LIC Financial Sector Challenges

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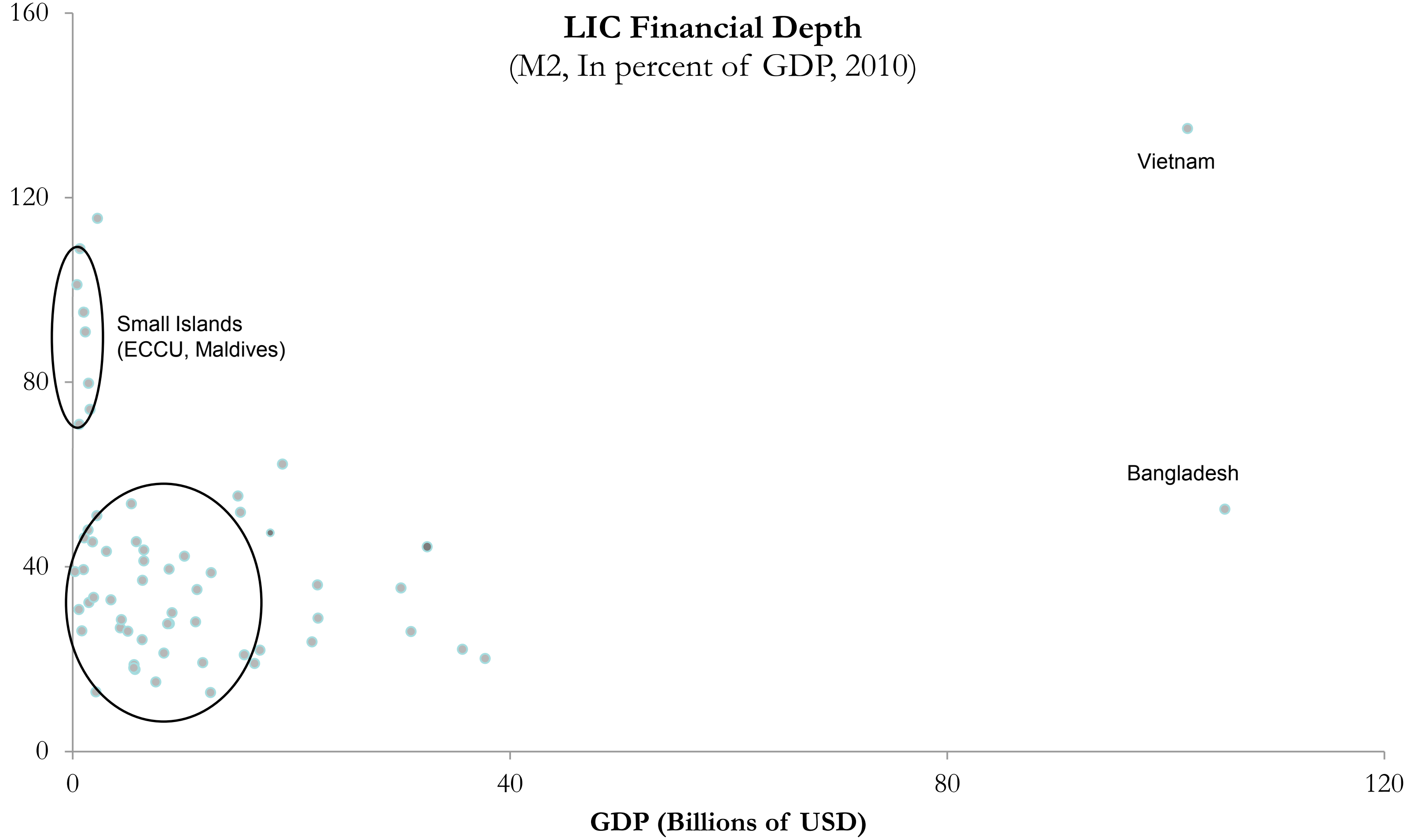
Two Questions

- How does state ownership affect bank and macroeconomic performance?

- What are some preconditions for and risks from capital market development?

LICs: A diverse family…



…but with some common features

- Lower savings and financial development
- Concentrated production and export base
- Higher vulnerability and exposure to external shocks
- Regulatory and supervisory capacity constraints

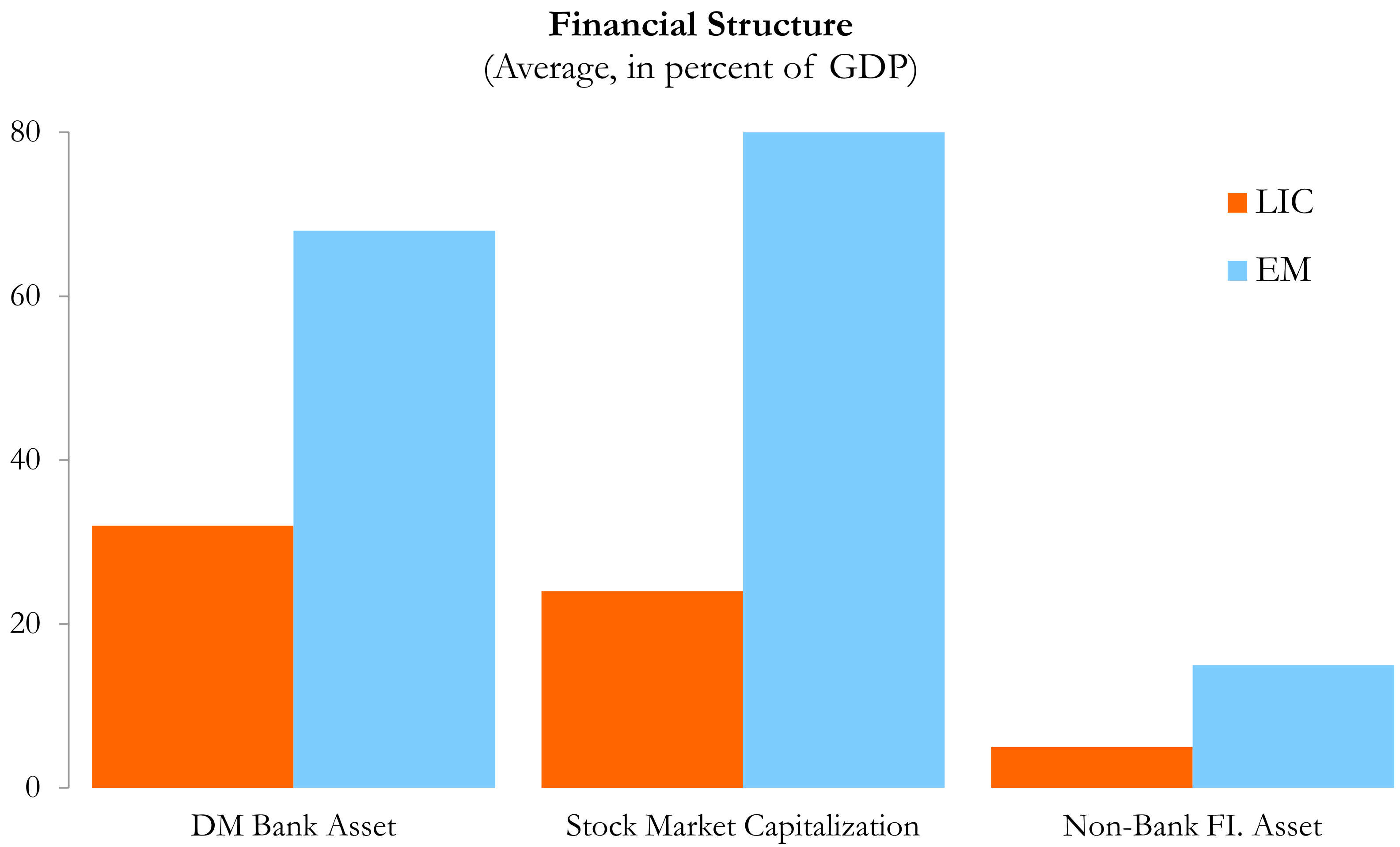
Frequency of Shocks across Country Groups

1970-2008

	LICs		EM		AM	
	Total Number	Probability	Total Number	Probability	Total Number	Probability
Terms of Trade Shock	453	17.2	160	9.6	45	3.8
Reversals of Capital Flows	405	15.4	141	8.5	46	3.9
Currency crisis	99	3.8	69	4.1	13	1.1

Source: IMF (2011)

LIC financial systems are primarily bank-based

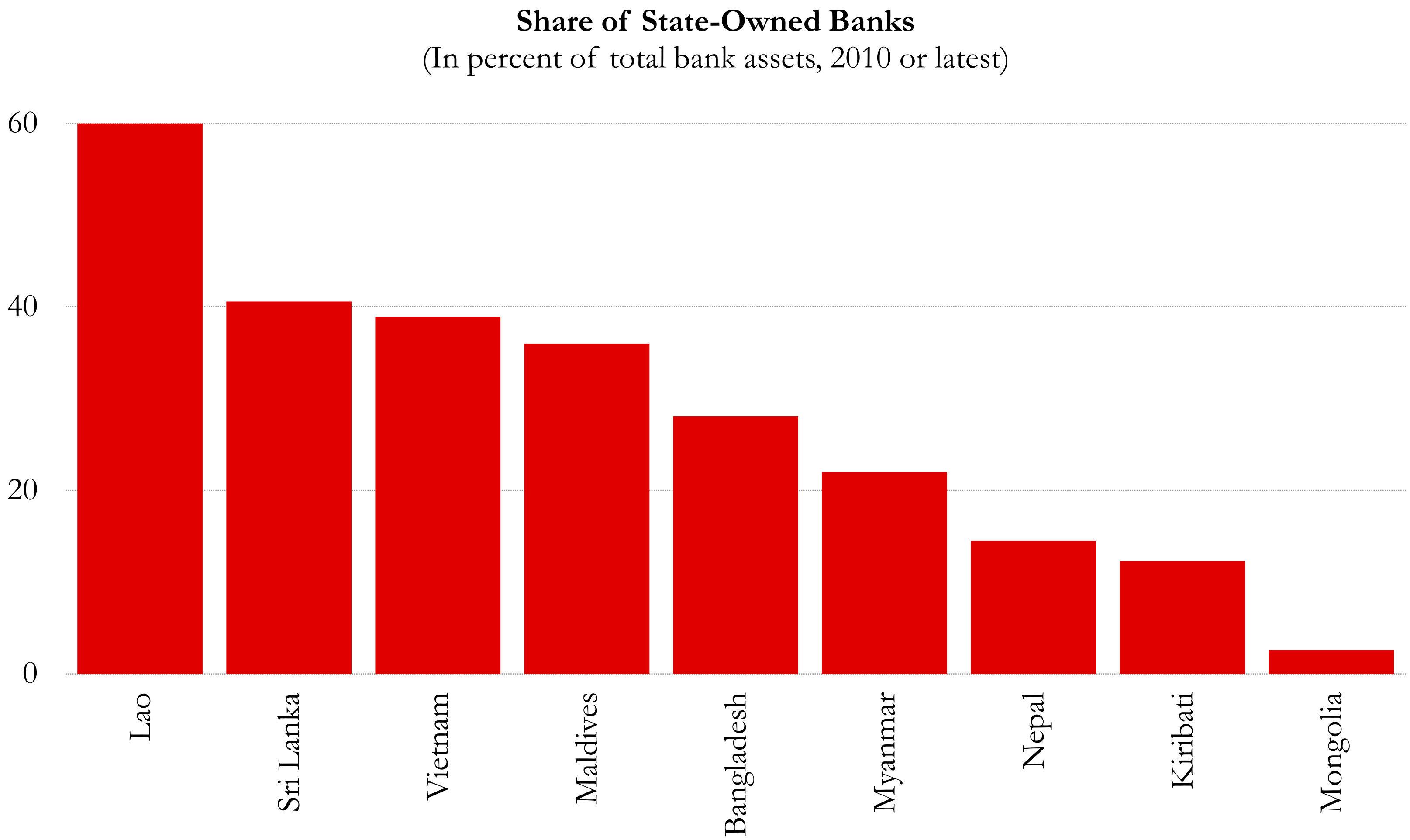


First Question: Impact of state ownership of banks on

1. Growth:
    - Negative in LICs (Micco et al. 2007)
    - ↑ 10 pct points in state ownership => ↓ GDPPC growth by 0.12 pct
2. Bank performance:
    - ↓ROA; ↓ Interest Margin; ↑Overhead Cost
3. The quality of financial sector reform (adverse)
4. Monetary policy transmission (weaken)

Asian LICs have sizable presence of state-owned banks

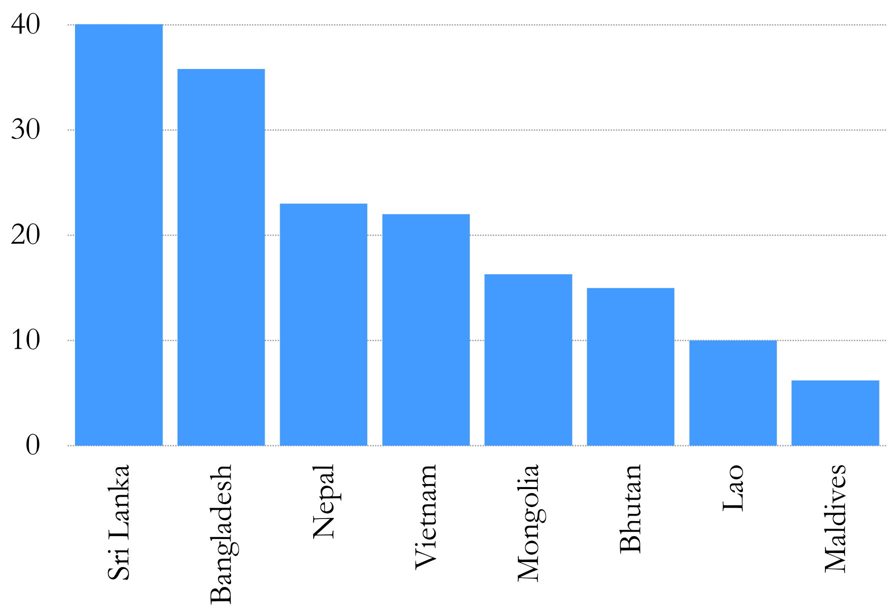
(mostly with lower capitalization and asset quality)



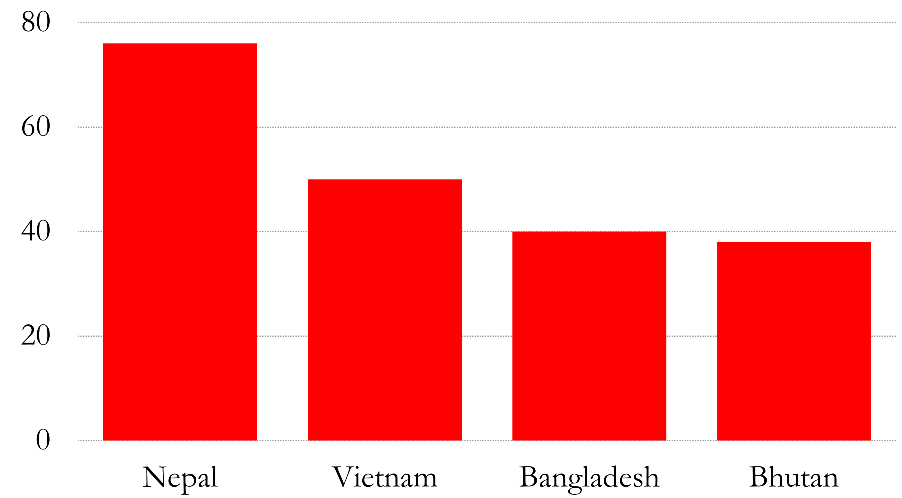
Second Question on Capital Market: Growing but episodic intermediation through the stock markets

(with financial stability implications given inter-linkages with banks)

Stock Market Capitalization
(In percent of GDP, 2010 or latest)



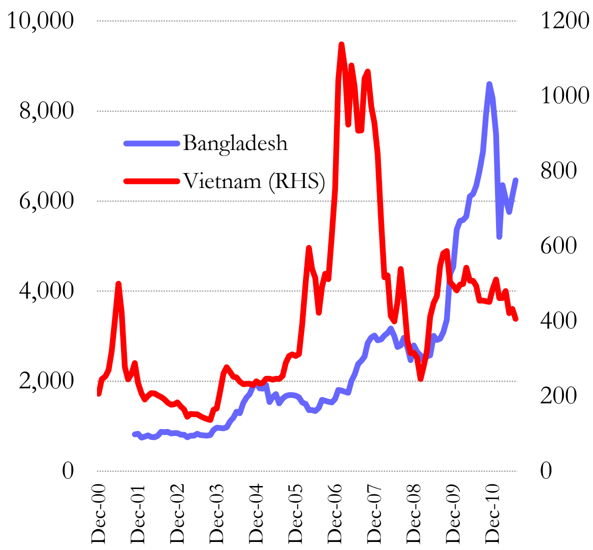
Share of Market Cap Issued by Fin Inst.
(In percent of total market cap, 2010 or latest)



A Tale of Two Stock Markets: Bangladesh &Vietnam

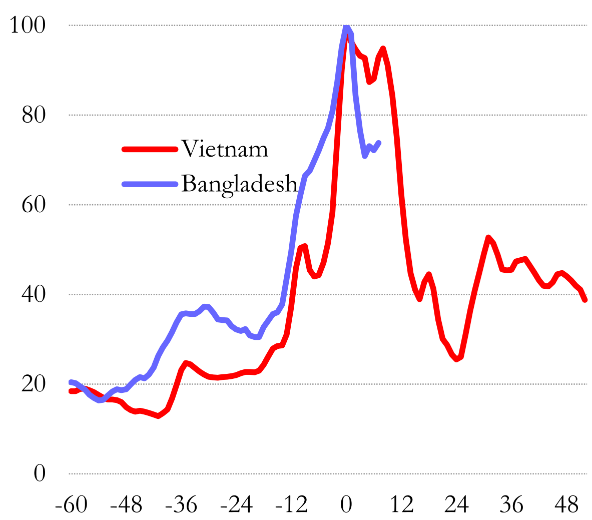
This tale shows the large swings in LIC stock markets, raising financial stability risks and stressing the need for improving regulation and supervisory coordination.

Stock Price Index



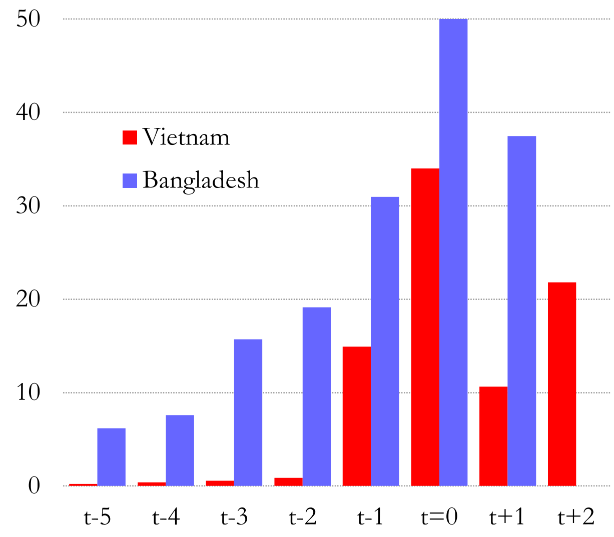
Bubble Dynamics

(In months, peak: 100 at t = 0, VNM: Feb'07; BGD: Nov '10, 3mma)



Market Capitalization

(In pct of GDP, peak t = 0; BGD '10; VNM '07)



A Tale of Two Bond Markets: Ghana & Kenya

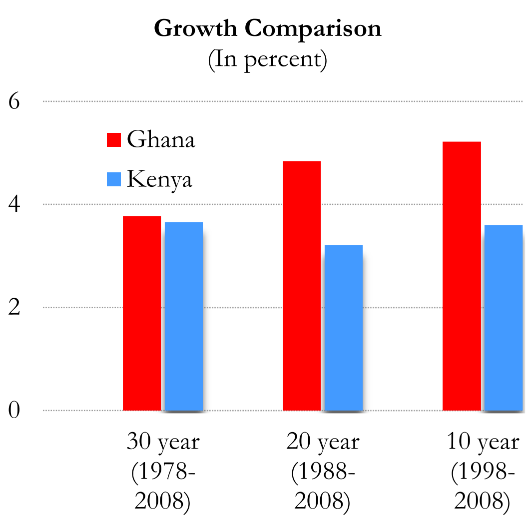
This tale shows how sound macro policies—in some cases, more than growth—are critical to develop a broader investor base and thus a more functional bond market, as in Kenya.

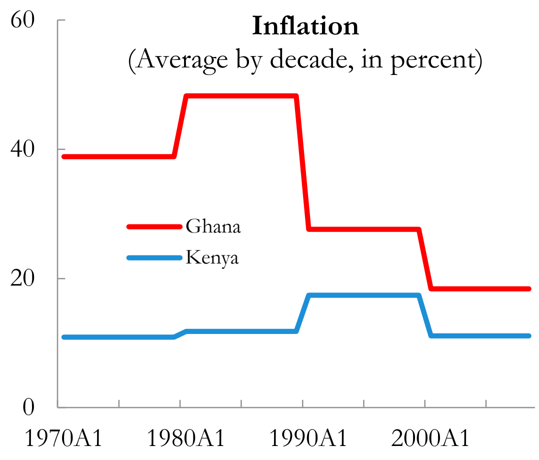
Debt Market Structure

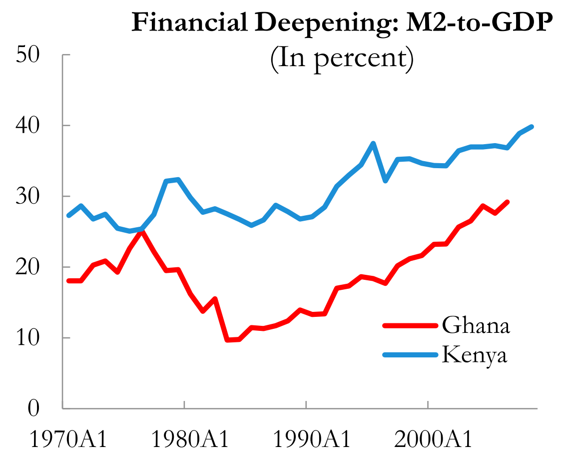
	Government			Corporate
	Stock (In pct of GDP)	Maturity (In years) Avg.	Maturity (In years) Max.	Stock (In pct of GDP)
Ghana	32	1	5	0.03
Kenya	22	5	20	2

Size and Quality of Investor Base

	Investor Base (Asset, In percent of GDP)			Bank Indicators (In percent)	
	Bank	Pension	Insurance	NPL	State Ownership
Ghana	57	14	3	17	30
Kenya	56	23	7	8	4







Conclusion

- In the bank-dominant LIC financial system, it is critical to *safeguard bank soundness, including by improving supervision and reducing interferences in lending decisions* as often seen in state-owned banks.

- Financial stability risks need to be minimized by *strengthening the quality of and the coordination among banking and capital market supervisory agencies* given the nexus between banks and capital markets.

- A track record of *sound macro policies complemented with a proactive market development approach* (e.g., promoting pension and insurance industries; debt management) can widen the investor base and deepen bond market.

- Given growing global financial integration of LICs, the *impact of monetary and exchange rate policies on capital markets needs to be closely evaluated*.

Thank You.