

STRENGTHENING THE EMERGING MARKET ECONOMIES

Jeffrey A. Goldstein*

The theme of this roundtable is Policies to *Prevent* Future Crises. Of course, crises are inevitable. But we can try to design policies to reduce the probability of crises and mitigate their effects.

FACTORS AFFECTING THE FREQUENCY OF CRISES

To begin, I would like to recall some key factors that may explain why we have seen a high frequency of financial crises over the past two decades. From my vantage point at the World Bank, I will focus on some of the factors especially relevant to emerging market economies. These include the following:

- The small size and greater volatility of many of these economies and their financial systems;
- The lack of adequate financial “infrastructure” (including many of the things we have talked about over the past couple of days—adequate supervision, reliable legal systems, and effective accounting systems); and
- The lack of sufficient transparency, which can hide many problems and allow them to grow and, of course, create inefficient allocation of capital.

First, small size and greater volatility. Even with state-of-the-art supervision and transparency, we should expect more crises in emerging markets because they see a much greater level of uncertainty and volatility. Some part of this volatility may stem from inappropriate

*Managing Director, The World Bank Group.

policies. A large portion arises from small size and the lack of diversification of the real economy. Even if banks are well diversified *within* such small systems, they are inevitably exposed to shocks, such as those when leading sectors suffer from price declines. And many of these systems are *very* small. In 1998, two-thirds of all countries had entire financial systems with less than \$10 billion in assets each.

Second, lack of adequate financial infrastructure. Even in countries that have introduced reforms of their financial systems, pieces of the puzzle are missing. In a number of cases, the financial liberalization that has been undertaken in the past couple of decades has been sequenced by implementing the easy and quick reforms (for example, interest rate deregulation, more open entry) before those that are difficult and time-consuming (like building better financial sector infrastructure). Moreover, building the financial infrastructure that is needed is especially costly in smaller economies. One example of the kind of micro-policy consideration that is crucial in getting the infrastructure on track, but a difficult reform to make in emerging markets, is the amendment of civil service policies to permit better pay for bank supervisors and central bankers. Without this reform, it will be hard to attract people with the necessary skills and to set up the right incentives for them.

But some countries have materially enhanced their financial systems. Not surprisingly, perhaps, by 1997 several Latin American countries that underwent severe crises in the 1980s had altered their financial regulatory and supervisory framework, in particular by emphasizing market oversight in addition to official supervision. And as another response to the need to strengthen domestic financial systems, countries like Argentina and Hungary are leading the way by allowing foreign banks to enter in significant numbers.

Third, lack of sufficient transparency. A detailed World Bank review of East Asian firms—conducted after the crises—indicated exceptionally high debt/equity ratios and high ratios of short-term to long-term debt. The ratios were not rising rapidly, but these fragile balance sheet conditions prior to the crisis meant that these firms were highly vulnerable. Because the fragility of these balance sheets had not been adequately disclosed, market discipline was not exerted in a timely fashion.

ENCOURAGING SOUND PRACTICES

The task ahead lies in encouraging national authorities and private participants in financial markets to implement sound practices. Not a novel idea, but worth emphasizing as some of the pressures have abated. One focus of efforts has been the promulgation of standards for sound practice in a broad range of areas—bank supervision, payments systems, transparency of monetary and financial policies, accounting. As emphasized yesterday, however, standards alone will not suffice. There also has

to be effective enforcement and disclosure, as well as a reliable legal environment.

Another effort has been the development by the World Bank and the IMF of a joint Financial Sector Assessment Program to identify key strengths, vulnerabilities, and developmental issues in financial systems. The Program is helping provide key insights on how financial institutions and their supervisors are positioned in risk management and mitigation. The assessments can then guide technical assistance. These efforts are all part of a process of building the institutional and technical capacities that are vital to the reduction in the number and severity of financial crises. It is a process that must be sustained, even when the immediate threat of crisis is past.

In general, strengthening financial systems involves building a reliable legal and judicial environment, strengthening banking systems, and fostering a more diverse financial sector. I will touch briefly on each of these points, which have all been discussed earlier.

Strengthening Legal and Judicial Systems

Weaknesses in legal and judicial systems can create vulnerability. Whereas it is sometimes easier to amend laws, affecting the manner in which the courts enforce them is more problematic. Building a reliable legal and judicial environment involves a transparent legal framework, equitable and reasonably affordable access to the enforcement of legal remedies, and competent and efficient judicial and dispute resolution mechanisms.

Strengthening Banking Systems

An adequate regulatory and supervisory environment is crucial for sound banking. This has been well elaborated here at the conference. I would emphasize that the private sector, not the bank supervisor, is ultimately responsible for maintaining adequate standards of governance and risk management in individual private banks. Banks' shareholders and management must address their individual banks' problems, which they will do only if they have real capital at stake. The private sector more broadly must exert market discipline on banks, as a complement to official supervision.

Developing Capital Markets

Finally, fostering a more diverse and resilient financial system, in part by developing capital markets. A diversified financial sector has many benefits. As Alan Greenspan said at the 1999 World Bank-IMF Annual Meeting, "The lack of a spare tire is of no concern if you do not

get a flat. East Asia had no spare tires." Capital markets not only can act as the financial system's "spare tire," they also facilitate debt management and provide longer-term finance for business, infrastructure, and housing investments. Various reforms, leading to the development of a range of financial institutions, are important in and of themselves, and also can give an impetus to the development of capital markets. For example, institutional investors such as pension funds, life insurance companies, and mutual funds develop capital markets through the mobilization of long-term contractual savings and their subsequent investment in long-term instruments. They also help to strengthen corporate governance.

THE TASK AHEAD

Financial systems in emerging market economies will not be strengthened overnight. It takes time to build capacity. Time is needed to improve the laws on collateral and bankruptcy, the accounting system, the regulatory and supervisory framework, and the capital markets and pension systems. Improvement in the enforcement of laws and regulations will take even longer. Problems of governance are an obstacle to reform. Corruption and insider lending plague many financial sectors.

The initiatives that have been described by others here at this conference, together with the ongoing work of the international financial institutions, can foster a better and more stable economic environment and can help point the way to preventing some future crises. But ultimately the private sector needs to be fully engaged, supported by local national authorities, to strengthen domestic financial systems. That in turn will determine the extent to which crises will be mitigated, and the extent to which sustained economic growth and poverty reduction will take place.