Building an Infrastructure for Financial Stability: An Overview

Eric S. Rosengren and John S. Jordan*

Numerous conferences organized in the aftermath of the financial crisis of 1997–98 offered analyses of what went wrong in the crisis countries. The immediacy of the crisis prompted a number of reform proposals directed toward reducing the risk of future crises. However, now that the crisis has abated, reform appears to be much lower on most political agendas, and the progress that countries are making toward implementing reform is rarely the topic of media reports or academic inquiries. The Federal Reserve Bank of Boston's June 2000 conference "Building an Infrastructure for Financial Stability" attempted to address this deficiency. Conference participants reexamined the recommendations made following the financial crisis and attempted to better understand why the adoption of reforms has proved to be so difficult.

Many of the conferences held soon after the crisis examined imbalances in international financial markets as well as imbalances in the macroeconomies of the crisis countries. Recommended policy responses often required some form of global coordination. In contrast, our conference focused on the financial infrastructure of individual countries – legal systems, accounting systems, banking sectors, and securities markets. Several experts highlighted the fact that the countries with the greatest deficiencies in their financial infrastructure experienced the most severe hardship during the crisis. The conference focused on reforms that countries could adopt unilaterally.

Participants reported that many of the crisis countries *have* made substantial improvements on several economic fronts, but they also

*Senior Vice President and Economist, respectively, Federal Reserve Bank of Boston.

reported that the pace of adoption of infrastructure reform has been less ambitious than the rhetoric during and immediately following the crisis. Once the crisis had passed, implementing corrective measures clashed with the reality that such measures often impinged on political, economic, and social norms in the local economies. As the local economies improved, forces for change began to fade, while resistance to change strengthened as it became clearer who would be adversely affected by reform. As a result, policymakers frequently have been reluctant to implement substantive change.

As conference participants presented their analyses of the reform process in various countries, a common theme became apparent: Those recommending reform need to do a better job of recognizing political, economic, and social constraints facing individual countries. These constraints tend to be the true impediments to successfully implementing reform. When one takes these constraints into account, one can begin to understand why more substantive reform has not occurred. In addition to this general theme, conference participants provided several recommendations that should be considered when attempting to improve the financial infrastructure of emerging economies.

First, countries should focus much more attention on improving the enforcement of existing laws, accounting requirements, investor protections, and bank supervisory practices. Too much emphasis has been placed on introducing new reforms, too little emphasis on improving the effectiveness of the existing financial infrastructure. Conference participants emphasized that most countries have prudent legal statutes in place, some form of minimum accounting standards, and regulatory agencies in charge of bank supervision and investor protection. However, enforcement is problematic. Court systems often lack the authority to enforce contracts and existing laws; accounting standards and investor protections are often ignored, and bank regulatory agencies often lack the political independence needed to implement prudent supervisory policy.

Second, where reform is needed, one must do a better job of molding the reform so that it fits the societal norms of the recipient country. Failure to take into account how a society's values will affect the implementation of a specific reform may render the reform ineffective. For example, conference participants discussed the appropriateness of using the U.S. bankruptcy code as a model for emerging economies reforming their legal systems. Since domestic courts must interpret the code on a case-by-case basis, the degree to which a country protects debtor versus creditor will depend on what the society views as fair. Similarly, for countries with different value systems than that of the United States, recommending that a country adopt U.S.-type accounting standards and investor protections for their domestically listed firms may be inappropriate.

Finally, most agreed that specific reforms are likely to work differently in a country that bases its legal system on civil law than in one that bases its legal system on common law. Legal systems in civil law countries are characterized by far less flexibility, following the "letter of the law" closely. These countries also tend to have concentrated ownership structures with bank-dominated sources of external finance. In contrast, common law countries have more flexibility, with legal precedents playing an important role, and they tend to have more diverse ownership structures with well-developed capital markets. These differences affect a diverse group of reforms. The demand for investor protections and extensive disclosure policies will differ across these two types of countries, as will the role of bank regulation.

The following provides an overview of the conference discussions rather than a summary of individual papers. In part, this is because the papers are generally accessible, with little need for clarification in an overview. However, the main reason is that the conference was highlighted by spirited discussions that often extended and amplified the arguments made in the papers included in this volume.

Lessons from the East Asian Experience

In his opening address, **Jagdish N. Bhagwati** examined the reasons behind the Asian miracle of 20 years of strong economic growth and the subsequent crisis experienced in the late 1990s. He first noted that not all of Asia shared equally in the prosperity. India was one of the notable exceptions. Bhagwati explained that India suffered from two major problems. First, "Adam Smith's invisible hand was nowhere to be seen." Government intervention stifled the ability of the private sector to flourish, a problem common in many developing countries. Second, the Indian government adopted an economic development policy with an inward focus, promoting growth of traditional domestic sectors such as agriculture. Such a policy limited the growth of the domestic economy. In contrast, countries that focused on outward development had much more success. Several of the most prosperous Asian countries imported new technologies from abroad and coupled these technologies with their own low-cost labor, enabling them to export domestically produced goods worldwide. This outward focus was a highly successful model, and one that developing countries outside of East Asia are only now beginning to emulate.

While this outward orientation enabled many of the East Asian countries to build highly developed manufacturing sectors, their financial sectors did not progress as quickly. Bhagwati argued that the weak financial sector eventually culminated in the East Asian crisis. In defense of this explanation, he dismissed an alternative explanation of the crisis, diminishing returns. While some may believe that the high returns East Asian countries experienced from their investment boom were destined to end, and that the crisis was caused by the setting in of diminishing returns, Bhagwati strongly disagreed. He argued that technology should have delayed the onset of diminishing returns, and that even if diminishing returns were really a problem, one would not expect the problem then to appear almost overnight. He believes the evidence is more consistent with a financial crisis. In particular, problems in the banking sector, with its excessive lending and heavy reliance on foreign-currency-denominated debt, formed the primary cause of the crisis. He also believes that poor policy decisions exacerbated the crisis, partly a result of pressure from international organizations.

In closing, Bhagwati stated that while the financial sectors of many of the East Asian economies need reform and must become internationally competitive, he did not favor some of the more dramatic recommendations for reform. In particular, he did not view favorably the sweeping changes proposed for the industrial organization structures in some East Asian countries, such as recommendations to eliminate chaebol and keiretsu groupings. He believes that these organizational structures, based on the unique cultural norms of individual countries, played an important role in East Asia's prosperity. Such recommendations show how outside agencies often fail to take into account the cultural framework of a country, trying to impose their own economic models on a country where they may not fit. Bhagwati was optimistic about East Asia's future, however. With improvements in the financial sector, he believes that the countries will regain their manufacturing prowess, and that East Asia will again be a high-growth area.

Building an Infrastructure for Financial Stability: Legal and Regulatory Framework

John L. Walker's paper examines the legal infrastructure of six emerging economies, Thailand, Indonesia, South Korea, Taiwan, China, and Russia. In his review of the financial crisis of 1997–98, he found that inadequacies in the countries' legal systems were not the primary causes of the crisis, but that these inadequacies did contribute to the tremendous cost of the crisis. Walker focused on the improvements these six countries have made in their legal infrastructure, examining the progress that has been made in establishing bankruptcy laws, providing an environment that allows parties to engage in secured transactions, ensuring the enforceability of contracts through the judicial system, and developing a bank regulatory and supervisory framework that promotes a stable financial system.

In comparing the legal and regulatory frameworks of Thailand, Indonesia, and South Korea, Walker noted that Indonesia has the weakest legal system, South Korea the strongest. He pointed out that this ranking is correlated with the degree of hardship these countries experienced during the crisis, as well as the speed of subsequent recovery. Taiwan has the most advanced legal system among the six countries he examined. Walker thought Russia had made substantial progress in developing a legal framework, but it still lags in the implementation necessary to develop a culture of law. China's legal and regulatory framework is behind that of the other five countries, but Walker believes that the impact of the East Asian crisis on China was minimal because it had yet to deregulate its financial system.

Based on his review, Walker draws the lesson that developing countries must have a sound foundation for their legal system, in each of the four areas listed above, before going ahead with widespread financial deregulation and liberalization. Finally, he warned that these countries still have much more progress to make in implementing reform before a culture of law is well established.

The first discussant, **Holly J. Gregory**, emphasized the importance of social values and local cultures in developing effective legal structures. She believes that placing new laws on the books is less important than the way a country implements existing laws, and that proper implementation requires a broader understanding of a country's social values. Legal reforms will be successful only if their implementation includes an understanding of what the culture views as fair and reasonable.

As an example, Gregory discussed the difficulties associated with improving a country's corporate governance practices. Countries with effective corporate governance have a financial sector that allows investors to monitor and, if necessary, discipline corporate managers so that funds provided by investors are appropriately, efficiently, and profitably put to use. However, imposing on developing countries the specific rules and structures found in countries with successful corporate governance will often not have the desired results, since such rules and structures are not fixed or absolute, but require flexibility and judgment and must fit within the cultural values of a country. Consider bankruptcy laws. Gregory noted that the United States has a culture that is accepting of failure, one that encourages individuals to start over and try again. This is in sharp contrast to the values of many Asian cultures.

Gregory believes that legal reforms should not be imposed by international organizations or governments. To be effective, reform requires adaptation to local conditions and social values. Since the private sector is so important in creating the necessary institutions for efficient corporate governance, she argued that any effort at reform must involve, and even be driven, by the private sector. In many nations, this will require significant dialogue and education to encourage the private sector to value and support corporate governance reform efforts.

The second discussant, **Mark A. Walker**, questioned how critical the differences in legal structure were to the severity of the East Asian crisis. He noted that investors seemed little concerned with the lack of legal protections prior to the crisis, actually preferring countries with the apparent certainty imposed by dictatorial regimes over more mercurial political regimes that were more democratic. Furthermore, while the countries that suffered the most in the crisis tended to have deficient legal structures, they also tended to have lower per capita incomes, poor employment practices, and more dependence on foreign direct investment. The correlation between inadequate legal structures and economic weakness makes it difficult to ascertain the degree to which inadequate legal institutions exacerbated the crisis.

Walker also discussed the difficulty of successfully imposing new legal structures that create a system of rule by law. He believes that the reform process needs a democratic element: not necessarily a political democracy, but a framework in which consensus is developed so that there is broad acceptance of the principles behind the reform. He also stressed the importance of equal application of the law—that the new rules be applicable not just to private participants, but to government participants as well. He pointed out that these conditions did not always hold for the reforms imposed by international organizations on some of the crisis countries. In fact, in some countries, the advocacy of reform by international organizations was interpreted as promoting the power of the existing ruling elite. This fueled skepticism toward reform, since the political elite were the ones who most benefited from the earlier corrupt processes. Without legal structures that enjoy popular support, reforms are unlikely to take root, particularly if citizens view the reforms as unfair and imposed from abroad.

The general discussion further emphasized the importance of adapting the legal system to local customs and developing legal precedents, so that the rule of law becomes firmly established. Several speakers were concerned that the formal presentations seem to imply that effective legal infrastructure would not develop for decades, leaving countries vulnerable to serious disruptions in the interim. While the presenters generally agreed that it would take considerable time, they nonetheless believe that many countries have made considerable strides in improving their legal infrastructure. Many currently have reasonable statutes, and while implementation remains problematic, countries can make improvements in this regard over a shorter period.

Finally, some discussion focused on the interaction between the legal system and the rest of the financial infrastructure. In particular, it was stated that the role of bank supervision becomes increasingly important, the more inadequate a country's legal system. Since countries with fewer protections for investors turn to bank-intermediated finance, commonly backed by implicit or explicit government guarantees, it becomes increasingly important that the bank regulatory system protect against excessive risk-taking in the industry.

The Role of Financial Reporting in Reducing Financial Risks in the Market

S. P. Kothari questioned the value of mandating stricter accounting standards. He picked up on two themes that had been raised in the first session: the importance of differentiating between imposing new rules and enforcing existing rules, and the importance of understanding the cultural norms of a country before advocating specific reforms. He argued that a market existed for accounting standards and policies on corporate disclosure, and that it is subject to supply and demand pressures just like any other market.

In countries with good law enforcement, common law, and adequate protection of investor rights, Kothari thinks that most disclosure requirements are unnecessary. He believes that market forces would require corporations to voluntarily disclose the appropriate amount of information. Each firm would compare the costs of creating and disclosing detailed financial information with the cost of capital it would face if that information were not disclosed. Each firm would then decide, on its own, the appropriate, profit-maximizing level of disclosure. For firms where the market demanded a high degree of disclosure, such as firms reliant on new technology, disclosure would be extensive. For firms in industries that are transparent and easily monitored, the demand for disclosure, and thus the quantity of disclosed information supplied, would be low. Requiring one set of accounting standards for all firms would be inefficient: Using the above example, the new technology company would voluntarily disclose much more than the minimum, while even the minimum standard would force the transparent company to supply an unnecessary amount of information.

Kothari also argued that imposing accounting standards, without the effective enforcement of investor protections, will have very little impact on the development of sound capital markets. He cited empirical research that shows that the enforcement of investor protections lowers the cost of capital, whereas the mere existence of high-quality accounting standards, without corresponding enforcement, has no impact on the cost of capital. He argued that the availability of external finance depends crucially on investor protections. If managers face few consequences for acting in their own self-interest, outside investors will limit the resources available to such firms. Weak enforcement limits the development of the capital markets in many countries and, in turn, adversely affects the economic well-being in those countries.

Kothari then discussed the impact of imposing accounting standards on countries where law enforcement is lax and investor protections are minimal. He noted that ownership and governance structures have developed there in a way that reduces the demand for significant accounting resources. Ownership is often highly concentrated and bank-intermediated finance is the primary source of funds for firms. Because the information asymmetries are greatly reduced with such a structure, the demand for accounting information is low, and mandatory rules will require more disclosure than is warranted, given the corporate governance structure.

Kothari concluded that appropriate accounting reform should be developed in conjunction with reforms to the legal system. Institutional factors such as investor protection and law enforcement significantly affect the demand for high-quality public disclosure. Kothari believes that a policy of strong enforcement of investor protections can result in an increase in the supply of external finance and an increase in the demand for public disclosure; these in turn would force improvement in financial disclosure, regardless of the quality of mandated accounting standards.

Both discussants strongly disagreed with the proposition that accounting standards might be unnecessary, while agreeing that enforcement and investor protection are important. **Gerhard G. Mueller** stated that poor enforcement does not imply that mandated accounting standards are unnecessary; rather, it implies a need to develop improved enforcement in conjunction with setting of standards. In particular, Mueller is concerned that firms will not disclose bad news if the decision to disclose is left to them. Thus, a negative externality will be introduced into the market, because investors will worry that material bad news remains undisclosed. This fear can make investors more reluctant to invest in all companies.

The second discussant, **Marisa Lago**, applauded Kothari's focus on the multidimensional aspects of financial reporting. She agreed that the usefulness of financial reports is affected not only by accounting standards but also by corporate governance, legal systems, and enforcement policies. However, she too disagreed with the proposition that countries should allow individual firms to do their own cost-benefit analysis when determining the level of disclosure. She too believes that such a policy would prove costly because it would reduce investor confidence in the market as a whole. Investors would find it difficult to differentiate good disclosers from bad disclosers, and all firms would end up facing a higher cost of capital. However, in addition to her belief in mandated accounting standards, Lago strongly affirmed the need for enhanced enforcement, through higher-quality audits, continuing supervisory reviews of filings, and active prosecution of firms that fail to disclose material events.

The general discussion included a spirited debate on the advisability of imposing international accounting standards. Kothari emphasized that adopting a single international standard could have a serious adverse consequence—stifling competition in setting standards. With different standards in different markets, the better standards will emerge as the ones that survive. If a market imposes costly ineffective standards, firms and investors will flee to markets with more appropriate standards.

Such competition will spur innovation in standard-setting, resulting in the adoption of standards that investors value highly and the elimination of costly inefficient standards. Kothari made the point that as a profession we economists welcome the concept of competition in markets, and we should welcome competition in the market for financial reporting as well.

In response, many attendees stated that competition in standard-setting would prove to be costly. First, analysts have had great difficulty interpreting financial statements when companies switch their standard or have the option of issuing different financial statements depending on the country where the firm is reporting. Second, some believe that international standards provide a public good, by raising minimum standards in countries with serious deficiencies in accounting infrastructures. Finally, several participants believe that international standards would also encourage greater international enforcement of accounting standards. While there was no consensus among participants on setting a single international standard, it was widely agreed that better enforcement was critical to improving the accounting infrastructure in emerging economies.

Reforming Bank Supervision in Developing Countries

Ruth de Krivoy expanded on several themes of the conference in her paper on reforming bank supervision. She stressed the importance of effective implementation, a theme emphasized in both the legal and accounting sessions. While many countries have adopted regulations consistent with more effective supervision, implementation requires providing the appropriate incentives so that banks and their supervisors act responsibly. She emphasized that the inadequacies in bank supervision in emerging economies are due not to a lack of understanding of what constitutes sound policy but rather to insufficient resources and political will to allow bank supervision to be proactive.

Krivoy highlighted several difficulties bank supervisors have faced in effectively implementing policies consistent with international banking standards. First, many supervisors have insufficient independence from special interests or the political process. She argued that supervisors should not be subject to removal when it was politically beneficial. Second, many bank supervisors in emerging countries lack the financial resources to do an effective job. With limited personnel and few computers, implementation is difficult. This inadequacy of resources frequently reflects the ambiguity that many politicians feel about proactive supervision.

Finally, Krivoy pointed out that the legal framework was often at variance with effective supervision, noting that differences between common law legal systems and civil law legal systems affect bank supervision. She described supervision under common law as flexible, able to adapt to the unique experiences and financial characteristics of the local financial system. In contrast, civil law only allows bank supervisors to enforce laws that are explicitly enumerated, giving supervisors little latitude to restrict behavior that they consider financially risky but that is not explicitly restricted by the legal code. In civil law countries, supervisors have at times been subject to personal liability suits for exceeding their powers, even if such discretion would have provided a more stable banking environment.

Krivoy recommended that emerging economies take steps to make bank supervision a priority. One suggestion was housing bank supervision in the central bank. Central banks have more and better resources than other government agencies, and thus they can hire more competent personnel and put in place adequate computer facilities. Moreover, central banks tend to have political support for independence, and housing the supervisory authority in the central bank could raise the status of bank supervision. Bank supervisors must have the ability and the authority to intervene early when banking problems arise. This requires prudent analysis of timely information, with a clear authority to intervene when it is judged appropriate.

The first discussant, **Frederic S. Mishkin**, emphasized the role of politics. He believes that without political support, prudential supervision will not be successful regardless of supervisory rules and regulations. He emphasized that the vast majority of economists agree on what constitutes prudential supervision, but politicians need to provide financial support, legal protections, and independence for bank supervisors.

Mishkin also pointed out that another means of improving emerging market banking systems, one that also requires political support, is allowing the entry of foreign banks. Foreign entry, while politically difficult, can substantially strengthen the domestic banking system. First, the host country benefits when the financial condition of well-diversified foreign banks is not closely tied to local economic conditions. Second, because most internationally active banks are well-managed institutions with long histories, their presence introduces best practices into the country. Foreign entry has collateral benefits for supervisors, because in the process of examining the foreign bank, supervisors can ascertain best practices and apply pressure on banks not employing these practices.

The second discussant, **John G. Heimann**, focused on the implementation and enforcement theme running through the conference. He discussed his involvement with an institution created by the Bank of International Settlements and the Basle Supervisory Committee, the Financial Stability Institute (FSI). FSI's primary mission is to help emerging economies develop a strong and sound financial system. "Operating on the ground level," FSI focuses its attention on offering practical solutions to the implementation of core principles in banking, insurance, and securities, while remaining aware of the fact that supervisors in emerging economies have limited resources. Heimann believes that political impediments are the true obstacles to sound bank supervision.

Heimann described as an example the problem of connected lending. Most would agree about the perils associated with connected lending. In practice, though, many emerging economies have difficulty implementing sound policies in this area because the beneficiaries of such lending are usually also politically well-connected. This is where the FIS can help. For many countries, having an outside source provide standards offers cover for supervisors trying to introduce regulations that lack widespread local political support. With the FSI providing information on standard practices regarding such matters as connected lending, risk management, and corporate governance, supervisors in emerging countries can argue that such policies are necessary to bring the country up to prevailing international standards. Thus, outside international advisors can play an important role in both educating supervisors and facilitating the implementation of politically unpopular regulations that can significantly improve a country's financial infrastructure.

The general discussion focused on two issues. First, what role should foreign bank penetration play in emerging economies' financial systems? Some believe that a foreign banking presence benefits the domestic financial system by enhancing competition and introducing "best practices," forcing domestic firms to improve in such areas as risk management. Others highlighted the potential adverse effects, noting that an increase in foreign penetration slows down the implementation of domestic financial sector reform, and that too much penetration by a single foreign country makes the domestic economy particularly sensitive to conditions in that foreign country.

The second issue was whether banking supervisory and regulatory policies should be uniform across countries. Unlike the arguments made in the accounting and legal sessions that emphasized tailoring the infrastructure to the political and cultural values of individual countries, most agreed that such a recommendation has not worked for bank supervision. The discussants felt that allowing countries to contend that "they were different" was just an excuse for those countries to do a poor job at implementing sound bank supervision.

Implications of the Globalization of the Banking Sector: The Latin American Experience

Eric S. Rosengren presented a paper, written with **Joe Peek**, examining the impact of foreign bank entry into Latin America. Their focus was the concern that foreign banks have weak ties with domestic borrowers and that during times of economic hardship, foreign banks will fail to provide needed credit to domestic firms. The evidence from the Latin American countries examined by Peek and Rosengren suggests the opposite. During host country economic problems, foreign bank penetration increased. Most of the expansion was the result of increased lending by subsidiaries of foreign banks; more modest increases occurred in cross-border lending.

These results highlight a problem facing emerging economies that restrict foreign entry into their domestic banking systems. Currently, many countries have restrictions on foreign banks directly operating subsidiaries in their country, but they place far fewer restrictions on cross-border lending. This biases the foreign bank presence toward cross-border lending. Rosengren pointed out that the evidence provided by Latin America suggests that such restrictions can have potentially adverse effects on the composition of foreign lending in the domestic economy. He noted that most cross-border lending by foreign banks is in wholesale operations, catering to large firms and the government sector. In contrast, foreign bank subsidiaries, with their brick-and-mortar operations, can focus on developing long-term retail lending and deposit relationships. These in-country operations are more stable than cross-border relationships. Thus, restrictions on foreign subsidiary entry may discourage the very lending that is least likely to flee during a crisis.

Furthermore, Rosengren noted that foreign bank subsidiaries can also enhance competition, introduce new management techniques, and increase the use of advanced information technology in the domestic banking markets. Collateral benefits also come from having better-diversified financial institutions operating in the domestic financial sector. Finally, he cautioned that even though emerging economies benefit from foreign bank entry, such entry requires better coordination between home and host country bank supervisors.

The first discussant, **Joseph R. Bisignano**, thinks it is still too soon to draw firm conclusions from the presence of foreign banks in Latin America. Much of the liberalization of the banking sector and most foreign bank entry has occurred in the past five years and, despite a number of shocks that have buffeted these countries, the reaction of Spanish and American banks to sustained problems in Latin America has yet to be tested. In particular, Bisignano noted examples of foreign banks operating elsewhere in the world that failed to provide the beneficial effects of foreign penetration discussed by Rosengren. He highlighted the operations of Japanese banks in many of the Asian countries, as well as BCCI in many of its host countries. He warned that the same may eventually be true in Latin America.

Andrew Powell commented on foreign bank penetration in Argentina. He explained that the banking industry is not the only sector in Argentina receiving foreign investment. The Argentine manufacturing, utility, and oil sectors have all experienced substantial foreign direct investment. Powell believes that the force driving foreign direct investment in Argentina is the opportunity to earn high returns, not changes to specific policies related to permissibility of foreign bank operations. Furthermore, Powell noted that the Argentine financial sector should be particularly attractive to foreign banks because of its growth opportunities, since the size of the financial sector relative to GDP is still quite small. Overall, though, Powell agreed with Rosengren and Peek's findings concerning the activities of foreign banks currently operating in Argentina. Powell stated that foreign banks have tended to behave much like their Argentine counterparts in times of crisis, and their entry has contributed to a more efficient and competitive banking system.

The general discussion in this session focused on whether emerging countries should prefer foreign bank penetration to occur through branches or through subsidiaries. Some participants believe subsidiaries would be the more beneficial route, since subsidiaries are required to have capital in the country and have tended to behave more like domestic banks. In contrast, branches have tended to be wholesale operations, which the foreign parent can close down more easily. However, it was also pointed out that foreign banks sometimes drafted legal documents so that only the capital of the subsidiary operating in the host country is at risk, not the capital of the parent bank. This action limits the parent company's exposure to the subsidiary bank but, in doing so, reduces the benefits of having subsidiaries of well-diversified and financially strong foreign banks operating in the domestic market. Unfortunately, a more rigorous analysis that distinguishes between offshore lending, branch lending, and subsidiary lending is not possible because of inadequacies in the available data.

Coase and the Reform of Securities Markets

Simon Johnson presented a paper on securities markets reform. He reviewed an extensive empirical literature that considers the relationship between economic prosperity and the quality of a country's institutions. The primary question examined in these studies is whether "institutions matter." Is the long-term economic growth of a country improved by having effective legal and regulatory systems that enforce the laws and regulations, protect investors' rights, and require adequate financial disclosure? The alternative hypothesis, that institutions do not matter, draws on the seminal work of Ronald Coase. Coase's argument was that institutions should not be important determinants of economic prosperity because firms and investors can establish private contracts to circumvent poor legal and financial infrastructure. In the extreme, firms operating in countries with particularly poor legal and financial infrastructures could use the infrastructure of countries with strong institutions, contracting in those countries or listing securities in those countries.

Johnson showed that the recent empirical work on this topic provides strong support for the hypothesis that institutions do matter. He discussed the findings of cross-country regression analyses that show that countries with strong institutions experienced higher long-term economic growth. He also provided several specific examples supporting these findings. One example was the success that Poland has had in its transition to a market-based economy. In designing reform, Poland imposed significant regulations to protect investors' rights and expended resources to develop institutions that enforce the regulations. The result has been a successful transition from its communist period. In contrast, the Czech Republic decided to set far fewer institutional protections for investors, relying more on market forces and reputation effects to protect the integrity of markets. Unfortunately, the Czech Republic has had far less success than Poland and has suffered through a series of financial crises.

Johnson also provided evidence that strong institutions allow countries to weather financial crises better, in addition to their beneficial effect on long-term economic growth. In the East Asian financial crisis, countries with stronger institutions handled the crisis better than those with weaker institutions, in terms of both the degree to which the crisis affected the country and the country's ability to recover from the crisis. To support this view, he compared Korea's experience during the crisis with Indonesia's, arguing that Korea's securities market reform allowed it to weather the crisis better.

In terms of policy recommendations, Johnson urged emerging economies to push forward with securities market reform. He acknowledged the difficulty of imposing widespread reform on the legal, accounting, and regulatory systems of a country. However, he explained that creating a new securities market in a country can be a worthwhile alternative to widespread reform. Johnson described the beneficial effects of the newly created securities markets in Germany and in Korea. Both of these markets have stricter listing requirements than other domestic securities exchanges, resulting in the improvement of investor protections, accounting standards, and corporate governance. These new markets have provided an alternative source of funds for many new firms, especially in technology-related areas. Given the success of these new markets and the positive impact on economic activity, Johnson urged emerging economies to mimic the recent developments in Germany and Korea, if broader reform proves to be politically unacceptable.

The first discussant, **Annette L. Nazareth**, drawing on her experiences at the Securities and Exchange Commission, emphasized that a regulatory framework specifically designed to ensure investor protection and to enhance market transparency has clear benefits over purely private sector initiatives. She gave as an example the beneficial effects of SEC-imposed rules affecting customer orders of Nasdaq-listed stocks.

There is widespread agreement that the SEC-imposed rules improved prices for customers, allowed customers to use limit orders more effectively, and improved information on prevailing prices, curtailing questionable behavior of Nasdaq market makers. These improvements only occurred after SEC intervention. Nazareth also discussed the importance of strong investor protections and disclosure policy in the international context, emphasizing that investors in increasingly global markets are demanding greater standardization across countries. She hoped standards in emerging economies would converge toward those in the United States.

The second discussant, **Donald H. Straszheim**, agreed that many emerging economies need to improve their legal and financial infrastructure. However, he argued that one must be cautious in making policy inferences from existing empirical work, because such analyses have done a poor job of incorporating adequate institutional detail. He cited the makeup of the Finnish stock market to support his claim. Nokia, a successful internationally active firm, makes up 60 percent of the total market capitalization of the Finnish stock market. Because the bulk of Nokia's operations are outside Finland, Nokia faces pressure from global financial markets, not just Finnish markets. Consequently, researchers must be careful in how they interpret the influence that the rules and regulations of the Finnish stock market have on Nokia's success and, in turn, the success of the Finnish economy. Noting the inadequacies in the current literature, Straszheim urged researchers to find better ways to quantify the factors that affect the prosperity of economies. He stressed the importance of obtaining a better understanding of the factors that affect countries' access to capital.

The general discussion focused on why private contracts are not sufficient in many countries, and why free market solutions have not been as successful as postulated in much of Ronald Coase's work. Most participants felt that the explanation was not that there were flaws in Coase's reasoning, but rather the fact that one of the important assumptions underlying his arguments is often not satisfied. Much of his work assumed that a judiciary could enforce private contracts. In practice, this assumption does not hold in many countries. Thus, as an empirical matter, countries with better securities regulations and enforcement are attracting capital from around the globe, resulting in better macroeconomic outcomes.

Roundtable: Policies to Prevent Future Crises

Stanley Fischer began the panel discussion by reexamining five factors that were important in the financial crises in the 1990s, stating that improvements in these areas would reduce the likelihood of future crises. First, countries with fixed exchange rates were at the epicenter of the crises, including Mexico in 1994; Thailand, Indonesia, and Korea in East Asia in 1997–98; and Russia in 1998. Second, financial operations in the crisis countries lacked adequate transparency. Fischer believes that more transparency would have put constraints on the actions of policymakers and helped avoid some of the economic problems, or at least led to a public reaction before the problems became crises. The IMF is actively encouraging countries to collect and disseminate information on the financial condition of their economies. Third, international standards for financial infrastructure are essential. Fischer stressed the need for a broad application of international standards across countries, and he said that policymakers should be skeptical of countries claiming to be "different," agreeing with Ruth de Krivoy's assessments. Fourth, countries with large foreign currency reserves fared better during the crises. Fifth, difficulties in countries' financial sectors substantially heightened macroeconomic difficulties during recent crises. Fisher believes that international organizations must increase their efforts toward improving the financial sector in emerging economies.

The second panelist, **Jeffrey A. Goldstein**, argued that financial crises are inevitable in many emerging markets because the small size of their economies prevents them from being well diversified. He noted that two-thirds of all countries have financial sectors with less than 10 billion dollars in assets; thus, diversification is virtually impossible to achieve in these countries. Because of this, it is imperative that these countries improve their financial systems by enhancing the transparency of their financial and corporate sectors and by subjecting more economic activity to market discipline. Goldstein was encouraged by the progress made in several European and Latin American economies in strengthening their banking and judicial systems. However, he cautioned that while these measures are likely to reduce the magnitude of future crises, it is unlikely that such measures can eliminate their occurrence.

The third panelist, **Masaru Yoshitomi**, emphasized the role of massive capital flows in the Asian crisis. Unlike the situation in many previous crises in emerging economies, the Asian economies received massive capital inflows prior to the crisis. However, these capital flows quickly reversed direction as currencies came under attack. The widespread use of short-term, foreign-currency-denominated debt exacerbated the problems. To help avoid future crises, Yoshitomi suggested government intervention in floating exchange-rate systems when the currency strayed from its fundamental value. He thought countries should also consider restrictions on short-term capital flows, such as those tried in Chile. He stressed the importance of countries reducing the exposure of their domestic banking sector to currency mismatches and maturity mismatches. Finally, he suggested that there is a need for an international lender of last resort when countries face sudden large reversals of capital flows.

The final panelist was **Andrew L. T. Sheng**. He believes that the financial infrastructures of many countries have failed to develop the sophistication needed in an increasingly integrated world economy. With globalization, central banks and financial systems face not only domestically created shocks, but also shocks from abroad. The more integrated the world economy becomes, the more susceptible it is to countries with weak financial infrastructures. To enhance their financial infrastructure before the next crisis, these countries need to make vast improvements in the quality of financial information about firms and financial intermediaries, and they need to develop deeper capital markets that allow firms to better diversify their risks. Sheng also believes that the lack of an international lender of last resort exacerbated the problems associated with the recent crises.

The general discussion focused on the implications of political instability. In many of the crisis countries, a political crisis led to the financial crisis. Such a situation makes the job of international organizations in mitigating the crisis particularly difficult. Some speakers suggested that floating exchange-rate regimes at least put the political establishment on notice that their actions have consequences, consequences that are easily observable. Another issue discussed was utilizing international organizations and the private sector as lender of last resort facilities. It was noted, however, that substantial resistance exists in many parts of the world to having an international lender of last resort. In addition, relatively few lenders are likely to be willing to provide contingent credit lines at precommitted rates during times of crises, because the loans would be issued at a time when other investors were abandoning the country.

The panel discussion ended with the observation that as emerging economies become larger and more globally integrated, reliance on domestic relationship-based forms of corporate governance becomes limiting, and the need for a more international, rule-based corporate governance system increases. However, the move from a heavily relationship-based system to a rule-based system will increase a country's susceptibility to crises until the rules are effectively and adequately applied.

Conclusion

The limited implementation of infrastructure reform following the financial crisis in 1997–98 has been disappointing. Infrastructure projects, by their very nature, take time to implement. However, the institutional and cultural impediments to rapid reform were not fully appreciated in the immediate aftermath of the crisis. As emerging economies become more globally integrated, the need to adopt rules and regulations that allow those countries to compete internationally will increase. Conference participants generally agreed that when designing these rules and regulations, countries must realize that the corporate governance models and disclosure policies of countries such as the United States may not transplant well to their own country. Country-specific characteristics, such as whether a country has a legal system based on civil or common law or whether a country depends on close relationships between banks and corporations, will determine whether a U.S.-based model will succeed in improving its financial infrastructure.

Despite the impediments to improving financial infrastructure, some countries have made progress with reform. The evidence that strong financial infrastructure can improve long-term growth and mitigate the effects of crises has caused a few countries to find innovative solutions to financial infrastructure problems. Almost all participants agreed that developing countries should focus on implementation and enforcement issues, an area that probably received too little attention immediately following the crisis. Countries should place greater emphasis on strengthening the judicial process, on improving the enforcement of contracts and investor rights, and on providing the resources for bank supervisors to properly oversee the banking and financial sectors.