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Introduction

This paper provides stylized facts with respect to the relationships among financial liberalization, economic growth, stability, and financial market development, with a focus on emerging countries and particularly on Latin American and Caribbean countries in the context of the increasing use of the domestic currency in emerging markets and the issue of access to finance.

Since the crisis of the late 1990s and early 2000s, many emerging market countries have directed greater attention and support toward developing domestic financial markets with long-term view and also to permit access to finance to various segments of the population as well as to entrepreneurs in the Schumpeterian sense\(^1\). This stance is mainly centered on better prudential regulation and professional management of government debt and bonds. It is different from the past, when emerging market economies relied on financial liberalization to access foreign rather than domestic markets for selected entities including the government, state–owned enterprises and big corporations. This new approach significantly changes the impact of financial liberalization on economic growth, financial sector development, and vulnerability to financial crises.

The models of economic growth constitute a starting point for the analysis. Solow’s model\(^2\)—in line with the neoclassical view of the loanable theory of funds—does not make reference to the role of the financial system and how investments would be financed. By putting emphasis on savings and investment, Solow’s model leads to giving the government a bigger role, in the sense of justifying the government’s intervention to undertake investments that permit the takeoff of the economy and “convergence.” In turn, this type of policy has led to central planning and to a number of restrictive measures that go under the term financial repression, and also include a great role for state-owned enterprises and publicly owned banks. Conversely, following Schumpeter\(^3\), the financial system constitutes an essential part of development and is instrumental to the deployment of entrepreneurship. The endogenous growth

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\(^1\) According to Schumpeter, Joseph Schumpeter, The Theory of Economic Development (New Brunswick, N.J.: Transaction Publishers, 1934) the entrepreneur is someone who carries out “new combinations” by such things as introducing new products or processes, identifying new export markets or sources of supply, or creating new types of organization.


\(^3\) Joseph Schumpeter, op.cit.
theory and Schumpeter’s work are the basis for policies that allow the private sector and an entrepreneur to carry out his or her “innovations,” which are the engine of growth and reduce the interference of the government in the economy. The government’s role is to ensure that the institutional setting, e.g., property rights and the rule of law do not hamper the positive force of entrepreneurship. The evolution towards a more democratic view of access to finance has then led among other things to the theory and practice of lending and financing for micro enterprises.

In this context, financial liberalization represents a key strategy, which has an impact on economic growth and development, vulnerability to financial crises, and domestic financial and capital market development. This paper proceeds as follows: the next, second section covers the definitions of financial repression—with particular attention to the role of public sector banks—and liberalization; the third section revisits the issues of economic growth and financial liberalization; the fourth section explores the links between financial liberalization and financial crises; the fifth section articulates the relationship between financial liberalization and domestic financial markets; the sixth section focuses on financial stability and the seventh concludes.

The figure shows an increasing number of investigations reports during FY2003-FY2007. The number of reports for investigations in this period is significantly higher than the number of management reports, grant and contract audit reports. The highest increase occurred in FY2007 when there were 1,006 investigation reports, which represents an increase of 214% in relation to FY2006. The number of grant and contract audit reports are second in terms of increasing number of reports. They have been modestly growing, reaching their highest number in FY2006 when there were 304 grant and contract audit reports, which represents an increase of 132% in comparison to FY2005. Management reports show a slight variance during FY2003 - FY2007. Their highest variance and increase occurred in FY2004 when there were 125 management reports which represents and increase of 187% in relation to FY2003.

Financial Repression and Financial Liberalization

Articulating the characteristics of the government’s intervention in financial markets—and particularly the role that public sector banks play in that context—permit us to gain a better understanding of the role of financial liberalization.

Financial Repression

McKinnon and Shaw pointed out the reality of extensive government interventions—mostly in emerging market countries—in financial markets. They characterized these interventions as “financial repression,” in which the government, in place of the market, makes a series of decisions with regard to the

- Allocation of credit to given “clients”;
- Determination of interest rates and “interest rate ceilings”;

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• Mandatory reserve requirement in the amount and type of reserves (e.g., government paper);
• Entry of new institutions into the credit market;
• Creation of state-owned financial institutions;
• Control of the “capital account,” i.e., lending and borrowing abroad are subject to specific authorizations.

In addition to these types of decisions, the government may also—directly or indirectly—determine several operational aspects of banking activities, e.g., hiring, opening of branches, and salaries.

The practices of government intervention are based on the theory of the “developmental state view” (Amsden; Wade), which works on the assumption that market failure is pervasive and recommends that the government take direct action in financial markets by creating a government-run financial sector. Hence, government intervention is necessary to mobilize savings and to allocate resources efficiently to catch up with developed economies. Wade believes that government intervention increases savings and enables them to be used for developmental and industrial purposes. Amsden asserts that subsidies are critical to encourage investments and also to support export-oriented strategies to deal with currency devaluation by competitors and importing countries. The developmental state view gives the government the explicit responsibility for resource allocation decisions and was the theoretical basis for many government interventions in the 1970s and 1980s.

The motivation of providing finance for development mainly implied making financial resources available for the central government and other related entities.

**Public Sector Banks and Financial Market Development**

Within the scope of government intervention in the economy and as part of financial repression, the role of public sector banks constitutes an important instrument that respond to failures of private markets of providing financing for economic activities that would lead to economic growth.

Domestic public sector banks are intended to play the role of providing finance for development. At the international level, Multilateral development banks (MDBs) – like the World Bank- are expected to provide long term financial resources given the low domestic savings that emerging countries would not find available in the private international markets.

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7 Government ownership of banks constitutes a major phenomenon worldwide. In 2000, the average proportion of state ownership in the banking industry around the world was about 35 percent. This share was even larger during the 1970s, when more than 50 percent of worldwide bank assets were controlled by the public sector. Ideological changes regarding the state’s role in the economy, as well as financial crises, led governments to privatize financial institutions.

8 Wade, op cit.

9 Amsden op. cit.
Most of the literature on the state ownership of banks focuses on development and also on commercial banks, or a blend of the two. However, these are very different types of institutions. Research has shown that state-owned development banks tend to have low profitability, and their return on assets tends to be lower than that of private banks. For Latin America, this is particularly true in countries such as Guatemala, Chile, Mexico, and Colombia. In Brazil and Peru, however, no major difference exists between the profitability of development banks and that of private commercial banks (e.g., this could be due to the fact that development banks have a lower cost of funds); and in El Salvador and Bolivia, development banks seem to be more profitable than private commercial banks. It should be noted that there are developmental banks, e.g., Kreditanstalt für Wiederaufbau (KfW) that operate effectively.

Following the work of La Porta, López-de-Silanes, and Shleifer, Galindo, Micco, and Panizza studied public bank performance—including commercial and development banks—relative to that of privately owned banks. Public sector banks charge lower interest rates than their private counterparts (e.g., this is consistent with Sapienza), and they also pay lower interest rates on their deposits (e.g., 90 basis points less than private banks). Public banks tend to lend more to the public sector, i.e., the difference between the share of public sector loans of private and public banks is 8 percentage points; and they also tend to have a higher share of nonperforming loans, i.e., about 8 percentage points. Finally, public banks are less profitable than private entities, i.e., the difference in returns on assets is 0.4 percentage points.

The results presented above should be taken with some caution. They suggest that while public sector banks tend to be less efficient than their private counterparts and—with more nonperforming loans, more loans to the public sector, higher overhead, and lower returns—they are perceived to be able to address in some cases market failures and to be safer (i.e., government is the ultimate guarantor), to be able to lend in a countercyclical fashion, and hence to be able to pay lower rates on their deposits and extend credit at a lower rate. An alternative explanation is that state-owned banks may benefit from indirect subsidies coming from government deposits, paying low interest rates or no interest.

On an efficiency basis, public sector banks—both development banks and commercial banks—do not perform as well as private sector banks. This is clearly an important limitation in that public sector banks do not exercise the function of allocating credit according to efficiency criteria, rewarding the “creative destruction” of the Schumpeterian entrepreneur, and

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13 Lending and support to public sector banks that are underperforming relative to private banks is tantamount to supporting inefficiencies and allocating credit that does not respond to efficiency criteria. Moreover, the existence of large public sector banks has another negative impact on financial market development. The existence of public banks requires the national budget to allocate funds to replenish the national development bank and also requires the government—or the domestic development banks directly, with the guarantee of the government—to issue bonds on the domestic capital market to raise funds.

therefore miss opportunities to finance growth. In turn, the presence of public sector banks limits the development of a healthy financial market that responds to market prices and incentives.

From the point of view of political economy, the government’s intervention in financial markets favors a number of players—e.g., big companies, state-owned banks themselves, and bureaucracy allowing them to have access to finance for developmental purposes—and also sets incentives for obtaining jobs in well-paying positions in those banks. In all circumstances, these players would resist changes and the elimination of interventions.

**Financial Liberalization**

Financial liberalization is defined as the removal of government intervention from financial markets. Liberalization includes eliminating the restrictions listed in the previous section—bank interest rate ceilings; compulsory reserve requirements; barriers to entry, particularly foreign financial intermediaries; and credit allocation decisions. These policies reduce the government’s interference in financial markets, leading to the privatizing of state-owned banks; introducing the convertibility of the currency on the capital account (i.e., capital account liberalization); improving prudential regulation; and promoting local stock markets. In the past three decades, both industrial and emerging market countries have moved toward this form of liberalization of their financial systems (see Figure 1, which is from Galindo, Micco and Panizza\(^\text{14}\)).

Research and experience show that financial liberalization has two main effects, which can have both benefits and costs. Liberalization can lead to faster economic growth. But it can

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**Figure 1: Financial Liberalization**

Note: The index plots the simple average of liberalization in the capital account, the domestic financial system, and the stock market. This measures ranges from 1 to 3, where 3 is full liberalization. The Average Liberalization Index in the graph is the simple average of the liberalization measure across countries in each year.

Source: Financial Liberalization is based on the indicators developed in Kaminsky and Schmukler (2003) and authors’ updates of this index.

\(^\text{14}\) Galindo et al. op. cit.
also increase the financial vulnerability of a country, even leading to a financial crisis.

**Financial Liberalization and Economic Growth**

The justification for government intervention in financial markets in the forms of financial repression and direct intervention through public sector banks - based on their assumed market failure- in line with a more or less stringent command economy, is that the government can direct resources to encourage the takeoff of the country and concentrate those resources in sectors and companies that favor economic growth and development.\(^{15}\)

However, financial repression has several negative effects on economic growth, which McKinnon\(^{16}\) and Shaw\(^{17}\), among others, have pointed out:

- Administrative interest rates would undervalue real interest rates, give an incentive to reduce savings and investment, and have a negative impact on the rate of economic growth.
- Individuals would find ways to export capital abroad (capital flight), creating pressure on the exchange rate.
- Administrative determination of credit—not established by the market price—would lead to an inefficient allocation of resources. This “bad” allocation would compound the negative impact on growth because the most promising investments would not get financed and therefore would not contribute to economic growth.
- Access to credit was granted for developmental purposes to big state owned and private companies, while the rest of the economy started to have some access to consumer credit.

The expected benefits of financial liberalization—and particularly a liberalized capital account—are the ability to undertake investments in excess of the level of domestic savings (which is especially important for Latin American countries with low savings rates) and finance economic growth; the technology transfers associated with foreign direct investment; and the increased competition in the financial sector due to the removal of barriers and also as a result of the entry of foreign banks. Conversely, the abolition of financial repression and the reduction or elimination of public sector banks stimulate competition, and market based allocation of credit, domestic savings, investment, and growth.

Therefore, by favoring financial development, financial liberalization increases the long-run growth rate of the economy. King and Levine\(^{18}\) link financial market development to the insights of Schumpeter\(^{19}\) about the role of finance in encouraging entrepreneurship.


\(^{16}\) McKinnon, op. cit.

\(^{17}\) Shaw, op. cit.


\(^{19}\) Schumpeter, op. cit.
The process of liberalization also implies that foreign banks can enter the domestic market of an emerging market country by establishing branches as well as acquiring existing domestic banks. According to the literature, the entry of foreign banks leads to various positive effects, including advances in technology, and ultimately increases competition within the financial systems. The entry of foreign banks, particularly in Latin America, has been beneficial in many respects. However, it has not improved the overall access to finance for various segments of the population, particularly small and medium-sized enterprises (SMEs), and individuals who want to perform the function of the Schumpeterian entrepreneur (see Claessens, Demirgüç-Kunt, and Huizinga20; Clarke et al21; and Moreno and Villar22). In some countries (e.g., Brazil), public sector banks, such as the Banco Nacional de Desenvolvimento Econômico e Social (BNDES), perform the function of lending to SMEs (see Morais23).

On the relationship between financial development and economic growth, McKinnon’s and Shaw’s analyses of financial repression as well as the “conditionality” of international financial institutions, such as the International Monetary Fund and the World Bank prompted a number of reforms in various countries. However, the expectation that financial liberalization would bring competition and access to finance has not fully materialized also considering that banks tend to lend to known risks and the various international requirements – e.g., Basle 1 and 2- as well as the strengthened supervision have not favored lending to SMEs. Financial repression has also prompted a sizable amount of research, which focuses on the role of financial development in giving a lift to economic activity by accelerating productivity, as well as by mobilizing savings.

A large number of empirical studies have been undertaken on the relationship between financial development and growth and they have concluded that the relevant ratios measuring financial market development—e.g., private sector credit /gross domestic product (GDP); stock market capitalization /GDP, and total stock market value traded/GDP and M2/GDP—are positively correlated with both growth rates of GDP.

Financial Liberalization and Financial Crises

Stability and financial crises represent the other side of financial liberalization. Opponents of financial liberalization argue that it would lead to financial crises (Caprio and Summers24; Stiglitz25). The opening of the current account may favor excessive borrowing—at

both the government and corporate levels—at an initial overvalued exchange rate (e.g., Argentina in the 1990s) that, if it cannot be sustained with growth, will prompt a financial crisis in which the excessive borrowing has to be repaid at a devaluated exchange rate. Glick and Hutchinson\(^{26}\) argue that banking and currencies crises constitute a phenomenon that is concentrated in financially liberalized emerging markets and does appear to emerge in advanced economies. In this respect, they suggest that banking crises provide leading information about the possibility of currency crises (i.e., foreign exchange), while currency crises do not constitute a leading indicator of banking crises. Following the previous literature, Glick and Hutchinson\(^{27}\) suggest that currency devaluation is a rational policy option to reduce bank runs in a country with a fixed exchange rate; and that bank crises are prompted by moral hazard, financial liberalization that makes foreign borrowing easier, and large macroeconomic shocks, e.g., a crash in assets prices.

In the 1980s and 1990s, following widespread financial liberalization, several industrial and emerging market countries witnessed financial fragility and crises. In Chile, in 1981, banking sector problems emerged shortly after the financial sector was deregulated. Argentina—a country that had undertaken far-reaching financial liberalization measures—in 2001 faced one of the most devastating financial crises in its history.

**Evaluation of Financial Liberalization**

While the predominant view is that financial liberalization—i.e., the removal of government intervention in the financial markets—spurs economic development and growth, an alternative analysis is taken against neoliberal policies and financial liberalization (see Eichengreen\(^{28}\)). Stiglitz\(^{29}\) argues that endemic information asymmetries in the financial markets will not be solved by financial liberalization. Stallings and Studart\(^{30}\) look at the ownership of banks (including foreign banks), performance, and institutions—not otherwise defined—and assert that the performance of the banking sector and of public sector banks, particularly in Latin America,\(^{31}\) depends on the strength of institutions. Crotty and Lee\(^{32}\), and Singh and Weisse\(^{33}\), refer to the South Korean experience. They argue that the economic and neoliberal reforms—undertaken in South Korea both before and after the 1997 crises—have replaced the traditional


\(^{27}\) Reuven Glick, and Michael Hutchinson, op. cit.


\(^{31}\) “Public banks can perform well according to commonly used indicators – but only if the country institutional framework is strong” (Stallings with Studart 2006, 80).


South Korean model of a state-led, bank-based financial system, leading to financial restructuring with continuous corporate problems and a declining rate of capital accumulation. An alternative strategy of a reform of state-led, banks-based growth that is thoroughly democratized would have left the South Korean economy better off. This approach is advocated for other emerging market countries.

A number of factors influence the fragility of the financial system, e.g., macroeconomic and fiscal policies, vulnerability to balance-of-payments crises, the flexibility of factors of production, and particularly labor markets. Financial liberalization has a negative impact on the stability of the banking sector, and the magnitude of this effect depends on the other weaknesses in the economy, including those mentioned above.

Under these circumstances, a solid regulatory and supervisory environment (Stiglitz\textsuperscript{34})—particularly for the banking sector—mitigates the effects of financial liberalization, for example, by putting constraints on lending to already-overleveraged corporations and preventing moral hazard. The legal environment—e.g., effective law enforcement, transparency and disclosure, an efficient bureaucracy, and negligible corruption—can contain the adverse effects of liberalization on the financial system.

These considerations lead to the policy recommendation that the objective of financial sector development should be pursued following some sequencing (see World Bank\textsuperscript{35}, 2005, chapter 12). In that context, macroeconomic stabilization and fiscal discipline, as well as labor market reform, should be initiated before financial liberalization is implemented. By the same token, strong and independent banking supervision of financial intermediaries should accompany financial liberalization (Karacadag, Sundararajan, and Elliott\textsuperscript{36}).

Given that institutions require time to make effective changes and adjust to them, financial liberalization process should be considered in the context of an overall strategy for domestic financial market development and should be gradual. Policymakers may weigh the positive effects of liberalization on financial development and economic growth against the negative effects of a banking crisis. In this respect, an improper sequence of reforms can lead to banking and debt crises and to disintermediation, thus undoing the potential benefits on the side of economic growth.

Research seems to suggest that countries coming from a background of financial repression have greater gains on the front of financial development and growth that surpass the losses from possible financial crises (Demirgüç-Kunt and Detragiache\textsuperscript{37}). The “gradalist” approach to reform has to be considered on a case-by-case basis, taking into consideration the

\textsuperscript{34} Stiglitz, Capital Market Liberalization, Economic Growth and Instability, op. cit.
political economy of the country and to what extent a gradual process of reform can be captured—or reversed—by those who would suffer most from the financial liberalization.

**Financial Liberalization and Domestic Financial Markets**

Financial liberalization is also expected to discipline excessive dependence on foreign capital flows by developing domestic financial markets. This “requirement” has caught some attention of researchers and policymakers in the process of financial liberalization. Research has been looking at financial liberalization as a positive for economic growth and as a risk for crisis. Kose and others show that developing countries benefit from financial liberalization with many nuances and that financial liberalization and globalization do not lead to financial crises. As these scholars point out, there are many more nuances, which they call collateral benefits, and there are also “threshold conditions,” above which financial globalization is leading to increased productivity and growth (see IMF).

IMF argues, “over the medium term—a more developed domestic financial market increases the volume and helps reduce the volatility of capital flows to emerging markets. Specifically, the estimation results find that, although growth is the primary determinant of the level of capital inflows, equity market liquidity and financial openness also help attract capital inflows. Moreover, financial openness is associated with lower capital inflow volatility. These results, which are consistent with the views expressed by institutional investors, point to the advantages of focusing on the medium-term goal of improving the quality of domestic financial markets. By adopting such a focus, emerging market countries will be in a better position to maximize the benefits of capital inflows while dealing with their potential volatility.”

The main reason for financial liberalization is to allow market forces to operate and create the conditions for an integrated global financial market, which nurtures a solid domestic financial market. While embarking on financial liberalization in the 1990s, most countries—and particularly those in Latin America—were still heavily relying on external savings and external borrowing rather than the long-term market in domestic currency. In fact, capital account convertibility allowed companies and banks to borrow in foreign currency—following the encouragement of lenders who thought they would get out before the crisis struck, if

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conditions worsened. Most of the banking lending was short term, and the bond market—both for government and corporations—was nonexistent.

**Domestic Currency and Capital Markets**

The crises of Mexico in 1994–95, the East Asian meltdown of 1997, and the subsequent crises in Russia and Latin America (i.e., in Argentina and to a lesser extent Brazil) have exposed the balance sheet weaknesses due to currency mismatches as “countries cannot borrow abroad in their own currencies, a fact that we refer to as “original sin.””

Aizenman, Pinto, and Radziwill suggest a “self-financing” ratio as a measure of the financing of the domestic capital stock; i.e., a ratio of 1 means that the domestic capital stock is entirely financed domestically. These researchers also find evidence that emerging market countries with a higher self-financing ratio (e.g., Asian countries) grew faster than countries with a low self-financing ratio (e.g., Latin America) relying on foreign sources.

In the last several years, and focusing particularly on the Latin America and the Caribbean region, there has been a significant improvement of external and internal macroeconomic and fiscal conditions, especially in the management of government debt. Several indicators—external debt service as a proportion of exports or interest payments, public debt as a proportion of tax revenues, public debt as a proportion of GDP—point in the positive direction. Under these circumstances, and following the lessons of the crises of the late 1990s early 2000s, Latin American countries—like Asian countries—show a strong commitment to develop domestic financial markets in domestic currency with long-term tenure and to increase the self-financing ratio.

According to the Bank for International Settlements, domestic bond markets for government debt have grown substantially in selected countries and in Latin America, i.e., the outstanding stock exceeds, in 2006, US$ 4 trillions compared with 2US$ 1 trillion of 1995 (see Committee on the Global Financial System, 2007, pp.2-3). Domestic debt issued by the seven largest countries in the region increased by 166 percent during the period 1995–2005, reaching the level of $850 billion. Short-term debt of the public sector in domestic currency has declined, but it is still high (about 45 percent for the region overall) and is therefore exposed to various risks: exchange rate, interest rate, and inflation. However, several emerging market countries—particularly those that are more advanced—have made substantial progress in

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44 With respect to Asia, following the crises, the financial authorities in the Asian countries affected by the crisis (e.g., Thailand) took severe measures to redress the unbalance of the financial system, giving priority to the development of domestic bond market.
45 The reasoning along the line of the self-financing ratio is equivalent to the argument of Stiglitz (2000, 1080–82) that borrowing abroad implies a high cost for developing countries. The lack of viable domestic capital markets could strengthen the “developmental view” arguing that the government—and public sector banks—would be the right policy to assure a self-financing ratio close of 1.
46 For Asia, the rise for the same period is around 400 percent.
developing their domestic government bond markets with longer maturities. Solid government yield curves—nominal and also liquid—of up to 20 years exist in many countries in Asia and Latin America (e.g., Colombia, South Korea, Thailand, Mexico, and Brazil). Countries have reduced currency and maturity mismatches and moved out of U.S. dollar liabilities and toward longer-term, domestic, and increasingly fixed maturities in domestic markets, reducing the vulnerability associated with refinancing risk. Standard and Poor’s, for instance, indicates that the better ratings for Chile (January 2004), Brazil (September 2004), and Mexico (January 2005) were positively influenced by the proportional increase of the ratio of financing in domestic currency to total debt—i.e., debt in foreign currency declined.

Overall, as the Committee on the Global Financial System indicates local currency bond markets helps financial stability.

Cifuentes, Desormeaux, and Gonzalez and Jeanneau and Verdia offer substantial contributions for the cases of Chile and Mexico, respectively, about the passage from financial repression to more complete financial markets.

Although the excess borrowing of government remains a problem and a significant part of government paper is still short term, the control of inflation, fiscal discipline, and stable and predictable macroeconomic policies represent noteworthy achievements in many emerging market countries. Under these circumstances, emerging market countries’ government bonds are of increasing interest to foreign investors, who buy such countries’ global and domestic issues.

Vulnerabilities still exist in connection with the significant portion of debt denominated in foreign currencies, and with the large short-term share of public debt. Also, a devaluation of the domestic currency would prompt an increase in interest rates and in the cost of debt in domestic currency and a decline in the prices of government paper. These vulnerabilities are even more significant if we consider that an increasingly large portion of domestic debt is sold to foreign investors, who would react negatively (e.g., by selling the government paper) in case of incipient crises and thus exacerbate problems.

**Domestic Currency Financing and the Banking Sector**

The impact of the increased use of the domestic currency on financial stability deserves increased attention also in relation to the differential treatment that the new Basel II capital establishes for banks with respect to exposure in domestic or foreign currency. This is also important for the rating agencies, which normally assign better ratings to credits in domestic currency than in foreign currency.

Financial strengthening is evident in many emerging market countries and particularly in Latin American countries. This improved situation derives from the reforms undertaken,

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47 Market trading in domestic bonds is still low (e.g., $152 billion for Mexico, which is the highest).
50 Many emerging countries benefit from a consistently high price of commodities.
especially in the regulatory and supervision environment undertaken at global and national levels, e.g., observance of Basel I and II, the Financial Action Task Force, the International Financial Reporting Standards, and the Core Principles for Banking Supervision, as well as International Organization of Securities Commissions principles and the Financial Sector Assessment Program. Balance sheet and market indicators are positive, and asset quality, profitability, and loan loss coverage improved.

On average, the financial soundness indicators for many emerging market countries are good and comparable to those in industrial economies. For instance, for Latin America, in 2005, nonperforming loans were at the level of 5 percent; the return on assets for banks was 1.9 percent, and the return on equity was 18.6 percent. However, on average, financial intermediation in the Latin American and Caribbean countries is stagnating, and bank intermediation is low compared to that in other regions:

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<th>M2/GDP (percent)</th>
<th>Private loans/GDP (percent)</th>
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<tbody>
<tr>
<td>Latin America</td>
<td>35.4</td>
<td>25.1</td>
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<tr>
<td>Advanced economies</td>
<td>111.2</td>
<td>86.1</td>
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<tr>
<td>Selected emerging markets</td>
<td>89.5</td>
<td>90.0</td>
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In 2007, some of these indicators have improved for selected emerging markets. Moreover, the interest rate spread—on average—in Latin America and the Caribbean is about 6 percent, while it is 3 percent in Europe and 2 percent in Asia.

In addition, the Latin American and Caribbean region has not so far witnessed a solid long-term capital market development in domestic currency, which is much more under way in Asia than in Latin America and the Caribbean. In 2007, stock market capitalization in selected Asian countries represents almost 100% of GDP, while in Latin America remains below 60%. Several countries still depend on long-term external financing. In turn, this may spin a recession and a deterioration of payments of the public and private sectors, affecting the willingness and ability to pay as well as the ratings assigned. Moreover, a large part of the population in Latin America and the Caribbean does not have access to financial services.

The development of domestic financial currency as a primary source of financing is expected to open lending opportunities for banks, improve access to finance, and have a crucial impact on the improvement of the ability to pay that would reinforce the financial systems. An advance in this direction would favor the implementation of Basel II, generating more efficient financial markets.

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52 The Federal Reserve Board of the United States defines Basel II as an effort by international banking supervisors to update the original international bank capital accord (Basel I), which has been in effect since 1988. The Basel Committee on Banking Supervision, on which the United States serves as a participating member, developed Basel II. The revised accord aims to improve the consistency of capital regulations internationally, make regulatory
With respect to sovereign and interbank exposures, the need for capital would be reduced. Banks would have more incentives to lend to a large array of clients and deepen the financial system. From the point of view of the exposure of the private sector, a positive impact is that in the case of the depreciation of the domestic currency, debtors would not be exposed to a deterioration in the domestic currency and thus a deterioration in the indicators of solvency (e.g., the ability to pay could even be improved at the aggregate level).

Under these circumstances, financial systems would be less exposed to traditional systemic crises. Unfavorable international conditions (e.g., falling prices of primary goods) would have an impact on the exchange rate and domestic interest rates. Fiscal discipline, public debt management, and a prudent monetary policy will be necessary for consolidating macroeconomic stability and avoiding bank runs in the case of a crisis. Under these new circumstances, it is conceivable that the domestic financial system would face cases of banking insolvency rather than generalized crises that can be solved according to the Basel II prescriptions of more capital aligned with the risks, better management and supervision of these risks, and safety nets such as deposit insurance.

An improvement in sovereign risk can generate more appetite for this type of risk with respect to the private sector. Again, this danger has to be mitigated with a fiscal policy that leads to a reduction of the fiscal deficit. An improvement in the business climate would permit the further development of domestic currency and an extension of long-term financing. In turn, an improved profile for sovereign risk will ease the migration toward Basel II in emerging market countries.

Financial Stability and Reforms

The International Monetary Fund’s 2007 Report on Global Financial Stability stresses that improving the domestic financial systems of emerging market countries implies a greater integration of these countries with the global financial system. This assessment is confirmed in the 2008 Report and its update (IMF2008a and IMF 2008b). Thus, in a more integrated system, not only does the correlation of returns increase, but the risk also increases that crises could erupt at any point in the system. This has been the case with the subprime housing mortgage crisis that started in United States and then spread to other markets.

The IMF Report stresses that the strengthened domestic markets of emerging market countries—particularly for those more advanced markets that have undertaken reforms—allow these nations to withstand the financial turbulence that is a global consequence of the lack of credit discipline. Overall, the risks in emerging markets remain finely balanced, with many countries benefiting from improved macroeconomic fundamentals, stronger policymaking frameworks, reduced external sovereign debt, and better-managed debt structures.

capital more risk sensitive, and promote enhanced risk-management practices among large, internationally active banking organizations.

The IMF Report empirically analyzes whether, in addition to strong macroeconomic fundamentals, a well-functioning domestic financial market encourages capital inflows and reduces these flows’ volatility over the medium term. The Report uses a panel estimation technique to examine the factors that determine the volume and volatility of annual capital inflows for a sample of developed and emerging market economies from 1977 to 2006. These factors include financial variables, such as equity market depth and liquidity and financial openness, and a smaller sample also includes institutional quality variables, such as corporate governance quality and accounting standards.

The key results from the IMF Report’s estimations are as follows:

- Growth and growth prospects are the primary domestic determinants of the level of capital inflows.
- Financial market liquidity and financial openness help attract capital inflows.
- Greater financial openness is associated with lower capital volatility.
- The volatility of capital inflows is partly driven by external factors, such as global financial liquidity, which are outside the control of emerging markets.
- Institutional quality, as measured by a number of diverse indicators, is important. Specifically, better corporate governance is associated with a higher level of inflows, and several indicators of institutional quality and sound market infrastructure, including regulatory quality and the rule of law, are positively associated with a reduction in the volatility of capital inflows.

The results of the IMF’s empirical work show that in addition to strong macroeconomic fundamentals, including sound fiscal policy and more flexible exchange rates, the liquidity of equity markets within a regulated financial system and financial openness positively influence the level of capital inflows and capital flows volatility.

As is shown by the current financial crisis, which is related to the lack of credit discipline in mature markets—that is, the U.S. subprime mortgage market and leveraged market—prudential measures and the quality of supervision remain crucial. In this respect, emerging market countries that have undertaken significant reforms can endure these types of crises and the subsequent “flight to quality.”

The IMF Report also outlines a series of recommendations to ensure that the financial system can withstand major shocks:

(i) Prudential measures in banking could focus on making sure that banks understand the risks stemming from capital inflows, that the banks’ capital structures are appropriate for these types of inflows, and that financial institutions develop proper risk management practices.

54 According to Alan Greenspan, “The current financial crisis in the United States is likely to be judged in retrospect as the most wrenching since the end of the Second World War.” Financial Times, March 16, 2006.
management policies and practices to measure and manage aggregate exposures, including the offshore exposure of domestic financial institutions.

(ii) There should be guidance to promote a good understanding of risk among borrowers, in particular for loans involving foreign exchange, for which the exchange rate risk for borrowers can easily translate into credit risk for banks.

(iii) Prudential measures concerned with the capital markets should aim to strengthen corporate governance, including shareholders’ rights, listing requirements, and the clearance and settlement system.

(iv) Margin requirements may be established that consider such factors as historical volatility, the risks of extreme movements, the length of the settlement period, and the capital adequacy of brokers. These parameters are most effectively established to promote systemic development and stability in the long run, rather than as a short-term response to capital movements.

(v) The easing of controls on capital outflows would reduce pressures from large capital inflows. The long-term trend toward increased financial integration is such that countries will need to put themselves in a situation that will make it possible to live with the potential volatility of capital flows. Financial policies that consider the longer term will aid countries in this endeavour.

(vi) Analysis has demonstrated the importance of transparency in relation to both financial policies—macroeconomic and microeconomic—and data. When transparency is combined with a strong self-assessment of macroeconomic and financial vulnerabilities and with sound risk management systems for both financial institutions and the public sector, countries gain an improved ability to deal with capital flows.

It is difficult to make broad recommendations beyond the ones noted above, because the policy challenges associated with capital inflows cannot and should not be uniform and the 2008 Report of the IMF and its update (IMF 2008a, IMF 2008b) stress that different situations exist in emerging countries. Countries differ in their exchange rate regimes and the type of capital inflows they experience, and therefore in the challenges they face. They differ also in the depth

55 A number of countries—including Brazil, Chile, China, and South Korea—have recently liberalized rules limiting individual or institutional investments abroad. This has led to a rapid increase in portfolio investment outflows, especially in Asia. It is too early to conclude from the data whether the liberalization of capital outflows will be effective in relieving inflow pressure over time. It is difficult to measure the effectiveness of this liberalization, given the possible role of other factors in determining the direction and level of capital flows. There are also indications that in past episodes of capital inflow surges, the liberalization of capital outflows was matched by larger inflows; see Carmen M. Reinhart and Vincent R. Reinhart, Capital Inflows and Reserve Accumulation: The Recent Evidence, NBER Working Paper 13842 (Cambridge, Mass.: National Bureau of Economic Research, 1998), http://www.nber.org/papers/w13842.pdf. In line with the earlier empirical results suggesting that financial openness encourages inflows, it is the case that capital controls, broadly defined, are usually not helpful in managing inflows.

56 Private institutional investors have repeatedly noted the importance of timely and accurate data, as well as a predictable and transparent way of communicating with the investor base, as factors that contribute to the effective management of capital flows.

and diversification of their financial markets and their stage of institutional and regulatory development, which means that they have a different menu of policy options at their disposal.

However, it is possible to offer several general guidelines for financial sector policies that can alleviate the pressures arising from large capital inflows:

- Loosening or eliminating restrictions on residents’ capital outflows is a tool that can ease pressures from large capital inflows. Outward investment will also lead to the internationalisation of capital across emerging markets and, therefore, can be a welcome means of risk diversification. More experience will show whether this policy will have a lasting effect.

- Supervisory and prudential measures have a key role to play in addressing the health and stability of the financial system. Ideally, however, they are best used to address prudential considerations, such as rapid credit growth or unhedged foreign exchange exposures—that is, to ensure the soundness of the domestic financial system, rather than as a response designed to alleviate pressures stemming from capital inflow surges. A well-supervised financial system will help provide safeguards that will permit capital flows to enter and exit the financial system without endangering financial stability.

- Capital controls should be used only as a last resort and as part of a package of macroeconomic and prudential measures. Under certain circumstances, they may be able to decelerate short-term speculative inflows, especially if the infrastructure is already in place. In addition to the challenge of effectiveness, reputational costs ought to be considered. Moreover, the effectiveness of controls can either be circumvented from the start or diminish over time, because financial instruments will likely be found to circumvent them.

Ultimately, the IMF Report concludes that it is the quality of an emerging market’s domestic financial market—in addition to strong macroeconomic performance—that will put it in a position to maximize the benefits of capital inflows and enable it to best deal with their potential volatility. These considerations are confirmed in the Global Financial Stability Report of April 2008 (IMF, 2008a) and in the most recent 2008 Market Update (IMF, 2008b), which indicates that Emerging Markets (EM) remain relatively resilient to the credit turmoil thus far. Due to improved fundamentals, abundant reserves, and strong growth. Some concerns remain with respect to the tightening of credit, balance sheets contractions, emerging corporate credit risks vulnerability of financial institutions, exchange rate volatility, and financial contagion related to the crisis of sub-prime. However, as the crisis remains protracted, external funding conditions are tightening, and some emerging markets are coming under increased scrutiny, especially regarding their policies to address rising inflationary pressures. Short-term measures intended for the immediate relief of pressure from large capital inflows may have uncertain effectiveness or unintended side effects, or be a distraction from the long-term goal of raising the quality of the domestic market—including the quality of its depth and liquidity, market infrastructure, supervision, and institutions. The past decade’s increasing integration of financial markets—across both countries and sectors—has both long-term and cyclical elements. However, even after the current cycle turns, the underlying trend toward financial globalisation is likely to point to continued financial integration, which will

 affect both advanced and newly arriving emerging market countries. Therefore, these countries will be best served if their primary response to today’s large capital inflows is to pursue the longer-term goal of developing their financial markets and building up resilience to capital volatility, rather than making short-term responses to inflow surges. Countries will be better off if flows can both enter and exit freely without disrupting domestic financial stability and the real economy. In other words, the best defence to the fragility of global financial markets and the possibility of a systemic risk, which exercise stress on the banks’ balance sheets, falling equity prices of banks, slowdown of the real economy and decline in economic growth rests with a solid and well supervised domestic financial system.

Conclusions and Policy Recommendations

From the review of studies and researches on the topics of stability, growth, liberalization and access to finance emerge a series of considerations.

At present, the situation can be generally characterized that while countries in the Latin American and Caribbean region have made significant progresses in monetary policy, debt management and government borrowing, supervision, prudential and risk based regulation, and the level of interest rates is low, corporations’ financing on domestic capital markets is still relatively thin; and individuals and even companies with acceptable fundamentals are left out of financial markets. There are some positive signs, but large and strong corporations issue bonds abroad, which aggravate the drain of resources from domestic capital markets and also possibly lead to negative social welfare of the type that Stiglitz identified.

The main challenges for policy makers lay on how to create room for continuing the efforts towards efficient domestic financial markets integrated in the global system. Those markets should be mainly geared towards financing the productive sector and growth-generating activities while also providing access to credit without determining crowding out by the government and thus deepening the financial system.

In a broader context, the challenge is how to develop modern financial systems with the institutional function of converting some uncertainty into quantifiable risk, allowing access to finance at all levels while favoring initiatives that are oriented to produce growth and not only income.

Responsible monetary policies should continue to keep the levels of inflation low. Fiscal frameworks still need to be strengthened, e.g., government debt management maintained as a significant component of fiscal discipline. The effectiveness of the institutional settings

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57 Corporate bond issuance has expanded since 2002 in Latin America and the Caribbean, even though bond issuance is restricted to few companies. Structured finance, e.g., securitization, has emerged in various countries (e.g., Colombia, Brazil). However, following the crisis of sub-prime the securitization deals are on retreat.


59 Inflation in the region, on average, declined from 263 percent (1990–94) to 6.3 percent (2005).

should be completed. On the banking and capital market front: accelerating the introduction of the “preconditions” to Basel II (e.g., principles of supervision), improving the efficiency of bank financial intermediation, and resuming the development of capital markets.

Several emerging countries and also the Latin America and Caribbean region uniquely favorable external conditions—including the price of raw materials, low interest rates, and a series of positive outcomes deriving from the reforms of the 1990s (e.g., the strengthening of legal and regulatory frameworks, fiscal consolidation, and financial liberalization)—provide a distinctive opportunity for the continuation of the financial sector reform. If the overall strategy and sensible policies—including extensive credit information, a solid supervisory framework and capacity, strong disclosure provisions supported by adequate accounting standards, and increased market discipline—continue to be put in place, we may see that “collateral benefits and threshold conditions” to which Kose and others refer would provide a better path to financial sector development and that the trade-offs of financial liberalization—growth and stability—would lose much of their effect.

The reforms undertaken have made many emerging economies less vulnerable to financial disruption derived from external factors, such as the crises of subprime lending in the United States. The establishment of government benchmarks and the market infrastructure should constitute the additional conditions for the expansion of lending, for reducing the crowding out of the private sector by the government, and for establishing healthy financial markets. However, domestic financing is still shallow, and while government financial needs tend to be satisfied on the domestic markets, solid private companies tap the global markets, e.g., still using securitization vehicles. Under these circumstances, a reverse of the existing favorable international conditions could set the stage for financial and economic crises that would mostly hit private companies.

The governments in emerging countries and in the Latin American and Caribbean region understand the trade-offs here and are in a position to continue on a more comprehensive strategy for domestic financial market development.

This effort also implies that the financial intermediation of banks would be put on the same level playing field in terms of supervision, regulation, and other regulatory requirements. It would also call for transparency and independent corporate governance. In terms of the price of loans, the interest rate charged would be in line with risk/reward criteria, and therefore no subsidy or below-market interest rate. Under these rules, public sector banks would not be eliminated, but they would be required to operate in a competitive environment and would be

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61 Vulnerabilities are still relevant because global conditions could change; the oil market could tighten and affect partner country growth; non-oil commodity prices are projected to soften after 2007.
63 Eichengreen and Hausmann (2003, 30–31) argue: “The evidence is strong that original sin will not go away anytime soon as a result of the standard recipe of macroeconomic prudence and institution building. Efforts to strengthen national policies and institutions will help, but they will suffice to ameliorate the problem over the horizon relevant for practical policy decisions. And even if some countries do succeed in achieving redemption from original sin through initiatives taken at the domestic level, they will only raise the bar for the others, insofar as the addition of one more currency to the global portfolio reduces the diversification benefits of adding yet another.”
expected to concentrate on those areas and sectors (e.g., rural areas, and poor people) that do not have access to credit.

Access to finance remains a significant issue and has the potential of being in contradiction with the aim of stability. However, a serious drive to access to credit not only has a substantial social and political impact, but also reduces the pro-cyclicality effect of Basle 2 rules. In this vein microfinance – including insurance -should be regarded as a sound policy and practice that allow a democratization of finance as well as social and economic benefits. This is a sector in which the public sector – including funds and state owned institutions- can play an important role without threatening the stability of the system, i.e., banks and financial institutions can operate and provide support while not increasing their risks. This is an area where market failures exist and the fine line is between activities that generate growth and activities that generate income. The financing of both types of activities might be necessary, but the key is to find a correct mix avoiding an excessive financing exclusively directed -for social reasons- to activities that generate income and constitute a replica of what is already existing without innovation, which in turn may lead to a flat economy without productivity gains and thus growth. This also implies a cultural shift that would lead banks to lend more based on the merit of the projects than on the existence of guarantees.

On the other hand, while this strategy applies to selected emerging countries, a different and more complex challenge remain for those economies that have not reached a satisfactory level of an efficient and effective financial sector. Thus, a two-tier country remains a major feature particularly in Latin America, with some countries well advanced and sophisticated while other at an initial stage of effective financial sector.

In the context of financial system development, the multilateral development banks – MDBs- such as the Inter-American Development Bank (IDB) have worked intensively on the development of a sound and safe domestic financial system. In the last few years, MDBs have not only been an issuer of local currency debt but also a promoter of domestic bond markets. The conditions required for issuance by multilateral lenders do not really differ from those of multinational corporations or governments. However, countries wishing to develop their domestic markets are able to use multilateral lenders as catalysts in addressing the impediments constraining the development of their markets and as partners in improving market infrastructure. In this context, MDBs offer support in a number of areas, including in the underwriting and market making of local currency securities, e.g., the IDB has assisted with 18 such issues in the past two years and also facilitates the issuance of securities by offering partial guarantees to private sector borrowers.