Developing and Transition Countries Confront Financial Globalization

In recent years, many developing and transition countries have become more closely integrated into the global financial system. But to benefit fully from their growing access to international financing, they need to strengthen their financial systems.

Malcolm Knight

THE NEW and growing links between emerging and developed financial markets have been reflected in a spectacular increase in financial flows to developing and transition countries. In the 1970s and 1980s, total net capital flows to this group averaged only $10–20 billion a year, or around 1 percent of their combined GDP; in 1991 alone, these flows jumped to $120 billion. Thereafter, they rose steadily, reaching $280 billion in 1997—more than 4 percent of these countries' combined GDP—before falling back to $234 billion in 1998 in the wake of financial crises in a number of emerging markets.

The increase in financial globalization and the rise in transborder financial flows that reflects it could lead, over time, to a more efficient worldwide allocation of savings than was possible in the past, when domestic investment in most countries was constrained by domestic savings. However, the experience of the past two decades demonstrates that international financial markets are subject to unpredictable swings, costly crises, and contagion. As the financial crises that struck Thailand, Indonesia, and Korea during the second half of 1997, and Russia and Brazil in 1998–99, have amply demonstrated, financial globalization also carries very large risks, because instability in one country can now spread almost instantly to others. If properly managed, the globalization of financial markets can create a virtuous circle in which market discipline is strengthened, thereby enhancing the soundness of financial systems in developing and transition countries. At present, however, there are grave deficiencies in the financial systems of many developing and transition countries as well as important information gaps in global markets. Globalization presents many challenges, so international investors, financial market regulators, and economic policymakers throughout the world have a strong interest in promoting measures to improve financial stability.

Macroeconomic stability

The basic elements of a sound financial system are a stable macroeconomic environment, a dynamic private sector, a supportive legal framework that provides for both strong internal governance in financial institutions and external discipline by market forces, and firm regulation and supervision.

It goes almost without saying that stable macroeconomic conditions are important for a robust banking and financial system. It is not possible to establish and maintain bank soundness unless prices and other nominal variables in the economy are evolving in a relatively stable fashion and economic activity is expanding at a reasonable pace. Real sector stability is particularly important in developing and transition countries, where production structures are often very sensitive to both domestic and external shocks. This is the

reason why real sector instability has been a perennial source of financial system instability in developing countries. It is also the reason why macroeconomic stabilization has been seen as a key prerequisite for restructuring banks in the transition countries since the collapse of central planning. A healthy macroeconomic environment and economic growth are also crucial to the development of a viable banking system, whose soundness and stability hinge on whether it has "bankable" projects to finance—it must have scope to lend to a dynamic private sector operating within a clear legal and ownership framework that facilitates the enforcement of financial contracts, loan recovery, and the realization of collateral.

Importance of bank soundness

Banks are still the core of the financial system in the developing and transition countries. Indeed, as noted in the European Bank for Reconstruction and Development's *Transition Report 1998*, banks play an even larger role in financing economic activity in transition countries than they do in many developing countries. Banks borrow by assuring savers that deposits are liquid and secure, and they use a substantial portion of the funds in these deposits to make credits to borrowers that, for one reason or another, are unable to issue securities that can be traded in active financial markets. Because markets for corporate securities are limited in most developing and transition countries, most lending is unsecuritized: this means that banks are the main institutions that evaluate and monitor the risks and returns on financial intermediation.

In evaluating a borrower's creditworthiness, banks assess the underlying profitability of the project to be financed, using a different information set from that available to the borrower. For example, while a prospective borrowing firm may know more about the cost structure of its project, banks have a comparative advantage in assessing the strength of borrowers' business plans and the quality of their managements. Banks may also possess more information about general market conditions and the macroeconomic environment (for example, the stance of monetary policy and the outlook for interest rates, prices, economic activity, and exchange rates). By using these types of information to develop an independent assessment of risk, banks aid firms in choosing profitable investment projects and avoiding unprofitable ones.

The soundness and resiliency of the banking system depend on how effectively banks perform the due diligence procedures that underlie their credit risk analyses and their lending decisions, and on how well they recognize and manage changing risk profiles as the economic circumstances of their borrowers evolve. But banks also perform other key financial functions, such as operating the clearing and payments system and the foreign exchange market. As a result, the banking sector is the main vehicle for transmitting monetary policy actions to market interest rates, the stock of liquidity, and, ultimately, overall economic activity and prices. Because of these diverse functions, a sound banking sector is the single most essential element of a healthy financial system.

How effectively banks perform these functions depends, in turn, on competition in the banking system and the state of the macroeconomy. One major reason why the banking sectors of many developing and transition countries are so uncompetitive is because of government intervention. Intentionally or unintentionally, governments in many developing and transition countries have often encouraged excessive concentration through nationalization and public ownership, restrictions on foreign ownership, and lax rules on relations between domestic banks and financial or corporate groups. These distortions have frequently been compounded by direct government intervention in banks' lending decisions, with adverse effects on banks' balance sheets over time.

When a small number of large banks dominate the financial system, as is the case in many developing and transition countries, these banks may respond to a sudden increase in bad loans by increasing the spreads between their deposit and lending rates while denying loans to new, creditworthy borrowers. Such actions can weaken the financial system by causing the deposit base to flow abroad and by putting additional financial stress on borrowers. A vicious circle of slowing economic activity and mounting bad loan problems may ensue, jeopardizing financial stability.

The many macroeconomic shocks to which developing and transition countries are subjected can also weaken their banks. Lending problems are much more likely to affect the banking sector as a whole when they are due to an adverse terms of trade shock to a major export commodity. In a macroeconomic downturn, there are fewer profitable new capital investment projects for banks to fund, and borrowers whose incomes decline have difficulty servicing their debt. These effects have been intensified in some of the countries embroiled in Asia's financial crisis as their banks have been forced, because of financial problems, to liquidate the collateral on loans called, leading to a sharp decline in the prices of the assets—especially real estate—financed by bank lending.

Problems of banking system unsoundness tend to show up suddenly, particularly in developing and transition countries. If the ability of borrowers to repay their bank loans is in doubt, depositors may lose confidence in the banks' ability to meet their obligations, which could lead to a "run" on banks. This possibility, combined with the fact that banks are highly leveraged, makes the banking system particularly vulnerable to sudden bouts of instability.

Strengthening private ownership and competition in their banking systems to address this vulnerability should be a high priority in developing and transition countries. Responsibility for the internal governance of banks and other financial institutions rests, first and foremost, with their owners, managers, and directors. Owners with their capital at risk have a strong incentive to appoint competent directors and managers and to closely oversee their business. This is why privatization is traditionally seen as a crucial element of banking sector reform in developing and transition countries. Liberalizing the

conditions of entry to make the banking industry "contestable" is another way to increase both private ownership and competition in the banking sector.

Nonbank institutions and markets

Banking sector weaknesses can also be addressed through the development of other financial intermediaries to compete with, and thereby exercise market discipline over, banks. Just as banks exercise market discipline over borrowing firms by assessing credit risk, so other markets and institutions—if properly regulated and supported by the legal and regulatory framework—can reinforce the soundness of the banking sector by competing with banks both as borrowers and as lenders, as they do in the industrial countries. Competition makes intermediation more efficient and acts as a check on the behavior of banks by increasing the breadth and depth of markets, thereby making the financial system more resilient to shocks.

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Government securities markets. Government securities markets, for example, provide savers with alternatives to bank deposits. When banks must compete with government securities markets for savings, the banks' freedom to widen spreads by lowering interest rates on deposits is curtailed. An active market for government securities has other advantages as well. It gives the central bank more flexibility in the implementation of monetary policy and also offers a means of providing temporary collateralized financial support to illiquid banks without creating the moral hazard problems that may arise when liquidity is provided directly to individual institutions. Repurchase agreements on government securities can also be used to develop a collateralized interbank credit market, further contributing to bank soundness and liquidity.

Foreign investment and foreign exchange markets. Capital account convertibility expands the menu of choices available to savers by making it possible for them to hold foreign assets. By increasing the number and types of instruments that can compete with domestic bank deposits, it also makes it more difficult for banks to charge large intermediation spreads. The development of a liquid interbank foreign exchange market is also essential to give traders and speculators the flexibility to take spot and forward positions in foreign exchange. Indeed, strong domestic financial institutions are essential to give the authorities proper scope to use the tools of monetary policy, including market interest rates, to manage capital flows and the exchange rate.

Equity markets. Active, well-functioning equity markets not only offer enterprises an alternative to bank credit as a source of funding for capital investment but also provide a means for exercising market discipline over banks. If bank equities are publicly traded, the markets can discipline banks with weak management by driving down the value of their shares, making them likelier targets for acquisitions and mergers and thus bringing about a change of ownership or control.

Equity markets have grown substantially in developing and transition countries in recent years. During 1992–95, the number of emerging market equity funds tripled, to over 1,200, as did their combined net asset value, which has surpassed $110 billion. However, they remain subject to a number of risks, including illiquidity, difficulties in transferring ownership, differential information, and political uncertainties.

Harmful restrictions on financial markets

In industrial countries, each financial market and institution—as well as the legal and regulatory framework that supports markets—performs a different role that reinforces market discipline and strengthens the financial system. But financial systems lack depth and breadth in many developing and transition countries, often because of prolonged periods of financial repression, government intervention in financial markets, and restrictions on external current and capital account transactions. Because of the many large gaps that remain in their financial systems, these countries do not benefit from the market discipline that would drive poorly managed banks out of business.

One of the most common weaknesses is a requirement for the central bank or commercial banks to lend to the government or to "priority" sectors, often at subsidized interest rates, which weakens the banks and stifles the development of markets for government securities. Another is extensive public ownership of financial institutions and nonbank financial enterprises, which hampers the growth of market capitalization and the development of equity markets. Ceilings on interest rates reduce the efficiency of financial intermediation and the signals for profitable investment, while restrictions on international current and capital account transactions result in shallow foreign exchange markets and the creation of parallel foreign exchange markets. Other restrictions on the operations of financial markets prevent their full development, as do inadequate disclosure standards, which also substantially increase the riskiness of these markets.

Public disclosure of financial information

No form of market discipline could be effective without a legal and regulatory framework that creates strong incentives for the disclosure of accurate information on a timely basis to market participants. Information is essential for efficient markets, and markets will be well informed only if all potential participants are able to obtain information at a reasonable cost. Well-informed creditors whose funds are at risk and not protected by government guarantees have a strong incentive to distinguish between the institutions to which they lend in

the interbank, commercial paper, corporate bond, and money markets, based on each borrower's risk characteristics.

Although there are many impediments to the development of nonbank financial institutions and markets in developing and transition countries, the lack of disclosure of accurate and timely economic and financial data is, without doubt, one of the most serious. It is critical that best practices for sound financial systems in developing and transition countries include standards for data provision, disclosure, and dissemination. Since 1996, the IMF has taken steps to encourage the dissemination of member countries' macroeconomic data through two related initiatives. The first is the Special Data Dissemination Standard (SDDS)—a voluntary system by which countries that are, or wish to become, active in international financial markets agree to provide certain key economic data on a regular and timely basis. The second initiative is the General Data Dissemination System, to which all member countries of the IMF must adhere as soon as their circumstances permit.

Supervision and regulation

Even with good public disclosure, however, there will be limits to the degree to which market discipline can ensure the stability of the financial systems of developing and transition countries so long as there are gaps in the structure of their markets. As financial markets in these countries continue to evolve, supervisory and regulatory authorities will need to bear a large share of the burden of maintaining robust financial systems and resolving crises when they occur. In this sense, official oversight of financial institutions and markets is an essential complement to internal governance and market discipline. A number of countries, notably Hungary and Poland, are adapting their legal and institutional frameworks for financial activity quickly to ensure that they are consistent with European Union directives. Many developing and transition countries are engaged in strengthening their supervisory authorities, although the effectiveness of these agencies has yet to be tested in a generalized downturn.

In recent years, there has been a growing consensus among financial system regulators in many countries on the necessity of developing a consistent international framework of financial and supervisory standards and best practices that would promote robust financial systems in all countries, including the emerging markets. The development of such a framework will require increased attention to the consistency and adequacy of regulatory and supervisory practices throughout the world. Thus, in 1996, the Basle Committee on Banking Supervision developed a general set of core principles for sound banking that are applicable to all countries.

Conclusion

Initiatives at both the national and the international levels to strengthen corporate governance in financial institutions, enhance market discipline, improve the quality and timeliness of disclosure, and strengthen supervision constitute a comprehensive strategy that should, in the long term, create incentives for developing and transition countries to close the gaps in their financial markets and address the weaknesses in their supervisory frameworks. If such a strategy succeeds, it will bring into being a more robust international financial system in which the global allocation of savings and investment will be more efficient than it is today, and, in doing so, it will lay the groundwork for sound long-term growth in developing and transition countries. F&D

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