Introduction

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Life is full of mistakes, and no domain of human activity escapes this basic rule – including economic activity. As György Szapáry, deputy governor of Hungary's Central Bank, reminds us in a discussion in this book about the recurrence of financial crises over the last ten years: "Bernard Shaw once said, that experience is that wonderful thing that allows us to recognise a mistake when we make it again. All the crises seem to have the same causes."

But let's remain optimistic. Experience may help us not only reduce the frequency of financial crises, but also their extensiveness, depth and duration. Moreover, experience may offer clues as to how financial stability and development could be promoted, nationally, regionally, and internationally. That is precisely what this book aims to do.

The book discusses four specific, yet broad, issues of financial stability and development. The first is the lessons that can be drawn from the recent experience in Latin America with financial liberalisation, privatisation, and volatile international capital flows. The second is the convergence challenges faced by transition countries in Central and Eastern Europe in the run-up to accession to the European Union and eventually the Economic and Monetary Union (EMU). The third is the prospects of regional financial cooperation in Asia. The fourth is the role that market participants and financial authorities can play in promoting financial stability and development.

The Global and Regional Level: Views From Asia

Often, the global dimension is lacking in the analysis of financial crisis and stability in emerging developing economies. Implicitly (or even explicitly), it is taken for granted that, *alas*, international economic relations are as they are, and nothing can be done to

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change them. However, former deputy minister of Finance of Japan, Eisuke Sakakibara, takes a different stance. In his chapter, he strongly advocates a change in the current global governance system, predicting the end of Pax Americana, that is: global capitalism under American hegemony.

In support of such a bold prediction, Sakakibara reminds us of the history of the world economic system in the last 1200 years. For more than ten centuries, it was dominated neither by the Americans nor the Europeans, but by the Asian and Islamic empires. "Except for the last 150 years," he says, "(these empires) were the centre of the world economy."

Not only is China now becoming a key player in the Asian and world economy, observes Sakakibara, but Asia as a whole is increasing its role. He believes that Asia is likely to regain its position as "hub" of the global economy, reorienting the centre of gravitation from West to East. Asians may help to speed this process a bit by getting their acts together and increasing the intensity of regional economic cooperation. In doing so, they would be paving the way for financial stability and growth in their own region, as well as in the world economy as a whole. In addition, they would provide the much needed countervailing power to western dominated international organisations, and thus contribute to a healthy competition among global and regional institutions and improve their performance.

Discussing the prospects of financial cooperation in Asia, Sakakibara suggests that the Asian countries should take three subsequent steps. First, they should coordinate their foreign exchange policies to achieve the stability of their currencies. Second, they should form an Asian currency unit (ACU) with a flexible snake around the central value, just like Europe did many years ago when it established the European currency unit (ECU) and the snake. Finally, when the need emerges to jointly defend the ACU, the logical next step would be to create the more ambitious Asian Monetary Fund, or whatever name one wishes to give to an Asian organisation that caters to regional financial coordination, surveillance and intervention.

In his comment on Sakakibara, Amar Bhattacharya of the World Bank argues that Asia should follow a two-fold track. It should ask for and play a major role in the global governance system and, at the same time, strengthen its own regional arrangements. He stresses Asia's interest in a well functioning global financial system, "given the inherent fact that financial markets are global".

In her comment on Sakakibara, Barbara Stallings, professor of economics at Brown University in the United States, compares Sakakibara's proposals on financial cooperation in the Asian region with those of other experts. She argues that Sakakibara's proposals "are more optimistic, but less clear, than most others", and that they focus exclusively on government-to-government relations, while others also look at the involvement of private sector institutions.

Yung Chul Park and Kee Hong Bea, economics professors from Korea University, analyse the more specific issue of whether financial liberalisation in East Asian countries has led to stronger financial ties with financial markets in the United States and Europe, or with one another. They conclude that the former is the case. They find that western financial institutions have now penetrated the East Asian capital markets to such an extent that they dominate them in two major services: underwriting in the primary market and trading and consulting in the secondary market.

To western market participants, this may seem a positive development, since it can be seen as a contribution to the creation of a global market for goods and services, but to Park and Bea it is not all that positive. They point to serious concerns among East Asian policymakers. One is that the gap in financial technology and expertise between East Asian countries and the advanced industrial countries will remain so large that East Asia may never be able to catch up with its western competitors. Another is that the advanced countries dominating the global financial system do not seem to be interested in reducing the incidence of financial crisis in emerging economies; so far they have failed to strengthen the supervision of cross-border financial flows and regulate large foreign financial institutions.

Finally and most important of all, say Park and Bea, it is hard for East Asian policymakers to predict how the branches and subsidiaries of foreign financial institutions will behave in times of crisis. Will they panic again and move out at the first sign of crisis as they did in 1997? Since most of the East Asian countries have not been able to borrow from international capital markets in their own currencies, "they will be continuously exposed to the currency and term mismatch problems that triggered the crisis in 1997," observe Park and Bea.

In his comment on Park and Bea, Heiner Flassbeck of UNCTAD agrees that regional monetary cooperation can be a proper answer to the challenges from globalisation and liberalisation. However, he warns that regional monetary systems do not prevent financial crisis and turmoil.

The National Level: Views From Latin America and Central and Eastern Europe

Brazilian economist Rogério Studart moves to the national level of the financial stability issue by looking at recent developments in the financial sector in Latin America. More specifically, he analyses the strength and fragility of the banking sector in Argentina, Brazil, Chile and Mexico. He describes the main changes in the macroeconomic environment and microeconomic regulation of Latin American banks and analyses the ways in which these changes are linked to bank performance and financial crises. He finds that the financial crises in the 1990s in Latin America led to improvements in the regulation and supervision of the financial sector and particularly of the banking sector. Such regulation and supervision in Argentina, Brazil, Chile and Mexico became even stricter than in the United States. Also, domestic financial systems were privatised and opened up to foreign banks. But despite these changes, the Latin American banking sector remained fragile. According to Studart, this unfortunate state of affairs can only be explained by linking macroeconomic and microeconomic aspects of the banking business and analysing how they interacted to generate bank crises and the boom-bust performance of credit in the region in the 1990s.

Studart concludes that banking activity is highly pro-cyclical. Capital account liberalisation and liberalisation of the domestic financial sector facilitated the surge of capital inflows from abroad. This surge of capital flows led to economic growth and successful price stabilisation, which stimulated banks in Latin America to expand their credit extension. When crises hit the region and capital flows stopped pouring in, the banks assumed defensive strategies. Credit stagnation resulted in lower growth, thus feeding into negative expectations. So while the regulation and supervision of banks in Latin America have improved substantially, "it has become evident that additional measures are required to achieve growth and stability of the banking sector in the region – so that the sector can make a significant contribution to the long-term development of the region," says Studart.

In his comment on Studart, Jürgen Stark, deputy governor of Germany's Central Bank, stresses the crucial role of sound macroeconomic policy resulting in stability. Given the current high mobility of capital, "the effects of bad economic policy ... can be much more serious now than was the case a decade ago," says Stark.

Taking the debate on the lack of "fiscal discipline" (in Latin America and elsewhere) as his point of departure, Charles Wyplosz, professor of economics in Geneva, proposes that the responsibility for setting the budget balance and ensuring debt sustainability should be delegated to independent (national) Fiscal Policy Committees. He argues that this solution is likely to enhance attempts at regional cooperation in the realm of exchange rate policy. In his view, Latin America will be a prime beneficiary of such an approach, since "the politicisation of fiscal policy has been excessive and has resulted in deep and repeated economic instability".

In his comment on Wyplosz, Mark Allen of the IMF stresses that, in a mature political system, discussions on the stance of fiscal policy are *political* decisions, not purely *technocratic* ones. "But perhaps Wyplosz' proposal is part of the spadework for creating such mature political systems," Allen recognises.

Turning to the financial stability challenges for Central and Eastern European (CEE) countries entering the European Union (EU), Henk Brouwer, deputy governor of the Central Bank of the Netherlands, and his colleagues Ralph de Haas and Bas Kiviet assess the potential risks of the banking sector. This sector is by far the most important part of the financial systems in the CEE countries and, as such, is the main source of risk for financial stability in this region.

They identify specific potential risks or challenges. First of all, there is the risk of large capital inflows. Such inflows have already increased substantially, and are likely to increase further in the run-up to actual EU (and subsequently EMU) accession. Although capital inflows as such are conducive to economic growth, they could contribute to real exchange rate appreciation, which might in turn erode competitiveness. Also, they could contribute to riskier lending practices and unwarranted currency mismatches in the financial sector. Second, there is the risk of excessive government involvement in banks' credit decisions as well as connected and imprudent lending to bank insiders, such as management or shareholders. Third, many accession countries still need to improve substantially their legal framework, in particular the enforcement of creditor and shareholder rights. Fourth, the low level of financial intermediation by banks is a potential source of risk, in the case that banks try to expand their client base by operating in new and riskier markets, such as those for company start-ups. Finally, the limited development of the non-bank financial sector in accession countries is another potential risk. In absence of well-developed capital markets (or in other words, if the private sector fully depends on banks for their funding), a banking crisis could have severe consequences for the real economy. Vice versa, this dependence of the corporate sector on the banking system also implies that the financial consequences of corporate failures would to their full extent be borne by their creditor banks.

In a postscript to the chapter by Brouwer *et al.*, Mark Teunissen reviews the recent EU decision to let the ten candidate countries enter the union in 2004. He observes that this decision has intensified the debate on how quickly these countries should join EMU. Most accession countries are in favour of entering EMU as fast as possible. However, overly quick compliance with *nominal* convergence criteria would force the candidate countries to undertake very tight budgetary and monetary policies, thus slowing down their already limited progress in *real* convergence towards the euro area, says Teunissen.

In his comment on Brouwer *et al.*, György Szapáry, deputy president of Hungary's Central Bank, discusses three characteristics of the financial sector in CEE countries: the low degree of financial intermediation, the dominance of the banking sector over the capital markets, and the high degree of foreign ownership. Marek Dabrowski, a former deputy minister of Finance from Poland, elaborates on the possible sources of financial fragility in the CEE countries, arguing that the biggest danger lies in the continuation of substantial fiscal deficits.

The Role for Market Participants and Financial Authorities

Age Bakker, of De Nederlandsche Bank, discusses the role of central banks in promoting financial stability. He observes that the link between price stability and financial stability is a complex one, and reminds us that in the run up to the Asian crisis, large imbalances were built up in the real estate and other asset markets while inflation was low. He therefore raises the question: Can central banks deliver both stable prices and financial stability simultaneously?

Bakker's answer is, that there are three ways in which the central bank should be involved in financial stability. The first is the identification of vulnerabilities in the financial system (by monitoring risks). The second is the analysis of the transmission of shocks in the financial system (analysing transmission channels and financial market behaviour). The third is, the implementation of policies to make the financial system shock resistant.

Other ways in which central banks can promote financial stability include: performing the role of lender of last resort, (partially) guaranteeing bank accounts through a deposit insurance system, overseeing payment and settlement systems, supervising both on individual firms (bottom-up) as well as on systemic risks of failing firms and the macroeconomic consequences (top-down).

Stephany Griffith-Jones, of the Institute of Development Studies in Sussex, stresses the importance of considering the global level in fostering financial stability (in addition to the regional and national levels), and the importance of simultaneously achieving economic growth. "I think it is often forgotten that the ultimate aim is growth and employment," she says.

Going to the issue of global financial regulation, Griffith-Jones defines two aims for international financial development. The first is the pursuit of financial stability, that is the whole agenda of crisis prevention and crisis management. The second is the provision of sufficient capital flows, both private and public, to developing countries to help sustain growth. She observes that progress on achieving the first aim has been insufficient and asymmetrical and that there have been important reversals. In her view, we are still missing a global financial regulator. Considering that the lack of accountability of financial markets is one of the deepest flaws in democracy, Griffith-Jones says that "the only, very technocratic, way of doing it is actually through regulation".

Progress on achieving the second aim has also been problematic, says Griffith-Jones. Most developing countries are receiving insufficient capital flows. She believes that this is not just a temporary phenomenon, but a more permanent structural feature of the global financial system. Global fund managers seem to have less appetite for emerging markets. And when they invest a little bit of their money there, they pull out quickly when they see problems. Griffith-Jones sees coming up with ways to encourage sufficient stable flows to developing countries as a new challenge for the international community.

Frans van Loon, of ING, presents some views from the private sector. He recognises the “deep unease” with financial globalisation, which is “so broadly felt”, but argues that over the last ten years, the attention of both the financial community and civil society has focused too much on cross-border flows. As a result, domestic financial sector development has been neglected. So the new emphasis is on strengthening domestic financial systems, “because weak financial systems have too often been at the centre of broader economic crises in emerging markets”.

Van Loon reports on three lines of action that bankers all over the world (as members of the Institute of International Finance) have agreed on. The first line of action deals with ways to promote domestic financial sector development, the second with the need to improve arrangements for reducing risk (which includes improving investor relations and improving macroeconomic and financial data collection and dissemination), and the third with implementing an orderly sovereign debt restructuring process (which includes the application of collective actions clauses).

Wouter Raab, of the Dutch Ministry of Finance, addresses the question of what ministries of Finance of the developed world can do to foster global financial stability. He sees four levels of action. The first is active participation in multilateral fora such as the IMF, the World Bank and the Financial Stability Forum. “We believe in a strong rules-based international system where there is equal treatment and in which every country has a voice,” he says. The second level of action is that countries keep their own house in order. International savings should not be used to finance public deficits in the developed world, but rather investment in developing countries, says Raab. The third, more indirect, level of action for ministries of Finance is to advocate trade liberalisation, in particular the reduction of agricultural subsidies in developed countries since they prevent developing countries from exploiting their comparative advantages. Fourth, the ministries of Finance should oversee adequate regulation, supervision and – in Europe – the integration of national financial markets. “A deeper and more liquid EU-wide capital market will be able to provide participants from inside or outside Europe with more tailor-made financial instruments, will facilitate access to credits at lower costs and will be better able to absorb shocks,” argues Raab.