In the past decade or two, we have all become acutely aware of the importance of strong financial markets and particularly of their crucial importance for sustained economic growth. As a result of the lessons we have all learned in recent years, considerable progress has been made in strengthening financial markets in emerging economies. But much remains to be done, and the currently benign global environment is exactly the right time to press ahead with further reforms.

The importance of the opportunity afforded by the favorable present conjuncture is not to be underestimated. Reforms introduced in such circumstances have many advantages and a better prospect of long-term success. They can be properly thought through, rather than, as is the case at times of crisis, introduced hastily and with an increased risk that mistakes will be made in either the formulation or the implementation. Reforms introduced in an upturn also have fewer adjustment costs and, in general, face less opposition. Adjustment is more easily absorbed in the context of growth.

In this chapter I want to examine some of the lessons we learned during the financial crises of the 1990s. I want particularly to focus on what we learned about the close relationship between financial markets and the macroeconomic environment that provides the framework for rapid and sustained economic growth—and the rise in living standards and reduction in poverty that growth makes possible. And I want to comment on the way the International Monetary Fund (IMF) is ready to help its member...
countries to undertake and implement reforms, especially those in the financial sector.

8.1 The Role of the Financial Sector

We have long known about the importance of the financial sector in supporting economic growth. As economies grow more sophisticated, an efficient banking and financial system becomes increasingly important in helping to ensure the allocation of scarce resources in an efficient manner.

When economic activity is at its most basic and is carried out within a confined geographical area, bartering and, in time, the reliance of family finance to provide limited capital for investment might suffice. But as productive activities increase, reliance on family finance soon starts to inhibit growth. More financial intermediation is needed if economic activity is to reach its productive potential because of constraints otherwise imposed on the growth of more profitable activities (especially when small). Banking comes to play a greater role in increasing resources for high-return activities and reducing the amount wasted in lower return ones. As economic activity becomes more sophisticated and complex—a consequence of growth—so the banking and financial system becomes more important. Banks need to grow in order to meet the demand for investment capital. And at the same time they need to develop their ability to assess risk and creditworthiness.

Without banks able to assess risk, creditworthiness, and potential rates of return, resources are allocated inefficiently, and growth is slower than would otherwise be the case. The banking system performs a crucial role in the early stages of economic growth by making credit available to the potentially most productive sectors of the economy. It allocates—or ought to allocate—much of the increment in resources available for investment. And this allocation does a great deal to determine the growth rate of the economy as a whole.

As the economy grows, and also grows more complex, the financial sector needs to keep pace. Banks need to grow and become more sophisticated in their ability to assess prospects for returns; risk; and to allocate resources efficiently; and, in parallel, there needs to be the development of other financial sources of investment capital. Sustained and rapid growth needs to be underpinned by a broadening and deepening of the financial sector, capable of serving the needs of agriculture, industry, and services. The breadth and depth of financial markets becomes ever more important as growth accelerates. High growth rates are only attainable and sustainable if they are supported by a strong and efficient financial sector. The economies that have sustained rapid growth over the long term are those whose financial sectors have become increasingly sophisticated, complex, and adaptable as the economy grows.
This was certainly the history of the industrialized countries. As they grew in the eighteenth, nineteenth, and twentieth centuries, their financial systems grew in depth and breadth. In the nineteenth century, London achieved its status as the world’s leading financial center because it had developed rapidly in order to serve the needs of British industry and British exporters. As it grew in order to support Britain’s economic growth, it also became a major contributor to that growth—and, for that matter, to growth in other parts of the world as it exported capital and financial skills.

In the twentieth century, New York played a similar role in relation to the American economy. As New York developed as a financial center to serve the needs of the dynamic and rapidly growing American economy, so it developed skills and services that could themselves be exported.

And this process has continued. As the industrial economies have grown ever more complex, so their financial sectors have continued to develop in order to meet the changing needs of the economies that they serve. The growth of hedge funds in recent years is an example of this continuing development in financial markets. And as the financial sector in industrial countries has become more complex, it has posed fresh challenges for those charged with ensuring that the financial sector is sound and well functioning.

Even twenty or thirty years ago, no one would have quarreled with what I have just said. Ronald McKinnon, my Stanford colleague, wrote of “financial repression” and its costs in terms of foregone growth in the 1970s.

But the financial crises of the 1990s brought home to all of us an increased understanding of the importance of the financial system and its smooth functioning. What we had perhaps not fully appreciated was the extent to which the health and effectiveness of the financial sector was bound up with the performance of the economy as a whole. It took a series of crises in emerging market countries to enable us to understand more about the linkages between the financial sector and the rest of the economy and their importance.

I want to illustrate my argument by examining the extent to which failings in the financial sector contributed to the Korean crisis of 1997–1998.

8.2 Korea

By the time the Korean financial crisis broke in late 1997, the crises in Indonesia and Thailand had already occurred. Initially, the Korean crisis manifested itself as a foreign exchange crisis: capital flows out of Korea forced the government both to float the won and to raise interest rates in order to stem the outflows. That, in turn, exposed the degree to which Korean firms and banks had a mismatch between their assets (in won) and liabilities (many of which were denominated in foreign exchange). The principal source of Korea’s problems lay in the low and falling rates of return
of the Chaebol, the large conglomerates that were so important to the economy and, hence, of the banking system. These low rates of return were a consequence of credit rationing in earlier years that in turn had led to an overreliance on debt financing for business investment.

For most of the three decades following the start of Korea’s reform program in the 1960s, this Asian tiger was the example that other developing countries sought to emulate. It is hard to remember that what is today the world’s eleventh largest economy and one of the richest economies in Asia was, in the 1950s, one of the poorest in the world and the third poorest in Asia. Many economists and policymakers believed at the time that this was an economy that could never be viable without sustained transfers of foreign aid.

Yet the reforms introduced in the late 1950s and early 1960s had a remarkable—and remarkably swift—impact. Korea’s growth record is dazzling even with hindsight. Real gross domestic product (GDP) grew at an average of 10 percent a year in the ten years from 1963. By the mid-1990s, real per capita income was close to nine times what it had been in the early 1960s.

The thrust of the reform program was to turn Korea into an open economy, with a consistent and single-minded focus on exports. In 1960, at the start of the reforms, Korean exports accounted for 3 percent of GDP and imports for 13 percent of GDP. By 1970, the export share of GDP had risen to 14 percent, and by 1980 it stood at 33 percent. Between 1959 and 1969, exports and export earnings grew at an annual average rate of 41 percent.

The Chaebol played a central role in this spectacular export performance. The Chaebol were conglomerates, usually family-owned, that grew rapidly as a result of the reforms introduced from the early 1960s that provided strong incentives for exporters. The Chaebols’ success in exporting was aided by government policies that allocated low interest toward successful exporters, gave exporters tax breaks, and provided a realistic exchange rate. As companies grew rapidly and expanded, access to credit was vital: and this was made available on the basis of their export performance.

It is important to remember that the export incentives on offer were uniform, available to any that increased exports: they were not geared specifically toward the Chaebol. Rather, the Chaebol were those firms, or conglomerates, that grew most rapidly and were exporters. For much of the three decades or so of spectacular Korean growth, the Chaebol were national heroes—they were seen as spearheading the remarkably successful growth performance, itself understood to be the result of opening up the economy.

Trade was liberalized at an early stage in the Korean reform process, but in the early years, the banking system was tightly controlled. Credit rationing according to preset criteria—predominantly export performance—continued well beyond the mid-1960s. The real interest charged on these
loans was positive but below the market-clearing rate. Deregulation of interest rates only started in the late 1980s.

At the outset of the reforms, rationed credit financed a very large part of investment, and that credit enabled more rapid expansion of exporting companies than would have been possible if companies had relied on reinvested profits. It also ensured very high rates of return: in the first decade, the Chaebol enjoyed rates of return estimated at 35 percent or more—so high that most Chaebol would have borrowed even more, had they been able to. Of course, these high rates of return resulted from the allocation of resources to exportables, earlier seriously underdeveloped.

But over the next three decades, as growth and investment continued, these rates of return fell, as indeed they should have. The real interest rate charged on loans rose, and the gap between the controlled rate and the market-clearing rate narrowed.

By the 1980s, the rates of return were slightly lower for the Chaebol than for Korean manufacturing firms as a whole. By the latter part of that decade, rates of return in Korea were, on average, slightly above 4 percent; they fell to under 2 percent in the early 1990s and were negative by 1997. This is in marked contrast to rates of return in the United States, which were higher and more sustained, and with Japan, where even after falling after the Asian crisis were still 2.3 percent.

The Chaebol continued to increase in importance relative to the economy as a whole, as credit continued to be allocated to them, with dangerous consequences. From the mid-1980s, the largest thirty, and the largest five Chaebol, were growing at around 20 to 30 percent annually. By the time of the crisis in 1997, their assets were many times higher than they had been in 1985 (fourteen times for the largest thirty and nineteen times for the Big five). By 1997, the Big Five Chaebol firms accounted for about 40 percent of manufacturing sector assets. But the close links between firms in a Chaebol included investing in each other and guaranteeing bank debt for each other and, indeed, borrowing from some banks owned by the same Chaebol.

Because of the history of credit rationing and the reliance on debt finance, Korean firms were highly leveraged. Firms in the manufacturing sector had debt equivalent to about three and a half times their equity in the mid-1990s. This figure declined somewhat in the 1990s, but it was still around two or three times higher than in the United States. Chaebol firms were even more highly leveraged than Korean firms as a whole. And they had strong incentives to continue to rely on debt financing, not least because the equity market was so small.

The highly leveraged position of the Chaebol had serious implications for the Korean economy as a whole. Sustaining rapid growth meant providing a continuing flow of credit to the Chaebol. But as rates of return, of manufacturing firms and the banks, declined, so maintaining the credit flow became more difficult.
Although bank assets rose sharply between 1992 and 1997, net income had peaked in 1994, and the rate of return on bank assets was falling continuously, as was the rate of return on equity. Nonperforming loans (NPLs) had not increased prior to the crisis—although NPLs rose sharply after the crisis started—but in hindsight that appears to be, at least in part, the result of “evergreening.” This is the practice by which banks extend new loans to enable borrowers to avoid default and service old debts. In other words, the financial health of borrowers was deteriorating before the onset of the crisis.

Conventional wisdom at the time of the crisis attributed the source of the trouble to the foreign currency exposure of the banking system. But this foreign borrowing had been needed to help sustain the rapid credit expansion at home. Foreign borrowing was needed to cover the problem of (mainly disguised) NPLs at home. The real source of Korea’s problems was homegrown, as the quality of bank loan portfolios declined.

In a paper I prepared with Jungho Yoo, we described early-1997 Korea as a disaster waiting to happen. Because of the need to sustain lending to the Chaebol, the banking system and, ultimately, the economy had become so vulnerable that any relatively small shock would have been enough to bring the system to breaking point. The trigger was the foreign exchange crisis that resulted in the sharp rises in interest rates needed to stem the outflow of capital. But it was the rise in interest rates that made debt servicing impossible for many firms and so ultimately brought the banking system to its knees. The situation was complicated by the need to restructure the Chaebol as well as tackling the problems of the banks themselves.

Korea’s painful experience helped bring home to economists and the policy community the importance of a well-regulated and transparent banking system—and the damage that can be inflicted on the economy as a whole by the absence of a healthy financial sector. Tackling the problem of nonperforming loans is always challenging for policymakers, as we can observe from Japan’s long (albeit ultimately successful) efforts to do this. But NPLs must be easily identifiable by bankers and regulators. Lack of transparency in the system, which gives bankers an incentive to ignore deterioration in the quality of their loan portfolios, can mean that NPLs only become apparent at a late, and even more dangerous, stage. And attention to balance sheet soundness, and the degree of open exposures, is crucial.

The events in Korea showed that weaknesses in the financial sector feed through directly into economic performance. A problem for the banking system is a problem for the economy as a whole. But this was greatly compounded in Korea’s case by the absence of well-functioning financial markets beyond the banking system—the lack of efficient bond and equity markets made the vulnerability of the banking system all the more dangerous. Crises and chronic weaknesses in the financial sector lead to low
growth rates—or, in the worst cases, a contracting economy. Output is lost, and poverty reduction efforts are halted, at least temporarily.

### 8.3 Lessons from the 1990s

It is difficult with an open trading economy to have other than a fairly open capital account. But in the absence of a strong regulatory framework, there is always a risk that financial deregulation will lead to a lending boom and create vulnerabilities in the banking system. The rapid expansion of domestic credit such as occurred in Korea in the 1980s and 1990s is always dangerous. When credit expands too rapidly, the quality of bank portfolios declines. Credit allocation becomes increasingly indiscriminate. The ability to assess risk is severely impaired, not least because the banks will lack sufficient experienced personnel to judge risk properly in a credit boom.

In such a scenario, even a small shock can be sufficient to turn many loans into nonperforming ones. That damages the banking system. But the too-rapid expansion of credit and the growth of poor quality loans also hamper economic growth.

A healthy banking sector is crucial. But it should not be the only source of finance and credit allocation. I noted at the outset that as an economy grows in size and complexity, the financial sector needs to grow with it. It must become wider and deeper in order to spread risk and fund high-quality investment. The more sources of finance and the more sources of credit—and the greater the competition—the better placed the financial sector is to assess risk and potential rates of return. The more efficient credit allocation is, the more likely it is that credit goes to where it will deliver the best return, so raising the potential growth rate of the economy as a whole. The better risk assessment and management, the better credit is allocated; and the better-regulated the financial sector, the more resilient the economy as a whole will be to external shocks.

Economies need well-developed bond and equity markets. As firms grow in size, diversity, and complexity, they need access to credit on the best terms; they also need access to different kinds of finance according to their needs. The ability to raise longer term finance through equity or securities reduces firms’ reliance on short-term bank finance that might make long-term investments vulnerable to shifts in interest rates. And citizens and institutions of different countries need to be able to hold each others’ securities. This is a natural part of the process of global economic integration and can also reduce the concentration of risk in each country in any one sector. The problems that Korea experienced underline the dangers of overreliance on bank loan finance for investment.

A final lesson pertains to the importance of assessing balance sheet risks. The severity of the Korean crisis had much to do with the mismatch in cur-
rency exposure between bank assets (won) and liabilities (more foreign exchange).

8.4 The Impetus for Reform

So the role of domestic policymakers is clear. A healthy efficient financial sector is a vital component of economic growth. Putting the necessary measures in place to ensure the banking system is sound, that nonbank financial systems are well managed, and that banks have incentives to identify both risk in the system and potential rates of return all contribute significantly to growth, even in the short term. But such measures bring significant rewards in the medium and longer term. And as those involved in the aftermath of the financial crises on the 1990s can attest, financial sector reform is far more difficult when undertaken in a crisis atmosphere.

Hence my earlier emphasis on the need to push ahead with reforms now, when change can be implemented in a relatively benign global environment. It is important for emerging market economies—here in Latin America as elsewhere—to address remaining vulnerabilities while the outlook remains favorable. It is not simply a matter of creating a stable macroeconomic framework, important though that is. Reforms need to go beyond this and lay the foundations for more rapid and sustained growth. The aim should be to raise the potential growth rate of an economy. Macroeconomic stability is a prerequisite for this, of course. But it is not enough. Structural reforms aimed at making economies more flexible and thus capable of achieving more rapid growth are also essential.

And financial sector reforms are a vital element of these structural reforms. The latest issue of Doing Business, published annually by the World Bank, underlines the importance of financial sector reforms and the contribution they can make to stability and growth. Each issue of Doing Business assesses individual country performance against a wide range of measures that create a business-friendly environment. It makes for interesting—and salutary—reading.

The latest issue has a section entitled “Getting Credit” and illustrates the links between such factors as legal rights for borrowers and lenders and the level of nonperforming loans and between the quality of credit information and the strength of the financial system.

The evidence clearly shows that the more legal rights that borrowers and lenders enjoy, the lower the level of nonperforming loans a country is likely to have. As you might expect, many of the industrial countries score highly on the strength of legal rights index that includes the ability of lenders to enforce collateral, for instance, as well as the time such enforcement takes. Out of a possible score of 10, the United Kingdom gets full marks, Australia 9, Germany 8, and the United States 7. But Botswana and Albania also score 9, whereas Italy only manages 3. Latin American countries also
tend to have low scores: Argentina manages 3, while Brazil and Mexico only score 2. Many countries elsewhere in the world score 1 or 0.

Strengthening the legal rights of borrowers and lenders is crucial if productive investment is not to be stifled. Lenders are understandably reluctant to lend to any but the lowest-risk borrower if they cannot enforce collateral contracts or if such enforcement takes an unreasonable length of time. Businesses with investment possibilities offering potentially good returns find it hard to obtain credit in such an environment. And credit allocation in an economy with weak legal protection for financial transactions is likely to be suboptimal at best, with the inevitable consequence that growth is below potential.

Doing Business also notes a correlation between ratings of financial system strength and the presence of private credit bureaus that are seen as improving the provision of credit information. The provision of good credit information—including negative as well as positive information on would-be borrowers—makes it easier for business to obtain credit because lenders are more accurately able to assess creditworthiness and risk. Making it hard for lenders to obtain information simply penalizes all would-be borrowers, including those whose creditworthiness is sound and whose borrowing would bring good returns.

Again, the industrial countries score well on credit bureau coverage. The United States, Sweden, Ireland, and Canada are among those countries where credit bureaus cover the entire adult population. Argentina also scores highly on this measure, with 95 percent coverage. But Brazil and Paraguay have coverage of barely half the population, while Mexico doesn’t quite have 50 percent. Chile has 22 percent coverage and Costa Rica less than 5 percent. More than half the 155 countries surveyed have no private credit bureau coverage at all.

Reforms are under way in some areas. Brazil, for example, was one of ten countries in 2004 that made it easier to create and then enforce collateral agreements, which make access to credit easier for borrowers and provide better incentives for lenders. Among the others introducing similar reforms were India, Japan, Finland, and Croatia—a mixed group that demonstrates that reform is, and ought to be, an ongoing process for all countries, be they low income, emerging market, or industrial.

8.5 The Role of the IMF

The IMF has an important role to play here. Our central task, according to our mandate, is the promotion of international financial stability. That is not meant to be an end in itself, of course. Our Articles of Agreement make clear that a stable international financial system is a vital ingredient in promoting the sustained rapid economic growth that brings rising living standards and poverty reduction. And, as our Articles also emphasize, in-
ternational financial stability is essential for the expansion of trade that enables rapid growth.

But international financial stability needs sound national financial systems. So the Fund, in the context of our Article IV and surveillance work, as well as in our work with program countries, focuses much of its work on the health of the financial sector. We have introduced new tools, including the Financial Sector Assessment Program, about which I will say more in a moment, to help us in this work.

We try to assess financial sector robustness in a variety of ways. We pay close attention to banks’ balance sheets and the extent of NPLs. We also examine the extent to which risk is clearly defined in the financial system as a whole. And we look at the degree of competition within both the banking system and the financial sector as a whole: competition improves the efficiency of credit allocation, and it also helps diversify financial risk and cut borrowing costs. We examine issues such as the rate of credit expansion; and we look for mismatched exposures as these are a potential source of instability.

I noted earlier that the breadth of financial instruments is important, as is the transparency of the system that enables more accurate assessments to be made of the asset and risk position of individual institutions. And a strong, effective regulatory regime, following international best practice, is vital.

I mentioned the Financial Sector Assessment Program (FSAP). Introduced in 1999, this is part of the attempt to enhance the Fund’s work in this area. It is a voluntary program—member countries request an FSAP, which involves bringing in a team of experts to undertake a detailed examination of the financial system of the country in question. The work carried out under an FSAP program involves a broad range of financial experts, many of them from outside the Fund. Some come with substantial experience in regulating the financial sector of individual member countries; others are involved with international regulatory bodies. Still others have specific qualifications needed for the tasks involved.

The FSAP program—which the Fund runs jointly with the World Bank when low-income countries are involved—aims to help member governments strengthen their financial systems by detecting vulnerabilities in financial supervision at an early stage, to identify key areas which need further work, to set policy priorities and to provide technical assistance when this is needed to strengthen supervisory and reporting frameworks. The end result is intended to ensure that the right processes are in place for countries to make their own substantive assessments.

Financial sector assessment programs don’t examine the balance sheets of individual banks, or even the banking sector as a whole. Their purpose is to help our member countries ensure that an appropriate framework is in place so that domestic regulators and supervisors are able to make ac-
curate judgments about the health of the banks and other financial institutions under their jurisdiction.

A large number and a wide range of our member countries have now had an FSAP program. The feedback we get is overwhelmingly positive, from both industrial countries with highly developed financial sectors as well as others.

The FSAP also forms the basis for Financial Stability Assessments (FSAs) in which IMF staff address issues related to the Fund’s surveillance work. These include risks to macroeconomic stability that might come from the financial sector and the capacity of the sector to absorb shocks. Is the level of NPLs a cause for concern? Are the banks well regulated and sound? How would the financial sector be affected by sharp rises in interest rates—would this lead to a rise in NPLs? Again, these FSAs cut across the full breadth of our membership.

We have also worked with the World Bank to develop a system of Standards and Codes—using internationally recognized standards—that result in Reports on Standards and Codes (ROSCs). These cover twelve areas, including banking supervision, securities regulation, and insurance supervision. The financial sector ROSCs are an integral part of the FSAP and are published by agreement with the member country. They are used to sharpen discussions between the Fund—and, where appropriate, the World Bank—and national authorities and, in the private sector, including rating agencies, for risk assessment purposes.

It is perhaps worth noting that some Fund research done a couple of years ago suggests that there is a tangible payoff—in the form of lower spreads—for member countries where the Fund has undertaken ROSCs and where the reports have been published in full. The markets take a favorable view of this transparency which can translate into lower borrowing costs.

8.6 Conclusion

For economists and policymakers, the experience of the 1990s taught us a great deal. Of course, we learned that reliance on fixed exchange rates can make economies vulnerable in the event of crisis (and most emerging market economies have, as a consequence, adjusted their exchange rate regime). We learned that in an increasingly integrated world economy a strong macroeconomic framework is essential both to make possible more rapid and sustained growth and to reduce vulnerability to shocks.

But we learned perhaps above all that financial sector soundness is vital—for its own sake, yes, but also for the health of the economy as a whole. Weaknesses in the financial sector result in lower growth than would otherwise be possible and make the economy more vulnerable to crises.

Financial sector health depends on a sound regulatory framework, rely-
ing on incentives, sound banking procedures that permit the proper assessment of risk, and the progressive widening and deepening of the financial sector to ensure that it continues to meet the needs of the economy. Like economic policy reform in general, financial sector reform cannot be a one-off. It has to be a continuous process, partly to reflect our growing understanding of the issues and partly to reflect the need for constant adaptation and refinement in the financial sector and in the economy as a whole.

Let me emphasize once again that policy made on the hoof in a crisis situation is always difficult to get right. Reforms forced on the authorities as they respond to a crisis stand less chance of long-term success because they are less likely to be well-thought out. But planned reforms implemented in the context of an expanding national and global economy have lower adjustment costs and present fewer political difficulties.

Financial market strength is vital in a successful and growing national economy. It is also vital for the smooth functioning and long-term growth prospects of the global economy. It is a central part of the economic policy reform process and, as such, is an important priority for the Fund in its role of promoting international financial stability and growth.