The Evolving Importance of Banks and Capital Markets in the Emerging World

Which Financial Structure is best for the Rapid Growth Markets?

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I. Introduction

The recent economic crisis clearly confirmed the critical roles financial intermediaries play in economic activity. Perhaps the most pressing and critical issue currently facing the emerging economies is the continued development of their financial sectors. Unfortunately, many of the Rapid Growth Markets (RGMs)[1] currently lack the financial sector infrastructure (both physical and intellectual) to take their economies to the next stage of sustained economic development.

Perhaps the most pressing and critical issue currently facing the emerging economies is the continued development of their financial sectors

This paper has two objectives. The first is to examine the level of financial development across the emerging world. Examining over 100 emerging markets (with a detailed focus on the 25 RGMs), this paper will assess the critical measures of bank and capital market development in recent years, including the availability of bank credit to the private sector and the capitalization of the equity and corporate bond markets.

The second part of the paper will examine the issue of financial structure, or the relative importance of banks versus capital markets in the RGMs. Although banks have dominated emerging financial markets, financial structure varies significantly across emerging market regions and countries. This section will explore whether a particular financial structure might be more suitable in allocating financial resources (and in turn economic growth) for emerging markets at different stages of economic development. Discovering or understanding a pattern can provide important policy implications for many RGMs, especially those which are making efforts to strengthen their financial systems. According to the World Bank, half of today's RGMs are now classified as "upper middle-income" nations and the evolution of their financial structure in the coming years will be critical to their economic prospects.

The paper finishes with a detailed examination of a host of factors impacting a nation's financial structure – such as investor protection and corporate governance – and provides policymakers some recommendations on improving these indicators.

1 The RGMs are the 25 high performing/high potential economies chosen by Ernst & Young.

II. Capital Markets and Banks – An Overview of their Current Development

The Capital Markets

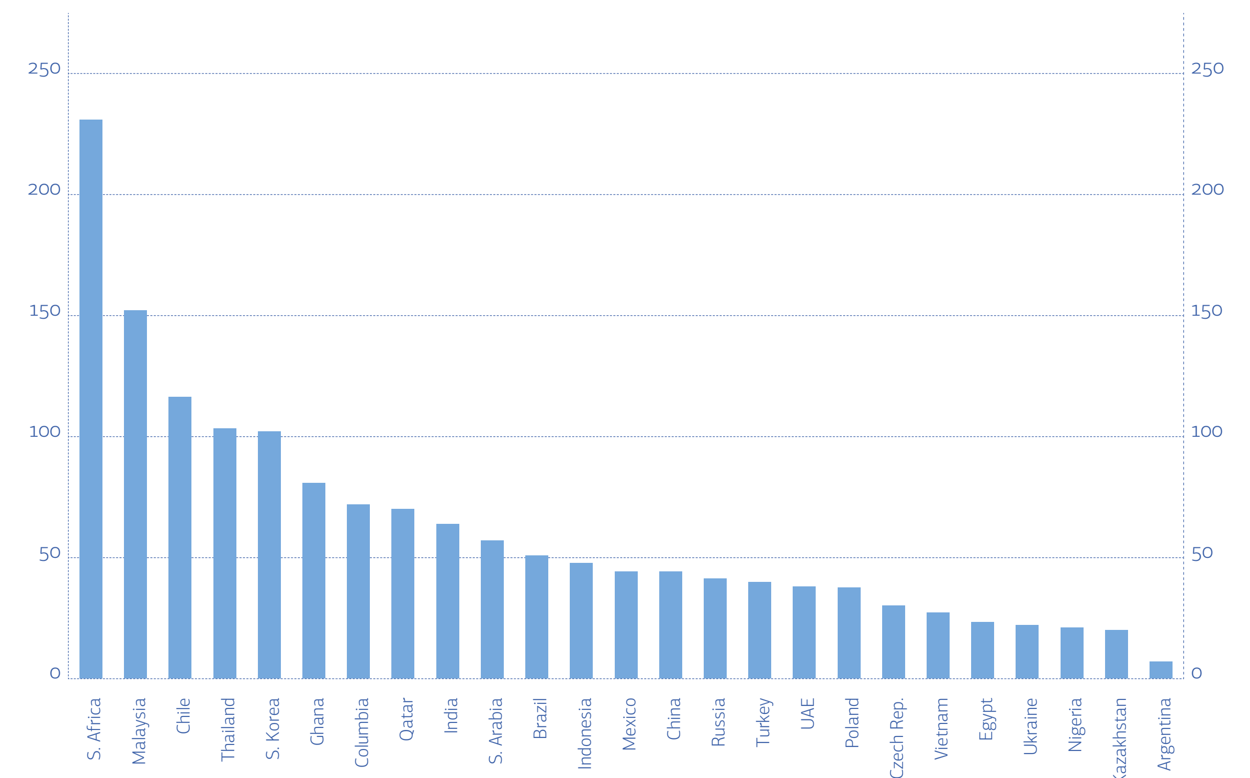
This section examines the level of capital market development in recent years for the RGMs with a focus on the equity and corporate bond markets.

The Stock Market[2]

To gauge the depth of the equity markets, we examine the stock market capitalization ratio, which equals the total value of listed shares divided by GDP. Among the RGMs, the average stock market capitalization ratio rose from 35% in 2000 to 62% by year-end 2012. South Africa, Malaysia, Chile, Thailand and South Korea have the distinction of possessing ratios in excess of 100 percent. Ghana now has the third largest equity market in Sub-Saharan Africa (after South Africa and Nigeria). Argentina's stock market has collapsed in recent years again and it is the only RGM with an equity ratio below 10 percent. At $3.6 trillion, China easily possesses the largest equity market in the emerging world. Its stock market capitalization ratio, however, has fallen from a peak of 180 percent in 2007 to just 45 percent in 2012.

The stock market capitalization ratio generally varies positively with the level of economic development with the high income nations pos-

Figure 1. Stock Market Capitalization Ratio (year-end 2012)



Source: Bloomberg

2 For a detailed examination of stock market development, performance and risk in the RGMs over the past twenty-five years please see the author's report, published by Ernst & Young, "Moving toward the mainstream: stock market development and performance in the RGMs".

sessing twice the ratio of lower-income and lower middle-income nations. Unlike their poorer cohorts, upper middle income nations went a long way in closing the equity ratio gap held by the rich countries, elevating their ratio from 17 percent to 40 percent over the past decade.[3]

By our count, 75 emerging markets had an "active" stock market in 2012. By major regions, East Asia & Pacific come out on top with a median equity capitalization ratio of 71%. After a turbulent decade after the fall of Communism, the nations of Eastern Europe and Central Asia increased their ratio four-fold (5% to 21%). Both South America and the MENA region have capitalization ratios of roughly one-third of GDP. Sub-Saharan Africa (SSA) has the least developed equity markets. Of the 41 countries in the region, only 12 had a stock market in 2011.

> Recently almost nonexistent, the corporate bond market in the emerging world has recently sprouted wings, providing another avenue for private companies to borrow other than equities markets and banks

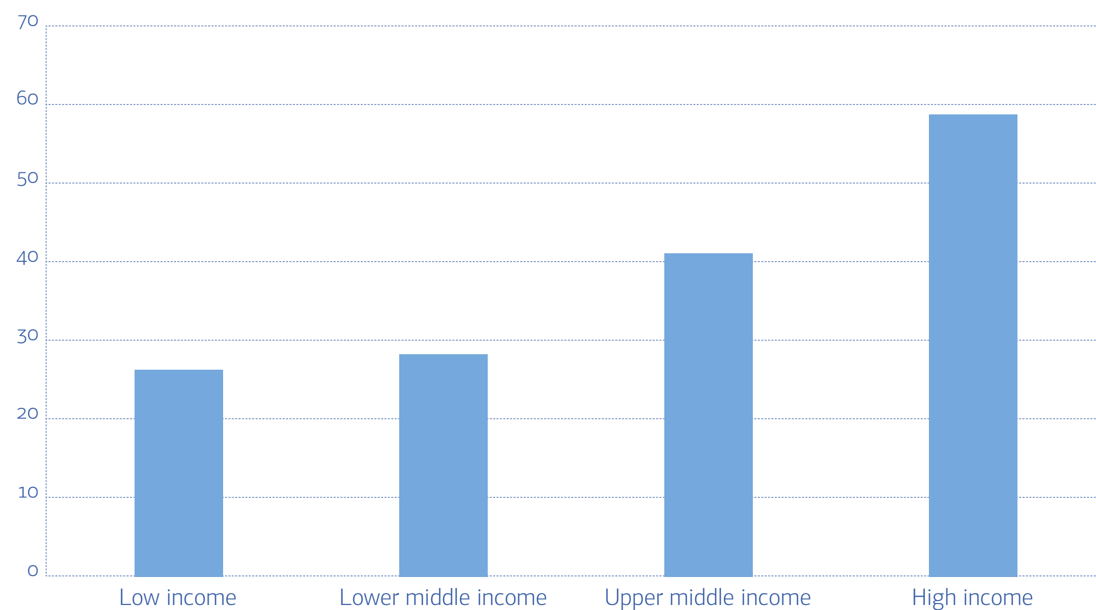
The stock market turnover ratio equals the ratio of the value of total shares traded and market capitalization. It measures the activity or liquidity of a stock market relative to its size. A small but active stock market will have a high turnover ratio whereas a large but less liquid stock market will have a low turnover ratio. Some RGMs have large state-owned enterprises whose shares are not actively traded and for this reason total stock market capitalization can provide a somewhat distorted indication of the level of equity market development. For the RGMs, this ratio has actually fallen over the past decade, dropping from an annual average of 64 to 56 percent. This is quite a contrast to the broad-based rise in the equity capitalization ratio in recent years and trading to economic activity. This implies that it is the price effect (i.e. – appreciation in values) of existing stocks, rather than more liquid markets that have largely driven their stock market development in recent years. In fact, the average number of listed companies (per 10,000 population) has not risen over the past decade. This has important implications because it is the liquidity of a stock market rather than its sheer size that matters more for economic growth.

Despite the rapid rise in stock market capitalization over the past decade, the majority of emerging bourses are totally devoid of liquidity. Outside the 25 RGMs (the remaining 50 exchanges in our sample), the average stock market turnover ratio has averaged about 10% in recent years.

Corporate Bond Markets

Recently almost nonexistent, the corporate bond market in the emerging world has recently sprouted wings, providing another avenue

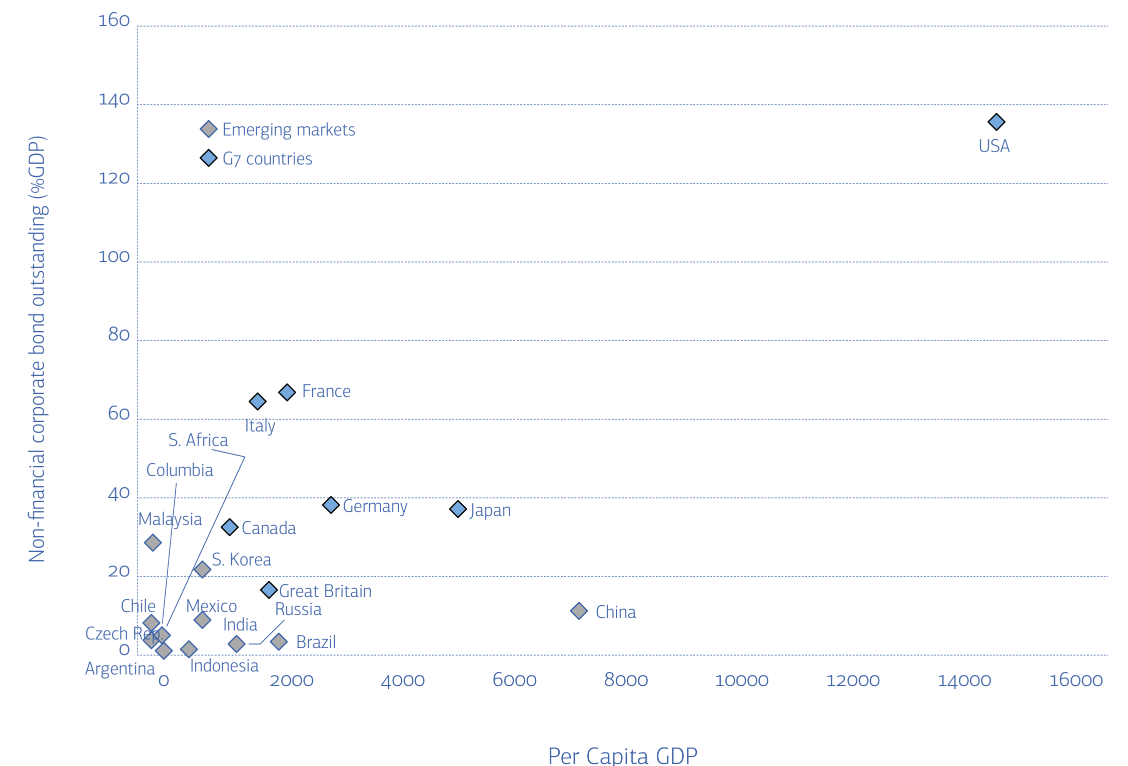
Figure 2. Stock Market Capitalization Ratio by Income Cohort (2012)
(average for countries with a functioning stock market)



Source: WDI, Bloomberg.

3 Economies are divided according to 2010 GNI per capita, calculated using the World Bank Atlas method. The groups are: low income, $1,005 or less; lower middle income, $1,006 – $3,975; upper middle income, $3,976 – $12,275; and high income, $12,276 or more.

Figure 3. Non-financial Corporate Bond Ratios, by country (2012)

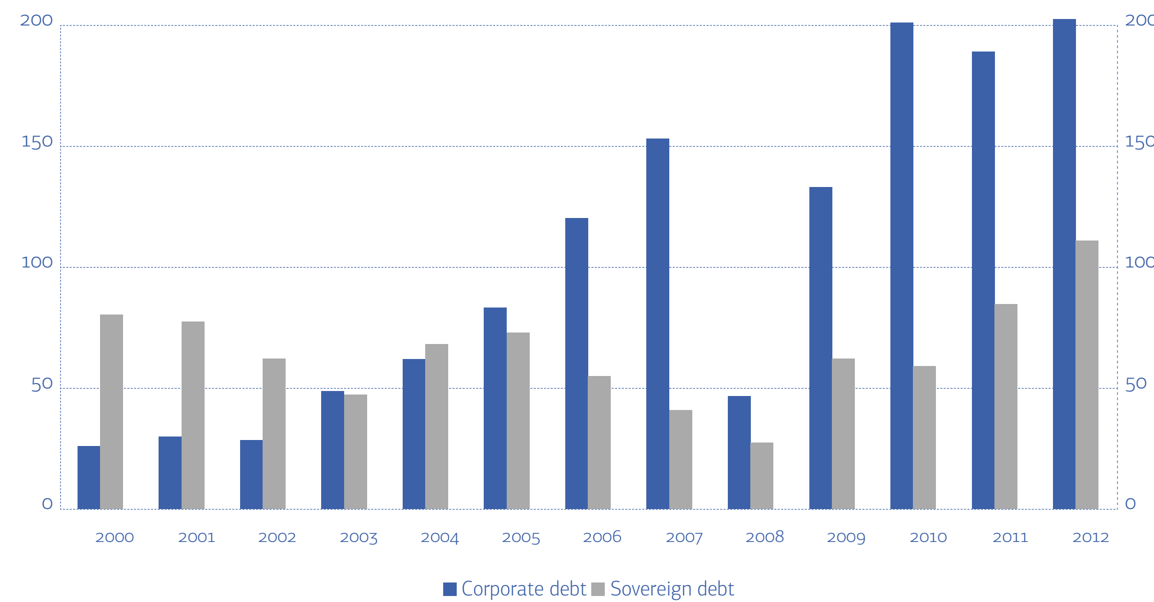


Source: WDI, Bloomberg

for private companies to borrow other than equities markets and banks. RGM companies are increasingly tapping the public credit markets to finance growth and corporate bonds are just now becoming a part of the broader emerging market investment universe. It is still practically non-existent in the low-income world but last year the corporate bond ratio (corporate bonds outstanding as a share of GDP) grew to 6% and 15% of GDP in the lower and upper middle income nations, respectively (it stands at 38% of GDP for the rich world). Of the 25 RGMs, fifteen reported having a functioning private bond market in 2012, with only South Korea and Malaysia possessing large markets (22 and 29 percent of GDP, respectively).[4] China, Mexico, and Chile all have ratios of approximately 10 percent. Both Mexico and Chile allow their pension funds, insurance companies, and other financial institutions wide leeway in investing their assets, providing support to their primary and secondary corporate debt markets.

As an asset class, emerging market corporate bonds surpassed the $1 trillion mark in 2012, approximately two-thirds the size of the total emerging market sovereign debt universe, valued at $1.6 trillion.[5] Corporate issuance has steadily grown (except during the financial crisis in 2008) and has surpassed total sovereign issuance each year since 2003, reaching a record $211 billion in 2010 ($190 billion in 2011). In 2011, the size of the emerging corporate bond market, including quasi-sovereign bonds, was more than half the size of the US high-yield bond market and five times larger than the European high yield market.

Figure 4. Corporate Bonds come to life in the RGMs
Emerging Markets Debt – New Issuance
Sovereign and Corporate Debt (in US$) – (2000-2012)



Source: JP Morgan, Reuters

4 All figures are for non-financial corporate bonds.
5 According to JP Morgan and IEMS estimates for 2012.

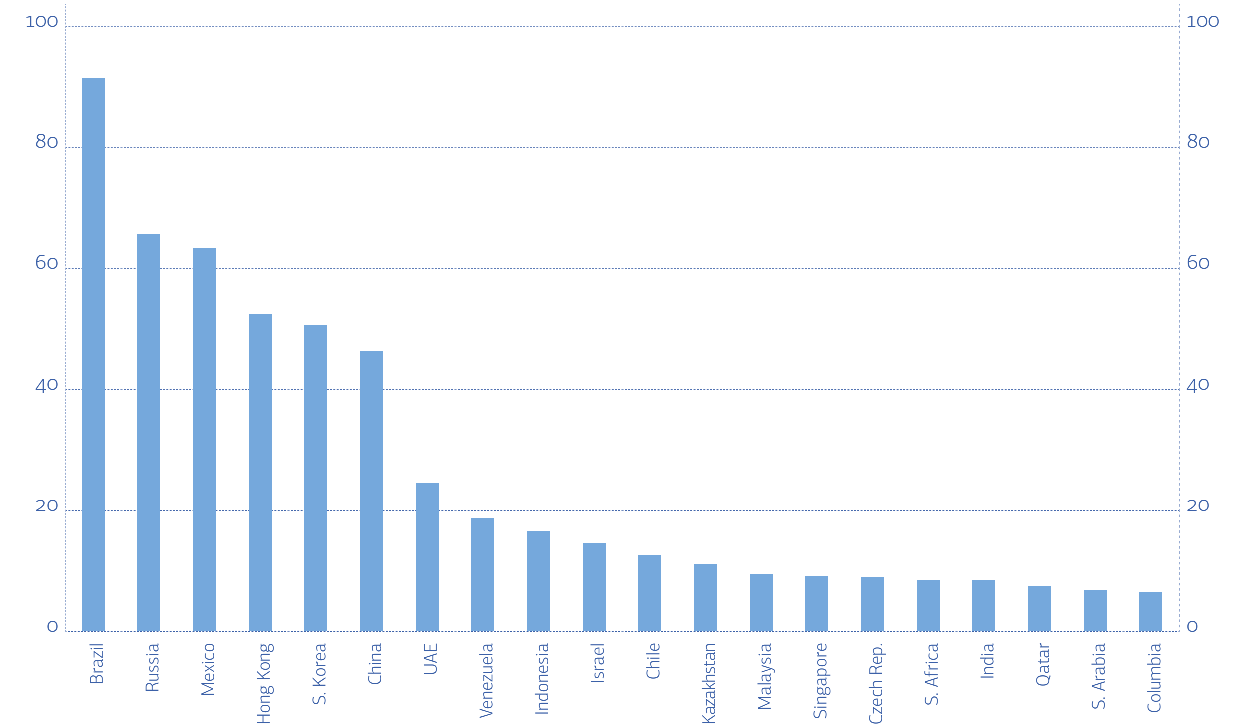
In recent years Brazil has been the standout in corporate issuance.[6] According to Dealogic, Brazil issued more than $90 billion in foreign exchange bonds since 2007. Besides faster economic growth (at least until recently), an improvement in Brazil's sovereign credit quality – which we will show supports the creditworthiness of the corporate sector – were the major factors behind the surge in issuance. With a corporate bond ratio of only 3.5%, however, Brazil has a lot of catching up to do. Russia's possess the same ratio, but issued $65 billion over the same period.

RGMs Capital Market Development

The private security market capitalization ratio, or the sum of the stock market capitalization plus corporate bond market capitalization ratios, is the most accurate measure of the depth of a nation's capital markets. The difference in this ratio between all the emerging economies and the high income countries is enormous (an average of 88% versus 37% for high-income and upper middle-income nations, respectively). What differentiates high-income countries from emerging markets, very simply, are well developed private capital markets.

For the 25 RGMs, this ratio's median value has risen from 29 to an estimated 79 percent of GDP from 2000 through 2012 (it peaked at 95 percent in 2007), with broad based increases across most countries. Only Argentina experienced a decline in their capitalization ratio, declining from 63 to 19 percent of GDP. Only South Korea, Chile, Thailand, Malaysia, and South Africa pos-

Figure 5. Emerging Markets Corporate Bond Issuance by Country
Cumulative value 2007-2012 ($bn)



Source: Dealogic

6 According to the Institutional Investor, from 2007-2012, Brazil witnessed the largest improvement in credit rating of any emerging market.

sess security capitalization ratios in excess of 100 percent, the threshold at which a nation's securities market is considered well developed.

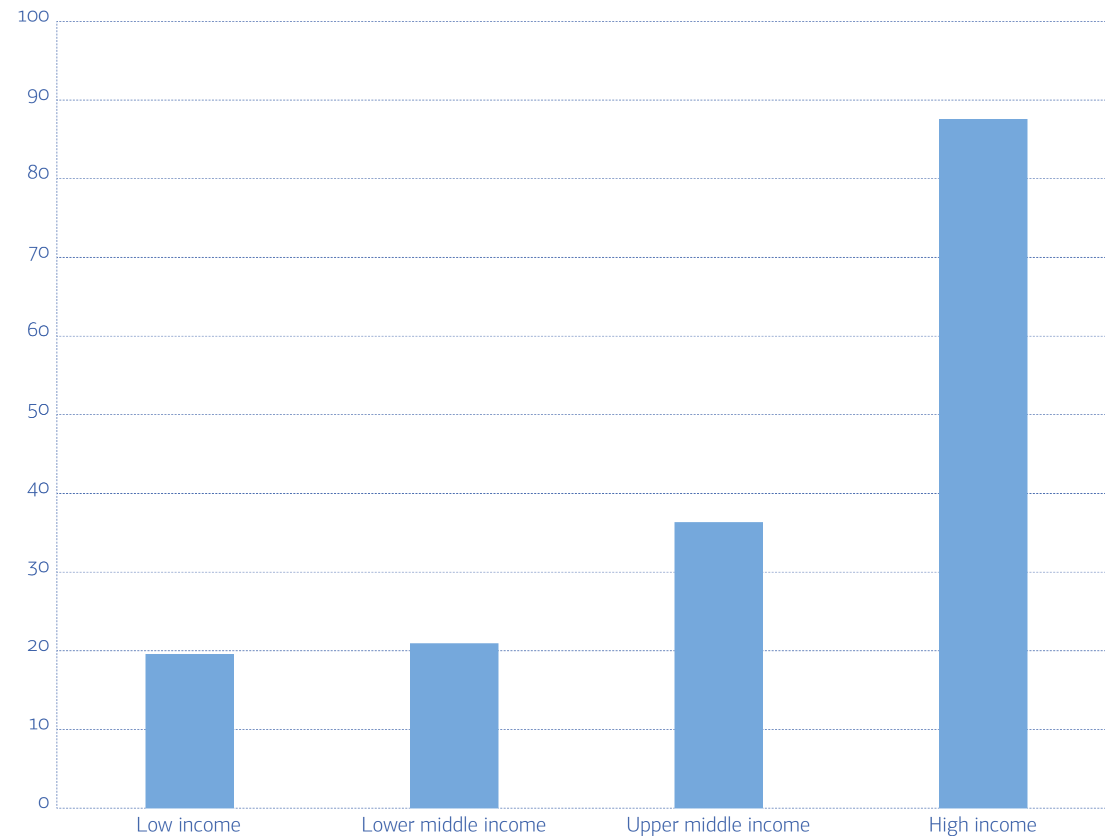
The Banking System

The banking system still constitutes the largest part of the financial system in most emerging market economies. It is the major financing source for both the private and public sectors and serves as the crucial engine for economic growth in most of these countries.

For instance, according to a research done by McKinsey Global Institute in 2009, bank deposits accounted for 58% and 44% of overall financial assets in China and India respectively, while the corresponding figure for the U.S. was only 23%. The banking sector is the major funding source for firm investments in these countries. According to the World Bank, only 11% of emerging market firms relied on banks for their investment in 2002, while the number rose to 35% in 2011. For example, 28% of Brazilian firms used banks to finance investment in 2003, and this ratio rose to 52% in 2011. In addition, banks are also the major creditors of public debt. The banking sector credit to the public sector as a percentage of total bank credit was 65 percent in Turkey, 57 percent in Argentina, 54 percent in Mexico, and 51 percent in Brazil, respectively.

Banks are also major borrowers in the corporate bond markets in the emerging world.

Figure 6. Security Market Development by Income Level (private security market capitalization ratio)



Source: WDI, Bloomberg

The banking sector accounted for 34% of the overall corporate bond issuance demand in 2011, leading the industrial sector (21%) and the telecommunication sector (13%).

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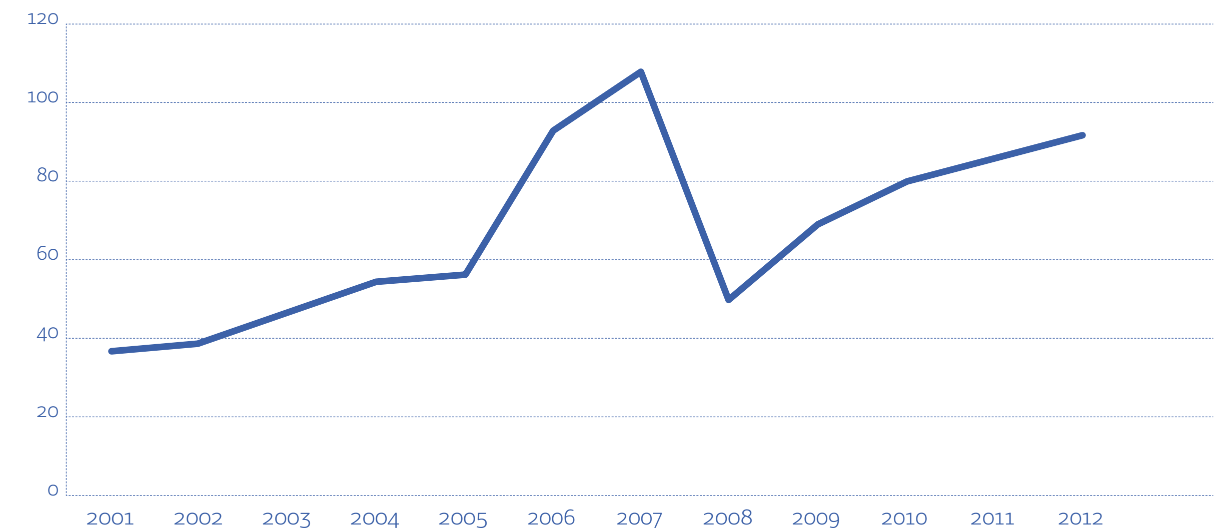
The Economics Intelligence Unit forecasts that emerging market banking assets will grow more than 20 percent annually from 2010 through 2015 (compared to 3 percent in the high-income countries). If these projections are correct, emerging markets will contribute approximately 70 percent of global banking asset growth, in absolute terms, over this period.

Their rapid growth in recent years has also made them global giants for the first time. Among the top 10 banks in the world ranked by market capitalization, four of them are from emerging markets. Among the top 100 banks globally, 36% of them are emerging market banks, while the corresponding numbers were 13% and 23% in 2002 and 2007 respectively, according to Bloomberg data.

While the rise in bank size was largely a China story until the middle of the 2000s, more recently institutions from Brazil, Chile, Indonesia, Thailand, Malaysia, Turkey, India, and South Africa have made their way up the rank.[7]

Domestic credit provided by the banking sector (as a share of GDP) is the most comprehensive measure of how significant a role banks play in allocating credit in an economy. The increase in the percentage during the past decade was significant, rising from an average of 58 percent in 2000 among the 25 RGMs to 81 percent in 2011. China, South Korea, Malaysia, South Africa, and Thailand had ratios in excess of 100 percent at year-end 2011.

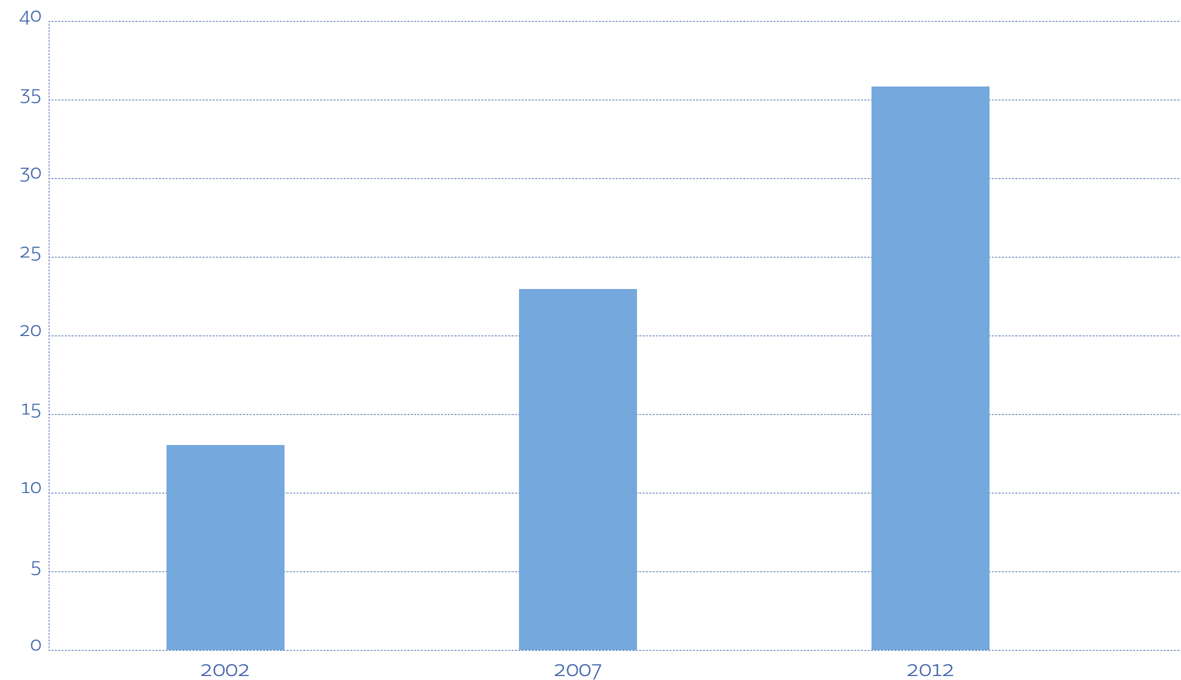
Figure 7. RGMs private security market capitalization ratio (median value)



Source: Bloomberg

7 According to Boston Consulting Group

Figure 8. Share of RGMs banks in the Global Banking 100 (measured by asset size)



Source: Bloomberg

Figure 9. Financial Depth by Income Cohort (median value)

Source: WDI, Bloomberg

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Combining our two primary financial indicators, the equity market capitalization ratio and domestic credit provided by the banking sector gives a good indicator of the overall level of financial development for each emerging market. The following two schematic maps provide a visual on the level of financial deepening that has occurred in the emerging world over the past decade.

Not surprisingly, financial depth is a positive function of income, with the low income, lower-middle income and upper middle income countries averaging 37 percent, 77 percent and 104 percent in 2011, respectfully, versus 220% of GDP for the high income countries. For all emerging market countries, financial depth increased by a quarter, rising from 49% of GDP in 2000 to 74% by 2011. By region, at 126%, East Asia has most financial depth while SSA brings up the bottom at 49%. East Asia and Eastern Europe made the greatest gains in financial depth last decade, rising 46% and 44% of GDP (absolute terms), respectively.

RGM Financial Deepening Highlights

- Among all RGMs, financial depth rose from 94 percent in 2000 to 141 percent of GDP by year-end 2012.
- Brazil, Chile, China, South Korea, South Africa, Qatar, Malaysia, Thailand and Vietnam[8] have financial depths in excess of 150 percent.
- South Africa is a standout that warrants particular attention. At 410 percent of GDP (the highest of any emerging market), its financial depth is approximately twice that of the average high-income country.
- Malaysia, Chile and Thailand possess financial depth equivalent to that of an average high-income country.
- At just 37 percent of GDP, Argentina now has the lowest level of financial depth among the RGMs.

8 The rise in Vietnam's financial depth has come almost exclusively from a very large and quick rise in domestic banking credit, typically a sign of a credit bubble.

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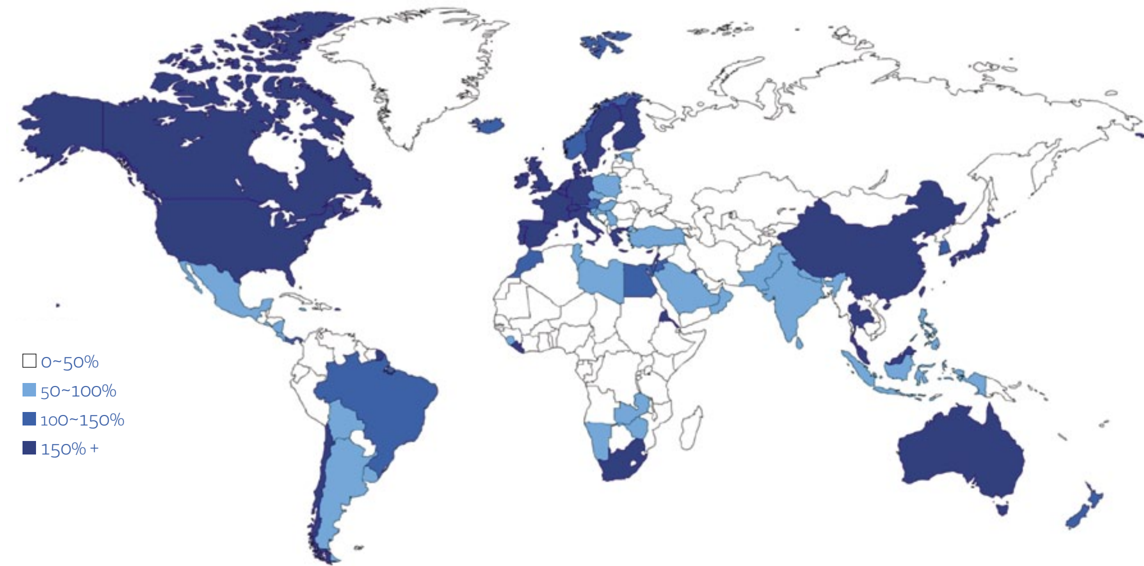
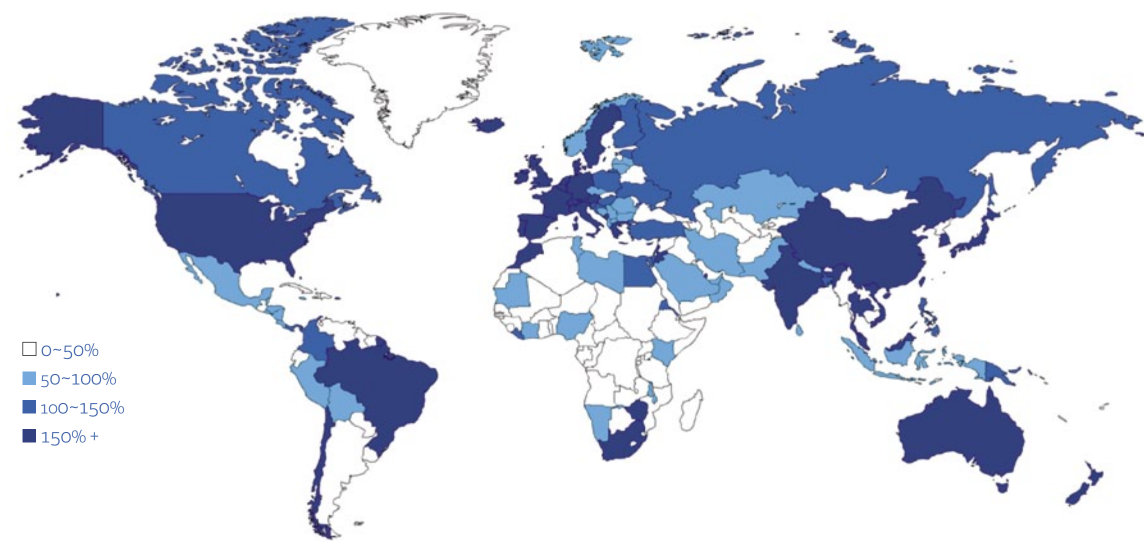
Figure 10. Financial Depth by country, 2000



Source: World Bank, IEMS' Estimates

Figure 11. Financial Depth by country, 2011-2012[9]



Source: World Bank, IEMS' Estimates

9 Domestic credit provided by the banking sector is from year-end 2011, the latest year available.

III. Financial Structure – Bank Based or Market Based?

The optimal financial structure for a particular country will be affected by a number of important factors, including a nation's industrial structure, the quality of its institutions, and above all its stage of economic development. If a developing country's mixture of banks and markets differs significantly from its "optimal" structure, then the financial system will not deliver the appropriate combination of financial services, resulting in a misallocation of capital and slower economic growth over time. Below we examine the merits/drawbacks for having a bank versus a market-based financial structure.

Arguments for a Bank-based System

Generally speaking, because RGMs are well endowed with labor but relatively scarce in capital, labor-intensive industries typically dominate their economies. Businesses in these RGMs tend to be smaller enterprises and typically require a smaller amount of external financing. Banks possess a comparative advantage in financing short-term, lower risk, well collateralized business investments over financial markets which are better suited in funding longer run and higher risk projects. As a consequence, banks are often better able to fund development more effectively than markets in these economies, particularly at earlier stages of development.

Because smaller enterprises and emerging market businesses often lack adequate transparency due to a lack of standard financial information, screening firms and monitoring firm managers are the main concerns for providers of external finance. As a result, bank-based financial systems are often in a much better position than markets-based systems to address principal-agent problems.[10] In these opaque financial environments, banks generally have more strengths than financial markets in reducing this information asymmetry.[11]

The fact is the lack of credit to SMEs is an Achilles' heel for many RGMs that potentially threaten their growth prospects

Does Bank Size Matter in Financial Structure?

Does bank size matter? The size and concentration of banking institutions is an important attribute for financial structure in the RGMs. It is an established fact that large banks tend to shy away from small businesses and focus on large enterprises. Because small business is the dominant form of enterprise operating in developing countries, this specialization suggests that the distribution of banks of different sizes can be an important dimension for our understanding of financial structure and economic development in addition to the mix of banks and financial markets.

The fact is the lack of credit to SMEs is an Achilles' heel for many RGMs that potentially threaten their growth prospects. SMEs provide an average of 45 percent of the employment in the formal workforce and 29 percent of GDP in emerging markets. The informal sector, however, where most SMEs reside, accounts for up to 48 percent of the labor force and 37 percent of GDP.[12] According to the International Finance Corporation, while three-quarters of emerging market SMEs maintain checking and savings accounts at banks, only one-third of SMEs have access to credit. The World Economic Forum's annual survey often rates "access to finance" as a major obstacle to doing business in many of the RGMs. Unable to find financing, many SMEs turn toward informal or underground lenders, borrowing at significantly higher interest rates.

10 The principal-agent problem in finance deals with the issue of management conducting a business in a manner that is not in the interests of the owners or shareholders.
11 Lin, Sun, Jiang. "Toward a Theory of Optimal Financial Structure". P. 20.
12 Boston Consulting Group. "Redefining the Emerging Market Opportunity: Driving Growth through Financial Services Innovation". May 2012. P. xi.

The brush-off by financial institutions is not necessarily a bias against size. A 2008 survey found that of 91 banks in 45 countries, more than 80 percent of the banks described the SME market as a large and attractive one.[13] Instead, it is insufficient access to reliable credit history.

In short, while banking is the dominant form of financial intermediation in the RGMs, the financial structures in many of these countries would probably fare better with a greater presence of smaller banks. The advance of microfinance[14] – although viewed with distinctly mixed results in some countries such as India – has tried to fill this void.

Arguments for a Market-based System

As economies evolve, their economies and leading industries become progressively more capital intensive and innovative. Their companies grow larger too, and develop more complex funding needs, such as handling larger investments. Today, financial markets have advantages in risk management, such as helping businesses to manage liquidity, interest-rate, and foreign currency risks. Markets can provide more sophisticated and flexible risk management tools for borrowers while banks can only provide basic "plain vanilla" risk management services.[15]

For firms with new technologies or innovative projects, relevant information for potential investors is often limited and there is often a wide diversity of opinions from potential investors about these investments. These types of firms are more likely to get funded through stock markets than banks.[16] As venture capital has illustrated, capital markets are just friendlier toward innovative ventures.

Banks tend to be more cautious by nature and so bank dominated financial systems are thought to stymie innovation and impede economic growth. Given banks limited capacity of risk diversification and inherent preference in being more conservative in choosing investments, banks tend to make loans to "mature" enterprises with steady and consistent cash flows instead of lending to new firms which are more risky but often promise higher returns.[17]

There are other reasons why a market-based system may be superior. Some RGMs have bank-based systems where the larger financial intermediaries possess huge influence over firms, and this control is believed to retard economic growth through various channels.[18] The most important is probably through state-owned banks, which dominate most banking systems in the larger RGMs. History has shown that markets are much better at allocating capital (picking winners) than state-owned or state-run financial institutions. State-owned bank lending to state-owned enterprises brings with it enormous political strings attached. Markets have no agenda other than maximizing the financial return of its investors.

Many large or innovative companies also view banks as "lenders of last resort" because of the restrictive covenants that banks place on direct corporate loans (according to the IMF, only 10 percent of US corporate borrowing comes from banks). Covenants are rules placed on debt that are designed to reduce the risk to which a bank is exposed when granting large loans. Examples of covenants include the inability to issue any more debt until the bank loan is paid off; the inability to participate in any share offerings until the loan is paid off; the inability to acquire any companies until the loan is paid off. The equity and bond markets generally do not

13 Beck, T., A. Demirguc-Kunt, M. Pería. 2008. "Bank Financing for SMEs around the World: Lending Practices, Business Models, Drivers and Obstacles." Policy Research Working Paper Series4785. Washington DC: The World Bank.

14 Microfinance is usually understood to entail the provision of financial services to micro-entrepreneurs and small businesses which lack access to banking services.

15 Lin, Sun, Jiang. "Toward a Theory of Optimal Financial Structure". The World Bank. Sept 2009. P. 4.

16 Ibid. p. 8.

17 Ibid. p. 10.

18 Ibid. p. 4.

place equivalent or as stringent restrictions on the borrower.[19]

The Argument for Corporate Bonds

The formation of a corporate bond market can provide RGMs enormous benefits in their developmental process. These include:[20]

More efficient distribution of resources: Local corporate bond markets help allocate capital more efficiently because they fill the gap left by banks in providing large-scale, long-term financing. Some projects need funding over a 20-year period but banks are constrained from lending in these circumstances because of the shorter life span of their liabilities. In India, for example, a significant portion of infrastructure projects are financed by banks because of the limited development of the corporate bond market.

Reduction in financial risk: Because bonds often satisfy financing needs with longer durations, they help reduce the concentration of credit and maturity risk in the banking system and free banks to provide other segments, including SMEs.

Greater corporate transparency: Like stock issuance, bonds require public companies to disclose financial and operations data, increasing the transparency of company finances. Moreover, the bond disclosures help educate investors, generating more informed investment decisions. The greater transparency lowers the cost of capital for higher-quality credit borrowers.

Another positive for corporate bonds is the there is so much room for growth in the emerging world. And the timing could not be better. According to a 2010 report by the World Economic Forum, $28 trillion in new bank lending will be needed in Asia alone (excluding Japan) by 2020 if emerging Asian economies were to remain totally dependent on banks. With the Basel III regulations sharply increasing the capital requirements of banks and with non-performing bank loans on the rise in many of the RGMs, this is an ideal time to increase corporate bond issuance.

Financial Structure as an Emerging Economy Develops

The evolution of a nation's financial structure is strongly determined by the three basic stages of economic development that emerging economies undergo:[21]

Table 1. World Bank's RGMs Income Rankings (2012)

Lower Middle Income	Upper Middle Income	High Income
Egypt	Argentina	Czech Republic
Ghana	Brazil	South Korea
India	Chile	Poland
Indonesia	China	Qatar
Nigeria	Columbia	Saudi Arabia
Ukraine	Kazakhstan	UAE
Vietnam	Malaysia	
	Mexico	
	Russian Federation	
	S. Africa	
	Thailand	
	Turkey	

19 Investorpedia. "Why do companies issue debt and bonds? Can't they just borrow from the banks?" November 28, 2007.

20 From "Redefining the Emerging Market Opportunity: Driving Growth through Financial Services Innovation". May 2012. P. 11.

21 Stages provided by the World Economic Forum's "Global Competitive Report 2011-12. Pp. 8-9.

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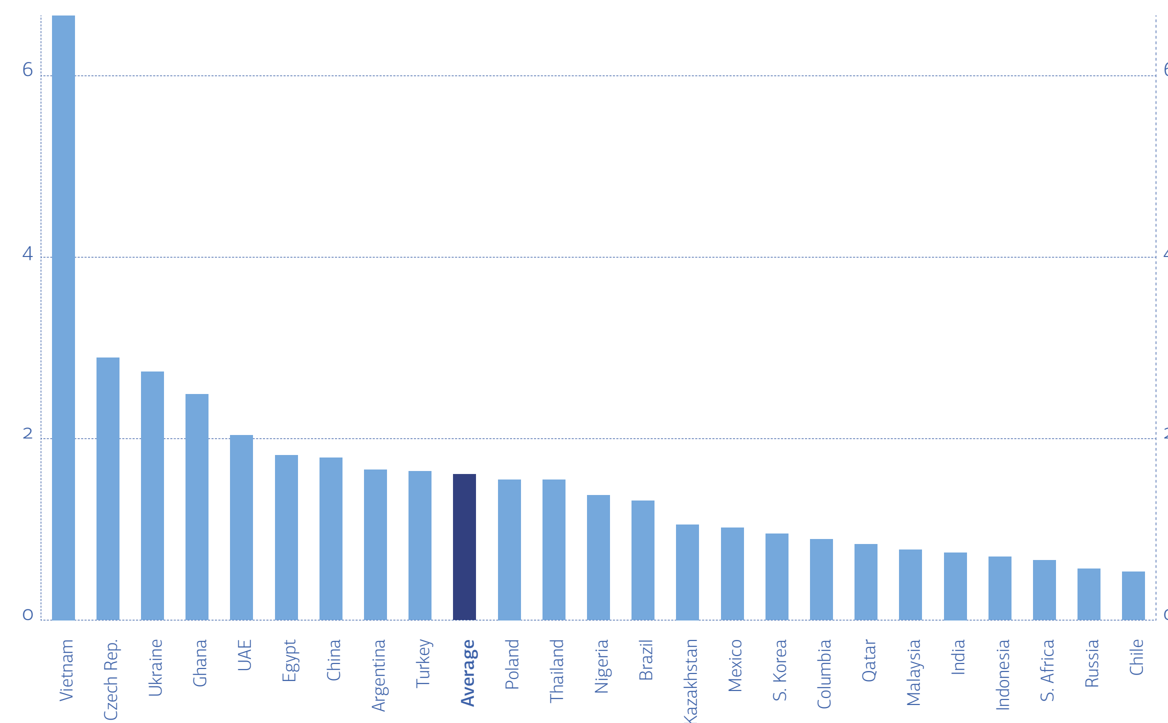
In the first stage, the economy is primarily factor-driven and countries compete based on their factor endowments, which are typically unskilled labor and/or natural resources. “Factor accumulation” of these inputs is the primary factor of economic growth. Countries have low productivity and wages and companies generally compete on the basis of price and sell low-value-added products or commodities. Countries at this stage are either in the low-income category or in the early stage of the lower-middle income strata. Economic growth at this early stage is tied closely to the development of the banking sector although some have developed functioning stock markets. Vietnam and Nigeria (see Table 1) are currently at this stage.

The second stage of development is efficiency-driven. In this stage a country becomes more competitive with both productivity and wages rising. Countries develop more efficient production processes and increase product quality because wages have risen and they cannot increase prices. In this stage, competitiveness is increasingly driven by higher education and training, urbanization and better physical infrastructure. To reach this stage, an emerging economy typically has a well-developed banking sector and is in the early stages of developing a market based financial structure. China, Mexico and South Africa are currently at this stage of development. Countries unable to advance beyond this stage are often caught in a “middle-income” trap, a commonplace occurrence for many emerging markets over the past half century. Moving beyond this stage will eventually require greater innovation, which in turn, requires a more market-based financial structure.

The final stage of development is innovation-driven. At this stage wages have risen significantly and so has the standard of living. The higher wages are sustained because businesses are able to compete with new products. These emerging economies have reached of a stage where innovation and solid institutions that protects property rights are driving economic growth. These emerging economies are either high in the upper middle income rankings or today’s high income nations. Chile and Poland are classic RGM examples. While some of these countries are still banking dominant, most are market dominant in their financial structures and all have significant development in their capital markets.

Figure 12. RGM Structure Size



Source: WDI, Bloomberg, author’s calculation

Financial Structure in the RGMs

The proxy for financial structure is Structure-Size[22] – which equals domestic bank credit to GDP divided by stock market capitalization to GDP (i.e. – higher values imply a more bank based system). In 2000, the structure size ratio for the 25 RGMs averaged 2.2, indicating a financial structure that was heavily bank-based. By 2011, this ratio had fallen sharply to 1.5. The movement toward markets was broad based. Over the better part of a decade, 21 of the 25 RGMs became more market-oriented in structure. This transition to a more capital-oriented structure, not coincidentally, occurred with an enormous improvement in average living standards. From 2000 through 2011, the average per capita income of the RGMs almost tripled, increasing from $5,700 to $15,000.

Chile, Russia, South Africa, Indonesia and India have the most market-oriented financial structures while Vietnam, the Czech Republic, Ukraine and Ghana are the most bank-based. Over the past decade, Thailand and Indonesia have moved the most in becoming market-based economies. At 1.8, China is the only BRIC country with a bank-based structure.

22 While our definition of financial structure does not take into account other financial institutions such as pension funds and insurance companies, they are the most comprehensive set of indicators that have been constructed for a broad cross-section of emerging market economies and cover the most critical aspect of an emerging market’s financial structure.

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IV. Where from Here? A Policy Guide to Deepening Financial Markets in the RGMs

Because the banking sector remains the dominant (in many cases the exclusive) form of credit for businesses in low-income and lower-middle income nations, expanding access to bank credit should be a short and medium-run policy goal for the RGMs at this stage of economic development.

The biggest obstacle to the expansion of bank credit to business enterprises is asymmetric information. Emerging market lenders often possess little if any information on borrowers. The World Bank's "credit depth of information" index (ranging from 0 to 6) measures rules affecting the scope, accessibility, and quality of credit information available through public or private credit registries. A high score indicates the availability of more credit information to facilitate lending decisions. For the RGMs, this average value rose significantly from 2.8 in 2004 (first year available) to 4.7 in 2010. This coincided with an expansion in domestic banking credit (as a share of GDP) of 45 to 69 percent over the same period.

The size of the informal economy in many RGMs is a major cause of the lack of availability of bank credit. Because many emerging market SMEs operate outside the formal sector, most do not report their financial information in any significant or systematic manner. Many have unrecorded income from noncore activities or significant off balance sheet activities. This opaqueness destroys the incentives for banks to make loans (particularly financial intermediaries operating in the formal sector). The literature on ways to mitigate the informal sector is extensive (and will not be discussed here) but reducing business taxes and labor regulations have been shown to successfully reduce its size.

What about bank size? As discussed earlier, large banks tend to ignore SMEs. The average concentration ratio – the ratio of the three largest banks' assets to total banking sector assets – of the 25 RGMs is currently almost two-thirds of total banking assets. For most RGMs, this does not leave many banking assets left for the periphery or smaller institutions. China is the archetypal culprit here (its top four banks control three-quarters of total banking assets). SMEs generate about 65 percent of China's GDP and 80 percent of its jobs but they have received only a fifth of bank loans, according to government estimates.[23]

> It is clear that the Middle Kingdom would benefit enormously by moving to a more market-based system

While some would argue that banks have served China well, at least up to now, in its state-based capitalist model, it is clear that the Middle Kingdom would benefit enormously by moving to a more market-based system. The country's capital account remains tightly controlled, forcing trillions of dollars in savings into the banking system where returns for savers are negative (in real terms). Meanwhile, these hard-earned savings are then channeled to finance inefficient state-owned enterprises and the $1.5 trillion property and local-government debt market at the expense of SMEs. The rapidity to which China can move to a more market-based financial system may be its biggest challenge in the coming years.

The recent financial crisis has once again brought home the problems of "scale" in banking and it makes a strong case for a financial structure where banks are not "too big". The RGM banks have largely escaped the recent financial crisis but that could easily change. In recent years, many RGM banks have reached enormous size both in absolute terms and relative to their national economies. For example, by mid-2012, the 12 largest RGM banks alone had $11.3 trillion in total liabilities, amounting to approximately 50 percent of 2011 RGM GDP. China's top nine banks' total liabilities are 130% of its GDP. Because of systemic risk and contagion, huge banks are considered too big to fail.

23 Financial Times. "Beijing reforms: China's lending laboratory." Simon Rabinovitch. May 22, 2012.

Saving oversized banks, however, can severely damage a country's public finances.

Of the 25 RGMs, 12 have already reached the upper middle-income stage of development. With an average 2011 per capita GDP of almost $10,000, many of them have or are close to reaching a point where a deepening of their security markets will be necessary if they want to eventually progress to the high-income club and avoid the middle-income trap. There are specific institutional characteristics that can quicken the evolution to a more market based financial structure. Three are discussed below.

In developing a securities market, nothing is more critical than protecting investors. The World bank's "Strength of Investor Protection Index" (based on a 0–10 scale) from their Doing Business Survey distinguishes 3 dimensions of investor protections: transparency of related-party transactions (extent of disclosure index), liability for self-dealing (extent of director liability index) and shareholders' ability to sue officers and directors for misconduct (ease of shareholder suits index).[24] The results from the 2011 survey for the 25 RGMs show a very high correlation between protecting equity investors and financial structure (i.e. – the more the protection the more market oriented).

The top five rankings went to Malaysia (8.7), Colombia (8.3), South Africa (8), Thailand (7) and Chile (6.3). With the exception of Thailand all are heavily market based. Vietnam (2.7), UAE (4.3), Argentina and Ukraine (both 4.7) were ranked the lowest in investor protection. All four, not coincidentally, are heavily bank dominant.

Private-sector transparency is indispensable to business, and can be brought about through the use of standards as well as auditing and accounting practices that ensure access to information in a timely manner. The degree of corporate transparency has been an important theme in the economic and financial literature. Public companies that are more open about disclosing their underlying business conditions have been found to trade at higher price-earnings multiples and have lower costs of capital than their peers. The strength of auditing and reporting standards index[25] assesses financial auditing and reporting standards regarding company financial performance (1 = extremely weak; 7 = extremely strong). For the 2011-12 survey, there is a strong negative correlation between auditing and reporting standards and structure size (i.e. – the better the transparency the more market oriented). For example, South Africa and Chile have the first and third highest transparency ratings and score third and first, respectively, in market structure among the RGMs. Conversely, Ukraine and Vietnam are ranked last and third from last in transparency and score third from last and dead last, respectively, in market orientation.

There are large differences among countries in ownership concentration in publicly traded firms. A common element to the explanations of these differences is how well minority investors are protected. The protection of shareholders turns out to be crucial because in many countries expropriation of minority shareholders by the controlling shareholders is extensive. Expropriation can take a variety of forms. In some instances, the managers and controlling shareholders simply steal the profits. Extensive expropriation will eventually undermine the functioning of a market based system and only improving corporate governance – through the legal system – will protect outside investors and restore confidence.

A measure of protection of minority shareholders' interests[26] among the RGMs finds a strong negative correlation. That is, countries with the high scoring protection, like South Africa, Malaysia, Chile and Qatar, generally possess market-oriented financial structures (the UAE is also ranked high but is bank based). Low ranking Ukraine, Argentina, Turkey and the Czech Republic, conversely, are bank based. South Korea is an exception. It scores poorly on protecting minority shareholders but is relatively market based.[27]

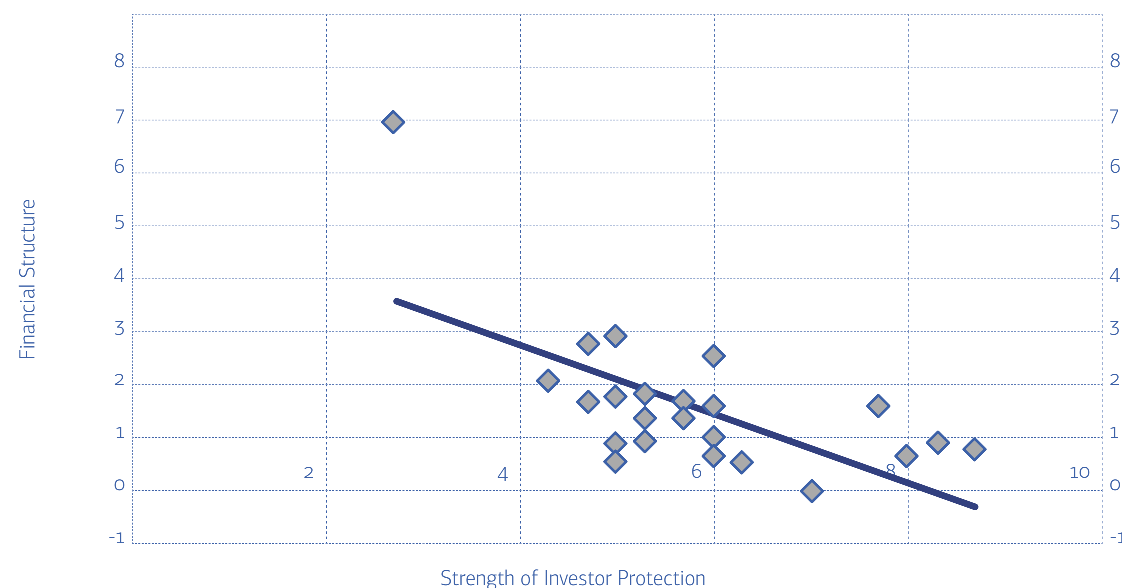
It is no coincident that South Africa has become so well developed financially. It has a perfect score in legal protection for investors and availability of credit information, and is ranked first out of the 25 RGMs in auditing and reporting standards and protection of minority shareholder rights. South Africa's financial services sector, backed by a sound regulatory and legal framework, is superb, boasting dozens of domestic and foreign institutions. Its financial system should be a model for the other RGMs.

It follows that the legal system then is critical in determining a nation's financial structure. Legal protection of investors and the effectiveness in implementing the law are more critical for the operation of financial markets than for banks. Interestingly, this implies that a bank-based financial system will have advantages in countries with a weak legal system.[28]

Interestingly, the most critical attribute in first developing a corporate bond market is possessing a well-developed sovereign debt market. In fact, it is a necessary precondition (there are no exceptions). Government bonds provide investors with valuable price and yield

The most critical attribute in first developing a corporate bond market is possessing a well-developed sovereign debt market

Figure 13. Protecting Investors is good for security market development



Source: World Bank's Doing Business Survey

24 The data come from a survey of corporate and securities lawyers and are based on securities regulations, company laws, civil procedure codes and court rules of evidence.

25 A large executive survey performed by the World Economic Forum.

26 A large executive survey performed by the World Economic Forum to what extent the interests of minority shareholders are protected by the legal system.

27 Last decade Korean authorities had a major crackdown on foreign investment funds that were thought to be dodging local taxes.

28 Lin, Sun, Jiang. "Toward a Theory of Optimal Financial Structure". The World Bank. Sept 2009. P. 6.

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benchmarks for evaluating corporate debt. Governments with large and liquid sovereign debt markets have the wherewithal to develop or deepen their corporate bond markets.

A country's size and level of economic development are also critical elements. Smaller countries lack the scale to normally have a large, liquid government and corporate bond markets. For middle-income countries, the establishment of a local bond market will depend on achieving a minimum level of capacity. The least developed countries, on the other hand, may be able to offer corporate bonds only on an opportunistic or sporadic basis. In these economies, only the largest and most reputable firms may be capable of issuing debt.[29] As a consequence, the large RGMs should focus on building corporate bond markets in the later stages of the financial development process.

29 From "Redefining the Emerging Market Opportunity: Driving Growth through Financial Services Innovation". May 2012. P. 49.

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V. Conclusions

This paper has shown that despite the recent and protracted global financial crisis, there has been a significant degree of financial development in the RGMs over the past decade. This is critical because countries with greater degrees of financial development are strongly linked with faster economic growth. While banks remain the dominant source of finance, emerging stock markets are no longer seen as a legalized form of gambling and are now important sources of finance for emerging market businesses.

This paper makes a strong argument that capital market development is critical if a RGM is to eventually achieve high-income status. This is not to say that the development of the banking system and capital markets are mutually exclusive. The four great powers of the twentieth century rose from different financial structures. The United Kingdom and the United States developed strong market based systems relatively early during their ascendancies while the rise of Japan and German was predominantly financed through their banking systems. Stock markets and banks play different but complementary roles. A healthy banking sector, for example, is crucial to the development of stock exchanges since banks are often a good source of capital for equity investments.

That said, over one-half of emerging market GDP has reached a level of economic development that necessitates a further deepening of their capital markets. A failure to do so will produce yet another generation of emerging markets that fall victim to the middle-income-trap.

And last but not least, there is potentially an enormous dividend that a more market based financial system could foster. As capital markets play a larger role in allocating capital and funding growth, there is increasingly more pressure for economies to adopt and follow market friendly policies. A growing class of equity holders (whether institutional or retail) and "bond vigilantes" will instantly punish any policy decisions that do not embrace free markets. Bank dominated systems, conversely, are not as susceptible to the same sort of market discipline. Over the long run, this could be the best escape from any middle income trap.

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