Letter from the Editor

An efficient, broad-based financial system is a prerequisite for rapid, sustained economic growth. Experience has shown that countries with liquid securities markets and well-developed banking systems have grown much faster than countries without these attributes. A strong institutional environment is also important. Financial markets cannot function optimally without a modern payment and settlement system, an efficiently run monetary policy, and a clear, well-enforced regulatory framework.

As part of a widespread movement by governments to favor policies that enhance the role of price signals in the economy, central banks are making greater use of indirect monetary policy instruments to improve the efficiency of financial markets. In their article on indirect instruments of monetary policy, William Alexander, Tomás Baliño, and Charles Enoch note that in today's increasingly open economic environment, direct monetary instruments, such as credit ceilings and interest rate controls, have become less effective because they can be easily circumvented by new types of financial instruments or institutions. This can lead to distortions in financial markets. As a result, most central banks have replaced direct instruments with policy instruments such as open market operations that influence interest rates and the demand for credit indirectly.

The design of payment systems critically affects the efficiency with which monetary policy is conducted, the soundness of financial institutions, and the functioning of the economy as a whole. As a result, redesign of payment systems has figured prominently in financial sector reforms in many countries. Nowhere have these reforms been more striking than in the transition economies, where a comprehensive reform of payment systems has been an essential step in the transformation from centrally planned to market-oriented systems. In their article, Tomás Baliño, Omotunde Johnson, and V. Sundararajan observe that the notions of risk and the opportunity cost of funds were new concepts for transition economies that had to be built into their payment systems.

The need to build a strong financial framework to support economic development is illustrated by case studies on banking reform in Argentina by Mauricio Carrizosa, Danny Leipziger, and Hemant Shah, and on financial sector reforms in China by Hassanali Mehran and Marc Quintyn. Argentina's bank restructuring effort represents an important milestone in the country's efforts to strengthen the banking system. In China, monetary and exchange market reforms have been driven by the need to provide efficient financial markets to underpin the country's very rapid economic development since 1978.

In his article on the effect of stock markets on economic growth, Ross Levine observes that by facilitating longer-term, more profitable investments, liquid equity markets improve the allocation of capital and enhance prospects for long-term economic growth. Growth-oriented economic policies and the development of bond markets have been mutually reinforcing in East Asia, according to the article written by Ismail Dalla and Deena Khatkhate. From a base of $167 billion in 1989, the East Asian bond market is projected to grow to over $1 trillion by the year 2004.

To better position themselves in today's open, global markets, governments in both industrial and developing countries are taking steps to strengthen and modernize their financial systems. Globalization is indeed an important force driving the reform movement; however, countries need to pursue financial reform, in any case, in order to realize their growth potential.

FINANCE & Development is published quarterly in English, Arabic, Chinese, French, German, Portuguese, and Spanish by the International Monetary Fund and the International Bank for Reconstruction and Development, Washington, DC 20431, USA.

Opinions expressed in articles and other materials are those of the authors; they do not necessarily reflect IMF or World Bank policy.

Second-class postage is paid at Washington, DC and at additional mailing offices. The English edition is printed at Lancaster Press, Lancaster, PA. Postmaster: please send change of address to:

Finance & Development
700 19th Street NW,
Washington, DC 20431
Telephone: **(202) 623-8300**
Fax Number: **(202) 623-4738**
English edition ISSN 0015-1947