This book brings together two opposing views of financial liberalization. In one view, liberalization induces excessive risk taking, increases macroeconomic volatility, and leads to more frequent crises. In another view, it strengthens financial development and contributes to higher long-run growth. This book shows that these two views of liberalization are complementary.

The data reveal that in countries with severe credit market imperfections and functioning financial markets, financial liberalization leads to more rapid economic growth and financial deepening. This higher growth path is not a smooth process, however. Rather, it takes place through booms and busts. These boom-bust cycles exhibit many properties that are common across middle-income countries (MICs) independently of the nominal exchange rate regime. We have also shown that the strong amplification of credit market shocks is not limited to crises times but is also evident during normal times.

In order to analyze macroeconomic patterns in MICs, it is not sufficient to look at aggregate data alone. Asymmetrical responses of the tradables (T) and nontradables (N) sectors are key to understanding the links among liberalization and growth, boom-bust cycles, and macroeconomic fluctuations more generally. Such asymmetries derive from the fact that in MICs, there are severe contract enforceability problems. Many T-sector firms are able to overcome
these problems and gain access to international capital markets, whereas most N-sector firms are financially constrained and depend on domestic banks for their financing.

Trade liberalization promotes faster productivity growth in the T sector, but is of little direct help to the N sector. Financial liberalization adds even more to growth because it eases financing constraints, leading to an increase in investment by financially constrained firms, most of which are in the N sector. Nevertheless, the easing of financing constraints takes place through the undertaking of credit risk, which leads to financial fragility and occasional crises. Borrowers find it profitable to take on credit risk because there are systemic bailout guarantees that cover lenders against systemic defaults.

We conclude with a list of seven policy implications. First, although several observers have claimed that financial liberalization is not good for growth because of the crises associated with it, this is the wrong lesson to draw. The empirical analysis shows that across countries with functioning financial markets, financial liberalization leads to faster average long-run growth, even though it also leads to occasional crises. This gain in growth is over and above that derived from trade liberalization.

A second, closely related implication is that trade and financial liberalization will not solve the structural problems of a country. The first-best solution is to implement judicial reform and improve contract enforceability. In the absence of such reform, liberalization permits financially constrained firms to attain greater leverage and invest more, at the cost of undertaking credit risk. Credit risk creates an environment of rapid growth and financial fragility.

We agree with the general view that Foreign Direct Investment (FDI) is the safest form of capital inflow. The third implication, however, is that FDI does not obviate the need for risky international bank flows. FDI goes mostly to T-sector firms and financial institutions. As a result, bank flows are practically the only source
of external finance for most N-sector firms. Curtailing such risky flows would reduce N-sector investment and generate bottlenecks that would limit long-run growth. Bank flows are hardly to be recommended, but for most firms it might be that or nothing. Clearly, allowing risky capital flows does not mean that anything goes. Appropriate prudential regulation must also be in place.

One is tempted to say that if a government had the appropriate information, the optimal policy would be to transfer resources to those in the population with better entrepreneurial skills and let them make the investing decisions. Of course, we now know that this is wishful thinking. After many failed experiments of this sort carried out during the last century, we now know that either governments do not possess the appropriate information, or crony capitalism and rampant corruption take over. A forth implication of our analysis is that since direct made-to-measure government transfers are not feasible, a second-best policy is to liberalize financial markets and allow banks to be the means through which resources are channeled to financially constrained firms—most of which are in the N sector. Here, it is key to make a distinction between “systemic” and “unconditional” bailout guarantees. The former are granted only if a critical mass of agents default. The latter are granted on an idiosyncratic basis, whenever there is an individual default. We have argued that if authorities can commit to only grant systemic guarantees, and if prudential regulation works efficiently, then financial liberalization will induce higher long-run growth in a credit-constrained economy. In contrast, if guarantees are granted on an unconditional basis or there is a lax regulatory framework, the monitoring and disciplinary role of banks will be negated. Therefore, financial liberalization will simply lead to over-investment and corruption. We would like to emphasize that this book does not defend such lax policies.

The findings summarized in this book do not imply that crises are a good thing. They are nonetheless part of the growth process
in financially liberalized countries with severe contract enforcement problems. The fifth implication is that there is no point in trying to delay an inevitable crisis. At the “tipping point,” beyond which it is unlikely that capital outflows will reverse, authorities should focus on what to do after the crisis instead of attempting to forestall it with unsustainable policies. Delaying an inevitable crisis will tend to make the effects of the full-blown one far worse, as attested to by the experiences of Mexico in 1994 and Argentina in 2001.

Sixth, GDP growth typically recovers rapidly from a crisis. Sustainable long-run growth, however, cannot be assured unless the banking problem is fixed. Recovery in aggregate activity is typically not uniform across the economy. The T sector may grow strongly while the N sector recuperates only sluggishly. This asymmetrical response is intimately linked to a severe credit crunch that hits the N sector particularly hard and goes hand in hand with a steady increase in the share of nonperforming loans. The experience of the last two decades shows that nonperforming loans are unlikely to disappear on their own, even if GDP growth resumes quickly. This raises the question of whether a policy under which all nonperforming loans are recognized at once and the fiscal costs are all paid up front is preferable to a piecemeal policy. On the one hand, if they are recognized, the most likely outcome is that the government will have to take over the banking system, make a once-and-for-all bailout payment, and incur a huge fiscal cost up front. This will increase government debt and interest rates. On the other hand, if just a small share of nonperforming loans are recognized, the up-front bailout and fiscal cost will be low. Yet this strategy might generate perverse incentives and lead to evergreening—as the accrued interest on nonperforming loans is capitalized over and over again. Over time, the banking problem might grow and the credit crunch might last longer.

Seventh, one can draw a lesson for empirical implementation. Statistical variance is not a good instrument with which to identify
financial fragility. The *fragility* in the context of our discussion is associated with infrequent but severe crises. While these infrequent crises lead to higher variance of macroeconomic variables, other frequently occurring disturbances, like bad economic policy or exogenous shocks, will also lead to higher variance. The variance of the distribution is therefore not sufficient to identify occasional crisis episodes in the data. By contrast, skewness, the third moment of the distribution, is able to discriminate between the two sources of variance. *Only if* crises are rare and of substantial size will the skewness of the credit growth rate be negative. Our argument has shown that infrequent crises are a by-product of a rapid-growth path. Hence, we view skewness as a better indicator for studying the effect of financial liberalization on economic growth.

Finally, we would like to point out that the above policy lessons are only applicable to the group of middle-income countries with functioning financial markets and severe contract enforceability problems. In particular, the argument supporting growth-enhancing credit risk does not apply to high-income countries where credit market imperfections are not severe.