shown in Figure 2 the ratio of bank assets to bond and equity market capitalization in the world has fallen dramatically in the last ten years. In other words, bank assets were about the same as the sum of equity and bond values in 1990. By 1999, the value of bank assets was only about one-half the sum of equity and bond values.

Country-by-country, however, the distribution of financial market assets varies substantially (Table 2). For example, in Malaysia, banks and equity markets have about the same share, similar to the world average figures. In Indonesia, on the other hand, banks still dominate, and the share of the bond market is only 3%. This is an important example of the national differences in capital markets that have to be taken into consideration when we examine the opportunities to develop financial institutions.

These differences can also be applied to regions. In Figure 3 we see that the Asian financial markets tend generally to be dominated by banks, with equities coming very

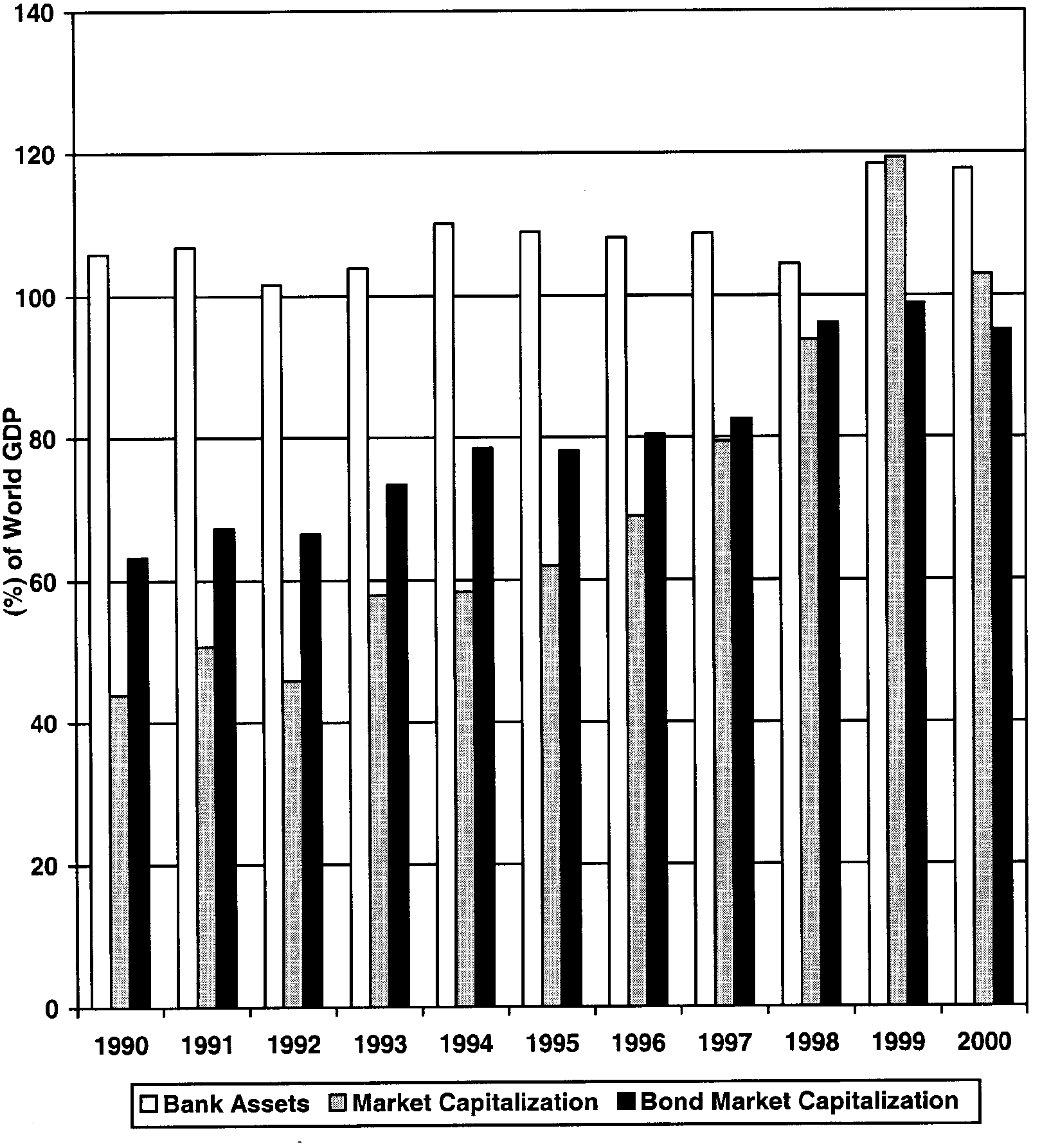

Figure 1 Size and structure of world financial markets
Source: Barth *et al.* (2002b).

strongly in second place. Contrast that with the display in Figure 4 of Latin American countries. Here, equity market capitalization has taken the lead in Argentina and Chile, compared with bank assets. All these figures reveal substantial variation across countries.

One area where countries have a relative lack of cross-border variation is in minimum risk-based capital requirements for banks. Of 106 countries surveyed in a research project sponsored by the World Bank (Barth *et al.*, 2001), 60% of countries responded that the

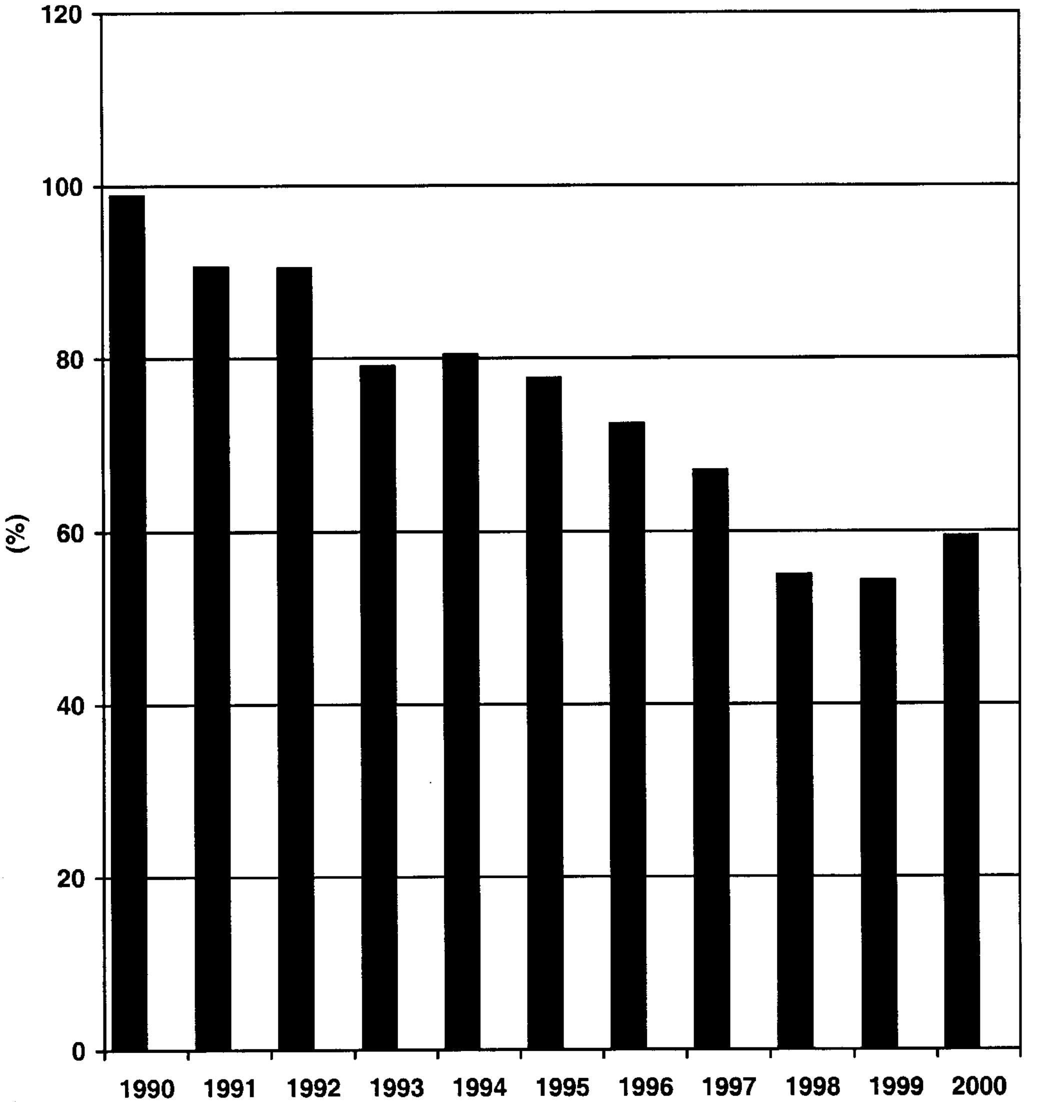

Figure 2 Ratio of world bank assets to world bond and equity market capitalization
Source: author's calculations based on data from Barth *et al.* (2000b); IMF (2000); Merrill Lynch (2000); Standard and Poors (2001).

minimum requirement was set at 8%. Not surprisingly, given this lack of variation, when countries were asked in the survey whether minimum capital requirements were in line with Basle guidelines, 93% answered 'yes'. Such near unanimity across so many countries with dramatic differences in bank risk exposure obviously reinforces questions about the accuracy and usefulness of these guidelines at an aggregated level.

Although more than 30 countries have created stock exchanges since 1990, the number of stock exchanges per country is falling. In 2000, the stock exchanges of Amsterdam,

Table 2 Structure of financial markets – 2000

Country	Bank assets total (%)	Bonds total (%)	Equities total (%)
Indonesia	74	6	20
Thailand	69	17	14
Poland	60	19	21
Hong Kong	53	3	44
South Korea	51	30	19
India	44	26	30
Malaysia	40	20	40
Brazil	38	34	28
Philippines	33	34	33
South Africa	28	15	57

Source: author's calculations based on data from IMF (2000); Merrill Lynch (2000); Standard and Poors (2000).

Brussels and Paris merged to form Euronext. The USA had 100 regional stock exchanges in 1900, 15 in 1965 and 5 today. China plans to merge its two domestic stock exchanges into a single exchange in Shanghai. After the Group of Thirty recommendations on national securities market infrastructure were promulgated in the early to mid-1990s, many countries made the move to centralized clearing, settlement and depository organizations. In the USA, where trade volume is pushing 3 billion shares a day, every trade is settled in one location: the Depository Trust and Clearing Corporation. For all the volume of trades that are settled there, it takes fewer than 1100 people to run the entire operation, and most of them are in exception processing. This includes the settlement of trades that require the physical delivery of stock certificates to individual shareholders.

The key issues for developing cross-border financial services are very similar to those for development within each country. There will be a regulatory body that oversees the interests of the investors, since they have the greatest political power in capital market transactions (as voters) but are often in the lowest position of power regarding transaction execution details. The question of jurisdiction may be the trickiest regarding financial services, because of the true global nature of these products. There will not be import and export regulators monitoring financial services that cross borders. The investors are in one nation and the assets they invest in are in another. Which nation's regulations will prevail in disputes? Do we need international self-regulatory institutions such as the Securities Industry Association in the USA, which provides arbitration services for investor/broker disputes? These are the new issues that need to be addressed and addressed quickly before the volume of cross-border trades pushes the world into a 'paper crisis' of a different sort.

V Conclusion

In summary, without a strong national financial system, a set of international standards

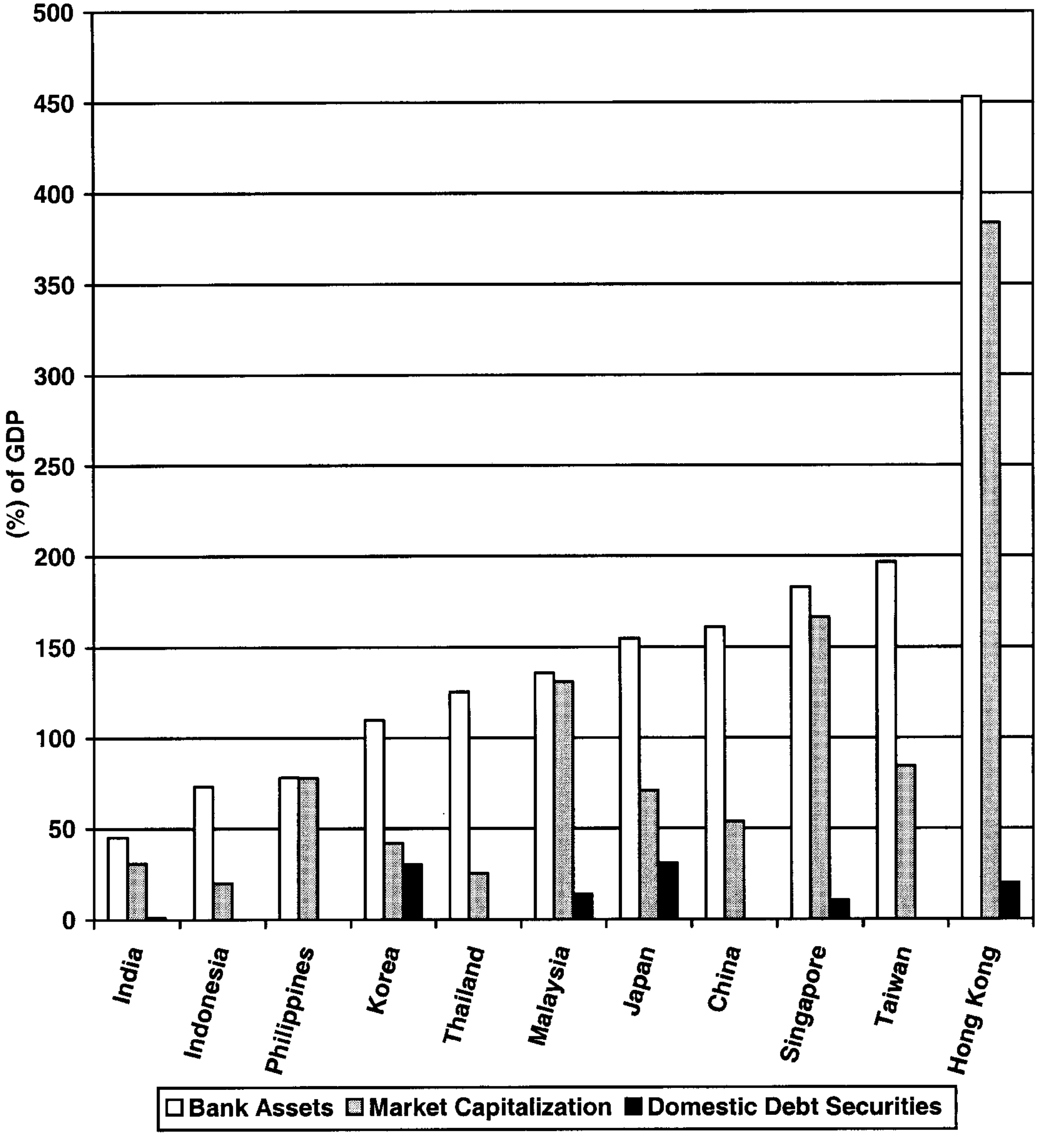

Figure 3 Structure of financial markets: Asia
Source: author's calculations based on data from IMF (2000); Standard and Poors (2001); Bank for International Settlements (2001).
Note: countries may not have data available for every category.

will be hard to implement. Four tools can be shown to generally promote stable national financial systems: (1) having independent rating agencies; (2) having some safety net; (3) reducing government control of national financial assets; and (4) allowing capital market participants to offer a wide-range of services. (See Barth *et al.* 2001 and 2002a for complete coverage of the theoretical and empirical literature on these four important

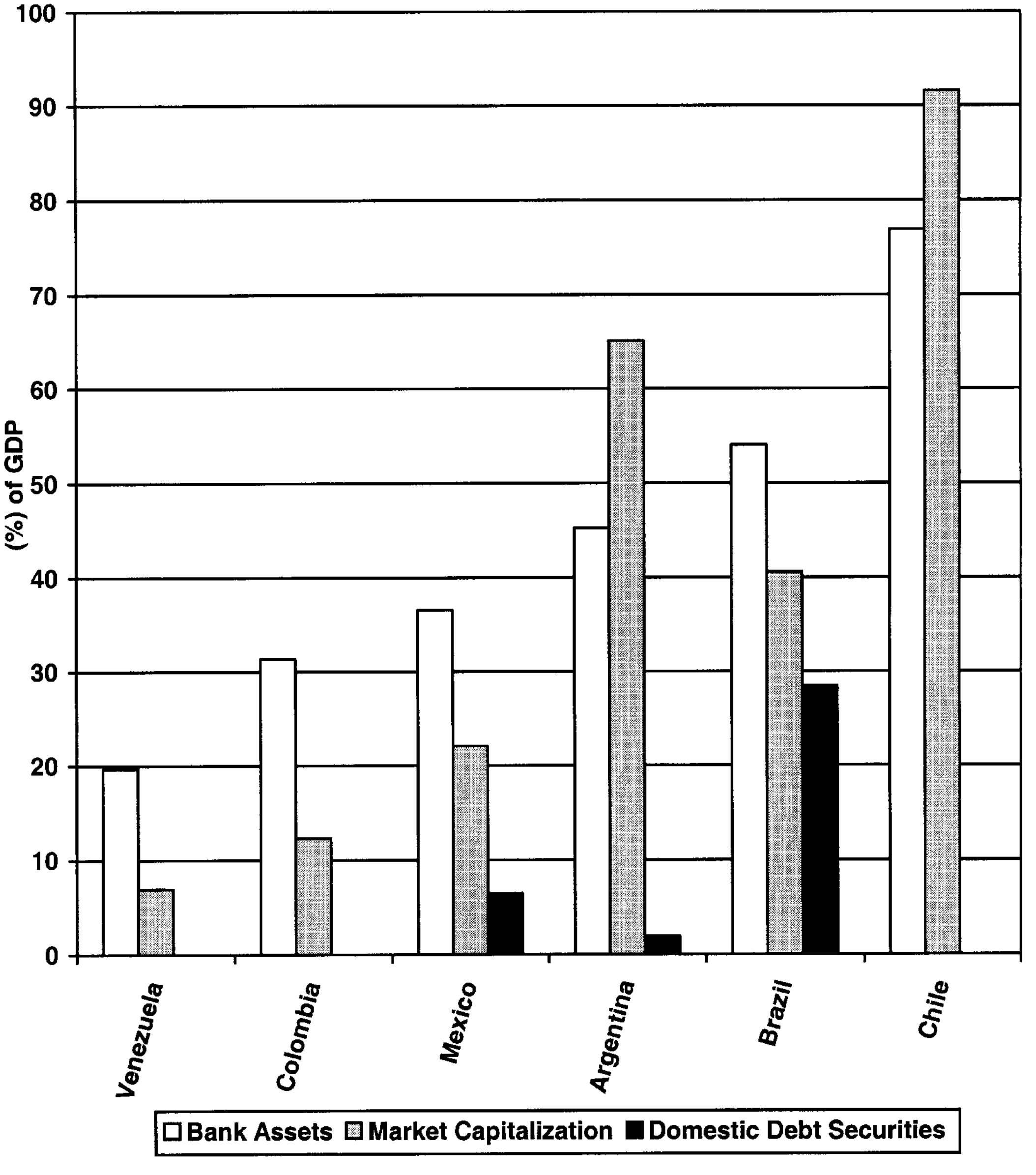

Figure 4 Structure of Financial Markets: Latin America
Source: author's calculations based on data from IMF (2000); Standard and Poors (2001); Bank for International Settlements (2001).
Note: countries may not have data available for every category.

issues.) Once international tools are decided, the four implementation factors will determine how any one nation will adhere to them in practice: (1) the financial strength of the market participants; (2) investor knowledge and understanding; (3) the social and cultural foundation of business practices; and (4) the existing laws.

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