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Economic Development Institute
of The World Bank

Financial Sector Reforms in Asian and Latin American Countries

Lessons of Comparative Experience

Edited by
Shakil Faruqi

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EDI SEMINAR SERIES

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FOREWORD

This publication consists of the papers prepared for the EDI Senior Policy Seminar on Financial Reforms in Asian and Latin American countries - Lessons of Comparative Experience, held in May 1992 at the Economic Commission for Latin America and the Caribbean (ECLAC), Santiago, Chile. The seminar was organized in collaboration with the Central Bank of Chile and with the support of the Government of Japan and was directed by Shakil Faruqi. This seminar was the first in a two part series designed to share experiences with financial sector reforms and liberalization in selected countries of Asia and Latin America. The countries represented were Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru and Uruguay from Latin America; and Indonesia, India, Japan, Malaysia, the Philippines and Thailand from Asia. A distinguished group of ministers, central bank governors, their deputies, and senior officials from these countries participated in the seminar. They were joined by the senior officials of the ECLAC and the World Bank.

This seminar was a part of EDI's ongoing program in the financial sector articulated around cycles of regional and worldwide roundtable conferences and seminars. The program is managed by Xavier Simon, Chief, Finance and Private Sector Development Division of the EDI.

The manuscript was edited and prepared by Shakil Faruqi for publication as EDI Seminar Series. The summary of proceedings of the seminar are reported in Chapter 1 prepared by Alan Roe who acted as seminar rapporteur. An edited version of the keynote speech delivered by Millard Long is reported in Chapter 4.

I would like to thank Xavier Simon, Andrew Sheng and James Hanson of the World Bank and Mr. Fransisco Garces of the Central Bank of Chile for their support and valuable advice in putting together this seminar. The papers were copyedited by Jeannie Massie, and the elaborate task of preparing and processing this book for publication was done by Michael Querrey with skill and patience.

Amnon Golan
Director
Economic Development Institute

ABBREVIATIONS

ATM	Automatic Teller Machine
BAFIA	Banking and Financial Institutions Act of 1989
BNM	Bank Negara, Malaysia
BOT	Bank of Thailand
BSE	Bumiputera Stock Exchange
CDS	Central Depository System
CEPAL	See ECLAC
CDs	Certificates of Deposit
DBP	Development Bank of Philippines
DFCs	Development Finance Companies
DFIs	Development Finance Institutions
DIDMCA	Depository Institutions Deregulation and Monetary Control Act of 1980
DTCs	Deposit Taking Cooperatives
ECLAC	Economic Commission for Latin America and the Caribbean
FDIC	Federal Deposit Insurance Corporation
FDSS	Fixed Delivery and Settlement System
FIRREA	Financial Institutions Reforms, Recovery and Enforcement Act of 1989
FSLIC	Federal Savings & Loan Insurance Corporation
GDP	Gross Domestic Product
GNP	Gross National Product
EPF	Employees Provident Fund
IFTS	Interbank Funds Transfer System
IMF	International Monetary Fund
IOCR	Incremental output-capital ratio
IOFC	International Offshore Financial Center
JPD	Japan Development Bank
KLCE	Kuala Lumpur Commodity Exchange
KLSE	Kuala Lumpur Stock Exchange
KLIBOR	Kuala Lumpur Interbank Offered Rate
KLOFFE	Kuala Lumpur Options and Financial Futures Exchange
LAC	Latin American Countries
LTCB	Long-term Credit Banks
MGS	Malaysian Government Securities

NBFI	Non-Bank Financial Institutions
NIC	Newly Industrialized Countries
NSB	National Savings Bank
PDS	Private Debt Securities
PNB	Philippine National Bank
RAM	Rating Agency, Malaysia
RARs	Risk Asset Reviews
RFB	Reconstruction Finance Bank
S&Ls	Savings & Loans
SBIF	Superintendency of Banks and Financial Institutions
SCAN	Securities Clearing Automated Network Services
SCORE	System of Computerized Order Routing and Execution
SEC	Securities and Exchange Commission
SEs	State Enterprises
SET	Stock Exchange of Thailand
SSTS	Scripless Securities Trading System
TSR	Transferable Subscription Rights

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SEMINAR PROCEEDINGS: A SUMMARY REPORT

Alan Roe

This report summarizes the papers and associated discussion presented at the Senior Policy Seminar held in Santiago, Chile between 25th and 28th May 1992. The seminar involved Ministers, Central Bank Governors and senior officials from several Latin American and Asian economies as well as several representatives of international organizations such as ECLAC and the World Bank itself. The countries represented were Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru and Uruguay from the Latin American continent, and Indonesia, Japan, Malaysia, and the Philippines from Asia, with India as an observer. The seminar was supported by the Government of Japan and was directed by Shakil Faruqi of the Economic Development Institute of the World Bank.

The central purpose of the seminar was to comparatively asses the wide range of country experiences with financial reform in the two regions, with a view to distilling general lessons. The materials presented were oriented mainly around the diverse experiences of financial policy formulation and implementation during the 1980s and early 1990s. These materials supported discussion of a variety of subthemes, including the management of financial crises, the interaction of financial liberalization with more general economic reforms, the industrial policy aspects of financial reform, and the roles of governments in stimulating the development of specific types of financial markets and institutions. The presentation during the four days included country papers as well as a variety of more general and synoptic papers included in this publication.

In the welcoming address, Roberto Zahler, President of the Central Bank of Chile, identified and elaborated on several of the main themes of the seminar. He noted that the reform experiments in Chile and the other Southern Cone economies during the past fifteen years have not been entirely painless. While many early mistakes have now been rectified, many problems still exist and much is still to be learned from the experiences of other countries and regions. The Latin American region had been characterized traditionally by both high inflation and the frequent failure of democratic processes.

Against this general background, present day financial sector management and reform, associated now with far more democratic and outward-oriented approaches than in the past, faces a variety of challenges. In particular, the authorities in most countries

now recognize that when poor management leads to financial crises, both the intermediation and the payments roles of the financial system can be seriously affected. At the same time some of the more obvious steps available to them to mitigate the effects of crises, such as deposit insurance, have been shown to involve serious moral hazard problems that lead, for example, to serious upward pressures on interest rates when banks are in difficulties. The liberalization reform experiments in Chile at the end of the 1970s ignored this as well as related dangers, such as the agency problem. This resulted all too frequently in unwise practices, such as extensive distributions of capital, even from banks in distress, in order to avoid a decline in shareholder values, as well as in seriously inadequate supervision of banks.

Zahler noted that with the greater attention that countries in the region were now devoting to bank regulation, governments needed to realize that regulation in the past has been concerned more with the prevention of problems rather than with the cures. But when cures are needed because problems have arisen, sound legislation, in his view, was enormously helpful. For example, he felt that the absence in Chilean law of a clear definition of property rights had significantly lengthened the crisis of the early 1980s. That crisis, however, had demonstrated the need for improved financial legislation, which was now forthcoming. In particular, the role of the central bank at the apex of the system had been more clearly defined. The central bank now discharged, above all, two important functions: first, it defined liquidity and the other rules for financial institutions, and second, it provided last-resort liquidity to institutions in crisis. In his opinion, a modern central bank in Chile or elsewhere should no longer involve itself in either selective credit allocations or the determination of interest rates.

On the specific topic of the seminar, Zahler thought it important to ask why experiments in financial liberalization and reform had failed so frequently. Several factors were implicated in such failures, including poor design, hasty and poorly organized implementation, inadequate bank legislation and regulations, and incentive structures that encouraged risk-taking. Future success would undoubtedly require a judicious mix of sound general economic policies and appropriate adjustments of financial legislation. A gradual and cautious approach was probably needed, although this did not necessarily mean that the reform process needed to take a long time. Above all, Zahler was very much in favor of a cautious approach toward the opening of a country's capital account. Errors in this area can and have led to unacceptably large fluctuations in critical prices, especially in the real exchange rate.

Zahler noted that while Chile's economy was now guided mainly by market forces rather than by an interventionist government, it was also benefitting from a much stronger and more effective financial regulatory system. But its financial sector and financial management still faced two substantial challenges, which will be encountered more generally as financial reform progresses in other countries. The first is the globalization of financial markets, with both the enhanced possibilities (for example, risk hedging), and the dangers that arise from this development. The second is the disintermediation that occurs as large corporations increasingly handle their financial requirements with less dependence on banking and other traditional financial institutions.

In Chile's situation domestic banks were pressing for licenses to enter new fields, such as mutual funds, and the regulators were in danger of being overtaken by events. It is important that central bank arrangements, both in Chile and elsewhere, be continuously adapted to cope with these developments as well as with the tighter international requirements exemplified by the recent recommendation of the Bank for International Settlements to increase capital requirements in the banks.

Replying to the speech of welcome, Deputy Governor Lin See Yan of Malaysia congratulated Mr. Zahler and the Chilean authorities for their success in detaching Chile from the traditional Latin American stereotype of high inflation, and also for their innovative approaches to the country's external debt management. He confirmed that many of the points made by Zahler about the challenges facing the financial sector applied equally to Asia. He noted, for example, that Malaysia, by the early 1980s, had already made excellent progress in diversifying its base of primary product exports. But then, against all the odds, the prices of all these products had fallen simultaneously, presenting the economy with an enormous problem of structural adjustment. The economy and the authorities had responded well to this challenge, but the financial sector had played a vital part in ensuring that the necessary adjustment was achieved successfully. This was done, above all, through the financial sector's role in contributing to a high degree of flexibility in both the commodity and the factor markets. The success of that adjustment is now evident both in the enormous structural changes achieved in Malaysia - 60 percent of exports are now manufactures rather than primary products - and by the great improvement in macroeconomic performance. For example, an average growth rate of 8 percent since 1985 has been possible consistently with the transformation of the country's external current account deficit from 14 percent of GDP in 1982 to a surplus by 1987, and with a reduction in the external debt service ratio from 20 percent to less than 5 percent at the present time.

This summary report builds on these basic issues and attempts to synthesize the remainder of the seminar proceedings under six main headings. The next section provides an overview of issues of financial reform, first by summarizing a conceptual analysis of these issues in a discussion led by Millard Long, and secondly by drawing on a more empirical analysis based on a discussion of recent research findings led by Gerard Caprio.

The subsequent five sections of this report provide an analysis of various dimensions of the financial reform process in selected countries in the two regions. This involves a somewhat difficult task of synthesis, because most papers presented at the seminar were oriented around the experiences of a single country, and, the papers considered a wide range of reform issues involving substantial overlapping of the subject matter from one session of the seminar to another. However, since there was a differentiation of topics across the various sessions of the seminar, these sections attempt to draw specific attention to particular topics while also including briefer discussions of other related issues brought up by speakers. Thus, the sections cover topics in the following order:

- An introduction of the contrasts between the Latin America and Asian experiences by considering two very different case studies of financial reform, namely those of Thailand and Chile.

- A discussion of the same contrasts, but this time with special attention to the particular issue of capital account liberalization in the context of more broadly based reforms. This is elaborated by a consideration of the experiences of Indonesia and Argentina.

- A specific look at the role of the financial sector and of financial reforms as elements in a country's overall industrial policy. This issues is elaborated by considering the experiences of Korea and Colombia.

- A somewhat broader theme, examining the impact of financial reform in the context of economy-wide restructuring efforts, including in particular, large-scale privatization of financial and productive enterprises. This is elaborated by reference to experiences in the Philippines and Mexico.

- A look at the important topic of the role of government in creating and nurturing the development of more diversified financial sectors, especially financial institutions able to support an economy's need for sources of longer-term financing. By contrast with other sections in the report, this topic is illustrated by reference only to the Asian experience, specifically the experiences in Japan and Malaysia.

The final section attempts to identify a few of the main themes and conclusions of the discussion.

Overview of Issues in Financial Reform

Millard Long introduced the topic of financial reform by recalling the manner in which financial systems in developing countries had typically operated in the 1960s and how and why these patterns of behavior were broken in the late 1970s and 1980s.

In the 1960s, he recalled, the dominance of short maturity commercial bank loans, many to large plantations and other dominant companies, were the backbone of most

countries' financial systems. To assist the development of more diversified economies, most governments, encouraged by the World Bank and other agencies, actively promoted new, specialized, development and agricultural banks, and had often intervened heavily in, or even nationalized, the more traditional commercial banks. Financing systems at that time were also characterized by a ubiquitous direction of credit as well as by the pre-emption of a large part of total domestic savings for government use.

The results of these interventionist approaches in terms of the gains achieved in productive output were initially good in many of the countries that tried them. However, the depressing effects they invariably had on levels of real interest rates necessarily served to keep domestic financial systems extremely small. Thus, as the external debt of many countries rose through the 1970s and rising rates of inflation caused interest rates to be repressed even more, the domestic financial systems of some countries, such as Argentina, actually became smaller than the accumulated levels of those countries' external debts. External finance, in other words, was effectively replacing many of the functions of a domestic financial system.

At the same time, the poor quality of loan portfolios of domestic banks resulted in rising accumulations of bad debts relative to total lending. In the Philippines, for example, that ratio in the late 1970s stood at something like 7.5 to 9. Chile confronted a similar problem.

Long noted that the change in attitude toward domestic financial systems had emerged gradually through the 1980s and had been influenced to some degree by the World Bank's analytical and policy work on this topic. The focus of the Bank's own policy advice in that period shifted from a narrow advocacy of development finance companies to an active involvement in broad-based financial sector policy loans.

The major motivating factor behind the change of attitude in the developing countries themselves was the severe external debt crisis of the early 1980s, which reduced aggregate net flows of external loans from more than $60 billion in 1981 to a negative quantity by 1984. This massive turnaround in the availability of external funds highlighted as never before the fundamental problems that developing countries face in trying to achieve stable macroeconomics and reasonable rates of economic development on the basis of tiny domestic financial systems. Together with the intensifying problems of rising inflation and deteriorating portfolio quality, the realization of this point encouraged large numbers of developing countries to abandon the "statist" approaches to which they had formerly been committed in favor of more liberal, market-based approaches to development, including the development of their financial sectors.

However, the widespread realization that financial reform was necessary has not made its achievement any easier. In many countries finance has been too closely and intimately involved with the political process for much progress with reform to be possible. In addition, the costs of recapitalizing distressed financial institutions have invariably seemed huge in relation to a country's available resources. This is despite the fact that the real economic costs have already been incurred in the form of the earlier and poor investment decisions that have caused the weak portfolios to accumulate. Above all, in many countries and especially in the reforming socialist economies such as Poland,

the fundamental and massive problems of cleaning up the finances of the large state-owned enterprises have proved extremely difficult to resolve.

What then are the main dimensions of financial sector reform if and when a country decides to go down the route of reform? This is a controversial matter in itself, but Long suggested six basic aspects. First, it is important to achieve a sound macroeconomic situation involving, above all, a reasonably modest rate of inflation. Second, it is essential to achieve a resolution of the financial problems of state-owned enterprises. In the absence of such a resolution, these financial problems can be black holes capable of absorbing large parts of a country's total domestic saving. Third, it is important to have realistic and moderately stable structures of relative prices. Large changes are extremely bad for banks, because productive sectors that are adversely affected by the changes will inevitably find it difficult to repay loans. Fourth, it is helpful to have realistic levels of interest rates to stimulate adequate savings while at the same time avoiding excessive disincentives to investment. Fifth, it is essential to have a strong financial infrastructure, including, among other things, a sound system of regulation of financial institutions and timely and efficient enforcement of the rules. Finally, a sound reform should incorporate the deepening of the institutional structures of banks and nonbanks as well as a diversified structure of financial investments, maturities, and so forth.

The main element of controversy in defining the scope of financial reform relates to the extent of the residual interventions in the sector that the state should provide. Long noted that the Bank, for example, has tended to advise governments against any selective intervention in the allocation of credit. The Bank, however, has been unable to incorporate this advice in its operational directives because several influential members of the Bank, notably Japan, have regarded judicious government involvement in credit allocation as desirable.

Discussion from the floor confirmed the strong divisions of opinion on this point. One view was that governments always articulate good reasons for intervening in financial markets even when these interventions are fundamentally deficient. Thus, clear guidelines discouraging intervention are preferable to loosely worded encouragements to continue as before. Also of considerable relevance to this debate is the well-established theoretical result that if the market imperfection that justifies an intervention is located in the commodity market rather than the financial market, then it is a lower-cost solution to intervene directly at the point of that failure. This solution also avoids the whole range of negative side effects that are associated with, for example, controls on interest rates. Similarly, if governments perceive a need to lower the costs of particular sectoral activities, they should examine less expensive alternatives to the solution of artificially controlling interest rates and, consequently, financial costs.

Against this was the view mainly articulated by Asian participants that some residual controls by government are essential, provided they are well managed. In Malaysia, for example, financial management has been built around a few very clear principles combined with a highly flexible approach to intervention. These points are explained more fully in the final section illustrating the Asian experience. The

principles, however, include the idea that any businesses or individuals can do whatever they like with their own money. Nevertheless, they cannot borrow funds from others to support the export of their own capital; any export earnings must be returned to the country, and any external borrowing must have the approval of the central bank. Equally, while foreign direct investment is welcome, the domestic borrowing rights of foreign investors remains very clearly linked to the amount of capital they import. Detailed interventions going beyond these basic principles are extremely pragmatic. It was suggested that the Malaysian authorities have a good sense of when and how to intervene and, equally important, of when to terminate an intervention. For example, in relation to interest rates, there is no direct intervention in the fixing of, say, the prime rate, but an extremely good understanding of the formula that the banks use for this purpose and a regular monitoring of movements is regarded as essential. Hence the information base is always there if some administered adjustment is thought to be necessary.

Although no definitive resolution of this debate was achieved, it was clear that the issue represented a possible divide between Asian and Latin American experiences. Also of significance was the fact that similar interventionist approaches in the two contexts often appeared to have been successful in the one case but not in the other. This is an issue to which this report returns in several of the more detailed sections that follow.

More consensus was achieved over a second point, namely, that even good control systems can go wrong because of the people operating them. Hence, most participants agreed that it is essential to regard the training of people as a critical element of any successful financial reform.

The discussion of some conceptual aspects of financial reform was continued and extended in the presentation by Gerard Caprio, which provided an analysis of the reform experiences of six countries that had recently been the subject of in-depth study. In a seventh case, namely Ecuador, the results were also elaborated by use of micro firm-level data. Two caveats about studies of this type were expressed at the outset. First, because financial reform is a process and not a discrete event, it is difficult to judge the success of reform on the basis of the few years of data that are typically available for most countries. For example, intrinsic difficulties with particular reforms may only become apparent after several years; certainly one or more complete business cycles is needed to fully assess the consequences of reform for the productive sectors of any economy. Second, success itself is difficult to measure. The main functions of a financial system are to mobilize the maximum amount of resources and then allocate these resources as efficiently as possible among competing users. Improved performance, especially in relation to the second of these functions, is extremely difficult to assess and not just because the theoretically appropriate measure of success - the equalization of marginal capital productivity across sectors - is likely to be influenced by many factors in addition to the performance of the financial sector.

Notwithstanding these technical problems, Caprio was able to report that gains in the incremental capital output ratios in Ecuador, Turkey, Malaysia, and Indonesia were at least consistent with the efficiency effects of financial reform. Firm-level data

for Ecuador also indicate that financial reform has been associated with a significant increase in the extent to which efficient firms obtained credit in preference to the less efficient firms. In the same country the dispersion of rates of return among firms declined following reform while the average return rose. In the case of Indonesia, small firms, which could be supposed to suffer most in a regime of directed credit, appeared to have benefitted most when reform brought about relaxed financial constraints. Less direct indicators of the success of financial reform, such as the ratio of financial assets to money (financial depth), also responded positively to reform measures in all the countries studied.

A most important result is that the evolution of borrowers' net worth is a determinant of the extent to which a financial sector is able to respond to the needs of deficit sectors. Because some aspects of financial reform, for example, the elimination of subsidized interest rates, will negatively affect net worth, there is a strong argument for moving aggressively with reform measures in good times when other influences on borrowers' net worth are favorable. Evidence from Malaysia illustrates the point that otherwise rapid reform, for example, in 1978 when interest rates were freed, may need to be halted or even reversed if the contextual factors are adverse, as they were in Malaysia by 1983 as a consequence of the adjustment to the country's large fiscal deficit.

A further message from the study is that the initial health of the financial sector is an important determinant of the impact of reform. For example, banks having negative net worth, as in the case of some U.S. savings and loans associations, may respond to the further pressures of liberalization by resorting to reckless risk taking. In addition, most banks in formerly controlled and interventionist regimes will have a large investment of informational capital tied up in their relationships with the heavily protected productive activities of the old system. The subsequent destruction of this capital, which might be caused by the liberalization of financial and commodity markets, could encourage the banks to retreat from lending, thereby imposing a serious financial constraint on investment.

These general guidelines received support in broad terms in the open discussion but were subject to several comments regarding their practicability. One strongly held view was that governments, in reality, have little choice about the timing of reform. Particular windows of opportunity need to be seized when available but the timing of these may be conditioned more by the political than by the economic circumstances of a country. In the case of the Philippines, for example, a political crisis and eventually a change of government were necessary before reforms could go ahead. Similarly, it was noted that reforms necessarily raise the net worth of some firms while lowering the net worth of others. With many different microlevel effects occurring at the same time, it may be difficult in practice to know whether the overall effects of reform will be positive or negative. This too can make it difficult to apply a very scientific approach to the timing of reform.

More agreement centered around the proposition that the human and managerial capicity in the banks ought to be one determinant of the design and speed of implementation of reform programs. Several participants stated that bankers in many

highly controlled financial systems make no real decisions about credit allocation. As the representative of Mexico put it, the life of a banker in Mexico used to be very easy: the banker merely needed to periodically negotiate the bank's profits with the central bank! In these circumstances, as Caprio argued, it is probably necessary to put time limits both on allowable shifts in bank portfolios and in the opening up of the market to foreign banks. Some participants, however, disputed this point but agreed that both restrictions can provide time for the established banks to adjust. In the case of New Zealand, for example, although most liberalizing reforms were introduced very rapidly, new entry was prohibited for about four years.

Finally, two reservations about financial reforms were illuminated by the studies. The first is that reform will result in high real interest rates, replicating the experiences of Southern Cone economies during the early 1980s. In fact, as Caprio emphasized, Indonesia, Malaysia, and New Zealand all demonstrate that financial reform is possible with real interest rates remaining in the single digit range. This was not the case in Turkey, probably because of the large spreads induced both by limited competition in the banking system and by continued high reserve requirements to finance government deficits.

The second reservation relates to a possible loss of monetary control. Once again, evidence from New Zealand, Malaysia, and Indonesia, where the post-reform inflation performance was extremely good, suggests that effective monetary control can be retained consistently with a broadbased financial reform program. It was noted that these three countries benefit from highly capable as well as independent central banks, which suggests that the building up of such capacities is a vital precondition for successful reform. As a supplementary point, the Malaysian representative noted that the retention of effective monetary control is easier when the domestic banking system is large relative to the foreign-owned component of the system. Foreign banks are likely to be more resistant to domestic monetary policy measures and will be able to circumvent some of them. By the same logic, Malaysia requires foreign banks to have local capital; they cannot be mere branches of overseas banks.

Caprio suggested that several main lessons about reform are indicated by the empirical work. First, it is invariably possible to immediately begin the process of strengthening the institutional and legal arrangements for the enforcement of controls and the punishment of fraud. This process can go hand in hand with efforts to strengthen the accounting, auditing, and banking professions.

Second, in economies that have operated previously with highly repressed financial systems, it is useful to compile in-depth information about the preexisting health of the main financial institutions. Rather than simple audits, in-depth risk asset reviews of collateral values and portfolio risks under various scenarios are recommended in this context. In the few cases where in-depth reviews have been carried out, they have typically revealed that existing internal systems are inadequate for a proper evaluation of the risks facing banks. Thus the reviews have helped in designing improved internal systems.

Third, it is essential to either restore the financial health of banks having negative net worth or close them down. This idea has many aspects, several of which were discussed in later sessions. However, a key recommendation is that it is dangerous to allow the banks to work their way out of serious nonperforming loan problems because this effectively imposes a tax on new investments and deposits. Similarly, any solution should separate bankers from their bad loans as quickly as possible to avoid the tendency to merely roll over or "evergreen" problem loans.

Finally, it seems important to delay the complete liberalization of bank portfolios as well as interest rates until the later stages of reform. The available evidence suggests that the main preconditions for successful deregulation are reasonably stable macroeconomic conditions, sound financial situations in both banks and their main borrowers, and financial markets that are reasonably competitive or contestable. If these conditions are not satisfied, deregulation can lead to very high real interest rates that can threaten the net worth of both borrowers and financial institutions. This was the case with the reforms in Chile and Turkey in the early 1980s. By contrast, both Malaysia and Korea adhered closely to the recommended precondition and achieved full liberalization of interest rates in the early 1990s.

The Asian - Latin American Contrast: Thailand and Chile

Thailand

Presenting the paper written by Mr. Ekamol Kiriwat of the Bank of Thailand, Mr Zamir Hasan drew attention first to the central problem confronting the Thai financial sector in recent years: The economy's exceptionally high growth rate (10.5 percent between 1987 and 1991) had resulted in a widening current account deficit and higher inflation. It was felt that critical infrastructures and other bottlenecks contributing to this problem could be resolved if the financial sector could be reformed to mobilize increased volumes of domestic saving and also allocate these more efficiently.

The prevailing inefficiencies of the country's financial sector could be traced, he argued, to three main factors. First, although competition within the dominant banking sector and the five main banks had been strong, the overall competitiveness of the financial system had been seriously constrained by legal restrictions that limit the scope of business among different financial institutions. Second, with the exception of a stock market, both the money market and the securities markets had played an extremely small role in corporate financing and secondary markets. Being almost nonexistent, the markets had provided little if any liquidity to most instruments. Third, many aspects of the infrastructure of the financial system needed strengthening. This included, in particular, the telecommunications and electronics facilities to deal with increased transaction volumes as well as with the globalization of business. It also related to the shortage of qualified management and other personnel, as well as the absence of crucial

confidence-supporting institutions, such as credit rating agencies and deposit insurance facilities.

As a response to these perceived problems, a comprehensive financial reform plan was designed at the end of the 1980s to cover the three-year period from 1990 through 1992. This incorporated four major component programs for reform:

- Deregulation and liberalization
- Capital market and new instrument development
- Improved regulation and supervision of financial institutions
- An improved payments system

Deregulation and Liberalization - The first step in deregulation and liberalization related to interest rates, beginning with the floating rates on longer maturity time deposits in 1989. This was followed by the removal of interest rate ceilings on all time deposits in March 1990, a step that has encouraged the banks to set their rates more flexibly but also more in line with international rates. A further step was the lifting of ceilings on savings deposit rates early in 1992. Loan interest rates, however, still remain subject to ceilings, although Hasan noted that these ceilings have always been used in a very flexible manner and cannot really be regarded as binding.

In relation to foreign exchange transactions, Thailand in May 1990 and thereafter allowed banks to buy and sell foreign currencies to the public for current transactions without prior approval. A substantial liberalization of the capital account occurred one year later when both individuals and corporations were authorized to open foreign exchange accounts up to prescribed limits.

The problem of the segmentation of banking services, referred to earlier, was partially resolved in early 1992 when the scope of allowable activities for commercial banks and finance companies was considerably expanded. At the same time, the banks were given a more flexible definition of their required reserves as well as their requirements under selective credit rules. However, some requirements to allocate credit selectively, especially to rural areas, remained.

Capital Market and New Instrument Development - In 1992 a new Securities and Exchange Act corrected several weaknesses in the legal system regarding the issuing of debt instruments and their trading. At the same time, a variety of inconsistent laws was unified as were the various supervisory agencies responsible for different aspects of the securities business. One of the main objectives of the reform was to provide improved protection of investors. To this end a newly established Securities and Exchange Commission (SEC) was charged with the task of approving all public issues; the approval was associated with requirements for the disclosure of specified financial and other information. At the same time, the penalties for insider trading were made far more severe.

The institutional structure supporting money and capital market development was also strengthened by empowering the SEC to supervise all types of public offerings of securities: short-term, long-term, new, as well as outstanding securities. The act also defined clear rules for each type of security business, including mutual funds and private fund management. The rules include substantially enhanced capital requirements for securities companies.

These various reforms, it was explained, are together designed to change the face of the Thai financial system: to ensure that business can obtain direct finance without needing to go through the commercial banks; to stimulate more financial innovation; and to provide for a more transparent and better regulated set of arrangements for the securities business.

Improved Regulation and Supervision - In this area the Bank of Thailand has initiated a modernization program comprising three main parts. The first is a new electronic clearinghouse system to handle the clearing of checks. The second element is improved interbank transfer arrangements using, at first, data disks from member banks to make transfers, and later, on-line systems. The latter change will also require the unification of the two automatic teller machine pools that currently operate.

An Improved Payment System - Finally, the Bank of Thailand proposes a new electronics network to handle a large volume of transactions, eventually including all government securities data as well as financial returns from the commercial banks.

The discussions pointed out that, notwithstanding the merits of the Thai reforms, the pre-reform economy had achieved remarkable progress. One explanation lies in the sound overall management of the economy and the associated high degree of macroeconomic stability. In a situation such as this, controlled interest rates were unlikely to deviate much in real terms from the levels that would be obtained in a liberalized environment and so would do relatively little damage even if the rates were set incorrectly. In addition, with a very strong, albeit concentrated, domestic banking system, corporate financing has been reasonably well provided for in recent years even in the absence of well-developed securities markets. It was noted in particular that the role of domestic banks in this area has intensified in recent years and that the influence of foreign banks has contracted substantially.

Chile

Thailand represents an example of financial reform enacted in a relatively stable environment with decisions being made to achieve marginal improvements in financial sector efficiency. There was no overwhelming pressure on the authorities to enact most of the reforms. The authorities chose to undertake them at a pace that was largely of their own choosing. Chile, by contrast, provides an example of turbulent change in

which several aspects of reform were largely unavoidable responses to situations of crisis or near crisis.

In presenting the Chilean experience, Nicolás Eyzaguirre noted that the radical reforms of 1973 involving the broad-based privatization of financial institutions had needed to be substantially reversed in the early 1980s when the financial difficulties of many banks forced their reversion into state ownership. Thus, the recent reform experience in Chile embraces both the frustrated deregulation of the mid-1970s as well as the management, including monetary management, of the more stable situation of the recent past.

The liberalization process initiated in 1974 was part of an overall strategy to liberalize the entire economy, including large reductions in tariffs and other barriers to trade, the privatization of state assets and the removal of most capital account restrictions. Although the economy initially grew extremely rapidly under this regime, several imbalances in the financial sector and a substantial increase in the indebtedness of most parts of the private sector signalled the fact that this good performance was probably unsustainable.

On the debtor side, many producers of tradable goods expecting this to be only temporary, borrowed to offset the profit squeeze associated with reduced tariff protection. The real estate sector, encouraged by exchange rate appreciation and large speculative demands, borrowed heavily to finance a construction boom. Consumers also borrowed heavily, encouraged by a perception of greatly increased wealth and the availability, for the first time, of unrestricted credit. A number of technical errors and other factors compounded this debt buildup. Above all, the authorities wrongly assumed that the market would adequately evaluate the risks of lending and therefore set lending rates accordingly. In practice, because of the implicit state insurance of bank liabilities, the banks and their depositors attached far too low an importance to risk. In addition, the banks wrongly regarded the inflated asset values associated with the property boom to be a true measure of the value of the collateral against the loans they were granting. With the benefit of hindsight these problems are directly attributable to inadequate financial legislation, which both stimulated and allowed a situation of over-indebtedness to emerge. Finally, because the banks were part of larger industrial and financial complexes, the protection of bank capital was often deemed less important than providing related credits to save the productive enterprises in the group.

The 1982 economic crisis was triggered by the fall in the country's terms of trade and the abrupt discontinuation of new external credits. At this stage the macroeconomic imbalance in the economy as a whole was manifest, above all, in a current account deficit equivalent to 14.3 percent of GDP. As economic activity contracted, private sector borrowers were unable to repay loans to banks, banks could not meet their own liabilities, and the country as a whole was unable to finance its external debt.

A first option to deal with this critical problem at the level of the financial sector was to allow creditors to take over the assets in failed banks and sell them to recover the amounts owed. Although this was tried in 1982 and 1983, it was abandoned because the legal procedures in Chile were too slow, and property rights too ill-defined to permit it

to work effectively. The options of either inflating out of the problem or developing a monetary reform to reduce the nominal values of debt were also rejected because of their damaging side effects.

The option that was actually adopted was that of deferring the losses through time using a debt assumption program coordinated by the central bank. The program involved granting state guarantees to private sector foreign debt, intervening in the main banks, and implementing a massive program to support both banks and debtors. This approach prevented the simultaneous sale of assets implicit in the first option, and it also avoided the closure of many productive activities. However, because the assistance was funnelled through the central bank, it involved a large increase in central bank losses and thus in the quasi-fiscal deficit of the government.

More specifically, between 1982 and 1985 the central bank granted emergency loans to commercial banks and proceeded to purchase the overdue parts of their portfolios. This was done using promissory notes that paid a real interest rate of 7 percent annually. The banks were required to repurchase assets from the central bank as soon as their own profits recovered sufficiently. The main subsidy involved in this was the excess of 7 percent over the normal cost of central bank funds. A further cost to the central bank arose from the commitment to sell preferential dollars to foreign currency debtors in Chile at a more favorable exchange rate than the strongly devalued rate that applied after the 1982 devaluation. This was additional to the foreign exchange losses of the central bank arising from nominal devaluations and the central bank's negative foreign currency position following its intervention in the foreign debt rescue. The overall cost of this package is estimated at between $7 billion and $9 billion, and thus reflects, even today, in an annual cost in quasi-fiscal terms of about 2 percent of GDP.

Remarkably, the rescue resulted neither in a major acceleration of inflation, which remained below 30 percent, nor in a major surge of the real interest rate, which remained at about 8 percent. Eyzaguirre attributes this to several factors, including the fiscal austerity of the late 1970s and the consequently relatively low level of public sector debt by the early 1980s; the increased depth of the Chilean financial system resulting from the early 1970s liberalization, which made it easier for private agents to absorb some of the new debt being issued; the strong real devaluation that occurred from 1982 onwards, which worked to lessen the current account deficit and also make possible a less restrictive monetary policy; and the downward flexibility of real wages associated with the diluted power of labor unions.

The response to the serious failure of banking controls in the 1970s was the banking legislation enacted in 1986. Central to this is a greatly strengthened set of supervisory arrangements and the requirement placed on the superintendent of banks and financial institutions to provide at least three times a year, even in newspapers, a published opinion of the financial state of each institution. Chile is thought to be the only country in the world in which detailed information on bank solvency is so frequently published. Associated with this arrangement are clear regulatory limits on the loans granted to any individual debtor; on exposures in different currencies; and on the ability

of banks to provide special terms on any related credits that they may extend. Rules for the establishment and the expanded scope of financial institutions have also been enforced. For example, the establishment of new branches now has to be done with segregated capital, which is deducted from capital for the purposes of calculating debt to capital and capital to adequacy ratios. Another major innovation in the new legislation is the stricter arrangement governing the provisions banks need for risky credits. This is to try to ensure a more accurate measure of each bank's true, as opposed to, book capital. Finally, the payments mechanism is protected by a guarantee system on demand deposits and deposit insurance for smaller savings deposits. An effort has been made to limit the moral hazard problem, referred to by Governor Zahler, by imposing a limit on the amount of an insurance claim by any one individual.

The new banking legislation clearly indicates that the lessons of the aborted 1970 liberalization have been well learned. Chile, however, is still coming to grips with the globalization of financial markets and finding the correct stance regarding the openness of the capital account. Certain advantages of this openness are recognized. First, it permits some supplementation of scarce domestic savings by access to cheaper foreign savings. Second, it permits a more efficient diversification of risk through the use of a broader range of borrowing instruments. However, against this, it is well remembered that the 1980s debt crisis in several Latin American economies was associated with a sudden and indiscriminate opening to foreign borrowing. This has encouraged the Chilean authorities during the most recent reform period to retain certain restrictions on external capital flows: reserve requirements imposed on foreign borrowings; restrictions on the overseas issue of stocks and bonds by Chilean companies; and restricted access to foreign exchange for the purposes of investment in other countries.

Although these measures introduce some friction into capital movements, the fact remains that Chile, subsequent to its most recent reform, has again been attracting very large capital inflows. These obviously complicate monetary management by expanding available domestic liquidity, thereby contributing to expanded levels of domestic spending and, possibly, higher inflation. An appreciation of the real exchange rate is a further probable consequence. Technically, these efforts can be offset by a full sterilization of the monetary effects of the inflows. However, this requires the issue of large volumes of internal debt at interest rates greater than the international rates at which the accumulating stocks of international reserves can be invested. This increases the already high losses of the central bank and adds to the large quasi-fiscal deficit. But the alternative of only limited sterilization results in a real exchange rate appreciation that eventually, if not immediately, will damage the profitability of tradeable activities.

A further complicating factor to the current situation is that of knowing whether existing levels of capital inflow can be relied on in the long-term to finance current account deficits or whether they are transitory. In these circumstances the best that the Chilean authorities can do, Eyzaguirre argued, is to maintain a watching brief to try to ensure that opening the capital account does not lead to levels of current account deficits that are unsustainable in the medium term. In this climate of uncertainty, taxes on foreign borrowing represent a useful instrument for ensuring a higher degree of monetary

control. In addition to allowing time to discriminate between temporary and permanent situations, taxes also allow for some degree of discrimination between short-term speculative capital and long-term investment capital.

Discussion from the floor drew attention to both the considerable achievements of recent reforms and the residual dangers confronting the financial sector. One assertion was that Chilean savings rates remain low in spite of the reforms and are certainly low in comparison with the rates achieved in much of East Asia. This means that the limits on growth associated with scarce capital would certainly be binding in the absence of the large inflows from abroad. Furthermore, some participants felt that trade and financial liberalization together had contributed to significantly increased expenditures on consumer durables and therefore to a depressing effect on domestic saving.

Others argued that the deepening of the financial markets to which Eyzaguirre had referred was partly a valuation phenomenon associated with the large increases in stock market valuations. By contrast, new issues to raise fresh money remained relatively limited. At the same time, it was noted that price-earnings ratios, at about sixteen, remained reasonable and were certainly not indicative of a bubble. Finally, it was suggested that only the larger firms had been able to benefit from financial reform. Financial reform for the time being, it was claimed, had done relatively little for smaller and medium size enterprises. However, this last point was disputed by the undoubted factor that Chile, in recent years, had seen the establishment of many new exporting firms, most of which have benefitted in some measure from the new financial possibilities that financial sector reform has opened up.

Capital Account Liberalization: Experiences in Indonesia and Argentina

The discussion surrounding the presentation on Chile by Nicolás Eyzaguirre indicated very clearly that capital account liberalization is a central but difficult aspect of any financial reform program. This basic point was elaborated in further detail in the presentations on the Indonesian experience, given by Syahril Sabirin, and on Argentina by Roque Fernández.

Indonesia

Sabirin began by noting some of the arguments that, in the past, had encouraged most developing countries to maintain significant controls over both inward flows of direct and portfolio investments, as well as outward capital flows. He noted several basic difficulties with these traditional arguments including:

- Controls on capital outflows normally required countries to also maintain tight current-account controls, and this frequently resulted in serious distortions of trade flows and commodity markets.

- Controls on capital outflows, while often designed to ensure full domestic use of scarce savings, could not ensure this in practice. The direction of such funds to consumption, inflation hedges, or illegal capital flight had proved to be more likely outcomes.

- Restrictions on offshore borrowing had invariably forced domestic producers to operate with higher costs and poorer risk diversity in their overall borrowing structures.

Sabirin argued that because of these and other difficulties it was now widely accepted that some liberalization of capital as well as current account transactions were necessary as part of a reform process. The difficult issue that remained was determining the appropriate speed and sequencing of these reforms. The Indonesian experience provides an interesting and somewhat unusual angle on this problem, in that the liberalization of the external capital account was achieved much earlier than most of the main components of domestic financial sector reform.

Prior to 1970 Indonesia had maintained a very tight control on foreign exchange transactions on both current and capital accounts. Highly restrictive legalization for example, in the 1964 Foreign Exchange Law, adopted most of the practices of the former Dutch colonial control, however, the substance of these controls seemed at the time to be fully justified by the severe balance of payments problems facing Indonesia in the early 1960s. After three centuries of Dutch occupation, the sentiments against foreign direct investment were particularly strong, and these were also in line with the government-directed approach to development that was followed at that time. However, as in many other countries the consequences of the type of restricted policies followed by the old order government were disastrous: low growth, high inflation, and large fiscal and external deficits.

The new order government, which came to power in 1966, moved quickly to introduce an economic stabilization program based on more restrictive fiscal and monetary polices, including high interest rates, and also to negotiate rescheduling arrangements with external creditors. These policies served to rapidly reduce inflation so that by 1969 the economy had a strong base from which to launch a series of more realistic development programs.

Regarding financial policies, a partial freeing of the foreign exchange rights of exporters in 1967 (the export bonus account system) was followed by a substantial freeing of foreign exchange transactions in 1970. The regulations of that year set few limits on capital outflows or inflows. Individuals and companies became free to transfer

capital out of the country without limit. Similarly, both domestic and foreign individuals and companies were allowed to transfer capital into the country, with restrictions remaining only on direct investment and on purchases through the domestic capital markets. However, offshore borrowing by state-owned enterprises remained subject to prior approval for the obvious reason that such borrowings, when they were made, became in effect a part of the government's own debt. Similarly, but this time for reasons of domestic liquidity management, limits were imposed on the offshore borrowings of both banks and nonbank financial institutions in the country.

Regarding foreign direct investment, a cautious opening up commenced in 1967 with the Foreign Investment Law of that year. Initially this liberalization was limited to joint venture arrangements with local partners. Almost full deregulation in this area was achieved only in 1992, although even then it was only in fourteen provinces of East Indonesia in which 100-percent foreign investment projects without any minimum capital requirements were allowed.

Significantly, these capital account reforms went ahead mainly in advance of the corresponding deregulation of international trade and domestic financial transactions. In relation to international trade, the trend to increased protection of domestic industries through import restrictions continued. It was only in the second part of the 1980s that significant liberalization began. Furthermore, a fixed-exchange rate policy continued until 1983, with three discrete devaluations in 1971, 1978, and 1983. In relation to domestic financial policy it was only in June 1983 that interest rate ceilings on the deposit and lending rates of state-owned banks were lifted. Prior to that the state banks, accounting for 70 percent of the sector, had little incentive to mobilize domestic deposits, because they had ready access to rediscount credits from the central bank on any loans extended to priority sectors.

Sabirin emphasized that the sequencing of liberalization in Indonesia appeared to have deviated significantly from the normal route, whereby capital account liberalization follows current account liberalization both of which were preceded by domestic financial sector liberalization. According to Sabirin, two difficult problems have arisen as a result of this somewhat unconventional sequencing. The first is the recurring difficulty that the authorities have faced in preventing widespread speculation in favor of an exchange-rate devaluation and the associated capital outflows. The second is the problem that the authorities have had of interest rate management, especially when it is clear that a domestic rate that is too high in real terms will both depress domestic activities and also attract a capital inflow that is too large; a domestic rate that is too low will encourage large capital outflows. This is additional to the point made from the floor that with high degrees of price variability, the concept of the real interest rate is difficult to pin down for policy purposes. Sabirin argued that the loss of monetary control associated with an open capital account is possibly acceptable to a government if the open capital account can help achieve significant benefits for overall economic performance. This is more likely, in his view, if other policies can work to achieve a low rate of inflation and a stable exchange-rate. This was only partially possible in Indonesia through the 1980s.

Sabirin offered several important caveats about whether the Indonesian sequencing provides any lessons for other countries. First, the capital account liberalization was part of a comprehensive economic package, and the administered increase in the deposit interest rate in 1968 served to improve the competitive power of domestic financial assets. Without this increase and a successful anti-inflation policy through the late 1960s, large capital outflows would certainly have resulted. Second, the determination of the new government after 1966 to achieve improved economic performance generated substantial public confidence and certainly contributed to the avoidance of speculative damage to the new open policy. Third, in spite of continued current account restrictions in the 1970s, the freer foreign exchange system after 1970 generated at least some features of current account liberalization. This casts some doubt about whether the Indonesian sequencing was really as unusual as it may have appeared to be at first sight.

Sabirin's broad conclusion, which was largely accepted in the discussion, was that theoretical guidelines about appropriate sequencing are potentially misleading. The reality is that the interaction between different structural policies, to say nothing of exogenous circumstances and the political climate, are complex and not easily generalized.

Argentina

Once again, the presentation regarding the Latin American experience - this time for Argentina - revealed a far more turbulent situation and one in which really dramatic solutions were being attempted. The problem in Argentina from the vantage point of mid-1989 was hyperinflation at the rate of 100 percent per month, an extremely high level of external debt, and a severely distorted and heavily taxed monetary system.

Roque Fernández, President of the Central Bank of Argentina, explained the range of measures adopted in the recent past in an attempt to resolve these problems. These had included as a central measure the progressive liberalization of the capital account of the balance of payments, starting with the equalization of the tax treatment of residents and nonresidents. In 1990 most controls on the exchange rate were removed, and for a time the rate was allowed to float freely. However, in 1991 with the new Convertibility Law, the Congress fixed the exchange rate at a one-to-one parity with the U.S. dollar and committed itself to intervening as necessary to hold the rate at this level. This same law also provided a 100 percent backing of the local currency by foreign exchange. This dramatic move on the exchange-rate was accompanied by the elimination of all capital controls. Now any funds can be taken out of the country, and the only transactions that absolutely need to be handled in peso currency are the payment of taxes.

This dramatic shift in exchange rate policy obviously needed support from tight fiscal and monetary programs. In the Argentina case the traditionally large fiscal deficit was reduced first through an emergency law that suspended most tax exemptions and also reduced many subsidy payments. This was complemented by a major privatization program directed initially at thirty-two major enterprises. Significantly, foreign

participation in the privatization sales was openly allowed and no prior approval for foreigners was required, even in the case of the more sensitive industries. In addition, elements of the quasi-fiscal deficit of the government were reduced by eliminating the automatic central bank rediscounts formerly provided to provincial banks. This in turn put pressure on provincial governments to reduce their previously large borrowings from these captive banks. This in turn opened up questions as to whether state-owned provincial banks were really necessary.

Regarding monetary measures, the most dramatic development was the freezing of short-term bank deposits and their replacement by ten-year maturity bonds. When the secondary market for these bonds opened up, the initial market price was only $0.15 in the dollar implying an apparent expropriation of 85 percent of the value of deposits. Defending this action, Fernández drew an analogy with corporate bankruptcy and Chapter 11 type provisions. He argued that facing up to the reality of the bankruptcy of banks in Argentina had provided some prospects of the viability of those banks in the longer term. The alternative would have been to leave the long-term burden with the taxpayer. Similarly, the hyperinflation that had characterized Argentina before 1990 had also served to expropriate wealth just as surely as the direct writing down of the value of deposits did.

In any event the measures that had been taken resulted in an apparently sustainable fiscal surplus to provide for the servicing of internal debt. By 1990 inflation had been reduced to about 10 percent per month and to only 1 percent per month by May 1992. The enhanced stability of the economy, together with the very liberal approach to privatization sales and the honest recognition of bankruptcy and downward adjustment of asset values, resulted in the country attracting substantial capital inflows from abroad. This in turn exerted some upward pressure on the exchange rate. At the same time, the gradual restoration of confidence helped to raise the secondary market price of the new ten-year bonds to some $0.85 on the dollar. Thus, people who had immediately sold these bonds had taken a large capital loss, whereas those who were able to hold on to the securities now faced the prospect of a reasonable rate of return.

Comment from the floor referred mainly to the revolutionary nature of the Argentinean reforms and to the apparent disregard of normal principles of sound financial management that were involved. It was noted that the 100 percent foreign currency backing for the peso had effectively eliminated the need for a domestic financial system. At the same time, the confiscatory measures employed must surely have undermined confidence in domestic financial assets for many years to come. Possibly, the extremely liberal approach to capital movements had amounted to a closing down of the domestic financial system rather than to its reform.

Fernández did not fundamentally dispute this interpretation. Indeed, he likened the financial sector in Argentina to productive sectors, such as car production. If they were unable to survive against fair competition from abroad then perhaps they should be closed. Protective measures, such as deposit insurance, that had been rejected by the Argentinean reformers were imposing enormous, and in Fernández' view, unjustified costs on taxpayers in many countries, including the United States.

The 100 percent foreign currency reserve requirement in effect transfers the responsibility for the stability of a country's currency to other central banks. This gold-standard approach in the Argentinean case had implied a major appreciation of the real exchange rate. To avoid undue disruption of economic activity, and especially tradeable activity, it required a high degree of price flexibility, which had been the exception rather than the rule in most of Latin America. Some gains in microeconomic and sectoral efficiency might be expected to compensate for some part of the overvaluation, but this could not be expected in large amounts. Fernández agreed that the fixing of the nominal exchange rate implied a belief on the part of the Argentinean authorities that adjustment could take place in nominal prices. However, price flexibility certainly needed to be enhanced to achieve this, and this was why a whole range of restrictions limiting downward price flexibility were being addressed and removed (for example, labor contracts and public utility prices).

Several other more general concerns were expressed about open capital accounts, such as those established in both Indonesia and Argentina. In particular it was noted that in repressed systems the quasi-rents associated with economic distortions became capitalized over time in the valuations of companies. Hence, any liberalization gave rise to capital losses that were difficult for some sectors of the economy to digest. The changes in capital values could not be regarded merely as transfers between losing and gaining sectors. Although policies of opening up the trade account first would certainly create new opportunities, it would also generate large capital losses for formerly protected firms as well as portfolio problems for their creditors' banks. This in turn would put upward pressure on domestic interest rates and provide any firms with access to cheaper foreign loans with opportunities to make substantial gains. If a country advances its deregulation of the capital account simultaneously with trade reform, then this process is merely accelerated, leading inevitably to large current account balance of payments deficits and rapid external debt accumulation. A country having a current deficit equivalent to 7 to 10 percent of GDP could expect the doubling of its debt to GDP ratio every four years.

From this general observation it was also noted that a country such as Argentina that chooses to combine an open capital account with a fixed exchange rate imposes on itself an enormous fiscal discipline: a discipline analogous in one person's view to a "dagger in the steering wheel." Argentina had, so far, gained substantial benefits in responding to that discipline because of the privatization revenues. However, this could only help the government in the short term. In the longer term the policy required higher levels of domestic saving relative to investment, as well as domestic interest rates that were not too far out of line with international levels. This is a difficult combination to achieve; the overheating or deflation of the economy would be a consequence of a failure to achieve it. As a specific example of the problem, Argentina had recently rejected the advice to sterilize the large inflows of capital now being attracted. Argentinean authorities argued that such an approach would necessarily result in higher levels of domestic interest rates and, therefore, in more inflows.

More generally it was pointed out that the large capital inflows currently being attracted by Chile, Argentina, and other Latin American economies were explicable in part by reference to the low level of interest rates in the United States. The real test for capital account convertibility would come later when interest rates rose internationally and the countries concerned needed to achieve real depreciations of their currencies. This would be a particular problem for countries that had nailed their flags to the mast of fixed nominal exchange rates.

Industrial Policy and Financial Sector Reform

Several papers were prepared to address the topic of industrial policy and financial sector reform, although the paper on Korea could not be presented in person by its author. Nonetheless, to take advantage of the valuable lessons from South Korea and also to maintain the comparative tone of this report, this section provides an overview of the experiences of both Korea and Colombia. The substantive issue that is addressed is the extent to which financial sector policies interface with industrial policy; the consequences for industrial sector performance of an insufficiently developed financial sector is an issue that is given further consideration in the next section as well.

Korea

This issue was illustrated first by the experiences of Korea, where, as Bon-Ho Koo's paper noted, a wide range of government controls over the financial sector had been retained through the beginning of the 1980s. This control was manifest in the direct government ownership and control of certain key institutions, such as commercial and special banks; in the control over policy loans; and in subsidized interest rates available on a wide range of discretionary loans. The main problem that arose from this, in Koo's view, was the weakening of corporate financial structures. As Korea began to grow rapidly in the 1960s, the limited internal funds available in most companies as well as the inadequacies of domestic capital markets meant that the financing of large investments needed at the time had to be financed using mainly borrowed funds. The results of these large investments have been generally successful, but the legacy is a very highly leveraged industrial sector. This problem culminated in the 1970s with the drive for heavy industry, pursued with considerable government direction and several significant failures during that period.

When the liberalization of the financial sector began in the early 1980s, the inheritance of the past, and especially the high levels of corporate indebtedness, resulted in several constraints being evident on the speed at which financial reform could proceed. First, the practice of providing government guarantees on almost all foreign loans provided a rationale and a set of practical reasons for continued government intervention in the domestic financial markets as well. Second, although the Korean authorities had

worried about the replacement of direct export subsidies by a flexible exchange rate, they also found it more and more difficult to retain the direct interest rate and other subsidies because of anti-dumping and other retaliatory actions. A route out of this dilemma was to continue the extensive support of the Korean export sector by using preferential credit arrangements directed at exporters. Finally, the high incidence of unsuccessful investments in the heavy and chemical industries in the 1970s was a major constraint on financial liberalization. This is because the government was so directly implicated in many of these decisions that it was obliged to play an important role in the process of the industrial restructuring that has been needed to achieve the recovery from the earlier mistakes.

Nonetheless, in spite of these obstacles, Korea achieved a significant liberalization of its financial sector in the 1980s. The process included the freeing of both deposit and lending rates of interest, the removal of some of the barriers to entry to the sector, and the granting of more autonomy to banks in day-to-day operations. The government sold its shares in the five nationwide commercial banks to the private sector, and in 1982 it substantially relaxed the requirements for establishing new nonbank intermediaries, such as finance companies and mutual funds. This latter action stimulated the emergence of twelve new short-term credit companies and fifty-seven mutual funds within one year. The reforms in general encouraged the establishment of five new commercial banks by 1991 and a variety of other new institutions, including eighteen new life insurance companies.

The role and scope of banks has also been substantially enhanced as a part of these reforms. Commercial banks can now issue certificates of deposit (CDs), handle trust business, issue credit cards, and own nonbank financial institutions and securities companies as subsidiaries. Significant progress was also made in the early 1980s in reducing the importance of loans at preferential rates; later, short-term export credits were reduced. Since 1984, institutions have been allowed more flexibility in setting their own lending interest rates within a defined range. In 1982 the monetary authorities abolished direct control of bank credit through credit ceilings in favor of indirect control through reserve requirements. However, entry requirements to the banking sector persist, some interest rate restrictions are still maintained, and the government still maintains control on the asset management of both banks and nonbank financial institutions.

Koo's overall assessment is that, notwithstanding the remaining restrictions, the Korean financial system grew remarkably in the 1980s, mainly because of the rapid expansion of a variety of nonbank financial institutions. These institutions were either less restricted or more competent at circumventing restrictions than were the banks. The development of the banking sector, however, continued to be hampered by a continuing lack of competition and the accumulated burden of nonperforming loans. Koo noted that further financial reform would undoubtedly occur in the future, and some specific measures were already targeted. One of the main sources of pressure for further liberalization will be from foreign sources, which increasingly want access to the Korean financial market in return for their countries' having allowed reasonable access of Korean

products to their own markets for goods and services. Pressures will also come from the rapid evolution of Korean industry and the need to support this with a financial sector that is as efficient and modern as possible.

Colombia

In Korea dramatic industrial success has been achieved in part from a range of interventions in a regulated financial environment. There is now a tension, as Koo's paper made very clear, between the evident need for financial deregulation and the instinctive worries of the authorities about giving up the controls that have served their productive sectors well in the past. The situation in Colombia, as the presentation by Maria de Martinez made clear, is fundamentally different. There, beginning only in the 1990s, virtually simultaneous steps were taken to adopt a more liberal industrial policy at the same time that far-reaching reforms of the financial sector were also attempted.

The more liberal industrial policy included a radical reduction of tariff barriers to trade, the rationalization of a variety of nontariff barriers, the elimination of price controls, the elimination of most labor market restrictions, the lifting of most restrictions on foreign direct investments and the associated remittance of profits, and the introduction of a more flexible set of arrangements for foreign exchange transactions.

The financial sector reforms were designed, above all to increase competition in the sector and to allocate resources more responsively to market forces. The reforms proceeded much more rapidly than they did in Korea. Specifically, most interest rates were freed rapidly; only the cost of agricultural credit is now subsidized. New financial intermediaries were authorized, the transformation of the functions of the established intermediaries was encouraged, and foreign investment in the sector was permitted for the first time since 1975. At the same time, several banks taken under state control during the 1982-83 crisis were privatized.

This abrupt liberalization of both the real and the financial economy has given rise to some successes but also to a number of remaining problems. The successes have included a very rapid growth of nontraditional exports - 40 percent in 1991 - and an equally dramatic increase in foreign direct investment to $1.9 billion by 1991.

The problems have been related to some of the same issues referred to in earlier presentations. First, the authorities initially decided to sterilize the large capital inflows through an active open-market policy. However, this resulted in very high domestic interest rates in early 1991 - 50 percent nominal and 20 percent in real terms - which merely encouraged even larger capital inflows. Nevertheless, the authorities were anxious not to abandon monetary targets because they thought that this might signal an abandonment of concern about inflation. Consequently, in 1992 a discrete adjustment of the exchange rate was made to try to establish approximately the same equilibrium level that had prevailed from 1986 to 1988. The authorities also decided that any further adjustments for achieving overall economic consistency should be handled through fiscal adjustments and interest rates. The fiscal leverage is expected to be achieved initially by

a program of tax-raising measures, while interest rates will be reduced by lowering the rate paid on funds borrowed by the central bank, which is now somewhat negative in real terms. In principle the lower rate should discourage capital inflows, although the evidence for the first months of 1992 indicates a further substantial increase rather than a fall.

Second, the uncertainties arising in part from abrupt changes in policy have contributed to a very poor performance of productive investment. This has opened a lively debate in Colombia as to whether the public sector should once again step in with investment to occupy the space left vacant by the private sector: an action that, if taken, would obviously nullify some of the original intentions of the reform program.

In general, Colombia, unlike Korea, does not have the tradition of a private sector that has been able to rely on the policy supports provided by government. This has enabled the authorities to go for rapid reform in the financial sector with few of the reservations found in Korea. However, this has been done without any real certainty about the productive sector supply response that will follow. Korea, on the other hand, has needed to proceed cautiously so as not to jeopardize the record of industrial success already achieved.

Restructuring and Privatization: The Philippines and Mexico

Financial deregulation and reform clearly represent important elements of any country's industrial policy and obviously need to be designed accordingly. The examples of Korea and Colombia illustrate this general point from two quite different perspectives. But in many countries in recent years financial reform has been devised as one critical element of far-reaching policies of economic restructuring, including major privatization of productive activities formerly under state control. Two major examples of this are the Philippines in Asia, and Mexico in Latin America. This section of the report summarizes the main issues arising in these two cases.

The Philippines

Jesus Estanislao, Secretary of Finance of the Philippines,[1] noted in his presentation, first, the contrasts between his country's experience of financial reform and those discussed in earlier sessions of the seminar, for example, a relatively late opening of the capital account; and second, the interlinking of short and long waves of economic and financial reforms. Financial reform began in the Philippines in the early 1970s with a package of reforms to strengthen central bank control over the financial system and to remove many of the administrative controls on interest rates. This first set of steps was consolidated in the early 1980s with measures to allow different banks to operate freely

1. At the time of the Seminar in May 1992.

in various markets while at the same time strengthening the capital, reporting, and other requirements imposed on banks. These early measures established the long-term direction of reform, but, Estanislao argued, they did not prevent major problems, such as the widespread rural and other banking failures experienced in 1983. Estanislao felt sure that the country needed the revolution of 1986 and the change of government before it could move to seriously challenge some of the more substantial repressive forces established over the previous two decades - forces characterized, above all by crony capitalism, insider abuses within the financial system, and extensive government involvement in many aspects of financial and economic management.

The Aquino administration in 1986 inherited a recessionary economy with an inflation rate close to 50 percent and heavy debt to foreign creditors. Thus, as in Indonesia some twenty years before, priority had to be given to the restoration of positive economic growth and the reduction of inflation. In spite of the turmoil that the Aquino government faced in its initial phase, these objectives were quickly achieved, as was the negotiation of some beneficial arrangements for external debt relief.

By 1989, however, the successful resumption of growth in an economy still encumbered with serious structural weaknesses had resulted in overheating. In particular, the fiscal situation had deteriorated because of insufficiently decisive action to adjust administered prices and because of populist decisions both about taxation and certain government expenditures. The large losses of state-owned enterprises also continued to represent an important element in the overall deficit. In addition, currency overvaluation had placed a large strain on the current account balance of payments and on the country's levels of international reserves. The central bank, handicapped by a very weak net income position arising from its own financial sector involvements, faced serious difficulties in its conduct of monetary and exchange rate policies. Certain exogenous circumstances, such as the Gulf crisis, as well as a difficult internal political situation compounded these various problems.

This was the broad background against which many of the more recent financial reforms in the Philippines were undertaken. Critical to the whole process, Estanislao argued, has been the rehabilitation and partial privatization of two dominant financial institutions, namely, the Philippine National Bank and the Development Bank of the Philippines. In the former case the priority given to rehabilitation was symptomatic of the government's anxiety to establish the viability of commercially motivated banks more generally. Its partial privatization (40 percent) indicated the intention to remove commercial banking from the direct control of the state. Although the implicit guarantee of loans by the state persists, this will end when private ownership surpasses 50 percent of equity. In both banks the rehabilitation process was completed quickly and effectively with 60 and 90 percent, respectively, of the bad loans of the two banks being taken off their books and assumed by the government.

At the same time the excessively short-term focus of the financial system was recognized, and plans were made to strengthen longer-term institutions and instruments. In particular, initial steps were taken to strengthen the country's already very large social

security and insurance systems and to establish the institutions necessary for a more active capital market.

The general objective of creating a more market disciplined and private sector economy was pursued, above all, through a systematic reform of the government-controlled, state-owned enterprises, which had proliferated under the previous government. In many of the 300 or more enterprises in this category, commercial objectives had been overridden for many years by social or even narrow private interests and subsidies and large losses were endemic. By 1985 the total net losses amounted to P6.4 billion, equivalent to almost 30 percent of the overall budgetary deficit of the national government. The reform to correct this situation was conducted mainly through a program begun during the early years of the Aquino government. Six years later, some 65 percent of the assets earmarked for privatization had been successfully disposed of and had provided total gross revenues to the government of more than P50 billion.

This exercise has been very effective, with many smaller and several very large enterprises being sold successfully to the public. The largest transaction to date has been the sale of 67 percent of the shares of Philippine Airlines early in 1992. The largest public offering in the Philippine stock market was the partial sale of the Philippine National Bank in 1989. However, Estanislao noted, sales have been hampered by the care that was needed to obtain independent appraisals of value for the enterprises, by the open and transparent process of public bidding that was required, and by the considerable problems of passing the necessary legislation. In addition, legal complications and frequent court challenges have slowed the pace at which the divestiture of state assets has proceeded.

In spite of all these factors, Estanislao argued that the privatization process had been extremely influential in pushing the private sector much more to the fore in the process of economic decision-making. The Philippines has been fortunate to have an active private sector that has demonstrated a willingness to take over assets formerly under state control. However, the consistent government stance in favor of a greater private sector role has also been critical to the success of the program thus far.

A final aspect of reform, emphasized by Estanislao and complementing the actions of privatization of state assets, was the restructuring of the functions of the central bank undertaken in the late 1980s. The motivating factor was the perceived need in a market oriented economy to remove the central bank from its earlier and heavy direct involvement in credit allocation and guarantees. The bank's involvement, especially with a proliferation of rediscounting windows, created a serious conflict with the government's regulatory and monetary management role and had led to the buildup of losses in the central bank's accounts. The main reform enacted was that of henceforward restricting the central bank's financial support to the banks to that required to meet temporary liquidity problems: the traditional lender of last resort function. At the same time, the special loans programs administered by the central bank were transferred away from its responsibility to that of appropriate specialized intermediaries: the agricultural loan fund to the Land Bank of the Philippines and the industrial loan program to the Development Bank of the Philippines. Thereafter, these same programs were also operated on the

basis of market rather than subsidized interest rates. Finally, strengthened arrangements were introduced governing bank capitalization requirements, reporting requirements to the central bank, and guidelines for asset valuation and loan-loss provision.

Mexico

Like the Philippines, Mexico has engaged in a far-reaching program of financial modernization in recent years, a program necessitated by the serious internal and external problems confronting the economy in the early 1980s. Guillermo Ortiz, the Deputy Minister of Finance of Mexico, explained that this program had been organized around three basic elements, namely, stabilization, structural change, and actions to ameliorate poverty. Ortiz explained that these three components had been mutually supportive and together had enabled a transformation of Mexican economic performance during the past ten years.

The stabilization policy was dependent, above all, on a major turnaround of the public finances from an overall deficit equivalent to 8 percent of GDP in 1981 to a substantial surplus from 1988 to 1991. Although this improvement owed something to the large-scale privatization sales, there was nonetheless a surplus by the early 1990s that was independent of such sales. Also of considerable importance to the success of Mexico's stabilization exercise has been the late 1980s pact among employers, trade unions, and the government. This agreement was extremely important in that it allowed the government to implement necessary increases in utility and other prices without generating run away wage inflation. Certainly the pact receives much of the credit for breaking the high inflationary expectations of the early 1980s and for rapidly reducing actual inflation since 1988. The forecast for 1992 is for inflation of only 12 percent as compared to more than 160 percent in 1987.

The stabilization program has also provided the necessary underpinning for the restoration of positive economic growth after several years of negative growth in the early 1980s. The average growth rate in the period 1989-92 has been of the order of 3.7 percent per annum. This has been associated with a buoyant investment performance, with total investment increasing by over 35 percent during the past three years; and with a radical change in the perceptions about the profitability of investment in Mexico - a change that has also stimulated large inflows of investment from abroad, especially from the United States.

The structural reforms that constitute the second main component of the overall reform package have been designed with the central objective of raising the overall efficiency of economic performance. The reforms have included, among other things, the commercial opening of the economy to international trade, the divestiture of many formerly state-owned enterprises, a reform of tax structures and rates, a broad-based modernization of the financial sector, and general deregulation.

The modernization of the financial sector was undertaken both to increase the mobilization of domestic savings and to improve the efficiency of its allocation to

different uses within the economy. In addition, a modern financial system was regarded as an essential component of Mexico's overall attempts to achieve high levels of international competitiveness in its productive sectors. Ortiz doubted whether there had been much direct effect of the reforms on the total of domestic saving, but the indirect effects through the improved use of saving had undoubtedly been of considerable significance.

Ortiz explained that the main elements of the financial reforms had been the liberalization of institutions, combined with greatly improved supervision; fundamental changes in the legal and regulatory framework; and the privatization of banks.

The main actions toward liberalization have been the 1988-89 freeing of interest rates on all bank liabilities and the elimination of the earlier mandatory investment regime that forced banks to maintain a given asset structure. These changes gave the banks both the means and the incentive to mobilize additional funds for providing private sector credit. The result has been a substantial increase in the ratio M4/GDP. At about the same time, however, the authorities set strict capital requirements for the banks at levels of 7 percent and 8 percent of risk adjusted assets for 1992 and 1993, respectively. These are higher than the recommended BIS standards. A comprehensive and novel system of loan classification was also introduced whereby a quarterly test of risk was adopted, with the banks being required to increase reserves in cases where risk levels were judged to have increased. Bank supervisors were given the power to intervene directly in a bank to provide the additional capital to meet these requirements in the event of any failure.

One important implication of the interest rate reforms is that the government now has to finance itself at market rates. This, of course, has been an easier arrangement to introduce as fiscal deficits have declined. It has also implied that the banks have been able to generate a reasonable return on their business with government and no longer need to engage in time-consuming negotiations in order to receive an appropriate remuneration on reserve requirements.

Regarding the legal framework, a major step was the constitutional reform of May 1990 that fundamentally changed the role of the Mexican state in the ownership of assets. It opened the way, among other things, for much broader participation by the private sector in commercial bank ownership. This was followed by a new Credit Institution Law and a Financial Groups Law, enacted in July 1990, which together did three main things. First, they defined a strict separation between the ownership of banking and the ownership of industry and commerce. This was done to avoid the emergence of large bank-industry groups. It was associated too with narrow limits regarding the part of a bank's capital that could be owned by any individual or institution. Second, they opened the financial sector to foreign ownership, albeit with a strict limit on the total foreign ownership of any one bank to 30 percent of the voting shares. Third, they provided for the conduct of several types of financing service in one organization - universal banking - a step also designed to increase the international competitive strength of the financial sector.

The aim of the privatization of banks was to spread the ownership of shares of the eighteen banks as widely as possible, while at the same time ensuring that the main potential investors were all appropriately qualified and experienced. After screening, each registered bidder group was invited to participate in an auction to acquire the whole controlling share of a bank. All interested groups were required to make a deposit to ensure their participation in the auction and to sign a confidentiality agreement; afterward they all received comprehensive information about the situation of the bank(s) being sold. Two independent valuations were obtained for each bank: one made by the institution itself using uniform criteria, and the second made by outside consultants. These were used to establish reservation prices. On the date of the auction all bidders were required to simultaneously present their offers in the presence of notary publics, after which the representative privatization committee reviewed all bids on the basis of a clear set of rules. The aim of all these procedures was to achieve a high level of transparency in the process, with full information being divulged throughout to all bonafide participants.

Ortiz noted that the process had proved extremely successful. Eleven months after its initiation, control of fifteen of the eighteen commercial banks had been sold for a total amount in excess of $11 billion. Forty-four separate main bidder groups had presented a total of 133 bids. In addition, the aim of ownership diversification had been achieved with over 80,000 investors participating in the process.

The third element of the overall package, namely the series of programs to alleviate poverty, was in Ortiz's view a crucial aspect of the authorities' anxiety to retain consensus for reform. The pact referred to earlier was a critical as well as an unusual feature of the overall program. In essence, the government had agreed to fix up the deficit in its own finances in order to limit the government's own contribution to inflation. It had also agreed to define a target path for critical prices of relevance to wage earners. Industrialists had agreed to accept limitations on their profit margins and to voluntarily restrain price increases for basic goods. In return, the trades unions agreed to negotiate wage controls on the basis of forecast or expected inflation. An escape route was also established to deal with the possibility of actual inflation rates surpassing the forecast rates by a significant margin.

In spite of some external criticism of this approach to stabilization, Ortiz noted that it had generally succeeded well. Inflation had certainly been reduced and real living standards had also been helped by the elimination of product scarcities' which was carefully and regularly monitored by the authorities and discussed regularly with the social partners.

Substantial pressures had been evident at the grassroots level for enhanced expenditures on crucial social projects, such as local hospitals. The greatly improved fiscal situation, together with the funds released by debt negotiations, enabled the government to make a substantial response to such pressures; the detailed organization and administration of projects was carried out by local communities. Whereas the debt crisis of the early 1980s had resulted in a major deterioration in equality, the reform effects of the past years have successfully corrected some of the worst manifestations of this, which in turn had certainly helped the authorities to retain a broadbased consensus

for a program of complex and often painful reforms. In some sense the people have been able to see some direct benefit from privatization sales and other reforms.

The next target of the government in this general area of reform, Ortiz noted, is the privatization of the Mexican collective farm system, which will be designed to allow farmers a much closer link between their own efforts and their incomes. A massive land titling exercise, costing an estimated $0.5 billion is the first step in this reform.

Finally, in the discussion Ortiz returned to two issues that had figured prominently in other sessions of the seminar. First, several people commended the rigorous nature of Mexico's new arrangements for bank supervision and especially the early-warning feature that it contained, but they wondered how effective it might be in practice. There was also a question raised as to whether a highly secure and well-supervised banking system might not push some of the main financial sector risks to fringe organizations in the financial sector. Ortiz agreed that it was impossible with any system to fully insulate banks from risk. However, the extremely demanding capital requirements of the Mexican arrangements, as explained earlier, provided the ultimate security of the system as long as the requirements were fully and strictly enforced. Ortiz also argued that the restructuring of the functions of Mexico's large development banks - for example they now provide less lending to state enterprises - had generally reduced the danger that financial sector risks would be pushed over to these banks.

In response to comments on the management of capital inflows, Ortiz noted that, as in several other countries represented at the seminar, Mexico had benefitted recently from large capital inflows. The authorities had chosen to sterilize about 40 percent of the inflows using open-market operations, but the real exchange rate had nonetheless appreciated. This had obviously created some problems, but the authorities had continued to peg the nominal exchange rate to the dollar as part of their anti-inflation campaign. Exporters were expected to raise their levels of efficiency to counteract any possible loss of price competitiveness and were certainly being told not to expect protection by way of frequent exchange rate changes. Efforts were being made to slow the inflow by the imposition of reserve requirements on bank borrowing from abroad. In addition, banks were required to match foreign-currency denominated assets and liabilities.

Financial Reforms: Markets and Institutions

The final substantive topic was the role of financial institutions in a country's development and the manner in which such institutions can be developed and strengthened through appropriate policies. This general topic was elaborated in detailed presentations about Japan and then about Malaysia.

Japan

Masahiro Sugita began by reviewing the arrangements set up in Japan after the war to ensure an adequate provision of long-term finance to industry. He explained that during the Reconstruction Era from 1945 to 1955, the government initially needed to establish certain temporary organizations, especially the Reconstruction Finance Bank (RFB), to help rebuild industry. More specifically, the serious collapse of Japanese industrial production (only 10 percent of the prewar level remained) and very high inflation made it impossible for limited private savings to deal adequately with the massive task of reconstruction. Therefore, a state-supported priority production plan was established and directed initially at four main sectors, namely, coal mining, electric power, iron and steel, and fertilizers. RFB funds were channelled both to finance investment capital, and operating capital including losses. Funds were raised mainly by debenture issues, which required substantial underwriting from the Bank of Japan. Lending rates on the loans provided were administratively fixed and were generally lower than in the existing private financial institutions.

In the early 1950s the immediate postwar reconstruction needs of industry were augmented by a widespread need to replace obsolete plants as new export opportunities for Japanese business arose, both from U.S. procurement and from the outbreak of the Korean War. One part of the response to this was the establishment of the Japan Development Bank, the successor to the RFB, and the Export-Import Bank to provide more international trade finance possibilities for industry. At this stage a broader source of funds for these institutions became possible, and after 1952 the Japan Development Bank (JDB) was allowed to borrow from the Trust Fund Bureau, which in turn attracted funds mainly from postal savings but also from various welfare and pension schemes. The availability of budgetary surpluses following the 1949 Dodge Plan also provided some justification for strong government involvement in the provision of long-term industrial finance.

JDB, like its predecessor, allocated funds to industry on a priority basis, which was clearly and regularly articulated in government programs. For example since 1952 JDB focused its loan objectives on reinforcing power supplies, promoting Japanese commercial shipping capacity, rationalizing production in industries such as coal and steel, and encouraging industries, such as synthetic fires, to enhance self-sufficiency. Special lending rates were initially applied to about 70 percent of these loans.

Also from 1952 onward a variety of long-term credit banks (LTCB) emerged in Japan as a result of the reorganization of the prewar specialized banks. These banks sourced their funds by issuing five-year coupon debentures to city and other ordinary banks, who in turn raised further funds; by mobilizing short-term deposits. The LTCB thus achieved a substantial transformation of the maturities of funds and this was greatly assisted by a controlled interest rate structure, set by the central bank, that had a strongly ascending yield curve.

At the same time, the trust banks, which were conversions of the prewar trust companies, were allowed to sell loan trusts to gather long-term funds. They sold 2.5-

year maturity funds mainly to individuals, and by so doing effected a considerable maturity transformation. Together with the ordinary banks, which concentrated on raising deposits from the private sector and supporting smaller businesses, this constituted the industrial financing structure of the early 1950s. As Sugita noted, it was essentially a dual structure with some private organizations, but others, such as JDB, operated largely independently of market conditions.

During the high-growth era from 1955 to the end of the 1960s, the various private financial institutions in this structure became progressively more active, with the government institutions complementing them quantitatively in the sense that they met both the business and the social needs left untouched by profit-oriented private institutions. Thus, for example, the government institutions' share of all equipment financing fell substantially to only about 22 percent from 1954 to 1960 and to only 16 percent from 1961 to 1967. They nonetheless remained extremely important in certain key industries, such as coal mining and shipping. The JDB shifted its lending targets to social infrastructure, regional development, and new strategic industries, such as petrochemicals and automobiles. It also supported restructuring operations in certain traditional but declining industries.

Sourcing arrangements for the funds of these various institutions also progressively changed and deepened in the high-growth era and beyond. From the mid - 1960s for example, the city banks needed to devote more resources to the purchase of government bonds and therefore were less able to absorb debentures from the LTCBs. Thus, the LTCBs began to borrow more from institutional investors and business firms, and at the same time they began to lend more to small and medium-size companies. City banks, as a reward for underwriting large amounts of government bonds were allowed to raise funds using longer-term deposits and to use the funds to increase the weight of their long-term lending. Thus, the similarity of business between city banks and the LTCBs increased, as did the intensity of their competition.

Sugita's assessment of the early interventionist arrangements for providing long-term finance was that these were essential, given the scarcity of saving, the malfunctioning of private financial institutions, and the predominance of short-term funds at that time. These interventions created many problems, not least the high inflation associated with the RFB's heavy reliance on central bank underwriting of its funds.

When the JDB was established many of these initial problems were resolved. The procedures of JDB, for example, were far more successful both in their ability to screen borrowers thoroughly and in their avoidance of lending merely to cover operating losses. The early basic successes of JDB enabled it to stimulate a progressively larger supply of private cofinancing for projects both in strategic productive areas and in social infrastructure. It thus became an important contributor to the overall mobilization and allocation of resources.

In the high-growth era the complementarity of the private and government financial institutions was an important feature of Japanese long-term financing arrangements. The private institutions were increasingly important in achieving a substantial maturity transformation of funds, but this was complemented both by the

strategic policy-based lending of the government institutions, as well as by interest rate and other policy controls supportive of the actions of the private institutions. Sugita noted that many features of the structure just described have outlived their usefulness, and substantial further transformation is to be anticipated in the near future.

Discussion among participants attempted to establish the basic conditions that had enabled the Japanese interventionist approach in finance to succeed while similar efforts elsewhere, including in Latin America, had failed. Three factors were identified as being of some importance at least in the early stages of Japan's postwar development. The first was the cultural factor, which had enabled the country to achieve high savings rates in spite of maintaining generally low rates of interest. The early achievement of a fiscal surplus, as Sugita himself had noted, was a helpful factor in this regard. This surplus had also helped to stimulate intermediation initiatives, which proved beneficial to the private sector. Second, the maintenance of a rising yield curve seems to have been very important in stimulating a large and sustainable maturity transformation of savings to support longer-term lending. Third, the Japanese authorities had undoubtedly been helped in their efforts to restructure the economy by the country's very strong endowment of well-trained and experienced people.

However, it was felt that the replicability of the Japanese institutional model in Latin America and other developing country contexts remained in some doubt. This is, above all, because it is extremely difficult to write down the actions needed to create the evolving and complementary relationship between private and public financial institutions that has been so important and successful in Japan.

Malaysia

Lin See-Yan, Deputy Governor of the Bank Negara Malaysia (BNM), presented a substantial paper on the institutional development of the Malaysian financial system. However, in his presentation he focused on a few main themes connected with the topic of financial institutional development.

The starting point in his view was the definition of what a country such as Malaysia expects and needs from economic development. Lin stressed two points in the Malaysian case. The first was the objective of sustained growth with stability. Economic stability had needed to be emphasized for many reasons. One was that at the time of independence, Malaysia contained many elements of potential instability, including the racial makeup of the economy and the strong correlation of race with profession and status. A stable economic environment was needed to provide any real prospect of keeping the tensions arising from the racial balance in check. Equally, it was recognized that the country needed to attract foreign capital, which was unlikely on a significant scale in the absence of a reasonably stable economy.

The second main objective was that of a more equitable distribution of income. The need for this arose, above all, from the serious poverty and inequalities inherited at

the time of independence. It was significant, for example, that at that time only some 2 or 3 percent of all bank loans went to indigenous groups in the economy.

Recognizing these basic objectives, it was the central bank's role in the early 1960s, in Lin's view, not to participate actively in development but to ensure the stability of the country's financial system. However, this was judged not to be a function that could be discharged properly in the absence of well-developed and stable banking systems supported by a network of other financial institutions operating within a sound regulatory framework. Hence, the Bank Negara, from its establishment in 1959, became pro-active in converting a very simple financial structure into the current modern and sophisticated one. [2]

An essential guiding principle in the early years was the need to nurture the development and expansion of the domestic banks, while at the same time reorienting the operations of the then dominant foreign banks to better meet Malaysian needs. Both negative and positive policy approaches were used to achieve this. On the negative side foreign banks were denied the right to establish new branches after 1966. On the positive side license fees for rural branches were set significantly lower than for urban branches in order to encourage the spread of banking facilities throughout the country. The result is that there are now more domestic than foreign banks in the country, with the domestic banks accounting for six times as many branches as the foreign ones.

A further important step was to encourage the dispersion of bank ownership away from the traditional but narrow family-based ownership that had characterized the situation in the 1960s. This was achieved mainly through legislative rules limiting corporate ownership to no more than 20 percent of any bank and individual ownership to no more than 10 percent.

Lin emphasized more generally that most decisions regarding the growth and development of the domestic banks had remained the decisions of the banks themselves. The central bank had complemented these private efforts mainly by providing a conducive policy framework and by actively exhorting the banks to adopt certain changes from time to time. However, experience had shown that strong competition in banking easily provides the greatest inducement to improved services and innovation. Hence, in the current phase of reform the BNM was giving considerable emphasis to removing structural barriers between financial institutions and giving every encouragement to stronger competition and the strengthening of free markets.

Similarly, Bank Negara has been pro active in stimulating and influencing the early development of most forms of nonbank financial institutions in the country. A few examples can illustrate this general proposition:

- Finance companies - BNM has regulated these companies since 1969 and has been active in encouraging mergers and other rationalizations between them.

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2. The name Bank Negara Malaysia was established only in 1963.

- Merchant Banks - BNM was active in promoting the establishment of merchant banks in the 1970s to fill a perceived gap in the provision of banking services.

- Islamic Banks - One such bank is already established, but BNM is proposing changes in legislation that would enable existing banks to offer both Islamic and conventional banking services.

- Development finance institutions - BNM and the government have provided both financial and technical support to such institutions to ensure a good degree of public confidence in their activities. A variety of specialized deposit taking institutions include regional institutions (Sabah and Sarawak), sectoral institutions (industry and agriculture), and community ones (for example, Bumiputera).

- Cagamas Berhad, the national mortgage corporation - This was established with equity participation from all banking institutions, including a 20 percent stake from Bank Negara.

- Capital Markets - In its capacity as the banker to the government, BNM has been consistently involved in steps to promote an efficient market for government domestic debt issues. In its capacity as regulator of domestic banks, it has also taken an active interest in the market for private debt securities as a means to ensure a balanced degree of leverage in company borrowing from banks. More specifically, in 1988 BNM introduced guidelines to clarify the basic legal and administrative framework for bond issues.

It was emphasized that with these and many other central bank actions to develop the institutional structure of the sector, almost no central bank funding was committed. Where money was expended it was generally done on the basis of achieving an early recovery of the investment of the central bank.

The result over the years has been the emergence of a very diversified financial sector and one that is large relative to GDP. The overall ratio of financial assets outstanding to GDP is exceptionally high - about 300 percent higher than in the United States in one participant's view - and even the ratio of capital market assets to GDP stands at over 100 percent.

However, this very success has created problems of regulation. As the BNM has embarked on what it regards as the second and inevitable stage of reforms, namely, deregulation and the removal of structural barriers between the activities of different institutions, there has been a major blurring of the division between previously separate institutions, especially between banks, finance companies, and commercial banks. These had traditionally been set up and managed under different pieces of legislation with differing operational assumptions. The dangers inherent in this were further exacerbated by the rapid growth through the 1970s and 1980s of development finance companies, cooperative, and specialized credit institutions that operated without the benefit of the control and safety nets of the central bank. A particular case was the deposit-taking cooperatives, whose financial crisis in the mid-1980s seriously undermined depositor confidence in the banking system as a whole.

A major BNM response to this development of the fringe bank institutions was the enactment of the Banking and Financial Institutions Act of 1989, which provides, for the first, time an integrated supervisory structure for the whole financial system. By design it provides a standardization of central bank powers across all institutions, but with some differentiation of detail for three broad groups, namely: licensed institutions, especially the core banking institution in the country; scheduled institutions that represent the main nonbank sources of credit and finance; and nonscheduled institutions, essentially all other individuals or companies involved in any way in providing financial services. Lin anticipated that this new act will play a prominent role in reforming and further reshaping the Malaysian financial system for many years to come.

Lin noted by way of summary that the active intervention of the central bank in Malaysia to promote a strong and safe financial sector had been guided by a few clear principles but had needed to adapt flexibly as the condition of the economy and indeed global institutions and conditions had changed. Diversification had been promoted actively from the center but having been achieved had led naturally to deregulation and then to the need for a far more integrated approach to the remaining prudential and supervisory arrangements.

Many lessons were learned in the thirty years, and some of these would doubtless translate to other country's situations. Chief among these are that substantial numbers of well-trained people are needed to manage a strong financial system; price and interest rate mechanisms work best when there is near perfect competition but this rarely exists in practice; the maintenance of price stability is easier when there is a well-developed financial system; and, above all, strong legislation cannot produce sound financial institutions if the basic moral responsibility is absent in these institutions or in a society generally.

In response to questions, however, Lin also acknowledged that there is undoubtedly an important but unexplained component in the contribution of financial policies to economic development in the Malaysian case. The Bank Negara, for example, had taken on the responsibilities to rescue financial institutions when the need arose. Central banks in other countries had either not done this or had often been far less successful than the Malaysians. Equally, Malaysia retained some guidelines over

credit allocation that in other countries had been shown to be a source of considerable distortion and inefficiency. These negative effects appeared not to have arisen to any significant extent in Malaysia. In general, it is extremely difficult to know why apparently identical policies in different countries can result in radically different outcomes.

Conclusion

In highlighting some of the main themes of the seminar, Alan Roe noted that it is helpful to clarify what is meant by financial reform and explain the essential benefits that were likely to flow from it, and to have a simple and agreed view on these matters. He suggested that the fundamental objective of any financial reform was to reduce the costs of intermediation as between savers and borrowers as well as the costs of operating a country's payments system. There are several reasons why such cost-reductions are beneficial. First, domestic saving is always scarce in any country, and it is important to have a financial system that makes the best possible use of it. Second, if intermediation costs are too high, some legitimate and beneficial uses of investment funds will be discouraged, and the equilibrium supply both of intermediation and investment services will be less than is possible. Third, in such a situation, some of the more expensive and difficult types of intermediation, such as maturity and risk transformation, will be particularly badly affected. In short, if the costs of intermediation are excessive, both the absolute amounts and the structure of the intermediation that can be provided will be affected. Reform is about changing such a state of affairs.

This being said there seemed to be some common ground among the participants, Roe argued, regarding the ways in which the biggest gains from reform can be achieved. A basic point here is that the cost reductions that reforms should address relate to economy-wide costs and not to the financial costs of particular activities or sectors. The experiences of the 1960s and 1970s, as summarized by Millard Long, had shown that it had proved very easy to lower the financial costs for selected sectors and activities of many developing economies during that period. However, this had invariably been at the expense of raising financing costs in other parts of those same economies. The favored sectors in this context had invariably included the state-owned enterprises as well as small-scale industry and agriculture. What had not been well understood in those early days is that these selectively favorable treatments would raise financing costs for other sectors because of, for example, credit rationing, the higher margins in banks caused by high bad debt ratios, and the effects of higher inflation.

Thus, the lesson that seems to have been well learned, judging from the comments made at the seminar, is that undue attention should no longer be given to lowering the financial costs of particular sectors, because this could serve merely to raise costs to the system as a whole and therefore result in a reduction in the size of the financial sector and in the quantity of intermediation it provides. Thus, financial reform in most cases

should aim to unify the treatment accorded to particular sectors of the economy and avoid the conferring of special favors on a few selected areas.

This, however, left open the question of how far reform should go in this direction: a subject Roe noted, that had divided participants. There was some consensus that if interventions in the financial sector were for purposes linked to the improvement of income distribution or even the support of an industrial policy, then it was invariably sensible to seek out lower cost and less distorting ways to achieve the underlying objectives before resorting to the introduction of distortions in the financial system.

However, it was also clear that the costs of direct interventions in the financial sector itself would differ greatly depending on the underlying stability or otherwise of the economy. Thus, in low inflation environments such as those in Thailand and Malaysia, limited direct interventions, either in the pricing of credit or in its allocation, are unlikely to involve large distortion costs, because the deviations from the true equilibrium can never be too great. In high inflation environments, on the other hand, the same interventions could impose extremely large costs. In addition, countries in which savings rates are high can obviously afford somewhat larger losses from financial sector distortions than can low savings economies. This was perhaps one factor explaining why the low-saving Latin American economies had generally been much more radical, in recent years, in their removal of discretionary interventions than had the East Asian economies.

For these reasons, it was difficult for seminar participants to argue that the removal of discretionary interventions in credit allocation or interest rates is always and everywhere an essential component of financial reform. But one matter that can be regarded as absolutely essential for financial reform, Roe argued, is the achievement of price stability. Why is this? There are two main reasons. First, high inflation will invariably raise the costs of intermediation at the economy-wide level, and, more important, it will introduce an extremely strong disincentive to either lend or borrow money on a long-term basis. Long-term financial contracts, in other words, will be strongly discouraged when there is high inflation, even though these are essential to sound economic development. This is why many countries, including Japan after the war, have needed to devise special state-supported schemes to achieve adequate levels of long-term industrial financing.

Second, high inflation introduces an avoidable uncertainty into the process of economic decision-making. The economy gets nothing in return for this uncertainty, but while it exists it undoubtedly adds a high-risk premium to most intermediation costs and so again discourages particular types of intermediation. Therefore, inflation should certainly be attacked with rigor as a part of any financial reform program.

Another question posed at the seminar, Roe noted, had been whether financial reform was a process or an event. He suspected that most of the reform programs that had been discussed had elements of both. Certainly in cased like the Philippines, where the reform program involved the need to remove very large distortions and clean up the problems of distressed banks, the initial steps in reform certainly do represent an event of major importance and political significance. As several participants had indicated, this

had sometimes required a change of government as well as a change in the technocratic team responsible for financial sector policies.

But once the large gains from the more dramatic components of reform have been achieved, the authorities invariably have an ongoing process of further reforms to design and manage. This was very apparent, for example, in the case of Malaysia where the institutional initiatives coordinated for many years by the central bank had resulted eventually in a far more complex financial sector, and the original procedures for control had ceased to be adequate. Hence, that country had to go through a process of deregulation associated with a fundamental revamping of licensing and supervisory arrangements. More generally, in the new global situation in which most countries at the seminar now found themselves, the ongoing process of reform certainly included a continuous search for new ways to deal with the effects of the globalization of most financial markets.

Potential productivity and cost-reducing gains of several percentage points a year could be expected in financial sector activities in much the same way that regular productivity gains have become commonplace in industrial activity. All countries with representatives at the seminar would need to work to exploit this potential to ensure that the productive sectors of their economies were not held back by uncompetitive finance.

Associated too with this general need to remain competitive is the central and critical issue for the reformers of how far and how quickly to move with the process of capital account liberalization. This was an important and ever present theme during the four days of the seminar. A number of subthemes had emerged. On the first, namely the question of sequencing, the paper on Indonesia had overturned some of the conventional thinking on the subject. In particular, that case study had shown that it was possible to liberalize the capital account in advance of a corresponding liberalization of international trade and domestic finance. The key to this appeared to have been the ability of the Indonesian authorities at the time both to achieve widespread credibility for their policies and to engineer a large upward adjustment of the administered interest rate to mitigate the otherwise strong risks of large capital flight. More generally, the Indonesian paper had demonstrated the dangers of seeking rigid formulas to guide economic policy making in important areas.

A second important subtopic was sustainability. The experiences in Chile in the late 1970s had indicated the dangers of enjoying large capital inflows for a short period, followed later by a massive export of capital. Capital inflows, as a supplement to scarce domestic savings, were most useful, it was agreed if they are at a level that has a reasonable chance of being sustained. Hence, countries which are not confident about sustaining the economic and political conditions that can attract foreign funds should certainly be more than usually cautious about the opening up of their capital accounts. In addition, countries such as Malaysia, that have demonstrated reasonable levels of long-term economic stability can derive benefits from policies that introduce some friction into the process of inward capital movements. In general, the case studies presented at the seminar, including those on Chile and Mexico, had indicated that this was indeed the way in which the more successful economies were now operating.

A third subtopic related to the manner in which inward flows from abroad could interact with domestic financial systems. The Argentinean case involved capital inflows that were being attracted without much consideration for the manner in which they might complement or compete with the domestic financial system. Most other countries represented at the seminar had demonstrated some reticence about this type of liberalism and not least because of the harmful effects that might accrue for the domestic financial system. The techniques necessary to use foreign inflows to strengthen the domestic financial sector were not well developed as yet. However, several participants certainly recognized the potential conflict between this objective and large inflows from abroad. In this context, the suggestions in the Malaysian paper about linking the direct investment inflows of foreign companies with their access to local borrowing was perceived to be a very helpful one.

The final broad theme of the seminar related to the extent to which a liberal financial system could be left alone to allocate and price scarce funds and also price risks. The general consensus here was that because financial contracts, especially the longer-term ones, are characterized by various degrees of risk, regulation has to be a part of a good financial system, both to protect the position of depositors and to safeguard the stability of the economy. The discussion about the 1970s, and early 1980s experiences in Chile had demonstrated very clearly the dangers of an inadequate legal and regulatory system to support the process of deregulation.

Several of the papers at the seminar, and particularly those for Mexico and Malaysia, illustrated the international trend for more relevant regulatory frameworks, larger capital requirements in banks, and much more careful supervision arrangements.

It was noted that an important and difficult aspect of this development is the issue of how to adequately address the problems of regulating fringe financial institutions: an issue that is arising in many countries as a consequence of the process of disintermediation. It was generally agreed that legislative arrangements could only go so far in heading off the dangers associated with this. Indeed, there was a very real prospect that tighter regulation and supervision of the banks would push many of the larger financial risks to the fringes of the financial sector. Legislation could do something to anticipate this, as the Malaysian example had demonstrated, by providing supervisors with authority over a very wide range of different institutions. But the only real solution was a willingness on the part of the authorities to remain continuously vigilant and to regularly update their procedures to deal with new developments as they arose.

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FINANCIAL SECTOR REFORMS AND LIBERALIZATION: WELCOME ADDRESS

Roberto Zahler

On behalf of Chile, of its central bank, and in my own name, I bid you a very warm welcome to this country and to this seminar. I am sure that the importance of the subject, as well as the variety of the experiences that will be discussed here, will become a very useful source of relevant conclusions for our different national realities.

It is not by pure chance that Chile has been chosen as the site for this meeting. The experience of financial liberalization experimented by this country in the last fifteen years undoubtedly deserves to be analyzed, and in some cases even taken as an example of what can be done in countries like ours, but let me tell you it has not been an easy or painless road to follow. Furthermore, there are still many issues that we need to address and a number of challenges for the future, especially in the area of the regulation of nonbank financial intermediaries and their relationship with banks.

Given that Chile was one of the first Latin American countries that embarked in financial liberalization and reform, it has had time, through learning by doing, to generate legislation, regulation, and supervision that have contributed to a successful functioning of the bulk of Chile's financial system. Of course, I am conscious of how important it is to be successful, especially in the field we are responsible for, but I also place an enormous value on mistakes, of which we have had many. Most surely the details of both successes and mistakes will surface over the next few days, to the benefit of all attendants. I only wish through this statement to stress the point of what we have learned as much as what we have done.

Before I get into the more technical issues, please allow me to tell you a little about Chile today.

I strongly feel that our continents are bound together by history; by the internationalization of scientific and technical culture; by scarce resources vis a vis what our population needs; and beyond all this, by the will to overcome poverty and inflation,

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a field in which sound macroeconomic policies and well-designed financial reforms play a vital role.

Since the Kemmerer missions in the early 1920s - when we seriously undertook monetary, fiscal, and banking reforms, which progressed from the creation of the central bank to budgetary policies, national comptroller, income tax, and custom tariffs - there occurred vital developments in the political and economic history of the Andean republics. Most of these developments led to the process of political modernization that created new institutions and policy agents in our countries, contributing to the expansion of the central government in ways that later, after the Great Depression and World War II, led to a strengthening of the state as an economic agent.

Although some countries of the region - mainly in the Southern Cone - have had a history of chronic inflation, in recent years most of Latin American countries have been marked by very high rates of inflation. Experts on the subject state that high and unstable rates of inflation have been an important, if not the most crucial, determinant that led to the breakdown of many of the traditionally democratic regimes on the continent. Apparently, my country was not an exception in this regard. It has been only in the late 1980s, after decades of poverty and lost opportunities, that the issue is being faced with a new approach, which tends to clarify the roles of the private sector and of the government in economic affairs.

Today, Chile is aiming to become what is known as a modern country. After two decades of political upheaval, which left deep wounds in our social fabric, the new democratic government and society are making an enormous effort to enter a new period characterized by a strengthening of the democratic institutions and by a growth sustained on the basis of equality. There is a strong national consensus on the need for these goals to become reality. In the economic sphere this consensus translates into the fact that we should pursue an outward oriented growth strategy, where the private sector should be the main economic agent and where relative prices and resource allocation should be determined and incentivated by the appropriate functioning of competitive markets.

Modernization is, however, a complicated process, which defines a new role for the state. In my country modernization mainly concentrates on reducing poverty and inequality in an efficient way. This means assuring basic macroeconomic equilibrium and consistency, and regulating and supervising very few, but relevant, sectors in which, for a different sort of reasons, market forces by themselves do not generate an efficient solution. This latter role, regarding the financial sector - which in the end may be summarized by the appropriate balance in the inherent tension between competition and efficiency on the one hand, and integrity, stability, and solvency of the financial system on the other - strikes at the core of my remarks this morning.

Importance of the Financial System

The financial system, in its role as intermediary, performs the important role of channeling resources from savings to investment. The more efficient the system, the

better the channeling of these resources; that is, savings will be directed to those investment projects that are most profitable, and the more productive the investments, the higher the rate of growth. Therefore, an efficient financial system contributes positively to economic development.

The reduction of barter between economic agents with surpluses and deficits of savings by reducing costs of transaction and information, as well as the provision of an efficient and less costly way to manage risk, are sufficient arguments to justify, in terms of efficiency, the existence of financial intermediaries. It is important to point out that in its role as an intermediary, the financial system not only transfers resources to better use, but also may have a positive effect on the level of savings and investment. Thus, if no intermediation existed, some profitable projects would not be realized, because the individual's own resources would be insufficient to undertake the desired investment.

As a central banker, I would like to stress the fact that a modern financial sector plays an important role in the payments system of the economy. As a matter of fact, through demand deposits the financial sector provides a place for persons and firms to hold their cash balances. At the same time, the sector speeds up transactions through the use of representative documents of said money. One of the main concerns of the regulatory and supervisory authorities who are facing a potential crisis of the banking system is precisely what the financial sector's impact will be on the payments system. If this system is interrupted because of a run on banks, the consequences on transactions, commerce, and general economic activity could be dramatic. In fact, many authors have put great emphasis on the contraction of liquidity, due to problems in the financial industry, as one of the main causes of the greatest economic crisis in modern history. Very often this emphasis is not placed so much on the financial crisis as a detonator of an economic crisis, but as an aggravating agent of such a crisis.

The above mentioned leads us to the analysis of the importance of the financial system in the desired goal of macroeconomic stability. It is evident that the financial industry is not like any other industry, since a run against banks may cause serious upsets to the payments system. In fact, the problem with these runs on banks is that they cause negative externalities when panic extends not only to particular banks with problems but throughout the financial system and, therefore, to the payments system as a whole. At the same time, if not adequately regulated, this industry could finance speculative bubbles, which sooner or later will burst with implications in the whole economy.

This type of situation has been adequately analyzed by Kindleberger (1978), who describes quite accurately the different stages of financial crisis and how these affect the real sector of the economy. In the beginning the financial system accommodates the spending boom by granting credit. Then comes a stage of collective euphoria when asset prices increase significantly. This gives way to an inverted stage in which some debtors are not able to honor their commitments. Thus the solvency of financial institutions is questioned. The sale of assets is sometimes done in an orderly fashion, but in other cases it generates panic or is resisted by the debtors, which translates into a greater crisis for the financial system and the economy as a whole.

In summary, the eventual macroeconomic consequences of the malfunctioning of the financial system justify why the authority has to design and implement an adequate supervisory and regulatory framework of the financial system.

Liberalization, Regulation, and Supervision

In general, governments have tried to protect the payments system by insuring demand deposits. In many cases this has extended to time deposits as well, at least to a certain limit. The idea behind this last insurance is to provide a risk-free asset to the small money saver, since it is believed that he or she does not have the adequate resources to process the information of the different financial intermediaries.

In spite of the potential benefits, an insurance on deposits also introduces the classic problem of moral hazard. In fact, as depositors are protected, they are indifferent to the risk a bank may have, and are only concerned about the interest rate the bank pays on deposits. Thus, if a bank that is experiencing problems decides to capture additional resources in order to avoid bankruptcy, it will only need to pay higher interest rates on deposits. Resources captured this way will be invested in high-risk projects in order to rescue part of the already lost capital. What appears to be more delicate is that such behavior by an individual bank tends to be imitated and generalized by the rest of the banks in order for them not to lose their market share of deposits. Thus, insurance on deposits may generate perverse incentives that could cause important losses, not only to individual banks but to the system as a whole, and may create grounds for future crises.

Theoretically, the efficient solution is to charge an insurance premium based on the risk of each bank. Nevertheless, the practical difficulty in implementing such a system has induced the use of other types of regulations. First, the insurance is given for a limited amount in order to transfer part of the risk to the depositor. Second, provisions for risky credits are required in order to disincentivate them. In addition, minimum capital requirements are established so that bank owners risk a significant amount of their own resources. Finally, banks can perform only those activities that are explicitly mentioned in the law.

Regardless of which of these mechanisms is used, certainly one inefficient option is to have deposit insurance (explicit or implicit) and not to implement any regulation in order to diminish the problem of moral hazard. Unfortunately, this was what happened in many of the processes of financial liberalization in Latin American countries at the end of the 1970s and the beginning of the 1980s. Thus, it should not be surprising that in general the processes ended in total failure.

Another classic characteristic of the financial system is what is called the "agency problem." For example, a bank that has seen its capital decrease to a very low level might be tempted to invest in risky projects or to distribute dividends in order to recover part of the already lost capital.

The solution to these types of problems is, on the one hand, an adequate capital base requirement in order to prevent capital from reaching such a low level that it may

generate perverse incentives, and on the other hand, the establishment of regulations that allow the appropriate measurement of the real economic value of a bank's capital. The latter is achieved with a system of provisions that penalizes those risky credits of doubtful recovery. Adequate supervision is also required in order to have these regulations obeyed. Again, many of the experiences of financial liberalization on our continent were accompanied by a deficient or worthless program of provisions and a very old fashioned, ex-post accounting type of - or practically nonexistent - supervision.

The above suggests that financial liberalization, where by definition the market plays an increasing role, must be accompanied by adequate regulation and supervision, to prevent or to appropriately face the market failures that characterize this industry. Insurance premiums for deposits, minimal capital requirements, provisions, and so forth, are ways to confront these problems efficiently. Likewise, it is very important that regulation, as well as supervision of the financial system, be oriented toward prevention; that is to say, to detect problems before they happen. If this is not so, the negative effects of financial problems may magnify and create a financial and macroeconomic crisis. Last, it is necessary to define the winding-up mechanisms and conflict solutions in cases institutions are in trouble. That is, property rights must be clearly defined so that the process of bankruptcy is solved speedily.

Unfortunately, these elements were generally absent in banking legislation in those Latin American countries that undertook financial liberalization over a decade ago. This "oversight," as mentioned before, eventually cost us dearly. The Chilean example is a clear one. There are several authors who agree that inefficient legislation and an almost total absence of supervision were key elements causing the incubation of a crisis of significant proportions in our country. Further on, when the crisis had already broken loose, the lack of legislative definition regarding mechanisms of conflict solutions and of property rights resulted in that crisis going on much longer than necessary. Nevertheless, some good came out of it anyway, because even though it is true that the experience of the crisis was traumatic, it is also true that important lessons were learned from it that gave way to a modern banking legislation incorporating many of the above mentioned elements, that very substantially improved the former legislation.

The Role of the Central Bank

Before going any further, some reflections are necessary on the role played by the central bank regarding the regulation and supervision of the financial system.[3] The central bank is generally the lender of last resort in the system. By granting short-term loans to sound banks that confront liquidity problems, the central bank contributes to minimize bank's losses because of fast sale of their assets or even eventual bankruptcy,

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3. See E. Marshall, 1991, "Del Banco Central Como Regulador y Supervisor del Sistema Financiero," presented at the XXVIII meeting of Central Bank Governors of Latin America and Spain, October 1991, Santiago, Chile.

while at the same time it precludes that these problems propagate to other banks of the system.

In summary, the central bank's role in this field consists of giving security to the payment system. For this same reason, its role as regulator and supervisor of the financial system is related to those banking operations where the financial system is connected to the payments system.

The constitutional organic law of the Central Bank of Chile, in paragraphs iv and v, establishes its attributions regarding the regulation of the financial and capital markets, as well as the faculties to safeguard the stability of the financial system. In synthesis, the central bank of Chile fulfills two roles in this area. First, it dictates an important part of the statutes under which the financial system is ruled, especially those referring to the liquidity of the system. Secondly, it is concerned with providing liquidity to financial institutions going through problems. In this second aspect, its role as lender of last resort is explicitly defined and is given the necessary instruments to effectively perform this function. It must be highlighted that the law establishes that loans from the central bank must be for short periods and only in cases of liquidity problems. Likewise, when a financial institution must be closed down, central bank loans will be considered a priority among the creditors. Thus, the central bank should generally suffer few, if any, losses in this area.

It is clear that the two roles mentioned above are intimately related, because both aim at the normal functioning of the payments system. The other norms that regulate the financial system, particularly those related to credit and solvency regulations, are found in the general law of banks. The Superintendency of Banks, which depends on the Ministry of Finance, is the institution in charge of supervising the system and dictating specific regulations on these subjects.

I do not want to miss this opportunity to emphasize that a modern central bank must not be involved in processes of selective credit assignation; in fixing ceilings on interest rates; or in granting subsidized credits to individuals, productive sectors, regions, groups, or others. I must emphasize that the institutionality of the Central Bank of Chile effectively guarantees that this does not occur. In general terms, that role, if it proves to be socially beneficial, should be implemented by appropriate fiscal budgetary procedures.

The Speed of Liberalization

Financial reform experienced by Latin American countries at the end of the 1970s and beginning of the 1980s had its intellectual inspiration in the literature on financial repression and financial deepening made popular by McKinnon (1973) and Shaw (1973) at the beginning of the 1970s. The literature sustains that financial repression - the administrative regulation of interest rates at negative real levels, and the qualitative and selective control of credits - was responsible, to an important degree, for the lack of an adequate rhythm of economic growth. Financial liberalization, on the contrary, generates

an increase in savings which is determined by the level of investment and improves the efficiency of the capital accumulation process.

These statements seem very reasonable, and it would be difficult to question them. As mentioned in former sections, a competitive financial system is more efficient in channeling investment and savings resources, thus promoting growth. Therefore, countries that have repressive financial systems must tend to liberalize them. Furthermore, there is wide empirical evidence that relates repressive financial systems with worse economic performance, while competitive systems tend to be associated with better performance.[4] Nevertheless, when experiences of financial liberalization in Latin America are analyzed, the question that immediately arises is why so many of them have failed.

In my opinion, the answer to this question is related to the fact that the liberalization process was erroneously designed. I am, naturally, not pretending to be exhaustive regarding the causes that motivated the financial crisis after liberalization. (I have done systematic research on this topic some years ago; Zahler, 1991.) Nevertheless, I think it is hard not to agree that one of these causes resulted from a hasty and unorganized liberalization for which these countries were not prepared.[5] As a matter of fact, the banking legislation did not correspond to a system in which market forces were prevalent and the moral hazard and agency problems, already discussed, were prone to occur. In particular, the existence of implicit insurance on deposits without adequate regulation gave way to excessive risk-taking and over-indebtedness that later turned out in a generalized crisis. Thus, while banking liabilities remained fixed in terms of their units of account, banks' assets fluctuated according to market conditions. As long as the latter was favorable, the banks had no major problems. Nevertheless, when the external and internal conditions worsened, the assets market value decreased, resulting in the worsening of the banking system's solvency.

The instability associated with the fact that on the one hand, there is a fixed exchange rate between deposits and the units of account, and on the other, the value of assets fluctuate freely with market conditions, was originally stated by Henry Simons (1948). Elaborations around this idea and applications to the Chilean case can be found in Zahler and Valdivia (1986), and in Rosende and Vergara (1986).

In summary, financial liberalization is desirable, and countries that have repressive financial systems should engage in a process of liberalization. But this process must be properly planned and must be accompanied not only by macroeconomic policies consistent with the liberalization, but also by adequate legislation and supervision. Thus, in my opinion it is better to have a gradual and orderly liberalization process in order to gain the necessary experience that will allow the adjustment of legislation to the needs

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4. For a detailed analysis on these subjects see *World Development Report*, 1983, The World Bank, Washington, D.C..

5. Other explanations relate to particular unfavorable external conditions and with internal macroeconomic policies inconsistent with the liberalization process.

that arise during the process. It is important to make clear that by gradual liberalization I am not necessarily referring to a long period of time, but to the time needed to establish the institutions required in order to have a financial system operating efficiently and soundly under market conditions.

Strictly speaking, the above considerations relate to the classic dilemma that exists between liberalization and regulation, which is particularly relevant to the financial industry because it operates in a "special" market in which functioning and outcome tend to have repercussions on the economy as a whole. The permanent and difficult challenge facing the authority is to achieve the optimum balance between these two elements, especially when faced with trends toward disintermediation, internationalization, and globalization in financial transactions.

A similar analysis applies to the opening up of the capital account of the balance of payments. Even though I will not go into detail on this matter now, again I would like to stress the convenience of being prudent in this regard. The final objective is desirable, but if we want to reach the goal successfully, I believe that wise advice is to liberalize gradually. Otherwise, one would run the risk of strong fluctuations in key prices of the economy, such as the real exchange rate and interest rate, that might destabilize the economy and make the liberalization process go in the opposite direction.[6]

Final Remarks

Countries with repressive financial systems should move forward in the process of liberalization of interest rates - taking all the precautions detailed before - and allow the allocation of credit to be made by the market.[7] Fortunately, Chile, although with many problems, already went through this stage; today its financial system is guided by the market forces, and there is efficient regulation and supervision. Notwithstanding, the economic process is dynamic, and new challenges and problems appear as time passes that must be faced. It is well known that two of the greatest challenges confronted by modern financial systems are globalization and disintermediation. Both have affected and still do affect the Chilean financial system, as I am sure is also the case of financial systems of other countries represented in this conference.

The process of globalization refers to the increasing integration of the world capital markets. That is, savers, when deciding where to allocate their funds, not only consider the financial instruments of their domestic market, but also look at what the rest of the world has to offer. On the other hand, those investors demanding funds also

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6. This issue is analyzed in R. Zahler, 1992, "Política Monetaria en un Contexto de Apertura de la Cuenta de Capitales." Boletín Mensual, Banco Central de Chile, May 1992.

7. It has to be mentioned that in the Chilean case there were other elements, besides financial liberalization, that helped to deepen the financial system and the capital market. Perhaps the most important one relates to the reform of the Chilean pension fund that began to operate in 1981. More on this subject may be found in the presentation in this seminar about the Chilean case.

evaluate cost and financing conditions around the world before making a decision. This process has been expedited with the growing development of different kinds of financial instruments that allow risk hedging for exchange rates and interest rates, and with the quick development of telecommunications and data processing technologies. To benefit from this process of globalization of world financial markets, it is evident that the opening up of capital accounts must strengthen. As mentioned recently, it is important that this process be carried out in an orderly way. Not only macroeconomic ramifications of the opening up must be considered,[8] but one must also ensure that legislation and supervision of the financial system are in line with this new reality. In my opinion, gradual progress in these matters is better than sudden steps that may end up with a more restrictive capital account than before the process of opening up ever started.

In fact, the gradual method has been the one we have adopted for the Chilean economy. We are certain that a small country like Chile should tend to the internationalization of its financial and capital markets. In this manner we will be able to take advantage, in a solid and sustainable way, of opportunities that arise in the international markets.

Even though substantial progress has been made in this area - Chile's capital account today is more open than in most periods of its recent economic history - there is still much to be done, especially in relation to the liberalization of foreign currency operations by banks, pension funds, and other institutional investors. We will continue moving in the direction of greater liberalization of the capital account, taking all the precautions mentioned above.

The process of banking disintermediation refers to the substitution by big firms of part of their bank financing for financing through the issuance of debt instruments (bonds, commercial paper, stocks) and the substitution by consumers or bank financing, due to a generalized tendency of commercial credit being granted directly by nonbank firms. The technological and financial developments, as well as the increasing role of institutional investors, has also contributed to financial disintermediation.

Besides market trends, regulatory and supervisory institutions may also have some responsibility when they do not keep up with these developments and maintain excessively restrictive legislation that impede banks to undertake new activities. Even though I do not seek to deliver a final opinion regarding this controversy, it is important to stress that in Chile, as in other countries, banks are being allowed to enter into nontraditional businesses, such as mutual funds, brokerage, leasing, investment banking, and so on.

This does not mean that there is not much to be accomplished. I see with particular preoccupation the sometimes unorganized birth of different financial intermediaries. The problem is not that there are many different intermediaries. On the contrary, the diversity is probably positive since it allows more competition and increases alternatives to savers and investors. The point is that events happen with so much

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8. For a detailed analysis, see Zahler 1992.

dynamism that regulators in many instances may be surpassed by these events. Thus, for example, it is not strange to find that regulations and supervision for the same operation, performed by two different intermediaries, are not equivalent. The challenge then is to achieve consistency regarding the norms that rule the different financial intermediaries. This is especially relevant for countries like Chile, where financial reform and banking legislation are quite advanced, and where non-bank financial intermediaries (NBFI), most importantly pension funds, have acquired an extraordinary dynamism and play a key role in our capital market.

Thus, the processes of globalization and disintermediation raise new challenges. Unfortunately, there is little from which to learn in terms of gradually adapting financial legislation and supervision according to changes as they appear, so as to deepen the modernization, efficiency, and contribution of the financial system to the ongoing process of saving and investment. In concrete terms, the challenge is to update legislation that takes care of banks and NBFI, and that is designed to prevent financial crisis and macroeconomic imbalances, without hindering the natural development of capital markets.

There are certain tendencies observed in the regulation of financial markets of developed countries that I think it would be wise to ask ourselves if developing countries should start to move in a similar direction. It is not my intention to give a definitive opinion on these topics (among other things simply because I do not have one), but simply to raise the corresponding questions.

First, capital requirements are being increased. As mentioned before, greater capital requirements help to decrease the moral hazard and agency problems that occur in the banking business. It is for these reasons that governors of the central banks of the principal industrial countries of the world decided, in what is known as the Basle Agreement, to increase capital requirements. Additionally, they decided to implement a system of risk-based capital. I believe it would be beneficial for developing countries to ask themselves if their standards of minimum capital requirements are adequate, using as a basis of comparison the Basle Agreement. It would also be convenient to ask ourselves if these capital requirements should be associated with assets risk, as in the Basle Agreement.

Second, another area to explore relates to the increasing interest in the academic world, as well as in legislatures in some developed countries, of the pricing of insurance on deposits. I think it is necessary to keep an eye open to this discussion and to look for practical solutions to the problem of insurance premiums on deposits.

Finally, the responsibility of government (fiscal) and central banks in the development, liberalization, and globalization of financial markets is essential, not only because of their role as regulators or supervisors, but, above all, because of their responsibilities regarding low inflation and ensuring appropriate levels and time paths of key macro prices.

Many studies of financial reforms or financial deepening failures highlight the role of macroeconomic disequilibrium as the ultimate cause of such outcomes. The roles of fiscal policy and the central bank are crucial in generating an environment characterized

by low, stable inflation, and consistency between exchange rates and interest rates. This, in my opinion, is the best contribution economic authorities can offer, as a necessary condition, for the financial sector to develop in a profound and efficient way.

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3

RESPONSE TO THE WELCOME ADDRESS

Lin See Yan

The stimulating welcome address of Mr. Roberto Zahler, President of Banco Central de Chile is a voice of experience and a very important one. The Chilean experience in my view has shown how a nation can, through the ins and outs of a difficult period, find its way to return to the growth path of monetary stability; indeed, significant growth with stability. In the course of this seminar we will hear many more voices from selected nations around the world reflecting diverse experiences and viewpoints. I certainly hope that this Seminar will put to rest the many myths about East Asia and Latin America, and I hope that we can learn from each other first hand.

For someone coming from East Asia and who has been absent for some time from this part of the world, the experience of Latin America remains rather mysterious, and if I may add, not quite always well appreciated. Yours has always been a rich continent. A number of its nations were once very rich and considered well developed; a few even industrialized. Yet the golden age didn't last. There are worthwhile lessons for all of us here, I am sure. Among the vast and varied experiences, many still see Latin America, perhaps rather naively, as synonymous with inflation. You seem not to be able to live without inflation and we, on the other side of the Pacific - certainly my own country - are not able to live with inflation. In fact, we in Malaysia are allergic to it; we regard it like toothpaste - once out it cannot be easily put back again. Our inflation rate today is 4½ percent a year, and this is already too high for us. We are trying to get it down to 2 percent, a rate we would feel more comfortable with, and a rate we are used to. Latin America is full of contrasts: you are rich, and yet in many things that matter you are not; you value stability and yet, in practice, you are not; you are a talented people and yet this talent tears you apart whether you like it or not. I know as a student at Harvard, some of the best and brightest in my class came from Latin America. We in East Asia make do with much less. Yet, we get what we want. We always say, if only we have proof of your talent.

I purposely refer to this rather Asian perception of Latin America because I find Chile today, and I am here for the first time, to be a breath of fresh air in this part of the world. Your recent experience shatters the Latin American stereotype; rather un-Latin American, if I may call it that. Since 1985, Chile has made remarkable progress toward achieving sustained economic growth and external stability. By 1990, I am told, you restored macroeconomic balance and preserved a favorable environment

for investment, especially foreign investment. You are open, pragmatic, and flexible in your approach to the implementation of policy; the very ingredients of success in East Asia. What is significant is that reforms have been carried out in the difficult fiscal, financial, and monetary areas, as well as in labor relations. More important, inflationary pressures appear to have subsided, and your medium-term economic prospects have certainly improved. Equally significant, your experience in innovative debt management and reform sets the standard to be followed. Coming from where I do, Mr. President, I know what you have had to go through to successfully implement a comprehensive program of macroeconomic adjustment and structural reform - in your case, fortunately or unfortunately, with the assistance of the IMF and the World Bank. I feel for you. Unlike yours, however, our reform program was a voluntary one. We decided to do so as a matter of discipline and commitment, and on the basis of self-reliance. We chose not to have international assistance. By 1980 ours was already, by most accounts, a diversified economy. We were by then the world's largest exporter of palm oil, tropical hard woods, and pepper, in addition to rubber and tin. For a small country less than half the size of Chile, that's quite an achievement. On top of that we were a net exporter of oil and gas, and a significant exporter of manufactures. Between 1980 and 1985, however, the prices of *all* our primary exports fell *at the same time* against all statistical odds; not once (in 1980) but twice (again in 1985) during this short period.

This spells disaster for any open economy. Indeed, our exports and imports together today account for about 150 percent of GNP. As much as 65 percent of our exports are manufactured goods; by 1995, this ratio will rise to 75 percent . When we began adjustment in 1983 we had to deal with a fiscal deficit in 1982 of 18 percent of GNP and a balance of payments deficit of 14 percent of GNP; ratios that were clearly unsustainable. We had a small debt in 1980; our external debt rose to 75 percent of GNP by the mid-1980s, with a debt service ratio of nearly 20 percent of exports. Within three years the fiscal deficit was reduced to about 6 percent of GNP; today it is less than 4 percent. The balance of payments turned into a surplus in 1987 of about 9 percent of GNP; and today we have an external debt that is about 25 percent of GNP, a debt service ratio close to 5 percent of exports, and external reserves almost the size of our external debt. In the past five years our real growth rate averaged 8½ percent a year, with an inflation rate averaging below 4 percent annually. We literally went through hell to get to where we are today. Indeed, the GNP fell absolutely for two years in a row. So, Mr. President, I do feel for you. And, I am very glad to read while en route to Santiago that the problems you now have to deal with have been described by an observer as essentially problems of success.

With the tone set by your welcome address, Mr. President, we all look forward to what promises to be an exciting and stimulating week ahead. On behalf of all present, we thank you for your presence here today, in particular your warm welcome and words of wisdom and encouragement. I wish you and Chile well, and look forward to seeing you in our part of the world; a world, I think, that values talent, stability, and private initiative; a world that is hands-on and is always willing to take on board anything that is a productive venture and; a world with high expectations for a better life for the

majority; and, I think, an increasingly responsible world where growth is increasingly being tempered with respect for the environment we live in, much to the surprise of visitors and despite what the popular press or television has to say about us.

4

FINANCIAL REFORMS: A GLOBAL PERSPECTIVE

Millard Long

I have been going to EDI sponsored conferences on financial reform for ten years, but this is the first occasion when the previous two speakers discussed how successful their economic and financial reforms had been, rather than the more usual stories of failure to reform or disappointment with the results of reform.

I shall paint a big picture and a historical one regarding financial reforms, going back to around 1960 and looking forward to the year 2000. I shall start in the middle with the year 1980 because it roughly corresponds with the beginning of a new view on finance, one that contrasts with the views prevalent during the 1960s and 1970s, an era in which governments were much involved in the financial system. With the emergence of a financial crisis in the late 1970s, there was reevaluation of the role of governments in the financial process; that reevaluation gained momentum during the 1980s.

In the World Bank, the views concerning financial sector have also changed from those prevailing in the early 1980s, when it was simply seen as a conduit for channelling funds to a few priority sectors.

Not much was written either in the Bank about the financial systems of the countries in which it was actively involved. But now, I do not think that there is a country in either East Asia or Latin America in which we are working that we have not reviewed the financial system. In many countries the Bank has made policy-based financial sector adjustment loans to help straighten out the financial system. We have also made technical assistance loans to improve operations in the financial sector. Line of credit to development finance companies (DFCs) have become suspect, particularly in the Latin American region. In other regions lines of credit are still being extended, but not nearly at the same level as before. Also, the model has changed. The Bank does not lend much money directly through DFCs; instead, lines of credit are made available to an apex institution, usually the central bank, and then channelled through the banking system. Thus, the World Bank deals with the entire commercial banking system in many countries and not just a few specialized finance companies.

This is the edited version of the keynote speech delivered by Millard Long at the opening session of the seminar.

In the Bank when we reviewed the Bank's portfolio of DFC loans in the early 1980s, we found that most DFCs were in financial trouble. Following that, in 1983 we held a three-day retreat on the status of financial systems and financial reforms in several countries. That conference focused heavily on the Southern Cone countries because by 1983 we had become quite cognizant of deep troubles in their financial systems. However, I thought financial distress was a general problem; to my surprise, my colleagues working in other areas of the world said at the conference: "Oh, that's the Southern Cone problem; the Southern Cone is unique; problems of solvency in the banking systems, inflation, poor interest rate policies are only Southern Cone problems. We who are looking at Africa and the countries of East Asia do not have to worry about such problems"; History proved them wrong.

I must tell you a little story that jumps a few years forward in terms of my history, to 1986 when a new vice president joined the Bank. He asked each division chief what was interesting in the field their division covered. When my turn came, I thought I had better say something outrageous to get his attention. I said, "Well, you should know that in all the countries in which the Bank is actively involved there is not a signal solvent financial institution." That was exaggerated, but not much, and it did get his attention. He asked me to write a paper on the subject.

It was not only a question of insolvency. Mr. Zhaler earlier on referred to financial repression, inflation, and capital flight. The financial systems at the time were small in size and were providing limited financial services. Transaction cost were high, the difference between deposit rates and lending rates was extreme, much of credit allocation had been distorted, institutions were weak, and most had loan repayment problems. Some countries did not yet recognize the problems in their financial sectors. For the next five years the World Bank tried to persuade countries to engage in financial reforms.

I believe this was one of the three reasons for change in the thinking in the 1980s. The second reason for the change was the debt crisis. Of course it affected primarily Latin America, but it also affected other developing countries. The crisis worsened in 1982 when Mexico and Brazil told the bankers they were not able to repay their loans. Between 1982 and 1987, there was a swing in the transfers of resources from abroad of about $70 billion per year. Net transfers, for example, decreased from about $60 billion in the early 1980s to negative transfers by 1987. Fortunately, the trend in resource flows has been reversed. For 1991, the last year for which I have data, net transfers had recovered by about $40 billion, a positive flow of about $30 billion. The countries that had been highly dependent on financing their investments abroad in the 1970s were no longer able to do so. Countries recognized that if they were to get the level of investment up, the resources would have to be mobilized domestically.

The third reason for the change in developing countries' viewpoints on financial systems was the change in the paradigm of development. In the 1950s and 1960s we had a model of big push development in which governments were to be the major engine of growth. But this view changed when Mrs. Thatcher and Mr. Reagan came to office. They represented in the United States and the United Kingdom an idea that was quite

common in the world at the time, namely that governments would not be able to play the development role in the future, and that the private sector would be the engine of growth. Governments can mobilize funds through the fiscal process, but the private sector needs the financial system. And so, the financial process became more emphasized. Thus, we had three things all coming together in the 1980s. First the paradigm of development emphasized the private sector, which needed a good financial system to be the engine of growth. Second, we realized that financial systems were in bad shape. Third, funds could not be borrowed abroad.

The crisis of the 1980s partially originated abroad. Inflation in the late 1970s in the developed countries made it attractive to borrow abroad when real interest rates were very low. When Mr. Paul Volker became chairman of the Federal Reserve, he decided to take draconian measures to stope the inflation in the United States by raising real interest rates. Higher real interest rates translated into global higher interest rates. It was a shock to everybody, especially the countries of Latin America that had borrowed so much on floating rate terms. Instead of those loans being cheap, they were suddenly expensive. The recession that followed led to very adverse changes in terms of trade in many of the developing countries. The second oil shock pushed import prices up, while the prices of many commodities exported by the developing countries fell.

Other than the recession, there were historical reasons for the difficulties in finance in the 1980s. I told you that I was going to take a long view. I now want to go twenty years to the early 1960s, to the financial systems then in place and to the policies governments followed. By trying to paint such a broad picture, I may do a bit of injustice to the situation in particular countries. The financial systems that existed in the 1960s were dominated by commercial banks lending short term. Commercial banks were often foreign owned and were lending to enterprises that were themselves often foreign owned. Banks lent money to large enterprises but very little to small farmers.

When the first wave of post-colonial governments came to power, the thinking was for state-led, bug-push development rather than small, balanced, private sector development. As this perspective did not fit with the existing financial system, the governments made a number of changes. The financial process was modelled to accord with the way countries wanted to run the real sectors of the economy, that is, with a great deal of government intervention. They nationalized the largest commercial bank in some countries and all the commercial banks in others. They started a series of development banks to make loans to designated priority sectors. The governments also forced those commercial banks they did not nationalize to allocate a good part of their credit to priority sectors often at subsidized low interest rates. In the countries I am now working on in Eastern Europe, the governments were responsible for allocating 100 percent of the credit. In the case of the average developing country, the government took for itself, channelled through its specialized DFCs, or told the commercial banks how they should allocate between 60 and 70 percent of their total credit. This contrasts with the developed countries in which government directed perhaps 20 percent of the credit.

The consequences of this approach, especially in the early years, were not all that bad. The banking system responded as they were instructed. In may countries they were requested to open branches in the country-side and they did. They were told to extend financial services to small firms and small agriculture, and they did that. The banks also financed governments and state enterprises that became so prominent in many developing countries. But much was neglected in the process. Low interest rate policies pursued in most of the countries kept financial systems small. To the extent that people did save, money did not go into financial assets. It was channelled abroad in the form of capital flight, or it was held in the form of real assets. This was the period in which much real estate was built, because people were not willing to put their money in the banks.

There was an explosion of foreign debt during the 1970s. At the peak, what countries owned abroad was far larger then their own domestic financial system. In the case of Argentina, the foreign debt was four times as large as its domestic financial system. In Brazil, foreign debt was two and a half times as large as the domestic financial system; in Indonesia it was six times; in Turkey it was four times. In other words, many countries were relying on foreigners to finance their investment projects, not on their own financial systems.

Accompanying this was a much higher rate of inflation. As domestic financial systems got smaller, the seignorage tax as a percentage of the base got larger, and the rates of inflation accelerated. During 1965 to 1973 the average rate of inflation was 10 percent. From 1974 to 1982 it was 26 percent, and from 1983 to 1987 it was 51 percent. The countries with inflation rates of over 20 percent year in the 1965-73 period were mostly the Southern Cone countries. During 1974 to 1982, there were fifteen countries that averaged inflation of over 20 percent per year, but in the years 1983 to 1987 there were twenty-seven. Inflation has now started to decline.

Let me now turn to issues of debt and insolvency of the financial institutions. The Philippines was one of the first countries in which the World Bank studies the financial system. The financial sector was dominated by two institutions: the Philippine National Bank and the Development Bank of the Philippines, which together accounted for about 50 percent of the system. The government, following the rather unusual process of financial reform asked the heads of those two institutions how much bad debt they had. If I remember the figures correctly, it was something like $7.5 billion out of $9 billion in total assets. That is just one example.

I could speak of another country, our host country, which at that time had to intervene in twelve of its banks, which had 80 percent of the financial assets of the system. However, Chile recognized that it had problems from 1974 on and was one of the first countries to start financial reform. What we found everywhere we looked in the 1980s was that the policies that had been followed had eroded the quality of assets. As I told the new vice president of the World Bank, the banks were really insolvent. From the mid-1980s on, we in the World Bank told the countries that financial reform was needed and was important.

Why, I wonder, have we had such problems convincing countries? The Philippines is a good example. We spent years telling them they needed to begin

financial reform, but we had little success until the government changed. One of the reasons it is so hard to get financial reform going is that finance is so close to the political process. Every government has skeletons in its closet: things they have done with finance to favor political friends. They understand that looking too closely at the banks and the banks' portfolios will reveal these things, so they prefer not to undertake reform. In fact, most of the financial reforms have been carried out shortly after a change in government.

Another thing that always creates problems is that once a government considers recapitalizing the banks, it feels it cannot afford the cost. The country is usually trying to engage in a stabilization program by curtailing its budget deficit. Recapitalizing the banks might jeopardize any agreement with the IMF. The cost of recapitalizing banks is a budgetary cost, not a real cost. The real costs are the losses embodied in the poor investments financed in the past. We should persuade the IMF that bank recapitalization need not be calculated as part of the government's budget deficit, but I have never been successful in doing that.

The third issue -- and I see this while working in Eastern Europe -- that really traumatizes government is the need not only to clean up the bad debts in the banking system but to reduce the ongoing losses in the state enterprises. Without such change the countries cannot solve the problem. The banks will be back in a bad position if they continue to lend to firms that cannot repay. Cleaning up a bank's portfolio of bad debts is relatively easy; it simply means rewriting some pieces of paper. But it is much more difficult to do something about state enterprise losses. Closing down loss-making state enterprises is a traumatic process for any government. You may have heard about big bang reforms in Eastern Europe; the big bangs have not yet caused the closing of perennial loss-making state enterprises.

Some lessons emerge from reviewing financial sector reform. First a country needs sound macroeconomic policies to have a good financial system. Latin American countries appear to have learned better than anywhere else how to live with inflation. In the rest of the world inflation rates of 20 to 40 percent per year are not tolerable. The comment has been made that in Malaysia, 4 to 5 percent inflation is regarded as high. Second, state enterprises seem to be black holes absorbing resources, whether financed by government budget or by loans that state enterprises often do not bother to repay. It now seems simpler to stabilize normal government expenditures than to stabilize, much less to close down loss-making state enterprises.

Third, a reasonable (domestic) relative price structure is necessary for a successful financial system. We saw this problem in Latin America and South Asia some years ago; We are now seeing the problem in Eastern Europe. If domestic relative prices differ from world prices, it will eventually be necessary to bring prices in line with world prices. Half the enterprises will be hurt, and half will benefit from changes in the relative prices. Those enterprises that are hurt will not be able to repay their loans from the banking system. We have come to realize that there is considerable price instability in the world without countries introducing additional instability, first by having high protective tariffs and crazy domestic prices and then by being forced to make reforms.

Fourth, related to this issue of prices, is the issue of interest rates. Without reasonable interest rates, people are unwilling to hold financial assets, or may indulge in capital flight, or a combination of both. We in the World Bank have gone a bit beyond the old doctrinaire point, I hope, that interest rates must be positive in real terms. We realize, or should realize that positive real interest rates are not sacrosanct. That is, if your market interest rates are slightly below the level of inflation to allow positive real interest rates of 1 or 2 percent that probably is not going to do that much damage to the financial system. But you cannot be way off. When you have inflation of, say, 20 percent then you have got to worry for the level of interest rates, and if inflation got higher than that, then you have to be inventive.

Fifth, a country has to deal with what I would call financial infrastructure issues. These issues include building a sound legal framework with capable enforcement. Not only must a country have the laws on the books, but it must also have a court system that is prepared to enforce those laws in a timely fashion. If the court system takes seven years to rule on bankruptcy, that time value of the assets will be dissipated. We have also learned that the financial system is information intensive. Hence, there is a need to build t a good auditing and accounting system. In Eastern Europe, accounting and auditing are very weak. Because you cannot ascertain the financial position of enterprises, reforms and restructuring are delayed.

Another aspect of financial infrastructure concerns prudential regulation. Experience shows that financial markets do not perform well when left on their own; financial institutions need to be supervised. Willie Sutton, when asked why he robbed banks, said, "That is where the money is." Finance is clearly a sector to which crooks gravitate. It is a convenient place to commit white collar crimes. Countries need a legal system and a regulatory framework to oversee financiers to prevent banking fraud.

The sixth point covers the need to build up the institutional structure of the financial system. That means not only cleaning up existing portfolio problems, but also trying to put in place good bankers and good owners. Some Latin America and East Asia countries already have good banking systems. They are now developing nonbank financial intermediaries such as the contractual savings institutions and provident funds; that is the long-term end of the financial system. For many years, the World bank provided long-term finance to DFCs in the belief that there was no other source of long-term finance. Malaysia, Singapore, and Chile have proven that term financial markets can be developed. If countries set up good contractual savings institutions, people will be willing to hold long-term financial instruments. Countries also need to build up their financial markets: the government bills markets, the commercial bills markets, the interbank market, the bond market, the equity market, and so on. These are closely linked to the nonbank financial institutions and the manner in which they allocate their funds. When countries have a substantial pool of long-term resources, they need to have long-term securities and financial institutions dealing in those markets.

There is now a debate in the World Bank on the role of government in credit allocation. Some feel that government played an important and positive role in the allocation of credit in Japan, Korea, Taiwan, and some other countries of Asia. I agree

with those who say that financial markets do not work perfectly. Some government intervention can probably make them work better. But too much intervention, or intervention of the wrong king, can impede the development of financial markets.

More often than not the problem in the developing countries has been too much government intervention rather than too little. Much of the actual intervention by governments in the financial markets of developing countries has not bee to make the markets perform better, but to offset the problem of poor income distribution. Funds have been allocated to small farmers, not because small farmers were better farmers and the rates of return on their investment higher, but because cheap loans were seen as an offset to rural poverty. Intervention has also been make in the name of regional development. Funds were channelled to the northeast of Brazil, not because the government thought that investment in the northeast had a higher rate of return, but encourage development in the northeast of Brazil. Other governments have used directed credit to encourage investment in steel mills, again not because steel had a higher rate of return, but because the governments believed a self-respecting country should have a steel mill industry.

If governments do not misuse the tools of intervention, they may be able to make markets work better If a government is going to channel funds to priority sectors, it should consider the following:

- It should be sure to identify priority sectors carefully. If every sector is a priority, then nothing is a priority.

- It should be sure that the amount of directed credit is not so large as to distort the entire market. A small percent of credits, say 20 percent, channelled to priority sectors will still allow the major part of the markets to develop without interference.

- On directed credit, interest rates should not be different from market interest rates on non-directed credit, otherwise, subsidies will distort the market.

These are not so subtle issues for you in Latin America or East Asia. But it depends on where you start from towards having a good financial system. For countries of Eastern Europe, these matters are very real (may not be so subtle) in their current situation. You in Latin America or East Asia are well beyond this stage. You are concerned with the kind of subtle questions that Mr. Zahler raised, the same kind we in the U.S. are facing--about globalization, securitization, the range of services to be offered by financial institution, whether we should separate payment processes from loan processes, have 100 percent reserve requirements for safe banks, and the like.

I hope that the kind of financial problems I mentioned are problems of the past in both East Asia and Latin America and that the countries in these two regions are not going to fall into old traps. The countries of Latin America and East Asia should be

concerned with more complex questions, such as globalization, securitization, the range of services to be offered by different types of financial institutions, whether payment processes should be separated from loan processes and so on. More advanced financial markets should be grappling with these problems, and I hope that such issues will be the focus of our discussions during this seminar.

5

FINANCIAL REFORM: LESSONS AND STRATEGIES

Gerard Caprio, Jr., Izak Atiyas, and James A. Hanson

General Considerations

Financial reforms -- and doubts about them -- are documented at least as far back as the Scottish free banking era of the 18th - 19th century, and it is likely that, in the wake of the banking crisis of 33 A.D., Romans debated putting a hitherto liberal banking system under government control.[9] Financial reform in the modern era is unusual at least in its frequency: most industrialized countries have embarked on measures to liberalize finance in some manner in the last two decades, and a growing number of developing countries are moving along that course more recently. Even if university courses in development traditionally have attributed little role to finance in the development process, practitioners in the field as well as increasing numbers of academics seem to be convinced both that finance matters and that "market-oriented" financial systems can exert a positive influence on the economy, albeit with significant differences as to the proper or optimal role for market forces.

This paper presents lessons on financial reform, which are derived from two World Bank research projects on both the real and financial sector effects of financial reforms in selected countries (Caprio, Atiyas, and Hanson, 1992). Table 1 presents a thumbnail description of the reforms in the cases studied -- Chile, Indonesia, Korea, Malaysia, New Zealand, and Turkey. These countries differ markedly in their economic, political, and institutional development, which, along with their meager number, raises problems in drawing lessons.[10] Moreover, it is difficult to describe any of these efforts as complete. Reforming the financial system should be thought of as a process, not an event, both because most governments enact reforms in stages and since institutions take

9. See Calomiris (1989) for a description of this "classic" example of a banking panic.

10. A variety of factors went into the determination of country coverage. Malaysia and Korea are known to have reformed at a very gradual pace, and are usually viewed as success stories, so it was difficult to consider a study without them. New Zealand is at the opposite extreme, having reformed at least as abruptly as any of the Southern Cone countries but without some of the latter's macroeconomic constraints. Turkey and Indonesia present interesting "in between" cases, with reform programs that are rapid in some areas and gradual in others, so they offer an intriguing middle ground.

substantial time to adjust. Even in the case of New Zealand, where many liberalizing changes were introduced abruptly and virtually simultaneously in late 1984, it would be premature to consider reform as complete.

Conclusions about financial reforms also should be viewed with caution because these experiments -- even in Malaysia and Chile, where reforms began in the early 1970s -- are relatively recent. New regulatory structures require at least a full business cycle, and preferably several, to permit a balanced assessment of the resiliency of the financial system in good times and bad. Indeed, the moral hazard problems of the U.S. deposit insurance scheme were present in the 1950s and 60s, but serious problems -- and a reconsideration of deposit insurance -- did not develop until the 1980s. An important factor likely was the gradual erosion of the franchise value of bank licenses -- reflecting regulatory and technical change -- which in turn led to greater voluntary and involuntary risk taking by banks.[11] The changes associated with low franchise value, which contributed to the problems in the United States and, as seen in Chile, may do so in developing countries, take time to become evident because they involve alterations of bank incentive systems ("bank culture"). Thus, a degree of circumspection is called for in making claims of success for policy changes in this area.

In addition to these caveats, there are serious challenges to measuring the success of financial reform. The main tasks of finance are to mobilize resources and allocate them efficiently; as part of this process, intermediaries provide instruments that allow for the diversification and hedging of various risks, thereby permitting economic agents to concentrate on other productive activities and utilize financial resources efficiently. Regarding mobilization, the present consensus is that the relationship between interest rates and aggregate saving may be only at most mildly positive, though higher rates will tend to increase the share of saving intermediated by the financial system. Other aspects of reform -- more branches, better service, more diversified savings vehicles -- may contribute to a deepening of the financial system and thus might raise aggregate saving as well. However, without much more and better data covering several business cycles for a number of countries, it will be difficult to provide convincing evidence for this effect. Still, it is at least interesting that of the six countries mentioned above, all but New Zealand have experienced their highest sustained rate of savings since the early 1970s (figure 1), and in New Zealand there is at least a hint that savings in the post-reform era is above what it might otherwise be.[12]

Savings in the financial sector increased in all the countries. The standard financial depth ratios (some measure of money relative to GDP) rose, in some cases considerably, and quasi-liquid liabilities, which can be thought of as a non-transactions component of broad money, expanded rapidly following reforms (Figure 2), except in New Zealand, where the innovation of electronic funds transfer directly to the point of

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11. See Summers and Caprio (1992) for an elaboration.

12. See Dimitri Margaritis, "Financial Policy Reform in New Zealand," in Caprio, Atiyas, and Hanson.

sale led to a temporary shift toward narrow money within an overall financial deepening. The countries' financial deepening typically involved a broadening of the menu of assets available to firms and individuals, as appears for example in Korea (Nam, 1992), which is at least suggestive of a greater use of finance to hedge risks.

Assessing improvements in the efficiency of resource allocation also is problematic: the presumption is that an effective financial system will maximize efficiency by allocating credit to industries and firms where it can be best used. However, total factor productivity is subject to a myriad of influences, is difficult to measure on an economy-wide basis, and ideally a number of years -- pre- and post-reform -- would be desirable to sort out its determinants.

Moreover, in most countries financial reform has been carried out simultaneously with significant policy changes in other areas, in particular in foreign trade, which also are likely to increase aggregate efficiency; hence the impact of changes in financial policy are often difficult to isolate. As noted in Schiantarelli et al (1992), the standard measure of efficiency, the incremental output-capital ratio (IOCR), only gives a good indication of efficiency under the assumption that factors of production are used in fixed proportions. For those who accept these simplifications, gains in the IOCR were seen in five of the seven cases examined in that study from the pre-reform period to 1988-89. In Malaysia, which, along with New Zealand did not experience efficiency gains over this period, the comparison is biased by including pre-1973 data; more recently there has been a recovery of the IOCR there.[13]

More tellingly, Schiantarelli et al show that firm level data in a few countries reveal an association between financial reforms and significant increases in the allocation of credit to efficient firms, even when the firms' efficiency is judged solely on the basis of pre-reform data.[14] In Ecuador, not only does average efficiency rise but the dispersion of efficiency among firms declines by the end of the period. While large firms have seen a relaxing of the extent to which investment decisions are constrained by financing, in Indonesia small and large firms enjoyed this benefit of reform, as these firms were more efficient than their medium size counterparts. Small firms are precisely those that might be expected to be discriminated against in formal directed credit

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13. In New Zealand the slight decline of the IOCR may reflect in part the lower output path associated with disinflationary macro policy and may therefore be temporary. At the same time, all of these comparisons are over relatively short time horizons, and therefore at least in part may represent cyclical forces. And as noted in Schiantarelli et al (1992), there are significant problems in estimates of the real capital stock, so for example the different data series for Ecuador show different swings of the IOCR.

14. This methodology thus allows for the possibility that firms could become more efficient by greater access to credit. Note that efficiency gains following reform are expected to be larger the greater the government's prereform involvement in credit allocation decisions - especially, the greater the government's role in allocating credit at the firm level, as this activity is (wide) open to rent seeking.

programs, even in programs designed to direct credit to this group.[15] *Although these results do not prove that financial reform increases allocational efficiency -- after all, they are only for a few countries and cover a short period -- they do represent the first micro level evidence of the positive real effects of financial reform, effects which have been assumed but never substantiated.* In sum, these results, along with the cross-country studies of Gelb (1989) and King and Levine (1991), are the most promising evidence to date of efficiency gains from financial reform. Together, the findings should influence the way in which development economists think about finance.

The next section presents a summary of the lessons from the studies in Caprio, Atiyas, and Hanson. The key points are that:

- the performance of the financial sector is inextricably linked to that of the real sector, in particular through the evolution of borrower net worth. Reform programs should be designed and modified to take account of these linkages;

- initial conditions in finance -- the portfolio of banks, their "information capital," their human capital, and their internal incentive systems -- play a key role in determining the success of reform efforts, and implicitly offer a blueprint for the design of reform programs;

- these two points create a bias in favor of moving promptly on various aspects of institution building in finance and more gradually (but still steadily) on interest rate deregulation and the removal of portfolio restrictions;

- a variety of sequences of financial reforms have been tried, and in particular several countries opened their capital accounts prior to or simultaneously with domestic financial reforms, with no obvious difference in success. Policy credibility may have been enhanced in economies with an open capital account, and attempts to bottle up capital flows may increase the riskiness of the domestic banking system. However, the sustainability of unconventional sequences may result from special factors, including in Indonesia the absence of government debt and in Malaysia and New Zealand a high degree of central bank independence.

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15. In Korea, investment by small and medium size firms became less constrained, and that by large firms more constrained, following the reforms of the 1980s. However, although reliance on directed credit decreased, and real interest rates became modestly positive, this change also reflects a shift in directed credit away from large firms.

The subsequent strategy section then tries to apply these points to the reform process, offering a guide to how to proceed and what sequences should be avoided, followed by some concluding thoughts on the reform process.

Some Lessons

Real and Financial Sector Linkages

The modern view of finance emphasizes imperfections in financial markets and implies certain consequences for reform efforts (Gertler-Rose, 1992). In particular, limited information (or information asymmetries) and limited enforcement capabilities pose significant problems in finance, certainly in comparison with the textbook case of a world of perfect information, where borrowers' and lenders' incentives can be easily aligned through contracts envisaging every possible contingency. With information and enforcement imperfections, financial intermediaries focus on borrower net worth, with higher levels aligning borrower and lender incentives more closely. Borrowers have to pay a premium for external finance (that is, financing from sources outside the firm), one which rises as their net worth is lower. Gertler-Rose thus illustrate the close relationship between the real and financial sectors: simply put, finance is not likely to thrive when the real economy is performing poorly. Consequently the evolution of borrower net worth will play an important role in post-reform developments. Shocks, such as adverse terms of trade shifts or higher real interest rates, that reduce borrower net worth will drive up the premium for external funds, reduce investment, and impact negatively on financial intermediaries. This linkage suggests that governments that attempt reforms during times of positive or neutral macroeconomic shocks will encounter greater success. However, it is not a prescription for inaction. *In order to benefit from good timing, the authors suggest that authorities move* ***more aggressively*** *on financial reform in good times and more slowly when borrower net worth is being reduced by negative shocks, such as recessions or terms of trade losses.*

Indeed, to the extent that financial reform entails an end to subsidized or negative real interest rates, reform itself induces a drop in the net worth of existing borrowers and the value of bank loans to them. This will reduce banks' willingness to lend to the existing clients. However, it should be noted that while ending interest rate subsidies reduces the net worth of subsidized borrowers, it may improve that of other borrowers, who likely were paying high premiums to obtain non-subsidized credit in informal credit markets.[16] Thus an important additional issue, discussed in the next sub-section, is the extent to which intermediaries can locate and finance these potential new clients in the

16. A real interest rate increase from slightly to very high levels likely means that funds are flowing to exceptionally high risk borrowers alone - that is, it effectively reduces the net worth of all credit worthy borrowers.

short run. If the banks are unable to do this, then the net result of reform could be lower investment and more finance for government, as appears to have occurred in the early 1980s in Turkey (Atiyas and Ersel, 1992) and in Uruguay in its financial reform of the mid-1970s. Thus, the results of financial reform are likely to be much better when other shocks are at least expected to be neutral, or when the government has taken steps to offset negative shocks.

In the six countries mentioned above, financial reforms appear to have progressed most smoothly when attention was paid to borrower net worth (and bank portfolios) and shocks were positive. Yusof et al. (1992) discuss how financial liberalization in Malaysia, which began in the early 1970s and accelerated in 1978 with the freeing of interest rates, was halted and even reversed in 1983, as the economy was adjusting to the elimination of a large fiscal deficit (19 percent of GDP) brought on by an attempt to smooth out the effects of the global recession and higher oil prices. Highly visible reforms remained largely on hold through the 1985-6 collapse of commodity prices, giving the banking system time to deal with a large non-performing loan problem. In particular, the re-control of interest rates prevented banks in difficulties from bidding away funds from sounder banks, as occurred to some extent in Chile and the United States. Liberalization efforts were resumed in earnest in 1987 as the economy improved, with full deregulation of lending rates only in early 1991.

Korean authorities also appear to have paid great attention to borrower net worth and to the initial conditions of bank portfolios. As described by Nam (1992), Korean authorities waited until well after the economy's adjustment to the 1979 oil price shock, a large devaluation in 1980, a beginning of trade liberalization, and a significant deceleration of inflation before attempting to eliminate preferential interest rates and to allow banks some discretion in setting interest rates on loans. By starting late and going slowly, Korean authorities were able to allow for the workout of pre-existing nonperforming loans and to benefit from both a realistic set of relative prices and healthier corporate balance sheets. This process also involved direct government injections of funds into banks to cover losses.

Indonesia also undertook reforms in less favorable circumstances but with good results [Chant and Pangestu (1992)]. The first phase of reforms, in 1983, came with oil prices near historic highs but clearly declining, budget and current account deficits growing, and protection actually increasing (up to 1985). However, initial financial reforms followed on the heels of a 46 percent devaluation, with more significant financial sector reforms coming in the late 1980s (after a second large devaluation). Importantly, banks had five years to adjust to the significant retreat of the government's role in allocating credit before new entry into banking was allowed, thus providing time for the banks to workout their bad portfolios before strong competition was introduced. Moreover, Indonesia for quite some time had an open capital account, and financial repression in the decade prior to reform was not severe. Thus it was unlikely that there would have been an information capital problem, and indeed the quite rapid rate of credit

expansion there has been the antithesis of a credit crunch.[17] So the lesson here is that macro conditions need not be ideal in order for financial sector reform to pay large dividends.

Turkey's experience with two interest rate liberalization episodes also supports the Gertler-Rose hypothesis. During the first episode, Atiyas and Ersel (1992) note that in the early 1980s, removal of controls on interest rates and an opening of entry was carried out in an environment of disinflation, and was accompanied by a significant deterioration of operating earnings in the corporate sector. The ensuing period of distress borrowing further weakened company balance sheet positions and generated a fierce competition between weak banks to attract deposits to finance non-performing loans, endangering the stability of the banking system and leading to a re-control of interest rates and entry. By contrast, the rapid increase in interest rates following deregulation in 1988 did little damage to corporations which, thanks to comfortable operating earnings, could rely on internally generated funds to reduce their demand for short term borrowing.

In sum, macro circumstances may never be ideal; the role of borrower net worth is important is highlighting how real sector developments can impinge on the evolution of finance. When political factors permit, authorities should attempt to liberalize finance more aggressively in times of favorable macro conditions and pay attention to other policies that can strengthen borrower net worth.

Initial Conditions in the Financial Sector

Various aspects of the initial condition of the banking system must be considered in determining the impact of reform (Caprio, 1992, 1992a). Not only banks' net worth, but the initial composition of their assets and liabilities, their information set, or "information capital", their endowment of human capital, and their internal incentive systems, all reflect the pre-existing set of controls and will determine the banks' response to reforms. *Those reforms that take account of the initial portfolios of banks, their information capital, and their stage of institutional development are expected to fare better.* For example, financial reforms when banks have negative net worth -- as arguably was the case with the U.S. S&Ls -- are likely to lead to unwise risk taking activities. Thus banks' net worth matters as well as the real sector's net worth. When banking skills are in short supply and bank incentive systems are geared for following

17. As Caprio (1992, 1992a) notes, bank lending depends on the information set, or information capital, that banks possess. In developing economies, where accounting and auditing skills (and standards) are scarce, banks will build up their stock of information capital by establishing banking relationships with their clients, often large firms. Exogenous shocks to relative prices may greatly reduce the value of this information capital, and thus lead banks to attempt to retreat from lending, especially where information about other potential borrowers is limited. Tunisia appears to fit this case. Despite the large devaluations in Indonesia, this problem did not arise there, as banks continued lending, even, as Schiantarelli et at show, to small firms.

government instructions on credit allocation, a sudden move to a laissez-faire system would most likely result in large losses. Similarly, when there are severe information asymmetries, banks main source of information will arise from longstanding relationships with their clients. Destruction of this information capital, through devaluation, reduction in protection, or cutbacks in public investment spending, can lead the banking sector to retreat from lending and thereby deter investment. This consideration does not imply that such changes should not be made, only that their impact on banks' willingness to lend should be taken into account.

The argument that post-reform developments likely will depend greatly on initial conditions highlights the key role played by banks' portfolios and the stock of information capital. Not just aggregates of assets and liabilities, but the division between different categories of each can have an impact on the response of individual institutions and the entire financial system to reform. For example, in many countries -- both among those reviewed here and more widely, including the industrialized economies -- problems with non-performing loans in the real estate sector followed on the heels of attempts to deregulate finance. In addition to the possibility of interest rate mismatching, in some markets it has been argued that there was a run-up of property prices spurred by bank lending.[18] In certain cases it appears that, prior to the onset of financial reforms, real estate loans had been "crowded out" of banks' portfolios by other priority sectors, so that as intervention was lessened, banks began to adjust their portfolios in favor of this sector. However, a widespread portfolio reallocation always entails some dangers: it can lead to higher asset prices in the favored sector, and persuade bankers that their initial portfolio reshuffling was so profitable that they should invest even more in the growing sector, thereby contributing to real resource shifts that later may well be reversed.[19]

Malaysia appears to fit this case, with a dramatic rise in the real estate exposure of banks (from 12 percent to 36 percent of bank assets), and Indonesian data are suggestive as well. More generally, the point is that financial reform usually entails a portfolio shift, away from forced holding of government securities and directed credit. Allowing the shift to occur suddenly both can entail swings in asset prices and may place great demands on banks not accustomed to new portfolio decisions. And they rarely will have the staff and management skilled in understanding and monitoring the risks associated with portfolio and credit decisions. The less the pre-reform control by banks

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18. By interest rate mismatch is meant the phenomenon whereby banks fund long-term fixed rate loans with shorter-term deposits.

19. This story applies to the diversification of U.S. banks into developing country debt, to the rise in oil lending by Texas banks and S&Ls, and to the boom in property lending in the United States, Japan, the United Kingdom, Scandinavia... While the role of regulation and interferences with credit allocation was different, in each of these cases the simultaneous shift of bank portfolios appears to have contributed to a temporary move in asset prices, the reversal of which led to an impairment of bank portfolios.

over their assets, the greater will be the expected learning problems and the wider the swings in asset prices.[20]

Abrupt portfolio shifts might be prevented by some "speed limits" on portfolio diversification -- that is, a gradual relaxing of forced lending and other portfolio controls -- along with prudential oversight of the total portfolio. The great difficulty is in deciding on appropriate limits. Total lending in real terms by Indonesian banks rose at an average annual rate of 24 percent over the 1983-90 period, that is doubling in real terms approximately every three years, a speed that would defy many supervisors' estimate of a safe rate for loan growth. Yet signs of widespread distress are not overt, real investment has grown rapidly, and inflation has decelerated and remained in the single-digit range during the second half of the 1980s. However, some warning signs apparently led the authorities last year to raise capital requirements in order to slow lending. And in Malaysia, the rise of property loans in bank portfolios occurred steadily over the 1971-87 period, making it difficult to determine an excessive pace of diversification.[21] Outright regulatory limits on exposure to various sectors are both difficult to defend and can resemble in practice the highly interventionist approaches that many governments are abandoning because of their negative effects.

A less recognized and perhaps more crucial initial condition is the banks' stock of human and managerial capital at the time of reform. Reform programs should take account of the absence, in countries with prolonged financial repression, of incentives for banks to invest in risk assessment and monitoring skills. Longstanding pay restraints in the financial sector will also contribute to a weakening of the skill base in this area. A history of severely repressed interest rates means that the market -- in most cases, the banking system -- has not been allocating credit; consequently, it is not surprising that the stock of human resources and internal controls in such a banking system will be far less than in one charged with the credit allocation task. In Malaysia, banks were left in control of a large portion of their portfolios during the decade prior to reforms. However, Korean, Indonesian, New Zealand and Turkish banks faced far greater intervention by government authorities in the pre-reform period. In Korea, a well developed non-bank financial sector helped mobilize and allocate resources, but part of the reason for the Korean Government's direct involvement in the restructuring of private companies was the financial system's perceived deficiency of workout specialists.[22] In Indonesia and New Zealand, banks were given time to improve their skill base before new entrants were allowed, and the reform process began with an already significant foreign presence. Malaysian banking remained relatively concentrated, with the ten

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20. True, reform may be more urgent in a more controlled environment. The point is that highly controlled banks will likely have portfolios and staff poorly suited to a completely deregulated setting. Section 3 elaborates more specifically on strategy for financial reforms.

21. However, in some years property-related lending reached 50 percent of the flow of new credit, a proportion that many bankers and supervisors would deem excessive.

22. See Leipzinger (1988).

largest banks accounting for about three-fourths of bank assets over the last twenty years. In Turkey, foreign banks remained insignificant in terms of market share after the reform. However, they played an important role in training a new generation of middle level bank managers, who were subsequently employed in domestic banks. More flexible attempts to deal with exposure questions through the supervisory process may be preferred, but it may well prove difficult for supervisors to recommend a halt to a boom in individual sectors. In theory, supervisors could even take the lead in requiring risk management systems in banks. However, supervision alone does not appear capable of preventing sizeable losses in banking, judging from the experience of industrial countries. Higher capital requirements -- or risk-based capital requirements, which could be geared to rise with the exposure to individual sectors -- are one effective mechanism for limiting exposure: the 8 percent risk-adjusted Basle ratio is just coming into force in most industrial and a few developing countries, but this ratio may not be high enough, especially in less diversified economies. Indeed, some highly regarded international banks have operated with 10 percent to 12 percent capital ratios. These banks also consistently rank among the highest in terms of profit rates, suggesting that restoring some franchise value to bank licenses may be important, and indeed may be the quickest way to ensuring that banks invest in upgrading their skills and management systems.[23] Bank supervisors, of course, can assist bank management in planning for various scenarios, such as commodity price reversals and swings in real estate prices; this focussing of attention on the impact on bank portfolios of various shocks may prove sufficient to avoid unbalanced expansions. Finally, it must be realized that when more than one sector is booming, the policy problem is more in the domain of monetary and fiscal authorities.[24] The best supervisory authorities -- and perhaps even the best bank managers -- will have little success reigning in risk taking behavior if aggressively expansionary policies remain in effect for very long.

The supervisory system itself is another (often recognized) initial condition likely to be of great importance. In determining how much countries should invest in supervision, however, one is confronted immediately by the difficulty in measuring supervision, and even if this were possible, judgmental assessments of supervisory capacity suggest that countries with deep financial systems usually have better developed supervision and better developed bank management systems. Most observers agree that supervision is important: when bank losses are large enough, governments inevitably are held accountable and few are able to resist the pressure to bail out at least some deposits. Some supervisory oversight therefore accompanies this fiscal responsibility. Financial intermediary activities frequently have been subject to fraud, embezzlement, and mismanagement, and supervisors have an important role to play as allies of bank

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23. A few international banks have in effect created their own franchise value by establishing their reputations, to the point that firms are identified as top performers by an association with these banks. Reforming economies can artificially create franchise value by not licensing excessive number of banks.

24. In this regard, Indonesia's achievement of low inflation despite rapid credit growth, and the evidence of increased efficiency (Schiantarelli et al) should give pause to any critics of their expansion.

managers in strengthening internal controls and risk assessment systems. The activities of financial intermediaries also are subject to significant externalities. In particular, financial distress in a small number of intermediaries is likely to be propagated to the rest of the financial system through, for example, increased competition for financial resources.

Improving bank supervision -- importantly, shifting it from a passive check on compliance with government lending guidelines to a prudential review of banks' risk management systems -- should be thought of as part of the "getting out of the dark" process.[25] But bank supervision alone cannot be the first line of defence against unsafe and unsound practices; creating or restoring a high franchise value for bank licenses, requiring high levels of bank capital, and encouraging liberal loan loss provisions would help ensure that bank management had ample incentive to police itself.[26] Bank supervision then would be a backup or ally for bank management. Clearly, authorities have to be wary of excessive limitations to competition; the point here is that as long as implicit or explicit deposit insurance is being provided, then the basis for wide-open entry into banking will encourage risk taking with public funds, a dangerous combination.

Liberalizing the Capital Account

The presumption, based on the experience of Latin American countries, that capital account opening should necessarily be the last step in the liberalization process. Hanson (1992) argues that if capital liberalization will lead to currency appreciation, then it will produce this appreciation whenever the capital account is opened. Moreover, the same forces producing an appreciation will lead to greater availability of resources and may provide some credibility for government policies, so early opening cannot so easily be ruled out. Governments often argue that capital controls are needed in order to tax capital and financial assets (including the inflation tax). Put differently, an open capital account may force authorities to rely more on taxing income or consumption, rather than savings. Hanson notes that the de facto internationalization of capital may greatly circumscribe the ability to tax capital -- such taxes mainly fall on those with less access

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25. Villanueva and Mirakhor (1991) argue that an adequate supervisory system a requirement for successful financial reform, but they do not provide a description or measurement of such a system.

26. Sheng (1992) and Summers and Caprio (1992) both argue that looking a bank supervision in developing and industrialized countries suggests that while important, more attention needs to be devoted to the incentive environment in which banks function. Summers and Caprio (1992) also cite studies showing that the stock market generally does not anticipate bank failures, and that even insiders - that is, bank managers themselves - apparently fail to anticipate them, as evidenced by their stock purchases immediately prior to the downgrading of their bank. If the market and even insiders cannot clearly anticipate bank failure, depositors - and perhaps even supervisors - will have difficulties in performing this role.

to international markets. Viewed in that light, an important reason for an open capital account is to allow all citizens to reduce the burden of taxes on savings. Finally, the argument of the paper strongly emphasizes the need to put both the domestic fiscal accounts and the financial system in order before opening the capital account and allowing foreign financial intermediation. Otherwise, large capital outflows may develop and the government could then end up bailing out the weakened domestic financial system at a cost to the taxpayer, as discussed above.

Valdés-Prieto (1992) notes that capital account opening itself cannot be blamed for the macroeconomic difficulties encountered by Chile in 1977-82, but that the culprit was a combination of several factors, some related to macroeconomic policies. A key factor appears to have been an implicit exchange guarantee, a notion to which the Chilean authorities at the time contributed by public statements. Recalling the aforementioned argument on realistic capital requirements, Valdes notes that banks with a foreign exchange mismatch were not required to hold higher capital or to add to provisions. Moreover, Valdes argues that an earlier opening up could have proved beneficial, both because it would have reduced the later shock to the system and because it would have increased bank profits. Thus authorities in other countries should not abstain from capital account opening merely on the basis of the Chilean experience, which reflected a number of country specific factors including a long prior history of prior repression, a peculiar exchange rate-based stabilization program, and an ill-timed approach (rife with moral hazard) to opening the capital account.

Liberalization Fears

Popular perceptions of the impact of financial reform are heavily colored by the Southern Cone experience. As noted above, however, the causes of difficulties there went beyond the financial sector, and experience outside this area is quite different. Margaritis (1992) recounts that New Zealand authorities also suddenly reformed a highly protected economy all within matter of months, removing tariffs, floating the exchange rate, and embarking on rapid financial sector reforms. When similarly rapid reform, albeit with a different exchange rate policy, was attempted in Chile, unsustainable capital inflows and a real exchange rate appreciation, according to conventional wisdom, were argued to have unravelled the reform program. In particular, false signals were thought to have been sent by a disequilibrium relative prices. However, part of the sharp (166 percent) rise in Chile's terms of trade over the 1973-82 period occurred in the wake of widespread political and economic change; over a shorter period (1977-82) the terms of trade rose by 26 percent, comparable to the 30 percent rise following reforms in New Zealand. While these shifts are large, huge swings are not a foregone conclusion; actual or incipient exchange rate movements will depend on the combination of monetary and fiscal policies pursued at home and abroad, to which officials should only respond by not putting policy, including that towards the capital account, on automatic pilot. The real appreciation of Chile's currency likely could have been limited by not providing an

exchange guarantee, in effect a free option investors. And New Zealand's terms of trade gain certainly was in part attributable to the shift in monetary policy towards fighting inflation since the mid-late 1980s. Tighter fiscal and easier monetary policy would have reduced the upward pressure on interest rates, thereby reducing capital inflows.

Another popular reason for avoiding financial reforms is fear of high real interest rates, again based on the Southern Cone experience. Yet in most of the six countries, real interest rates were generally well behaved (Caprio, Atiyas, and Hanson, 1992). The exception was Turkey, where real deposit rates were quite volatile and reached 20 percent in the early 1980s, subsequently fluctuating from slightly negative to modestly positive levels (up to 9 percent); lending rates are harder to determine but appear to have been quite high and variable across different types of borrowers, in part because of a large degree macroeconomic uncertainty. Large spreads between borrowing and lending rates can reflect a lack of competition, but often follow directly from high reserve and portfolio requirements, with reserves and other required holdings earning either little or no interest. These requirements were lowered significantly in Indonesia and Malaysia, while in Turkey the weak budget situation led to continued reliance on financial sector taxation. Especially in Malaysia, where bank competition was not that intense, the reduction of financial sector taxation likely helped banks to earn higher spreads, and for part of the period lending rates were restrained by the government's "cost plus" guidelines.

Fears of a loss of monetary control also often inhibit developing country authorities from reforming financial markets. However, the evidence for New Zealand, Indonesia, and Malaysia is that monetary control was maintained, as is attested to by the favorable inflation performance of these countries. *It is important to note that all three countries at the commencement of reforms had highly capable central banks, suggesting that building up the research and implementation sides of central banks is a critical precondition for successful reform.* Indonesia also had a relatively favorable fiscal position, while central banks in Malaysia and New Zealand enjoyed an especially high degree of autonomy, and all three countries appear to have had a consensus for achieving and maintaining low inflation. With high but still imperfect substitutability among currencies, monetary control and capital account openness demands a reasonably agile response on the part of policy makers, and it is unlikely that control could have been maintained in a less disciplined fiscal environment. In Turkey, even though the Central Bank was institutionally capable, efforts to gain independence were often unsuccessful due to the government's authority to raise limits on Central Bank advances to the Treasury. In 1991, with increasing budget deficits and inflation, the Central Bank had to abandon the practice of designing annual monetary programs, which was initiated only a year ago. Indeed, Turkey's progress in many aspects of financial reform has been less marked than in the other cases examined here, including the limited progress in financial deepening, in part as a result of continued demands placed on financial institutions to absorb government paper. Reserve and liquidity requirements are back to 35 percent of deposits, a higher proportion than in any of the other countries in the sample, coinciding

with a relative lack of progress in financial deepening and standing in contrast to the experience of Indonesia, Korea and Malaysia.

Central banks also are in a position to help the reform process by stimulating the growth of markets and instruments, as noted by Meek (1991). This contribution to financial deepening is most noticeable in the cases of Indonesia and Malaysia, where money market development was vigorously pursued by the monetary authorities. Indonesian authorities developed central bank certificates and bankers' acceptances in order to permit the withdrawal and injection of liquidity, and oversaw the deepening of money markets. With Malaysian money markets already relatively well established, the authorities in the 1980s concentrated on the development of a viable secondary market for government securities and mortgage paper, by changing operating procedures, and limiting the scope of "captive" markets for government debt, thereby moving to market pricing. Similarly, in Turkey the Central Bank played a major role in the establishment of interbank money and foreign exchange markets.

Towards a Strategy for Financial Sector Reform

Authorities interested in reforming finance first should think of what types of interventions in the financial sector are desirable for their societies, and then consider how to get from the current set of arrangements to the desired one. Perhaps the primary issue is the amount of subsidized, targeted credit. Arguments in favor of intervention never are in short supply. Various constituencies seek support for farmers, small and medium enterprises, exporters, and students, not to mentions specific commodities or activities, such as oil, coffee, etc. For a policy maker, targeted credit is often the most convenient intervention and has a low political visibility since it regularly does not require parliamentary approval. At the same time the evidence suggests that targeted credit has a number of costs. In the real economy, targeted credit usually worsens income distribution since it usually ends up going to the better-off; it is unlikely to increase output much, as it often substitutes for investors' own funds or leads to the recipient's intermediating the funds rather than investing them; and to the extent output increases this reflects an undesirable increase in the capital intensity of targeted activities. Targeted credit also tends to weaken the financial sector. To the extent the subsidy comes from the financial sector through forced lending at below-market rates, rather than the treasury, depositors receive lower rates and non-favored borrowers pay higher rates, reducing the financial sector's ability to mobilize and allocate resources. Moreover, targeted credit tends to weaken incentives to assess credits, monitor them, and even to collect on debts (and for borrowers to repay them). The resultant weakening of the financial health of banks can lead to eventual large fiscal outlays when the losses have to be covered.

These problems argue for keeping targeted credit schemes small, leaving them broad based, so that responsibility for credits remains with individual banks, and limiting as much as possible the subsidy element, not only to reduce the distortion of the cost of

capital but also to remove any notion that directed credit is a grant. Establishing a "sunset provision" for the ending of the scheme would ensure that credit today is not being directed at old priorities, in effect forcing authorities to re-visit the debate over which activities should be favored. And where subsidies are desired, they should be done directly from the budget. Of all the countries reviewed here, Malaysia comes closest to this type of intervention.

The importance of information in finance (Gertler-Rose and Caprio) has major implications for both goals and strategies, implying that correcting -- where possible -- information and enforcement problems is highly important to financial and real sector development. *This means that vigorous attempts are needed to develop the accounting, auditing, and banking professions, as well as pursuing judicial and legal reforms that will facilitate the prompt enforcement of contracts and punish fraudulent activities. Because of the significant externalities, it is in precisely these areas that government intervention is "first best" policy: this is what governments do best.*

Sequencing of efforts in all of these areas is straightforward: they all take a considerable amount of time, and should be commenced early on -- as soon as possible -- in the reform process. Although some aspects of financial reform must await both the achievement of macro stability and (where price controls are widespread) moves to market-determined prices, that is not the case with these efforts, and they are of overwhelming importance. Institution building lacks the glamour of more visible aspects of reform, such as an immediate deregulation of interest rates, but there is a good deal of evidence, both from countries considered here as well as others at various stages of development -- that progress in these areas is essential for successful implementation of other reforms in the financial sector. Attempts to correct perceived shortcomings in financial markets, such as a scarcity of long term finance, without developing these building blocks and without addressing the likely causes -- high inflation, uncertain government policies, and severe information asymmetries -- likely will prove self-defeating.

Institutional assessments

The need for and emphasis on institution building will depend to a great extent on the history of financial repression. If interest rates have been severely repressed -- say below negative 5 percent -- for a significant period of time, then experience indicates that banks will have underinvested in credit assessment and risk monitoring skills. But even without significant financial repression, governments should first "get out of the dark" about the condition of their financial sector, especially of their banks. Simple financial audits often reveal little about banks. Instead, risk asset reviews (RARs) are needed to assess borrowers' financial condition, collateral values, portfolio risks under various scenarios, and the adequacy of provisions, complemented by an inventory of the

human capital in the banking system.[27] RARs help form an assessment of banks' ability to plan and to evaluate the risks they face, and can assist in changing their internal incentive systems; in effect, these reviews can be a form of technical assistance in training bank managers to think about and evaluate their business. In the limited cases in which risk asset reviews have been attempted, a typical finding is that internal systems are (often grossly) inadequate for an evaluation of the risk confronting banks, and RARs have been instrumental in establishing such systems. Highly and even mildly repressed banking systems, also typified by low levels of bank capital, will sorely need precisely this type of assistance.

These measures should not be interpreted as merely technical; they require substantial political will. In most cases they will uncover significant problems with the financial health of major borrowers, which are likely to call into question the existing interventions in the financial system. These measures also are likely to indicate problems in the intermediaries, including possible decapitalization of the system. This in turn will require government action to remedy the state of the financial institutions.

Restore and Recapitalize?

Ordinarily, at this stage in the reform process the government must decide either to restore the financial health of banks with negative net worth or close them down. In general, restoration efforts are not likely to pay off and the banks should be closed unless there are well-run banks as merger candidates or other sources of managerial expertise, or unless the needed institution building, mentioned above, is well underway. This point must be modified where doing so would involve essentially closing down the entire financial system. Restoration -- either through replacing bad loans with government bonds, merger with another institution, or a combination of the two -- and recapitalization are recommended only when the resulting institution(s) will be less likely to make bad (nonperforming) loans than the predecessor(s).

Recapitalization will have to be paid for either by the public (through higher taxes or lower government spending), if the government provides the capital; or by borrowers and depositors (through higher spreads), if banks are allowed to work out their own problems and new entry is limited (an approach followed in Turkey, Indonesia, and Malaysia among the countries studied). Fiscal arguments often are made that cleaning up banks is expensive, and will enlarge the budget deficit. But the replacement of bad loans with government bonds has no macroeconomic effect given that the authorities have effective control over monetary policy. The proper measure of the government's current deficit used to gauge the impact of fiscal policy on the economy does not change at all

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27. See McNaughton (forthcoming, 1992) for a description of risk asset review. Although courses on banking, accounting and finance can help, courses alone are not as likely to capture the attention of senior bank managers as well as the glaring inadequacy of their own internal controls. In effect, their own institution offers the best case study possible.

from the stock effect of the operation, although the cost of the interest payments will, indeed, have to be financed, and may be substantial.

Allowing banks to work their way out of a serious nonperforming loan problem is politically attractive, since it requires no government resources and allows a more market-based workout. However, this approach also has some dangers. New investment and depositors have to pay a "tax" to cover existing losses, which may reduce growth. Moreover, decapitalized banks, especially if privately owned, may well bid up deposit rates and invest in overly risky assets. This can create distress in some initially sound borrowers and lead to higher losses in the system eventually. Moreover, banks may conceal their problems by rolling-over bad loans, leaving a time bomb that can go off in the future. Many of these problems occurred in Chile and in the U.S. Savings and Loan industry.

If banks are allowed to work out their problems, then, at a minimum, bankers should be separated from their bad loans so as to avoid the tendency to "evergreen" problem loans; indeed well managed banks perform this function themselves, creating separate units or subsidiaries to handle problem loans.[28] In order to establish incentives that will minimize future problems, bank managers and owners responsible for poor internal controls should face some consequences, at the very least, loss of jobs and capital. Wherever the bad loans are placed, it is important for fiscal and incentive reasons that every effort be made to collect; collections are likely to be maximized when private agents -- including if applicable the originating bank -- are paid (handsomely) on a commission basis. *Given the dangers, strong, early intervention is probably the least risky -- and lowest cost -- solution to widespread non-performing loans.*

Among the countries studied, Korea managed to enjoy a rapid growth of investment against the backdrop of banks saddled with large nonperforming loans only because it had an exceptionally deep -- and much less regulated -- nonbank financial sector that was able to help finance investment, as well as booming macro conditions and an already high savings rate that facilitated an increasing degree of self- and equity-finance.[29] In addition, the Government funded substantial restructuring of some of the indebted enterprises and, as noted earlier, injected funds directly into the banking system.

Malaysian, Indonesian, Turkish, and Chilean authorities permitted banks to work out their own problems. Malaysia appears to be the most successful, allowing a mild

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28. Evergreening consists of granting new loans to facilitate the repayment of past debts. Note that if banks are actively working with their clients in restructuring or rehabilitating firms, some new lending may be necessary. In many cases, however, new loans are made only to disguise bank losses and do not include any significant attempt to improve the viability of enterprises. Japanese banks are cited (Hoshi et al., 1989) for continuing to lend to distressed firms but at the same time taking an active ownership role in restructuring. Banks in systems that prevent equity links may not be able to assume such a role, in effect facing a greater agency problem, and thus must choose between recognizing losses abruptly or lending more an hoping that the client performs.

29. The proportion of ivestment in Korean industries funded by self- and equity-finance rose fairly steadily from 28 percent during the 1980-82 period to about 60 percent in 1988-89.

increase in bank spreads to cover a smaller nonperforming loan problem, in conjunction with some interventions for problem banks. Indonesia controlled entry, which might have allowed banks to build up capital positions, but banks there until last year have focussed more on loan growth, and there are hints in the press that a nonperforming loan problem may be emerging. In Turkey, freeing of rates in the early 1980s, at the same time as the fiscal deficit remained fairly large, led to a bidding up of real rates and some financial distress. Eventually, deposit rates were re-controlled and entry restricted.

The Chilean results were the least successful. Interest rates were freed in the mid-1970s and remained very high for most of the decade in real terms, in part reflecting risk of devaluation under the exchange rate based anti-inflation policy used in the early 1980s. When the debt crisis began in 1982, it became clear that banks had a substantial volume of non-performing loans, in many cases to borrowers closely related to the bank's management, which had been hidden by rolling-over the debt service. Confronted with this large nonperforming portfolio and massive private international borrowings, the authorities took over the banks, transferred bad loans to the central bank and then recapitalized the banks using central bank debt. The treasury and the new owners of the re-privatized banks were obligated to service the resulting debts with the central bank. In effect, this spread out the financing of the losses over time. However, the central bank remains with a quasi-fiscal deficit of some 3 percent of GDP as a result of these operations, which hinders its ability to make monetary policy. It should be noted that once the losses reached a large size -- about 60 percent of GDP -- then even a slow rate of growth of the losses (say 5 percent) would have matched the interest cost associated with the transferral of bad loans. In other words, had the authorities not intervened, the eventual "bill" in all likelihood would have been much larger. So the only criticism of the Chilean effort was that the authorities waited until the losses were so large.

Restructuring of the Real Sector

Restoration of banks' financial health unavoidably requires decisions about what to do with non-performing loans. Whether these remain in banks' balance sheets or are transferred to a government agency, such as the Central Bank, serious efforts to collect the loans are desirable. Collection reduces costs of the financial sector restructuring and indicates to future borrowers that they should expect to repay their loans. This often implies that borrower companies will be liquidated, for example, through bankruptcy courts. Efficient cleaning of banks' balance sheets often also entails substantial reorganization of banks' claims over the corporate sector, provided that borrowers may regain profitability once they are restructured.

In such cases, restructuring in the financial sector becomes the mirror image of that in the real sector. If extensive interventions by the government, which may involve bailing out of enterprises or widespread and economically unjustified liquidations, are to be avoided, banks likely will need to play an important role in the restructuring of the

assets and liabilities of borrowers, especially since in most developing countries they are the major claim holders of companies in the real sector.[30]

Financing real restructuring is a complicated and risky activity. It presents a case where informational and contractual problems of the type described above are severe and requires banks to assume sufficient control rights to ensure that resources they advance are used to maximize their claims (or the value of the debtor company) rather than being unproductively consumed by managers or owners. Banks may be unwilling to assume such a role, either because of regulations that limit their ownership of non-financial institutions, or because they lack the managerial and technical expertise that would be necessary to monitor restructuring efforts in the real sector. Whenever restructuring needs in the real sector are widespread, such as after a substantial trade reform, reform of the bankruptcy legislation (so as to introduce a reorganization procedure that provides banks with adequate control rights) or introduction of time-bound special legislation may be useful in allowing the banking sector to play a constructive role in real restructuring.[31] Promotion of private institutions that provide turnaround skills also may help overcome a critical institutional barrier and speed up bank restructuring. These institutions provide specialized skills in financial engineering and have a deep understanding of problems in industry; hence, they are in a good position to design and obtain agreement on restructuring programs that are acceptable to both banks and the borrowers.[32] *As difficult as this process is, success in financial reform critically depends on and can be enhanced through appropriate policies that encourage and facilitate restructuring in the real sector.*

Next steps

Beyond the initial institutional building phase, and assuming that the banking system has positive net worth, attention should be switched to the institutional capacity to adapt to reforms and the expected near term evolution of borrower net worth. With respect to the former, where banks already appear to be able to allocate prudently the fraction of their assets over which they have had control, and where capital levels are high, more rapid rates of decline of requirements on portfolio composition and directed credit can be considered. But where banks have faced substantial reserve and liquidity requirements, it would be unwise even where budget situations permit, to shrink abruptly or end these requirements until banks are prepared to deal with the ensuing portfolio decisions. The dangers of simultaneous portfolio adjustment noted above can be

30. Main banks in Japan often play such a role. See Aoki (1990).

31. Such legislation is currently being considered in Poland.

32. On the role of turnaround entities in financial and industrial restructuring, see Atiyas, Dutz and Frischtak with Hadjimichael (1992).

minimized by a gradual reduction of the control of assets. Moves toward market financing of government debt may be constrained by budget realities.

However, even where these constraints are severe, it is important to begin the transition to market funding in order to maintain pressure to shift taxes away from the financial sector.[33] Waiting instead for "free" budget resources may well delay reforms indefinitely.

Regarding borrower net worth, its influence on the behavior of financial institutions implies that the financial system's response to reforms as well as its future evolution is closely linked to the performance and credit worthiness of the real sector. As noted in Caprio (1992a), financial sector reforms usually occur concomitantly with real sector reforms, including prominently changes in trade and exchange rate regimes. Adjustment can be eased by direct interventions in support of borrower net worth, including the use of investment tax credits, or by amending other policies, such as the taxation of inflation-linked capital gains, which unwisely limit retained earnings. As noted above, rather than use concerns about borrower net worth as an excuse to delay indefinitely financial reforms, authorities should examine measures that can help reduce the likelihood that firms' net worth will be suffering as reforms are instituted.

Other, more indirect measures that affect performance of the real sector also may improve borrower net worth and the outcome of financial sector reform. Adjustment to reforms in trade regimes often increases firms' needs for information, for example, on foreign markets, technology, design and standards. Fixed costs in acquiring information often justifies either subsidies or direct government involvement in collecting and disseminating it. Such policies will benefit both the financial sector and the economy as a whole. Also, policies that help firms adjust -- for example, to switch their sales from domestic to foreign markets -- will minimize the destruction of firm-specific information capital and therefore can help avoid a post-adjustment learning period for banks.

What to Avoid

Interest rate deregulation in general should proceed in stages, with complete deregulation awaiting later stages of reform. Both the cases examined here and experience in other countries suggest that the following criteria be satisfied before complete deregulation:[34]

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33. Occasionally it is mentioned that in much of the post-war period up to the late 1970s, Japanese authorities relied on captive financing of government debt, implying that the same reliance should be possible for developing countries. However, this argument overlooks the point that Japan run budget surpluses until 1965, and that deficits remained small until after the 1973-74 oil shock. When the tax imposed on the banks by forced holdings of government paper grew large, the banks' rebellion in 1979 was an important factor in beginning the financial reform process.

34. See Caprio and Levine (1992) and Caprio and Honohan (1991) for an elaboration on these criteria for, respectively, transitional socialist economies and developing economies.

- macroeconomic conditions are reasonably stable;
- the financial condition of banks and their borrowers is sound;
- at least a minimal base of financial skills have been attained; and
- some checks are in place to limit collusive behavior among banks in the determination of interest rates.

When these conditions are not satisfied, interest rates may rise to exorbitant heights in real terms, threatening the net worth of borrowers and ultimately the soundness of the financial system, as was seen in Chile and, to a lesser extent, in Turkey in the early 1980s. Malaysia and Korea adhered most closely to these criteria, in fact both waiting until 1991 to achieve complete interest rate deregulation (albeit in Malaysia's case this was the second time around). This recommendation is not without some cost: continued government intervention in setting interest rates can easily be biased towards significantly negative real rates. Nonetheless, when these criteria are not satisfied, going to free market determination of interest rates has proven to be quite risky given an explicit or implicit government guarantee of deposits. Short of full deregulation, interest rates at least can be raised to within the neighborhood of inflation rates, a gradual and sustained easing of portfolio requirements and directed credit programs can start, and the vital steps of institution building can commence.

Other steps and sequences also can be ruled out. For example, deregulating interest rates completely in a country just entering a recession, or with a large percentage of shaky banks can never be advocated. Nor would an open entry policy for banking ever be recommended, but especially not for a country with little or no bank supervisory capacity.[35] New entry can be dangerous if banks need to build up their capital; it may be especially dangerous if domestic banks have positive but low net worth, in particular if the new entrants are foreign banks who may be able to take some of the less risky banking business.[36] Nor is suddenly raising capital requirements desirable. Although it is an effective way in the long term to increase the safety of the banking system, in

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35. Entry into banking should require adequate capital, evidence of some banking expertise, and a sound reputation. Open entry is meant to denote ignoring either all three requirements or even just the latter two. Where bank supervision is limited, authorities might focus on building a core of profitable banks, effectively licensing only a small number, which will be easier to supervise.

36. An exception might be if the banking industry were to be turned over to well-known foreign banks (Uruguay has followed something like this approach; there is only one domestic commercial bank and one domestic housing bank, both public, although these banks are by far the largest in their respective markets). In this case these banks typically would guarantee the deposits themselves; the bad publicity to such a bank from bankruptcy in a small market would outweigh the costs of providing the necessary additional capital. Of course, the authorities have to ensure that the entrants are in fact such banks, and must be able to cope with a number of political negatives in turning over the country's banking industry to foreigners.

the short term it may lead to a cutback in credit growth, as has been intentionally accomplished in the last year in Indonesia. Therefore governments might make sure at the least that the schedule for attaining a target capital ratio is consistent with the macro environment: too steep an increase can produce a recession, while an excessively slow increase can lead to a prolonged continuation of unsafe banking practices.

Conclusions

Financial reform, in all of its diverse forms, is timely in many developing countries because of the widespread distress in the financial sector and because with funds scarce, authorities are concerned about the mobilization and efficient allocation of resources in what is perceived as an increasingly risky environment. The study reviewed here provides the first microeconomic evidence, albeit from only a few countries, of efficiency gains following financial sector reforms, and illustrates how authorities in selected countries have gone about the reform process. Where possible, a gradual -- but sustained -- reform process appears desirable for many countries. Of course, political factors can present unique opportunities to point an economy rapidly and permanently towards a more market-based system, and these opportunities should be seized. Thus even though the approach in New Zealand may not have been ideal, many there argue that the economy is better off having instituted its "big bang" reforms. The lessons presented here, to paraphrase Vaclav Havel, are meant to give a sense of strategy for countries in which reform is not an all or none choice, and not to present a rigid or unique sequence for financial reform.

The case for gradual reforms is not one for inaction. Indeed, the conclusions of this study suggest that financial reform is worth the effort and that with due attention to institutional environments the lessons can be applied elsewhere. Authorities can do much to increase the market orientation of their financial system, with all its benefits, even without a "big bang." They can rationalize interest rates -- that is, eliminate the grossest interest subsidies, move towards market financing of government debt, and raise deposit rates at least to only slightly negative or modestly positive levels -- paying due attention to budget realities. In several countries examined here, authorities ended mild financial repression early in their reform efforts, while still retaining some controls. Of those that moved fastest on interest rate deregulation, New Zealand and Indonesia met most of the above conditions, with some uncertainty about the health of their banks at the point of deregulation. However, in both cases banks had a window of a few years before new entry was permitted, thus allowing them some time to adjust before competition intensified. In the language of Summers-Caprio (1992), caution regarding entry helped to limit the reduction in the franchise value of bank licenses, especially given the limitations on supervisory skills. Moreover, in both cases deregulation coincided with falling world interest rates.

In contrast, the reforms in the Southern Cone during the 1974-82 period, which are usually cited as reasons to avoid reform, took place in the context of a lengthy

history of severe financial repression, numerous weak banks, macroeconomic instability, limited attention to improving bank regulation and supervision or to maintaining the franchise value of intermediaries and, towards the end of the period, sharply higher world interest rates. So unless one can count on good fortune, it seems wisest to move gradually and improve the fundamentals until the above conditions are met, particularly given most governments' explicit or implicit commitment to providing deposit insurance. Although this eclectic approach to financial reform is more difficult a process to manage than one of immediate, complete deregulation, it appears born out by the experience of the country cases and the theoretical approaches summarized above. Financial reform, as judged from these experiences, calls for more nuance than simply "letting the market work." Still, in many countries the direction of change is clear, in favor of greater, rather than lesser, reliance on the market to allocate credit, and policy makers need to "keep their eye on the ball."

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WHAT SHOULD BANKS DO IN THE FINANCIAL INDUSTRY OF THE 1990s: The CASE OF MIDDLE INCOME COUNTRIES[37]

Vittorio Corbo and Leonardo Hernández

In the early 1980s the financial system in many middle-income countries entered into a severe crisis. The reasons for the crisis varied. In the late 1970s massive capital inflows resulted in expenditure increases, a large real appreciation, and a boom in the non-tradable sector. Since bank activities were restricted to the local economy, their portfolios were heavily concentrated in the non-tradable sector. Following sharp external shocks, including a sharp increase in international interest rates, a large drop in terms of trade of oil importing countries, and a severe and sudden reduction in the access to international capital markets, several middle-income countries had to reduce expenditures and implement large devaluations in a short period of time. In the countries that judged these shocks as permanent, stabilization policies were accompanied by the initiation of a profound structural transformation which had major effects on price incentives. In the short run the stabilization and structural transformation programs were accompanied by recessions.

As the recession developed and drastic relative price changes took place as part of the restructuring, the overall economic climate became very risky for the financial system as a whole, and for the banking sector in particular. In countries with inappropriate bank regulations and supervision, and with generous implicit or explicit deposit insurance, the macroeconomic crisis encouraged the banks to take risks. As some banks lost their capital base they started to gamble, encouraged by the implicit or explicit understanding that they would not be allowed to go under. If as a result of the gamble they could collect the high real interest rates with a large spread, then profits would be large and they could recover their capital base. If on the contrary, they could not collect the interest payments, then the government would pay the bill. As the macroeconomic crisis continued, the share of nonperforming loans in banks' portfolios increased, and eventually a banking crisis resulted and the taxpayers had to foot the bill.

In other countries, banks were increasingly used to support government-selected activities without the appropriate evaluation of commercial risks. When some of these

37. This paper was especially prepared for the seminar as a background study.

loans were not repaid, the banks that made them experienced low profitability and a rising share of nonperforming loans. Because there was not strict official supervision and prudential regulations requiring sufficient reserves against losses, and because implicit or explicit full insurance was present, not surprisingly, moral hazard problems accelerated as the share of nonperforming loans in total loans increased.

Finally, in some countries financial liberalization in an environment characterized by macroeconomic instability and inappropriate bank supervision and regulation resulted in high real interest rates thus encouraging adverse selection of clients, and ultimately a financial crisis.

As the financial system in general and the banking industry in particular entered into crisis, countries introduced different systems to minimize the effects of the crisis on the safety of the payments system and to ensure the functioning of credit markets. Although the types of solutions differed among countries, in most of them the solutions induced elements of partial rescue of commercial banks, some vehicle for capitalization of insolvent banks, and in some cases outright liquidation or nationalization. Future economic growth was supposed to provide a favorable environment for an increase in banks' profitability and the final restoration of the health of this sector. Furthermore, to avoid another crisis, countries overhauled their explicit insurance system, revised their regulatory practices, and strengthened banks supervision. At the same time the role of state development banks was also reviewed to avoid future repetition of the problems they faced in collecting loans. Reforms in the regulatory framework restricted the type of activities banks could engage in and gave power to supervisory authorities to promptly intervene in problem banks.

In parallel, the revolution in information processing has increased the competition among the banks just when they began to recover from the crisis of the early 1980s. As new financial instruments and financial intermediaries have started to erode the traditional markets of commercial banks, the authorities have begun to be pressured into liberalizing bank regulations and allowing banks to adjust to increased competition without abusing the advantage that emerges from underpriced insurance on demand deposits. These technological developments are also affecting the structure and future of the banking industry in industrial countries, and the regulatory authorities in those countries are also in the process of continuously updating financial regulations.

With these developments the strict regulation that was enacted in the middle of the crisis of the first half of the 1980s has been called into question. In particular it is argued that with new financial services being invented every day, the regulation of bank activities by the use of a positive list of permitted activities gives banks a tremendous disadvantage with respect to other financial intermediaries in the dynamic financial industry of the 1990s. In this environment it is not surprising that the regulatory authorities in both industrial and middle-income countries are currently struggling to redefine banking regulations that will change the role of banks. The challenge for regulatory authorities is to create a regulatory framework that will reduce incentives for moral hazard and at the same time provide enough flexibility for commercial banks to

successfully adjust to the increased competition they face from other financial intermediaries.

The purpose of this paper is to review recent developments in the banking sector and in banking regulations and to draw out the main lessons with respect to how to develop a safe, sound, and efficient banking system in middle-income countries. In particular this paper examines whether there is a role for banks and whether in order to exploit this role existing financial regulations have to be reshaped.

The rest of this paper is divided into four sections. In the first section below, we present a brief summary of the main factors behind the developments in the banking sector during the 1980s in both industrial and middle-income countries. The second section examines the rationale for bank regulations and explores areas in which changes will be required to face the challenges of the 1990. The third section reviews recent reform experiences in industrial countries to examine their relevance for middle-income countries. Most of these reforms emerged as a response to the challenges faced by the banking sector due to the information and technology revolution. In the final section we draw on the findings of the previous sections to present the main options for the regulatory authorities in middle-income countries with respect to the type of banking regulations needed to ensure a safe, sound, and efficient banking system for the 1990s.

Banking in the 1980's: An Industry in Need of Restructuring

After the traumatic experience of the Great Depression and during the several decades since World War II, banks around the world were recognized as very solid and sound institutions. This was the result of two factors: first, banking laws protected them from competition while simultaneously restricting the number of activities banks were allowed to undertake; and second, the macroeconomic environment was fairly stable.

Nonetheless, the situation changed drastically during the 1980's, particularly in the case of the U.S., British, and more recently Japanese banks among developed countries. In fact, it is more common to hear about a failing bank or a financial scandal today than it was in the 1950's and 1960's. Also, in the early 1980's in most less developed countries the banking industry was collapsing and had to be rescued by their governments. As a recent report of the World Bank shows "more than twenty-five governments have helped distressed financial institutions during the past decade." (The World Bank, 1990).

The main question we want to answer in this section is: why is it that banks became more fragile institutions during the 1980s? To answer this we begin by reviewing the main changes in the financial systems of industrial countries, because many of these changes are starting to spread to middle-income countries. Because this question is particularly relevant for U.S. banks a natural way to proceed is by comparing U.S. banks with European and Japanese banks. This comparison proves to be useful in understanding the difficulties that U.S. banks have faced for the past ten years. It is also relevant because some of these issues will appear sooner or later in the financial

sectors of middle-income countries. In fact, it has been a common pattern in middle-income countries to closely follow all the developments occurring in the financial markets of industrialized countries. However, because the financial crisis in less developed countries during the 1980s may have an explanation of it's own, we will also compare the differences between the experiences of less developed countries and the U.S. experience.

Developments in computer technology

The most important factor that has drastically changed the way of conducting business in the financial intermediation industry is the revolution in information processing and computer technology. In fact developments in this area have allowed the emergence of new intermediaries that offer close substitutes at much lower cost for some of the traditional functions historically undertaken by banks. Examples of this are nonbank suppliers of credit, such as General Motors, Ford, Sears; and also the increasing number of investment funds and other nonbank intermediaries offering highly liquid investment opportunities.

At the same time new financial instruments have been created that could be easily traded (priced) only because of the new available technology. Among these are revolving floating rate debt instruments, perpetual debt instruments, convertibles, financial futures and options, and currency and interest rate swaps. In short, what the developments in computer technology have done is to decrease the cost of handling and processing information. The final effect of this has been to eliminate or erode some of the barriers that isolated banks from other financial intermediaries in the economy. Thus, the banking industry has become more integrated with other markets, both domestically and internationally, and it is facing a more competitive environment.[38]

It is worth mentioning that this factor by itself is not enough to explain why banks performed the way they did during the 1980s. However, it is by far the most important factor because had the technology not been available, the other factors we mention would not have had such significant effects on banks.

Exogenous shocks, regulations, and restrictions

The change in economic conditions during the 1970s in terms of inflation, interest rates, exchange rates, and the volatility of each of these is one of the elements that triggered the search for new financial markets and instruments. However, due to restrictions on activities that banks were authorized to undertake and the existing

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38. It is noticeable, however, that to date it has been far easier for nonbanks to enter the traditional banking business than for banks to enter other financial markets. This can be partially explained by some of the factors discussed in the following paragraphs.

regulations on interest rates that banks could pay on deposits, it was difficult for banks to serve their clients' needs.

One clear example of this is the restriction that did not allow U.S. banks to pay interest on demand deposits at a time when inflation and interest rates increased. This regulation, which helped the U.S. banking industry in the 1950s and 1960s, became a problem when the economic conditions changed. Thus, a restrictive banking regulation that forces banks to adhere to traditional "banking," which is thought to be beneficial in increasing the stability of the payments and credit system, proves to be harmful when economic conditions change. This effect was stronger in the United States than in other European countries where restrictions were less severe. For example, it was easier for German banks to enter into the new growing markets than it was for American banks. This happened because in Germany a universal banking model exists, while in the United States banks could pay interest on demand deposits only after legislation allowed the formation of affiliates through a banking holding corporation.

The result of these shocks was a loss of competitiveness and a reduced volume of intermediation by the banks. Indeed, nonbank financial intermediaries offered better investment opportunities, such as money market mutual funds, and nonfinancial firms were able to bypass banks by issuing financial instruments to general investors.

The same sort of problem occurred in countries where banks had to compete with a less regulated type of financial intermediary during a period of high inflation. Examples of this are the "curb market" in Taiwan and Korea during 1980-81 and 1979-84, respectively, and the "financier" as in Chile and Argentina during the 1970s (see McKinnon 1988, and references therein).

Financial liberalization in an unstable macroeconomic situation

In the middle-income countries an important aspect of the financial crisis during the 1980s is related to the early financial liberalization policies implemented concurrently with stabilization programs in the previous decade (mid to late 1970s). In many middle-income countries, and particularly those in Latin America, the reforms implemented during the 1970s sharply contrasted with the deregulation experience during the same period in countries such as Britain, Canada, France, the Netherlands, and Sweden, where changes were cautious and gradual. The experience of countries such as Chile, Argentina, Uruguay, Turkey, and the Philippines is characterized by large real interest rates, the selection of risky borrowers by commercial banks, the erosion of the equity base of existing banks, the lack of appropriate regulation and supervision, and, ultimately, an explosion of moral hazard problems. Not surprisingly, the final result was a deep financial crisis with a large cost to the treasuries and the economies of these countries.

Lax supervision, deregulation and deposit insurance

Another important element that helps to explain the poor performance of the banking industry during the 1980s in the United States, as well as the undue risks taken by banks in middle-income countries, has to do with deregulating the industry at a time when either a deposit insurance scheme was in effect or the public perceived that the monetary authorities would not permit the bankruptcy of commercial banks. The fact that banks and other financial intermediaries (thrifts) were undercapitalized made matters worse. The rationale for this is as follows:

- After having lost some of their earnings to other financial intermediaries (or because of an economic recession), bankers were willing to invest in risky activities because of the high expected return. In fact there was a lot to gain if the risky investment succeeded, and there was little to lose if it became a failure (moral hazard behavior).

- The existence of deposit insurance allowed the undercapitalized depository institutions to borrow without an increase in their borrowing cost that reflected the risk of their portfolios.

- The deregulation of the 1980s and lax supervision from the government monitoring agencies allowed the depository institutions to hold risky portfolios and to stay in business despite the fact that the net market value of their equity was near or below zero.

This is particularly important in the case of U.S. thrifts, which invested large amounts in junk bonds and were not closed on time by the Federal Savings and Loan Insurance Corporation (FSLIC), as well as in the case of Norway (World Bank 1990).

Among middle-income countries, similar problems emerged in Chile, Argentina, Uruguay, the Philippines, and Turkey. In these countries there was an unstable macroeconomic situation, and an implicit or explicit deposit insurance was in effect. Furthermore, the government agencies in charge of regulating and supervising banks were very weak. Thus, the lack of appropriate supervision of banks allowed bankrupt firms to stay in business by borrowing heavily from the banks. Also, a high concentration of risk took place because of bank lending to owner-related parties. Finally, banks were allowed to roll over and accrue interest on nonperforming loans. All of this occurred at a time when real interest rates were very high. Among the middle-income countries that liberalized their financial systems, Malaysia avoided a financial crisis. The contrast with the other countries is that Malaysia had a stable macroeconomic situation and had developed appropriate bank regulations and supervision.

In summary, the problems of the financial sector were not confined to the middle-income countries only. Systemic effects related to moral hazard and adverse selection

behavior occurred in countries such as Chile, Argentina, Uruguay, Colombia, Spain, the United States, and Thailand, because of poor prudential regulations and supervision and the existence of an inappropriately priced deposit insurance. The outcomes of these developments have been an increase in the share of nonperforming loans for many banks and, in some cases, bankruptcy (see Litan 1991, McKinnon 1988, Sundararajan and Balino 1991, and World Bank, 1990).

The 1980-1981 recession

The last factor that helps to explain the poor performance of the banking industry during the 1980's relates to both, the oil-price increase and the change in monetary policy implemented by the FED in 1979. The increase in interest rates after October 1979 caused problems to those institutions where long term assets were financed by short term liabilities (S&Ls in the U.S.). However, the most important effect of these two shocks was on the banking industry of middle-income countries.

The worldwide increase in real interest rates at a time when most developing countries were highly indebted, in addition to the terms of trade deterioration for all oil importing countries, forced expenditure reduction an a large devaluation of the exchange rate in most of them. The short term recession that followed the initial stage of the adjustment caused the inability of borrowers to repay their loans and, therefore, increased the number and the volume of non performing assets. As banks lost a substantial part of their equity, and as supervision was weak, the stage was set for a sharp jump in moral hazard and adverse selection problems.

These developments not only jeopardized the stability of the financial system in each of the borrowing countries, but also in those developed countries whose portfolios were highly concentrated in the third world debt.

The Rational for Bank Regulation and the Need for Change

During the 1980s many middle-income countries responded to the financial crisis by reforming bank regulations and strengthening bank supervision. To understand these changes we will examine the logic of commercial banking.

Financial intermediation is the main function of commercial banks. It involves the transformation of deposits, which are redeemable at par and often on demand, into illiquid assets (loans) that carry a risk of default. Banks invest in obtaining and processing information to assess the risk of default of each actual and potential loan. Banks, by diversifying their lending portfolio, minimize the information cost that lenders would incur if they were to lend directly to borrowers. Banks' profits result from selecting a lending portfolio that will have low risk and high return but will not jeopardize the banks' ability to pay back the depositors. Banks' problems emerge when a large share of loans becomes uncollectible or collectable with a large discount (the

insolvency problem); or when independent of the soundness of a bank's portfolio, a large share of its deposits are withdrawn (the liquidity problem). The emergence of liquidity and insolvency problems, especially when simultaneously affecting a large number of banks, could result in large macroeconomic costs by disrupting the payment and credit system.

The main purpose of bank regulation is to achieve a safe, sound, and efficient monetary system and credit market while avoiding undue risk-taking, financial instability, and the eventual need for government bailouts.

In a modern society, checking account balances at commercial banks are a large component of transaction balances. Therefore, a run on banks could result in a severe contraction in the money supply with negative effects on the overall level of economic activity. The second objective of bank regulation is to ensure that borrowers have stable, reliable sources of credit. A run on banks could result in the nonrenewal of loans to solvent but illiquid firms. The ensuing credit crunch could result in bankruptcy, with private and social costs.

Two different mechanisms have been introduced in most countries to cope with bank runs and panics: (1) lending of last resort by a central bank; and (2) the establishment of deposit insurance. Although these two mechanisms have shown to be able to contain financial crisis, their fiscal costs could be very high. These costs are related to moral hazard problems that emerge.

After deposit insurance is introduced, depositors no longer have an incentive to monitor the banks in which they are putting their money. Rather, because all banks are equal in terms of risk, depositors will put all their money in the bank offering the highest interest rate (usually the bank with the most problems). Weak banks - those with a low capital base or banks that envisage the potential loss of their capital base - will have a major incentive to gamble by taking undue risks on their lending. For a bank that can stay in operations because of deposit insurance, the losses for the owners of the bank from going bankrupt are limited to the value of their equity, while the costs for the insurer are at least a large share of the bank's deposits, and are substantially larger than the value of the bank's equity. On the other hand, potential gains for the bank owners are many times their equity if the result of the gamble is favorable. This type of payoff provides incentives for the bank owners to pursue unsound banking practices, that is, activities with too high a risk. This problem, known as moral hazard, is common to all types of insurance. It is more likely to happen for banks having a low capital base. It is not surprising that when there is a slowdown in economic activity and the share of nonperforming loans in banks' portfolios increases, the moral hazard problem becomes more acute.

When considering the introduction of deposit insurance the authorities have to consider that any insurance inappropriately priced could result in moral hazard problems by encouraging risk- taking to increase the payoff from the insurance. In deposit insurance systems where insurance premium is not related to the risks of assets held by the banks, the mere existence of the deposit insurance encourages the banks to opt for riskier portfolio.

The coverage of the deposit insurance may be extend to: (a) monetary accounts of limited size; (b) monetary accounts of any size; (c) all monetary and non-monetary accounts of small size; (d) all monetary and non-monetary accounts of any size. If the purpose of the insurance is to protect the monetary system, then only monetary accounts should be included among the protected bank liabilities. On the other hand, if commercial banks are the main credit intermediaries and the purpose of the deposit insurance is to avoid a credit crunch, then a mix of deposit insurance for all accounts and a lending of last resort role for the central bank should be used.

Deposit insurance, while partially solving the problem of bank panics, creates its own problems: moral hazard and adverse selection. The moral hazard problem arises when the existence of insurance increases the incentives for risk-taking and the likelihood of an insurance payoff. The adverse selection problems arise when high risk taking entrepreneurs find the banking sector an especially attractive industry to enter.

One of the main objectives of banking supervision and regulation is to control the side effects of deposit insurance. Deposit insurance, appropriately priced or with adequate prudential regulations and an adequate supervision system, has been introduced to ensure against a run on commercial banks, which could have a systemic effect on the overall soundness of the monetary system. Prudential regulations of this type include minimum capital requirements, restrictions on bank activities, restrictions on the composition of bank portfolios, and screening of new entrants. The minimum capital requirements in the form of equity primarily reduce potential moral hazard problems by increasing the potential losses to bank owners from failures caused by undue risk-taking. Restrictions on bank activities have the dual objective of keeping banks away from risky activities while maintaining a competitive financial system. Such regulations avoid noncompetitive practices that could arise from offering packages of financial services, some of which are funded with insured deposits. Restrictions on portfolio composition are introduced to control the overall risk of the business. The screening of new entrants is used to keep high risk-taking entrepreneurs away from the banking sector.

Banking regulation under stress

But even prudent regulations with appropriate supervision face problems such as credibility or consistency and, the need for industrial restructuring in the banking sector to face shocks coming from financial innovations and a reduction in the cost of information processing. Furthermore, as countries with moderate to high inflation, where demand deposits pay no interest, make progress in reducing inflation, the revenue from the inflation tax captured by commercial banks is reduced. This is another external shock to the banking industry. An appropriate response to this shock is for the commercial banks to price the host of services offered to the holders of demand deposits. Today, these are financed by the inflation tax collected by the banks.

The credibility or time consistency problem refers to the operational practice of regulators in using the "too big to fail" approach for the rescue of large banks. This

policy increases the incentive of large banks to undertake risky activities since no depositor or creditor of large banks is at risk. In this case there is also a bias against small banks when they become riskier for large depositors because they do not qualify for the "too large to fail" criterion. Further, to reduce the likelihood of a run on the banks, some governments have introduced explicit deposit insurance for small depositors, and in many cases they have provided ex-post insurance to large depositors too. This pattern does not encourage large depositors to monitor the banking system.

Financial innovation and the reduction in the cost of information is another problem that requires an adjustment of bank regulations. Just as the banking industry was recovering from the crisis of the early 1980s and was restoring profitability and its capital base, it was hit by a major revolution in information and communications. This revolution has eroded the banking industries' market share in the financing of large businesses to the bond and commercial paper markets or other financial intermediaries with lower costs. In some countries the banking sector also faces increased competition in its source of funds from new financial institutions such as money market funds, mutual funds, leasing companies, and so forth.

These new currents have made a dent in the profitability of the banking sector. As they lose business to other financial intermediaries, commercial banks have been forced to compete among themselves within a reduced market. Consequently, profits have started to suffer. To restore their profitability and to continue the rebuilding of their commercial base, commercial banks have been forced to seek out potentially riskier businesses in which profit margins are more attractive. As banks move in the direction of riskier businesses within the areas in which they are allowed to operate, the potential for moral hazard problems increases. This has forced a reexamination of the whole regulatory framework of banks, especially in the area of activities in which they can operate.

These developments have created a major challenge for the design of appropriate bank regulations for the 1990s. The challenge is to put in place a regulatory framework that will allow the restructuring of the banking sector in the 1990s while controlling potential moral hazard and adverse selection problems that could jeopardize the survival of deposit insurance schemes and macroeconomic stability.

Recent Reforms in Industrial Countries: Some Lessons

The difficulties of the banking industry during the 1980s in many countries have motivated some changes in the regulatory and institutional framework in which banks operate. The two issues that dominate the reforms in all industrialized countries concern a move toward universal banking and, simultaneously, the setting of a strong and powerful supervisory framework capable of (1) providing early warnings of financial problems in bank and other depository institutions; and (2) after detecting a problem, taking the necessary steps to avoid contagion, bank runs and panics, and unnecessary fiscal losses. To do the latter the regulatory agencies should have the power as well as

the necessary financial resources to lend or liquidate troubled financial institutions. However, the framework must be flexible enough to guarantee that the innovative capacity of the financial industry is not damaged by inappropriate regulations, nor that the industry is threatened by inadequate regulations.

Because of the initial differences in their financial markets, not all industrialized countries have implemented the same policies to reshape their banking industries. The most notorious changes have occurred in the United States and Britain, the two countries that have been most affected by the crisis of the 1980s. The following subsections briefly summarize the major institutional and structural changes in the financial sectors of some industrialized countries during the 1980s.

Institutional changes in the United States

One important change occurring in the U.S. financial markets during the 1980s concerns the increase in the capitalization rates required for banks and other financial intermediaries. In 1981 the federal regulatory agencies increased the primary capital[39] to assets ratio to 5.5 percent, and the total capital[40] to assets ratio to 6 percent from previously lower levels. This increase applied to both banks and banking holding companies. In 1985 the Treasury and the Federal Deposit Insurance Corporation (FDIC) jointly proposed a minimum capital to total assets ratio of 9 percent. More recently, the Federal Bank's regulatory agencies adopted the guidelines of the Basle Agreement, which requires a total capital (primary) to risk adjusted assets ratio of 8 percent. Furthermore, the Financial Institutions Reforms, Recovery and Enforcement Act of 1989 (FIRREA), required that the same kind of risk-based capital standards be developed for thrift institutions.

Another relevant change in the U.S. banking industry concerns the type of activities in which depository institutions are allowed to engage. This change has been more gradual for banks than for thrifts. Commercial banks have been allowed to deal in financial futures (1983) and, through a banking holding company, to underwrite, distribute, and deal in commercial paper (1987), asset-backed securities, that is mortgages and others (1987-89), corporate bonds and corporate equities (1989), and all revenue municipal bonds (1987). In addition banks were allowed to underwrite deposits with returns partially tied to stock market performance (1987), and to provide brokerage and research advice to institutional (1986) and non-institutional investors (1987).

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39. Primary capital includes equity, mandatory convertible instruments, reserves for loan and lease losses, and minority interests in consolidated subsidiaries minus equity commitment notes and intangible assets.

40. Total capital includes primary capital plus limited life preferred stock, subordinated notes and debentures, and mandatory convertible instruments not eligible for primary capital.

In the case of thrifts, the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) allowed thrifts to increase the percentage of total assets held in consumer and commercial real estate loans. They were also authorized to make unsecured commercial loans for up to 5 percent of their assets. In 1983 the S&Ls were allowed to invest up to 11 percent of their assets in junk bonds. Nevertheless, due to the explosive moral hazard problem that emerged in the 1980's, most of these restrictions were reimposed in 1989.

Finally, the other major change in the institutional framework for U.S. banks during this period concerns the greater geographic diversification that they have been able to achieve. Although most of this diversification has been through a banking holding company buying different independent banks, rather than through branching of a single bank across state lines, the fact is that today 47 states permit interstate banking. Moreover, FIRREA requires that capital of any banking affiliate should be made available to cover depositor losses anywhere in the holding company.

Institutional changes in the United Kingdom

The British financial system has historically been characterized by (1) its supervision style, which relies heavily on a practitioner-based self-regulation system; (2) its openness to the entry of foreign banks and its international orientation; and (3) its structure which is based on the specialist principle. The major changes that occurred during the 1980s in the United Kingdom concerned features 1 and 3 above. Thus, banks and other financial institutions are increasingly becoming conglomerates offering multiple products. On the other hand, as self-regulation usually implies noncompetitive practices,[41] regulation and supervision have changed toward guaranteeing greater competition in the market place and, at the same time, significantly tightening prudential supervision arrangements.

In 1979 a new banking act introduced authorization procedures, whereby any company wishing to operate as a deposit taker in the United Kingdom had to secure authorization from the Bank of England. In 1982 a deposit protection scheme was forced upon the banking industry. The insurance covered 75 percent of the first 10,000 of any sterling deposits with an initial maturity of less than five years made by a nonbank customer.[42]

In addition, in 1986 a new Building Societies Act was enacted that is widely viewed as a deregulation package that allows societies the freedom to compete effectively

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41. The clearing banks and the Building Societies Association in the United Kingdom operated an interest rate cartel until 1971 and 1983, respectively.

42. In 1987 a new Banking Act was enacted. Its major features were amendments of the Depository Protection Scheme, reforms of the authorization procedures and reporting requirements, introduction of new criminal sanctions, and the extension of the Bank of England's supervisory powers.

in several markets previously denied to them.[43] Most important, beginning in 1988 the Act proscribed particular activities within certain broadly specified powers. This was a significant change in the approach concerning the granting of new powers to societies. In fact, the previous approach was to prohibit societies from offering any service or product unless it was specifically sanctioned by the Act. Nevertheless, the Act also overhauled the supervisory regime governing the activities of the societies by limiting the percentage of total assets to be invested in certain particular activities while, at the same time, it obliged the building society industry to replace its voluntary deposit protection scheme with a statutory one.

Finally, in November 1986 a new Financial Services Act was enacted that attempted to improve investor protection by increasing disclosure, tightening the rules of business conduct, and strengthening enforcement procedures. According to the Act, all advisors and companies involved in the investment business were required to be formally authorized. This involves meeting prescribed standards for probity, competence, and adequacy of financial resources. In addition to this, in March 1986 the stock exchange rules were changed to allow 100 percent outside ownership of stock broking and jobbing firms. In October 1986 fixed commissions for securities trading in the London market ended. As a result of all these institutional changes, commercial and investment banks as well as foreign banks entered into this sector, and the domestic and Eurobond markets merged.

Institutional changes in Japan

The process of financial reform in Japan started in the mid 1970s and continues to the present. Its main causes were the oilshock in the early 1970s that significantly increased the government deficit and changed the internal pattern in the flow of funds; the abandonment of the fixed exchange rate policy in 1973 that made the rigidly regulated domestic financial structure incompatible with Japan's role in international trade; and the U.S. pressure in the early 1980s on Japan to internationalize its financial market. Thus, the process of financial reform in Japan has been characterized by regulatory changes rather than by market innovations; that is, it has been a smooth, administratively directed process lacking the type of disruptions observed in other industrial countries.

The most notorious change in Japan's financial structure has been the increasing importance of Japanese banks in the world. Indeed, Japanese banks have not only

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43. Building societies were allowed to enter the following activities: estate agency services, conveyance services, surveys and valuations of land, property development and house building, money transmission, the making or receiving of payments as agents, the provision of check guarantee cards and credit cards, foreign exchange operations for individuals, unsecured lending and the provision of ATMs and overdraft, stock brokerage and share dealing services, the marketing and management of personal equity plans, unit trust business, pension fund management, and the provision of insurance and related services.

become the largest in the world,[44] but they also have expanded internationally in ways significantly different than they did in the 1970s. Prior to 1980 the majority of international activities on the part of Japanese banks was associated with trade financing. However, since 1980 Japanese international banking activities have broadened significantly to become directly competitive with both the retail and the wholesale businesses in the United States, the United Kingdom, and other countries, and Japanese banks have been assigned an increasing role in the Eurocurrency markets.[45]

It is worth mentioning that the Japanese financial regulation structure is centralized in a small number of institutions,[46] of which the Ministry of Finance (MOF) plays the most important role. In fact, the MOF combines the functions of at least a dozen different U.S. entities,[47] because it is in charge of setting interest rate ceilings on deposits, examining financial institutions, supervising the deposit insurance system, defining permissible and nonpermissible portfolio activities of financial institutions and markets regarding both domestic and international financial transactions, licensing and supervising banks and other financial institutions, and developing the overall financial policy.

The regulatory changes introduced in the Japanese financial system during the 1980s have transformed it from a rigid and inflexible structure to a more flexible and competitive one. Thus, the capital market has expanded tremendously as a result of the growth of government debt regarding both the new and secondary issue markets. Also, a variety of new financial services has been introduced during the past decade, including money market instruments, combination type deposits, resident foreign currency deposits, CD, and different types of investment funds. A large number of restrictions on the inflow and outflow of capital has been relaxed since 1980, allowing a closer relation between domestic and foreign interest rates. Foreign institutions have been given greater access, and foreign securities companies have been admitted to the Tokyo Stock

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44. In 1986 nine of the twenty largest banks in the world were Japanese, while in 1970 only four were Japanese. (see Litan 1987).

45. Foreign banks play a minor role in (domestic) Japanese finance. Indeed, even as recently as year-end 1987 foreign bank assets represented only 2.8% of all bank assets in Japan, although after 1985 the number of foreign institutions operating in Japan increased greatly.

46. This number includes the Ministry of Finance, the Bank of Japan, and the Ministry of Post and Telecommunications.

47. The Ministry of Finance combines the functions of the treasury, the Security and Exchange Commission, the Internal Revenue Service, the Office of Management and Budget, the Commodity Futures Trading Commission, the Office of the Comptroller, the Federal Deposit Insurance Corporation, the Federal Savings and Loan Insurance Corporation, and others (see chapter 7 in Kauffman 1992).

Exchange. Finally, interest rate liberalization is increasingly taking place in several areas of the financial system.[48]

Two issues concerning regulation and supervision are worth mentioning. First, the deposit insurance system was amended in 1986 to increase the maximum insurance level from 3 million to 10 million yen. Second, as of May 1989 the Financial System Research Council was considering two policies for restructuring the Japanese financial system in terms of reducing the degree of specialization, namely either to allow existing financial firms to enter other (financial) industries through subsidiaries, or to allow the establishment of new financial institutions with wide-ranging portfolio powers.

Institutional changes in Canada

The regulatory framework of Canada's financial system is undergoing a complete reshaping. Many of the provisions in the Spring 1989 regulatory framework proposal of the federal government are being criticized; the proposal has not been fully enacted yet. This proposal will replace the previous 1980 bank act that granted trust companies and credit unions access to check-clearing facilities through the Canada payments system while, at the same time, it allowed foreign banks to incorporate banking subsidiaries in Canada, subject to the restriction that as a group the subsidiaries do not hold more than 8 percent of aggregate total domestic assets.[49]

The 1980 act tightened the regulatory framework for banks as it empowered the superintendent of financial institutions to set maximum leverage ratios.[50] It also prohibited banks from underwriting corporate securities and from first-hand brokerage in securities, although banks were allowed to buy and sell through brokers on behalf of their clients.

Since 1980 several policies that have been implemented have affected the banking industry. The policies were designed to tighten the regulatory framework of banks while giving them more freedom. Thus, the federal government has been increasingly active in monitoring the use of bank service fees. In 1987 an increase in loan loss provisions was required, and a year later the federal government introduced minimum capital guidelines that relate capital to risk-adjusted assets and off-balance items. Also, the Canadian Deposit Insurance Corporation (CDIC) has been given greater power to discipline institutions for unsound financial practices. These powers include the

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48. For a complete list of the major regulatory changes introduced in Japan during the 1980s, see chapter 7 in Kauffman (1992).

49. This percentage was later increased to 16 percent.

50. Previously this decision was left to each bank's management. The regulator used this power only in 1983 after Canadian banks had reached an average leverage ratio of 30 to 1. The limit was decreased to be between 20 to 1 and 25 to 1 and later, in 1985, it was set at 20 to 1.

imposition of penalty fees, the revocation of insurance coverage, and the power to request an inspection of a member institution.

Despite this, under the United States-Canada trade agreement (1989) U.S. banks were exempted from the total assets (percentage) ceiling, while the remaining foreign banks were subject as a group to 12 percent of the aggregate total domestic assets as of January 1 1989. Also, entry restrictions to the industry have been eliminated through allowing common ownership of regulated financial institutions and the entrance of foreign financial institutions.[51] Nevertheless, banks with capital over $750 million must be widely held; no share holdings of more than 10 percent are permitted.

As a result of the removal of these restrictions, the move toward conglomerates has been particularly marked in Canada. Thus, the traditional four-sectors approach that maintained a legal separation between banking, insurance, securities, and trust and mortgage businesses is increasingly being replaced by a unified system. Under the new system it is possible for firms in one of the four sectors to move into any of the other three either directly or through the establishment of a specialized subsidiary. Thus, banks in Canada now conduct insurance business, and life insurance companies have diversified into merchant banking and mutual funds.

Institutional changes in West Germany

The German banking system is distinguished sharply from the American and British systems in several respects. Its most outstanding feature is that it is based on a universal banking model, that is, banks are allowed to engage in a wide variety of activities, such as factoring, securities brokerage and trust services, the operation of investment funds, the provision of financial guarantees and fund transfer services and so.[52] [53] Banks may even provide mortgage banking services through subsidiaries.[54]

A second important feature of the German system is that banks are allowed to invest directly in nonfinancial enterprises and may be owned by nonfinancial institutions. In fact, banks hold substantial interest as share owners in commercial enterprises because they are allowed to develop very close relationships with German industry. It is important to notice that in addition to the direct holding of voting shares and because

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51. A ceiling of 65 percent was placed on the cross-ownership of financial and nonfinancial assets by a group.

52. As of 1988 universal banks represented about 94 percent of incorporated banks, 99 percent of the offices, and 73 percent of assets.

53. As a result of the universal banking model, bond markets in Germany are not completely distinct from the financial intermediation industry. The five largest members of the German exchanges are banks, while the share of corporate bonds in the market is less than 0.5 percent of all outstanding German bonds.

54. Most private mortgage banks are wholly owned by universal banks.

most stocks and bonds are held on deposits at commercial banks, the banks routinely vote the proxies of these shares on behalf of their customers.

A third important difference between the German banking model and the model in other countries is that public (state-owned) banks and other public financial institutions play a significant role in the domestic financial market. They represent approximately 36 percent of total assets in German banking and operate 40 percent of all banking offices. However, Germany places no significant restrictions on the entrance of foreign or domestic financial institutions to the financial industry. In fact insurance companies have been recent entrants into conventional banking, and vice versa.

Concerning regulation and supervision, the German model is very similar to the Japanese system; that is, supervision for all banks is almost fully centralized in the Federal Banking Supervisory Authority.[55] However, German banking policy is different from the Japanese policy as it reflects the desire to rely on market forces. In fact, when the Herstatt Bank failed in 1974, the German authorities did not intervene to compensate bank's creditors. Also, the deposit guarantee system was privately funded when it first started in 1966. Although there is some public regulation on the deposit insurance system, it is still privately administered.

Financial Liberalization and Appropriate Bank Regulation in the 1990s.

The crisis of the early 1980s provided many lessons for financial liberalization and the creation of a safe, sound, and efficient banking system. In middle-income countries a particular lesson of this period is that financial liberalization in an unstable macroeconomic situation without appropriate supervision and prudential regulation is bound to result in high real interest rates, commercial banks taking undue risks as a result of moral hazard and adverse selection problems, and, eventually, large fiscal losses.[56] Some authors have gone as far as suggesting that financial deregulation in an unstable macroeconomic situation should be accompanied by setting ceilings on real interest rates and strengthening supervision (McKinnon 1988; Villanueva and Mirakhor

55. The FBSA has four function: (1) it issues the necessary licenses for doing banking in Germany, determines the adequacy of capital, managerial and other resources of all would-be licensees, and can also remove licenses; (2) it determines the standards relating to capital and liquidity adequacy, foreign exchange exposure and credit exposure; (3) it collects timely financial information and conducts periodic audits of credit institutions; and (4) it intervenes in the case of capital inadequacy and endangerment of deposits. It may require the suspension of activities, may appoint substitute managers to take control, and may force liquidation of a bank.

56. See, in particular, McKinnon (1988) and Villanueva and Mirakhor (1990).

1990).[57] A conservative approach seems to be not to liberalize the financial market until inflation and other key macroeconomic variables have been brought under control (Corbo et al. 1986).

In countries that are undertaking reforms that result in major changes in relative prices, such as trade liberalization or large adjustment in prices of public enterprises, the credit- worthiness of a typical bank's borrower may be severely affected. In this case potential problems of moral hazard and adverse risk selection are exacerbated. In these situations it would be advisable to have a gradual deregulation to allow enough time for banks to upgrade their capabilities to assess credit worthiness at the new relative prices.

Initial conditions in the financial sector also play a role in determining the speed of financial deregulation. For countries in which previous policies have resulted in a large proportion of bank loans carrying a below market rate or are nonperforming, then financial reforms will create difficulties for existing institutions if carried out at once. In particular, if deposit and lending rates are deregulated simultaneously, and free entry into a previously restricted financial system is allowed, existing banks will be forced to pay market rates and will suffer substantial losses.[58] If a large portion of existing banks face this type of problems the banking system's

operations to limit potential moral hazard problems. These constraints have taken the form of minimum capital requirements and risk-adjusted capital measures for the purpose of computing capital requirements. Also, the coverage of deposit insurance has been limited. Limitations include the type and the amount of deposit that is covered.

Second, to minimize moral hazard problems, deposit insurance must be made more explicit and credible, that is, that no ex-post insurance should be provided for deposits that ex-ante were not covered by the deposit insurance scheme. As the German experience shows, this "credibility issue" seems to be extremely important in limiting the risk-taking of banks and other financial institutions. As this rule will be difficult to enforce for large banks - the too big to fail problem - it is necessary to develop early warning mechanisms to assess the quality of banks' portfolios and to have an explicit way to take corrective action long before an insolvency problem develops.

Third, prudential regulations requiring sufficient reserves against losses have to be introduced, and the information capacity of the supervisory authorities has to be raised to improve their effectiveness. In particular, regulators must be aware that the existence of explicit or implicit deposit insurance that is inappropriately priced results in moral hazard and adverse selection problems. Therefore, the supervisory agencies need the capacity to evaluate the quality of banks' portfolios and the necessary power and financial resources to act promptly when a potential solvency problem is developing. The Japanese and German systems have shown that a powerful and (almost) unique agency seems to be more effective than the U.S. system of several federal agencies.

Fourth, an important lesson that has been learned by comparing the experience of the United States and other industrial countries is that a geographical restriction to branching could unduly increase the risk of a bank's portfolio. To avoid this problem the geographical area of operations could be extended, or capital requirements could be raised. Because the second option decreases the profitability of banks, it could be more attractive to follow the first one. For small countries this problem is similar to letting banks operate internationally.

Fifth, in reshaping regulations, two models are possible: universal and specialized banking. Industrial countries have by and large chosen the universal banking approach. The selection is based on scope economies and the difficulties in imposing and enforcing legal barriers to the type of activities that banks could engage. To minimize moral hazard problems the movement to universal banking has been accompanied by a rise in capital requirements and the eventual introduction of risk-adjusted measures of capital. As the experience in the United Kingdom and Canada shows, due to economies of scope the two most important candidates for expansion of services are life insurance and investment services.

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7

FINANCIAL SECTOR REFORMS: THAILAND

Ekamol Kiriwat

Overview of the Thai Financial System

Financial institutions

The Thai financial system comprises the Bank of Thailand, which is the country's central bank; twenty-nine commercial banks (fifteen Thai banks and fourteen foreign bank branches); three specialized banks owned by the government; ninety-two finance and securities companies, of which twenty-one conduct only finance business and seventy-one conduct both finance and securities business; and twelve securities companies. These financial institutions constitute nearly ninety percent of the total assets of the financial system. The remaining financial institutions which make up about fifteen percent of total financial assets, are credit foncier companies that finance the purchase of immovable properties, government-owned industrial finance institutions, life insurance companies, cooperatives, and pawnshops.

The supervision of financial institutions falls under several governmental agencies. The Bank of Thailand is authorized to supervise and examine the operation of commercial banks, finance businesses, and credit foncier companies. The other financial institutions are under the supervision of the Ministry of Finance (government-owned specialized banks and industrial finance institutions), the Ministry of Commerce (life insurance companies), the Ministry of Agriculture and Agricultural Cooperatives (agricultural cooperative and savings cooperatives), the Ministry of Interior (pawnshops), and the Securities and Exchange Commission (securities business).

The financial system is dominated by the commercial banking sector, which accounted for over seventy percent of total financial assets, and mobilized around seventy-five percent of domestic savings. Within the banking sector, the fifteen Thai commercial banks dominate the market, accounting for around ninety-five percent of total bank assets. Among Thai commercial banks, the five largest banks accounted for about two-thirds of total bank assets.

Financial and securities companies constitute the second largest group of financial institutions, accounting for approximately fourteen percent of total financial assets. Finance companies primarily engage in short-term finance and hire purchase that have higher margins but also higher risk. They mobilize their funding by issuing promissory

notes. Securities companies primarily engage in securities-related business, such as brokering and underwriting.

Overall, the Thai financial system is highly concentrated. Most businesses are channeled through commercial banks, followed by finance and securities companies.

Financial markets

Financial markets consist of money markets, the capital market, and the foreign exchange market.

There are two main money markets, the most active one is the interbank market, in which commercial banks, finance and securities companies, specialized bank, and the Industrial Finance Corporation of Thailand lend and borrow funds among one another. The other is the government bond repurchase market, operated by the Bank of Thailand (BOT), in which commercial banks and some other financial institutions can borrow to finance their short-term liquidity. This market is another channel for the Bank of Thailand to influence the liquidity of the financial system. In other words, the Bank of Thailand can conduct its open market operations through the government bond repurchase market.

The capital market can be divided into the equity market and the long-term debt market. In the equity market, nearly 300 companies trade their shares in the Stock Exchange of Thailand (SET). The trading volume of the SET stood at about 7,450 billion baht (US $298 million) at the end of March 1992. The long-term debt securities market is currently small and shallow, because debt instruments are still limited. Commercial banks have been the main providers of long-term loans.

The foreign exchange market has a limited number of participants: consisting of commercial banks and the Exchange Equalization Fund, which is a governmental agency. Foreign exchange risk management products primarily rely on the forward market, which is mainly a U.S. dollar/baht market with a maximum of three months. Options are also available, but their volume is small. Other types of products are still underdeveloped because of the small size of the market.

In all, money markets and long-term debt securities markets should be widened end deepened. The primary market for debt instruments needs stimulation measures, which in turn should help develop secondary markets.

Financial instruments

In terms of lending, the main financial instruments available to individuals are bank deposits, promissory notes, and shares. The major sources of funds for borrowing are loans and share issues.

Government bonds and treasury bills are usually held by commercial banks to meet the portfolio requirements. Other types of financial instruments, such as certificates of deposit,short-term notes, debentures, and floating rate notes, play a limited role.

The conduct of monetary policy

The ultimate objectives of monetary policy are to influence domestic stability, growth, and the balance of payments to be in line with one another. Intermediate targets are set in the form of monetary aggregates, for example, M1, M2, M3. The Bank of Thailand employs several policy instruments: open market operations in the government bond repurchase market, intervention in the exchange market; and lending to financial institutions through a loan window and refinancing facility, which provides credits at preferential rates to commercial banks against their promissory notes issued to enterprises In priority sectors. Direct controls, such as reserve requirements, interest rate controls, and credit controls, have declined in significance, and the Bank of Thailand has been relying more on indirect instruments such as open market operations. The Bank of Thailand also issues its own bonds to absorb excess liquidity in the financial system.

Problems and Constraints of the Financial System

The Thai economy has been growing at a very high rate during the past five Years. The GDP increased 10.5 percent per annum during 1987 - 1991. The success has not been without a price. Chief among the signs of overheating were a sharp increase in the current account deficit and a rise in inflation. Infrastructural bottlenecks pose a serious constrain. A large amount of investment will be required to expand and improve the facilities.

Hence, substantial domestic savings have to be mobilized to support this process. The efficiency of the financial system needs to be enhanced to mobilize savings and to support the real sector growth, which currently has outgrown the capacity of the existing financial system.

This section examines the problems and constraints of the financial system, which can be grouped into three areas: high concentration and low competition, money market and capital market constraints; and infrastructural and human resource constraints.

High concentration and low competition in the financial system

The financial industry is dominated by the banking sector, particularly the five largest Thai commercial banks. On the one hand it could be argued that the financial system as a whole has not been competitive. On the other hand once cannot deny that there is strong competition within the banking sector and among the finance and

securities companies. This phenomenon could partly be explained by the laws governing the financial institutions, which strictly separate the scope of business among different types of financial institutions. In addition, the vast difference in size of these financial institutions also accounts for the lack of competitiveness of the financial system. However, the high degree of competition existing among banks and among finance and securities companies indicates that these financial institutions do compete, but their competition is limited by the legal framework.

Small financial institutions are concerned that they will lose their business niche once the business scope widens. This fear is not entirely invalid. The authorities take note of their concern. But to improve the systemic efficiency, every type of financial institution will have to adjust. The structural handicap of the small institutions could be improved, for instance, through mergers.

To correct the high concentration and low competition in the financial system the authorities need to remove the legal constraints, especially those restrictions that help create a niche of market power, and promote a structural change for financial institutions so they can successfully withstand the increasing competition.

Money market and capital market constraints

While the stock market has a good trading volume, the money market and the debt securities market, especially for private debt instruments - are very small relative to the overall financial system. Secondary markets are almost nonexistent, with the exception of the government bond repurchase market.

The obstacles to develop wider and deeper money markets have been mainly legal. Commercial banks are principal holders of government bonds, and they normally hold the bonds to maturity. This is because commercial banks are required to hold bonds in order to apply for the opening of new branches. In addition, the supply of both short- and long-term government paper has been low, and considering the recent surplus of the government's budget, the volume of new government paper is not expected to increase.

A study by the IMF indicates that an active government bond market usually precedes the development of a corporate bond market. This is because individual corporate issues are too small to develop an active secondary market of a size to support the necessary institutional infrastructure.

Until recently, the laws permitted only a handful of corporations to issue long-term debt instruments. Private companies were prohibited from issuing debentures, and only the companies listed or approved by the Stock Exchange of Thailand and the companies awaiting securities to be listed on the SET were allowed to issue long-term debt.

Infrastructural and human resource constraints

A rapid internationalization and globalization of the world financial markets prompted the Thai financial system to upgrade its facilities, especially in telecommunications and electronic banking. In view of the fast-growing number of transactions, the interbank clearing system needs to be modernized to improve the speed and efficiency of the process, which is currently manually operated.

A more sophisticated financial system also requires a financial infrastructure that would provide confidence and a safety net for the public, such as a credit rating agency and a deposit insurance scheme. This type of financial infrastructure is yet to be established.

Another problem facing the financial sector is the shortage of qualified personnel, particularly at the management level. Large banks are experiencing higher turnover rates in management staff while smaller financial institutions are struggling to recruit good quality staff. The shortage of human capital could pose a major constraint on the future development of the Thai financial system.

Financial reform

The previous section discussed the problems facing the Thai financial system that pose challenges to policy makers on how to make the financial system less concentrated and more competitive as well as to further develop the money market and capital market, especially the debt securities market. Apart from these structural and legal problems, the authorities are faced with the physical task of upgrading the infrastructural facilities to help modernize the undertaking of financial activities. The external environment makes reform all the more necessary and urgent. Not only does the Thai financial system have to keep up with developments in the world financial markets, it has to prepare for upcoming changes, especially with regard to the more competitive environment envisaged after the conclusion of the GATT negotiation.

Objectives

Having identified the problem and future challenges, the policy makers find it necessary to make changes to induce more competition to enhance the overall efficiency of the financial system. Financial markets should be integrated rather than segmented as they have previously been. Savers as well as investors should be provided with greater choices of financial instruments. Legal amendments are needed to introduce a more simple and transparent financial system whereby financial institutions will have more flexibility and greater freedom of action. The strict segmentation of business between different types of financial institutions has bred complacency, and the public would be better off if each type of financial institution can offer more varied financial

service. The idea is akin to the universal banking concept but is adopted to suit Thailand's local conditions. To use a metaphor, instead of having to make several visits to various specialized stores, the public will now have to make one visit to a financial supermarket to select products.

Concurrent with the introduction of a more liberal environment, it is equally important that the authorities step up the prudential requirement to ensure the soundness and stability of the financial system.

Gauging the Readiness of Financial Institutions

Before the financial reform was launched the authorities kept watchful eyes on the performance of financial institutions to assess their readiness to operate under a deregulated environment. The timing of the implementation of deregulation measures was crucial to ensure a smooth and successful transition. The authorities judged the readiness of financial institutions to take on financial reforms on the following grounds: the old style of family managerial control has been largely replaced by professional management; capital adequacy of most banks and finance and securities companies has increased; the portfolio quality of financial institutions as a whole has improved; and the profitability of the institutions has risen sharply.

The three year plan: (1990-1992)

A comprehensive financial reform plan was designed in the late 1980s to coordinate and synchronize several aspects of reform with the ultimate aim to enhance competitiveness, flexibility, and the efficiency of the financial system. The three year plan encompasses four major programs:

- Deregulation and liberalization
- The development of the capital market and the promotion of new financial instruments
- Supervision and examination of financial institutions
- Improvement of the payment system

Deregulation and liberalization

During the time when financial institutions were in distress, several regulations were introduced to impose strict control over the institutions to restore stability in the financial system. As conditions improved these restrictions were no longer necessary. The existence of obsolete regulations hinders the modernization process. In addition, experiences of many countries indicate that economic efficiency is higher when the

market mechanism determines the allocation of resources. For these reasons, the authorities have removed several legal barriers to make way for the market force to play a larger role. The major areas that have undergone deregulation and liberalization measures are interest rates, foreign exchange control, the scope of financial institutions, and portfolio management.

The first step toward interest rate liberalization was the floating of interest rates on time deposits with a maturity of more than one year. This was announced in June 1989. The measure had dual objectives: to ease the banks into a more flexible interest rate system and to encourage long-term savings.

In March 1990 when the interest rate ceiling on all time deposits was abolished. This resulted in the flexible adjustment of time deposits rates; on the whole, interest rates have been moving more in line with world interest rates.

In January 1992 the ceiling on savings deposits was lifted. As a further step in the same direction, the ceiling on loan rates will be removed when the conditions are deemed appropriate.

In the area of foreign exchange control, in May 1990, the Bank of Thailand announced the first round of foreign exchange deregulation measures. The measures allow commercial banks to buy and sell foreign currencies to the public for current transactions without having to seek prior permission from the authorities.

The second round of deregulations for foreign exchange cam in April 1991, virtually liberalizing capital account transactions. Individuals can now open foreign exchange accounts up to US$ 500,000, and corporations can open such accounts up to US$ 5 million abroad for direct foreign investment. Free repatriation of investment funds, dividends, and loan repayments was allowed. Only resident purchases of property and securities abroad still remain under restriction.

In line with the international trend of universal banking, the authorities are widening the scope of business for financial institutions to make them better able to compete with foreign banks. In early 1992 commercial banks have been allowed to underwrite government securities and debt instruments for state enterprises, provide financial information services, and act as financial adviser.

Finance companies are now allowed to undertake leasing, underwriting government securities and debt instruments for state enterprises, provide financial information services, and sponsoring or advising companies to apply for listing on the Stock Exchange of Thailand.

Securities companies have been permitted to provide custodian services, registration and agent services for dividend payments, information services, and sponsoring or advising companies to be listed on the Stock Exchange of Thailand.

Several restrictions regarding portfolio management of commercial banks have been relaxed to create greater flexibility and induce higher efficiency in commercial banks' operations:

- The requirement for holding government securities for banks wishing to apply to open new branches, which was originally set at no less than 16 percent of total deposits, was reduced to no less than 7 percent in February 1992. Pending other considerations, this requirement may be abolished entirely in the medium term. The elimination of this requirement could also contribute to more active trading in the secondary market of government securities.

- The authorities also adjusted rules regarding commercial banks; holdings of cash reserves by allowing a more flexible definition of the term reserve. Reserves now include foreign exchange held by commercial banks and the Bank of Thailand bonds, as well as securities issued by government agencies approved by the Bank of Thailand. Commercial banks are now required to hold liquidity assets at the ratio 7 percent of total deposits.

The definition of agricultural credit, which commercial banks were required to extend to no less than 20 percent of their deposits, has been expanded. It has now become rural credit requirement. This requirement, however, it also expected to be abolished in the medium term.

Development of the Capital Market and Promotion of New Financial Instruments

Thai businesses have been relying heavily on commercial banks and finance companies for their credit needs. During the boom years, however, credits from these institutions were not adequate. To avoid a credit crunch it is necessary to create an alternative source of funding, namely, direct financing, to satisfy the business credit needs so as to maintain economic growth. More varieties of financial instruments, particularly debt instruments, will be instrumental in promoting the savings mobilization necessary to support the long-term growth of the economy.

The securities and Exchange Act, which was promulgated in early 1992, corrected several weaknesses in the legal system regarding the issuing of debt instruments and their trading in the primary and secondary markets. Previously, limited companies were not allowed to make any initial public offering of their shares, nor could they offer debentures to the public. Only public companies and listed as well as authorized companies in the Stock Exchange were allowed to do so. In addition, the previous Securities and Exchange Act was primarily a regulation on trading of securities in the secondary market. There was no legal framework to supervise the primary market.

Moreover, previously there were numerous laws that securities market participants had to observe. These laws were not always coordinated, which resulted in inconsistency among them. This created confusion for the market participants. There were also a

number of supervisory agencies overseeing different aspects of the securities business. These factors led to inefficiency in the enforcement of securities regulations.

The Securities and Exchange Act was designed to achieve for main objectives:

- To set a framework for the development of financial instruments to become an important funding vehicle for Thai businesses. Limited companies that are granted approval by the Securities and Exchange Commission (SEC) can issue debt instruments to the public, increasing the supply of debt instruments in the market.

- To provide better protection for investors.

- To make the securities supervisory systems more transparent and more unified.

- To facilitate the development of the securities business and the Stock Exchange of Thailand.

The Securities and Exchange Act has introduced several important changes to expand and improve the securities market in Thailand. These are described in the following paragraphs.

The Securities and Exchange Commission (SEC) was established to supervise all aspects of securities businesses. Currently there are eleven commission members including representatives from the various agencies that formerly supervised securities businesses; financial accounting, and legal experts; and professionals in the securities business. The SEC is supported by the Office of the Securities and Exchange Commission, headed by the secretary general.

The Securities and Exchange Act stipulates that only public companies can mobilize funds from the public by issuing stocks or equity instruments, and that debt instruments can be issued by both public companies and limited companies. These companies, however, must obtain approval from the SEC to mobilize funds from the public.

Previously, public offering of securities by public companies was regulated by the Public Company Act, while the public offering by listed companies was partially regulated by the Securities Exchange of Thailand Act. No provision regulated public offering of outstanding securities by existing shareholders of limited companies that were not listed or authorized in the stock exchange. Companies thus could circumvent the laws by selling new securities to existing shareholders who later sell the securities to the public. The Securities and Exchange Act closed this loophole by empowering the SEC to supervise all types of public offering of securities: short-term, long-term, new, and outstanding securities.

One of the key concepts of the Securities and Exchange Act is to create transparency in the securities business. The offerer must disclose as much reliable

information as possible to the investors to enable them to make informed decisions. Under the Securities and Exchange Act, the definition of debenture includes all kinds of debt instruments, both short and long term, except for bills as defined in the Civil and Commercial Code. This is intended to prevent circumvention of the law by calling basic debt instruments by other names. The act also introduces the concepts of investor representatives and trustees under the section on secured bond and fund management. This provision is to provide mechanisms to protect investors and to prepare the groundwork for the supervision of securing assets.

The Securities and Exchange act clearly defines rules, procedures, and supervision of each type of securities business, and adds private fund management as a new type of securities business. Thus, securities companies can now manage the surplus funds of persons and foundations. In regards to mutual fund companies, the mutual fund approved by the Office of the SEC will be a Thai juristic person and a separate legal entity from the securities company.

The Securities and Exchange Act restructures the authority and responsibility of the Stock Exchange of Thailand by transferring the enforcement work from the SET to the SEC. The responsibility of the stock exchange is to oversee the operational work of the securities exchange. The act also permits the setting up of smaller over-the-counter markets with no cross-listing with the Stock Exchange of Thailand.

The Securities and Exchange Act lays the groundwork for the establishment of various securities-related organizations, such as the Securities Deposit Center, the Securities Registrar Office, and the Securities Clearing House. These organizations are to be privately run.

The provision regarding supervision of securities business, emphasizes the importance of capital adequacy. The provisions increased the required capital for securities companies. The SEC is empowered to set the capital requirement in relation to the volume of activities or the net position of securities companies. The Securities and Exchange Act specifies a number of requirements to improve investor protection, namely, the requirement of SEC approval prior to the issuance of securities to the public, and the requirement for disclosure of information prior to public offering. The act also sets more sever penalties for insider trading.

The promulgation of the Securities and Exchange Act is expected to change the face of the financial system. Direct financing to businesses seeking financial sources without have to go through commercial banks of finance companies will help boost the source of funds for businesses while offering the public additional investment tolls. The act has set up a framework for supervision and development of both primary and securities markets. In addition, financial innovation is encouraged, which should lead to new types of businesses.

A new dimension is added to the Thai financial markets, and the securities business will benefit from a more transparent, efficient, and effective supervision and legal framework. Finally, the economy will be better served by more diversified and sophisticated means of financing.

Strengthening of the supervision and examination of new financial institutions

The authorities have shifted emphasis from ensuring that financial institutions adhere to laws and procedures to determining and monitoring the performance and solvency of financial institution. The improvement of supervision of financial institutions is primarily to promote transparency of the status of financial institutions, to increase consumer protection, and to ensure the stability of the system. It is important to step up prudential regulations while the authorities are relaxing structural regulations.

The prudential requirements emphasize capital adequacy and asset quality. The Bank of Thailand is currently introducing to commercial banks a revised capital adequacy requirement in line with the rules of the Bank for International Settlements (BIS). In principle, the BIS rules suggest that the ration of capital to risk assets for commercial banks should be 8 percent. However, the formula for capital adequacy requirements as well as the composition of core capital and supplementary capital will be adapted to suit local conditions. In addition, commercial banks are required to follow the guidelines on the calculation of risk assets that the Bank of Thailand also adapted from the BIS guidelines.

Improvement of the payment system

As the financial system becomes more sophisticated, payments other than by cash have increased. Thus, the speed and efficiency of the payment system is crucial to support smooth and accurate settlement of payments. The Bank of Thailand has conducted a study to modernize the country's payment system and proposed that the system comprise check clearing, interbank transfer, and Bank of Thailand (BOT)-Net.

The study proposes that the Electronic Clearing House system be employed for check clearing. This system will be more efficient and less time consuming than the Automated Clearing House system.

In the initial stage the study recommends the offline interbank system in which the clearing house will use data disks containing data on interbank transfers to debit and credit the accounts of the member banks. Later on, an online system should be developed. In this latter system, the existing two automatic teller machine (ATM) pools will have to be unified, and the unified ATM pool will act as a switching center. Customers will be able to order their transactions through bank tellers or ATMs.

The study recommends for setting up an electronic BOT-Net for big volume transactions. This system should be able to incorporate the government securities data and commercial bank reports later on.

Currently the Bank of Thailand has selected a consulting company to help develop the three systems of payments settlement along the lines proposed by the study.

The authorities have implemented a number of measures on the basis of the proposals in the three-year plan. The most notable change has been the increasing

flexibility of financial institutions. Interest rates have been adjusted more in line with the international trend, reflecting the commercial banks' cost structure and management efficiency. Commercial banks have become more efficiency-oriented. Their operations have also been facilitated by a more relaxed portfolio requirement.

The measures to develop the money market, the capital market, and new financial instruments have been started by the promulgation of the Securities and Exchange Act, which will help broaden and deepen the financial markets. The strict separation of business scope has been relaxed, which has enhanced the competition among financial institutions. As a result, the financial institutions will have to raise their efficiency.

The process to step up prudential regulations and to modernize infrastructural facilities is still continuing. It is very important that the thai financial system keep up with the world standard in both supervision and technological progress.

A number of measures are still in the pipeline to improve the financial system, including setting up a financial infrastructure such as a credit rating agency and a deposit insurance scheme. The authorities are primarily concerned with increasing the variety, quality, and safety of financial services. Their objectives are ultimately to equip financial institutions with the necessary strength and stability to cope with future challenges.

8

FINANCIAL CRISIS, REFORM AND STABILIZATION: THE CHILEAN EXPERIENCE

Nicolás G. Eyzaguirre

During the last two decades the Chilean financial system has undergone a far-reaching process of institutional change that has led it from a highly restricted and state-regulated system to one that is basically market oriented, although subject to public supervision. The process, however, was not free of obstacles before it became firmly established, and reforms at times ran in opposite directions. At the end of 1973 most financial institutions were state owned. A radical process of privatization followed, with the transfer of these institutions to the private sector. The foreign debt crisis of the early 1980s affected the financial sector with particular intensity, resulting in state intervention and take-over of an important portion of the national financial system. In that way, quite a few institutions reverted to state hands. Finally, around the middle part of the 1980s, when the domestic debt crisis had been partially controlled, the process of privatization began again, this time through a system called "popular capitalism," under which institutions owned by the state were sold to the private sector, with the purpose of diffusing the ownership of banks. From then on the financial sector has continued to strengthen; a process of innovation and updating that project it as one of the fundamental sectors in the future development of the Chilean economy.

This paper is divided into four sections. The first covers the process of domestic and external liberalization of the Chilean financial system and its role in the origin of the crisis in the early 1980s. The next section analyzes how the state intervened to rescue the system, the costs that this involved, and the financing of these costs within a framework of macroeconomic equilibrium. The next section analyzes the challenges confronted by monetary policy in a world that tends toward globalization of capital markets. The final section concludes the paper by summarizing the Chilean experience.

From Financial Deregulation to Crisis: (1974-83)

At the end of 1973 the Chilean financial system was practically all state-owned: the National Savings and Loan System (SINAP) channeled most of the economy's savings; the banking system was state controlled; and both interest rates and credit allocation were regulated. Liberalization of the system started in 1974 by allowing the

operation of financial companies. These entities were permitted to borrow and lend resources at freely determined interest rates. In early 1975 this function was extended to banks and to SINAP. By the end of the same year, the ownership of most commercial banks was transferred to the private sector. Starting in May 1976 the credit control system was eliminated. Finally, with the freezing of the VHR, which was the main borrowing instrument of the savings and loans system, the extinction of this system was hastened.

Liberalization of the financial system was based on two fundamental ideas. First, a freely agreed upon interest rate would allow rates to reach positive levels in real terms, thus stimulating savings and investment and therefore reaching higher economic growth. Second, with a uniform interest rate and no credit allocation controls, resources could be channeled in a more efficient manner.

Although well-intended, Chile's first liberalization effort failed. In fact, in 1983 the state had to intervene in the system and again control over 70 percent of it (measured by capital). The following paragraphs describe the underlying reasons for this frustrated liberalization.

Freedom of the financial system was part of an overall government plan to liberalize the economy entirely. The idea was to create a market-oriented economic system in which the economy would be open to foreign trade of goods and services and to capital flows. Thus, in 1974 a strict program of tariff reduction began. Having started with an average differentiated rate of around 100 percent, by 1977 the process ended with a uniform tariff rate of 10 percent. Simultaneously, the transfer of public companies to the private sector commenced. From 1976, restrictions to capital flows were eliminated, reaching almost total mobility by 1980. Simultaneously, between 1974 and 1976 a monetary-fiscal adjustment and an exchange rate devaluation took place in order to restore external and domestic balance. From 1976, positive economic results began to be observed, and an accelerated growth occurred between 1977 and 1980.

While the economic system was being reformed and the economy grew at high rates, the financial system accumulated a number of imbalances that later transformed the fall in terms of trade and the interruption of capital flows that occurred in 1982 into a severe crisis. First, real annual interest rates remained, on average, above 30 percent between 1976 and 1980; rates at these levels were clearly far above the capital yield in most economic sectors. Second, even though the loan portfolio in the tradable goods sector was deteriorating due to the reduction of tariffs and the fall of the real exchange rate - which in turn occurred because beginning in 1979, the exchange rate was being used as one of the main anti-inflationary instruments - the sectors' indebtedness increased at high rates. Third, a speculative increase in real estate prices was generated, all of which led to a channeling of a considerable amount of banking loans towards that sector. Fourth, the perception of higher levels of wealth made consumers significantly increase their indebtedness.

The 1982 decline in Chile's terms of trade and the strong reduction in foreign credit flows resulted in a severe contraction in activity. This made evident the fact that

the level of indebtedness was higher than the value of assets of a great portion of indebted producers and consumers and of most of the financial system.

It is fair to ask why creditors and debtors of the financial system, as well as the banks themselves, allowed the situation to reach such a level of over indebtedness. Let us first look at debtors. As mentioned above, the producers of tradable goods were faced with strong drops in their yields due to the tariff reduction and the fall of the real exchange rate. Probably thinking that this situation was temporary, they went into debt at higher rates than their capital yield. With debt increasing and the value of their assets falling, the capital of many of these producers vanished. From then on the most rational behavior was to continue going into debt in order to survive, regardless of the interest rate. They had nothing else to lose and a lot to gain if the economic situation reversed, even though the probability of this occurring was very low.

The real estate sector was experiencing a boom. In fact, due to the great expansion of aggregate demand caused by a perception of more wealth, prices in this sector grew at high rates. Expressed in foreign currency, these were even higher due to the exchange rate appreciation. Thus, with a rather short-run view, investments in shopping malls and luxury apartment buildings expanded immensely. The interest rate on debts, even though high for normal yields, continued to be attractive for the real estate sector, which experienced at that moment higher than normal profits.

The high rates of growth and the degree of confidence transmitted by the government generated a perception of greater wealth for consumers. It was the first time they had ample access to credit. Both these factors helped in the expansion of debt for consumption and the acquisition of real estate.

Thus, indebted producers of tradable goods went into further debt speculating on a change (unlikely) in the exchange rate that would save them from bankruptcy; debtors of real estate acted on the basis of clearly unsustainable yields in the medium term, and consumers acted on the basis of excessively optimistic income expectations. But the question remains, why did the financial system and their creditors finance these excesses? There are three main reasons for this.

First, there was a dissociation between risk and yield of bank liabilities. On the one hand, and due to the existence of an implicit state insurance on bank liabilities, bank creditors were not worried about portfolio risk;[59] on the other hand, the state did not control the market because the economic authorities supposed that the market would take care of evaluating and rating risk.

Second, at the beginning the banks were also drawn into this excessive optimism. The expected wealth of consumers made their indebtedness not seem too high; the real

59. The view that the state would respond to bank liabilities in case of insolvency was confirmed in 1976 when the government had to take control over some informal financial companies and the Bank of Osorno, and gave financial support to compensate creditors. Foreign creditors also perceived that their credits to the system were guaranteed, as shown in their behavior in 1982 when even under conditions of early financial crisis they kept and increased their loans to the internal financial system. The measure by the government to guarantee private external debt proved the foreign creditors were right.

estate boom made it appear as if the guarantees were a proper insurance on loans to that sector; and the poor situation of the tradable goods sector was deemed to be temporary. Seeing their capital fall drastically due to an increase in their past due loans, it was convenient for banks to refinance their debtors, attracting resources at high rates in order to save them, even though it seemed unlikely. The bank was no longer risking its own capital, only its depositors' and creditors' capital in general; this is similar to what happens when a company has lost a great portion of its capital.

Third, the most important banks were part of huge economic groups. The bank's own capital was marginal within the group. Thus, saving the rest of the companies of these groups by granting so-called related credits was deemed more important than saving the bank itself.

The Crisis of 1982 and the Rescue Strategy of the Financial System

As mentioned earlier, the fall in terms of trade together with the interruption of the flow of external credits triggered the 1982 economic crisis. The economy at that time had an excess in its aggregate expense, which, measured by the current account deficit, was equal to 14.3 percent of GDP. At the same time the economy had a high level of indebtedness. The productive sector and consumers were unable to pay their debts to commercial banks. In turn, the banks could not pay their domestic and external liabilities, and the country could not finance its external deficits if it did not reschedule its debt with international banks.

Facing a situation such as this, the government has various options. The first one, which we could call the "liberal option," consists in allowing creditors to take the assets of banks, sell them, and take over responsibility for the difference between this value and that of its deposits and credits. In fact, the authorities tried this solution in 1982 and 1983, but abandoned this attempt later on.[60] The problem of this choice is that if the legal system is unable to handle these cases the lawsuits are slow and complicated, resulting in long periods during which property definitions are unclear. All of this has high cost in terms of production and employment. In addition, the interruption of the payment system that could be generated by a run on the banks would also imply high costs in terms of production and employment.

A second alternative to face the debt crisis is what is known as "to melt the debt." This alternative consists in decreasing the real value of obligations by increasing the inflation rate. Nevertheless, in the Chilean case very high rates of inflation would have been required to solve the problem, due to the widespread indexation of assets and liabilities of the banking system. Furthermore, it is not clear that the collection of this tax would be sufficient to cover losses of the system, since a reduction of the monetary base could occur.

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60. This in certain ways materialized in the case of banks that had been taken over, where depositors lost up to 30 percent of their funds.

A third alternative is a monetary reform that would decrease the nominal value of liabilities. The same thing must occur to assets in order to decrease losses; that is, the value of deposits must decrease by the same proportion. This solution was not feasible because of state guarantees on deposits. Should this have been implemented, a generalized distrust in financial intermediation could have occurred, with very costly future consequences in terms of the savings-investment process.

The fourth alternative, in fact the one most commonly used, is to defer losses in time through a debt reprogramming mechanism by the central bank. This alternative has a few advantages: it prevents the fall of prices of assets caused by their simultaneous sale; it prevents the closing of activities that suffered due to very high interest rates but that had reasonable yields and positive capital (at interest rates of renegotiations); and it encourages keeping deposits in the system as their soundness slowly improves.

Special mention needs to be made of an additional component that generally accompanies this type of solution, which is the special guarantee given by the state to private foreign debt. It is probable that this characteristic explains why foreign banks were not worried about private over indebtedness, because they trusted that the state, as a last resort, would respond.

This fourth alternative also involves several difficulties. First, the renegotiation terms must be precise and unchanging. If the terms change, debtors will postpone payment of their obligations and await better renegotiating terms. Second, it is difficult to establish a correct criteria for volumes and costs involved in the renegotiating process. This requires a very precise evaluation regarding the degrees of insolvency. If conditions are too strict the problem cannot be solved, but if they are softened, expectation of debt "forgiveness" may be created. If conditions are too good there is a transfer of resources to the debtors: these are resources that in last resort must be paid by everyone, while the continued existence of activities with negative capital will be allowed. Furthermore, this implies that resources must be diverted which otherwise could have been used in generating new assets. Finally, there is the problem of whether public opinion would consider this option to be legitimate, since resources that belong to everyone are used to help a few debtors and banks.

The Chilean economic authorities chose the fourth option. This brought about the granting of state guarantee to private sector foreign debt, intervention in the main local banks, and the implementation of a massive program to support national banks and debtors. The latter meant granting credits and subsidies by the central bank, which in turn originated Chile's quasi-fiscal deficit.[61]

The rescue strategy also incorporated other important medium-term elements: a sustained policy of devaluations that more than doubled the real exchange rate between 1982 and 1988; negotiations rather than a confrontational strategy with foreign creditors; new banking legislation (1986) that corrected former shortcomings in the area of financial regulation; and a policy of aggregate demand consistent with external restrictions. The

61. According to the current agreement, quasi-fiscal operations include those activities developed by central banks but that correspond to a fiscal policy measure rather than a monetary of financial one.

following paragraphs analyze the principal programs that were intended to help national debtors and banks, and examine the programs' effects on the quasi-fiscal deficit. The macroeconomic policy that enabled the country to regain sustained economic growth with price stability in spite of the presence of the aforementioned deficit, and the new banking law are also covered.

Quasi-fiscal transactions originated by the crisis

In early 1983 the state had to take control of the financial system. Five banks, including two of the most important economic groups, were intervened; three banks were closed down; and two were subject to direct supervision. Taken together, these ten entities represented 64 percent of capital and reserves of the private financial sector.

Nevertheless, the support programs for the financial system had already begun in December 1981 when the central bank and the state bank granted emergency loans to four banks and four financial companies that were closed down. Those credits were completely written off by the central bank since they would not be repaid.

Between 1982 and 1985 the central bank granted emergency loans to commercial banks not controlled by the state and proceeded to purchase their overdue portfolios as well. This transaction enabled commercial banks to continue operating since the non-recuperable portfolio figure by far surpassed their capital and reserves. The central bank acquired 60 percent of the bad debt portfolio with promissory notes that yielded real annual interest of 7 percent, redeemable in four years. In addition, the sale generated an obligation to repurchase from the bank. This earned a real interest rate of 5 percent per annum, which was redeemable with profits earned by the banks in an indefinite term. Thus, the portfolio purchase program had two implicit subsidies: the first arose from the fact that the promissory notes yielded a higher rate of return than the cost of the central bank funds at the moment they were issued; the second resulted from the discount rate applicable to bank profits, with which the portfolio was to be repurchased, which was (and is) more than 5 percent. In the case of the controlled banks, the central bank had to absorb the losses through allowances to the account for risky credits. In addition, once the central bank decided to privatize the banks again, it had to purchase the poor portfolios and subsidize the new stockholders. The portfolio purchase process of state-controlled institutions was similar to that of the banks that had not become state controlled, the only difference being that only 70 percent of profits had to be used for repurchase purposes.

Strong devaluation in 1982 substantially increased the value in pesos of foreign debt. The government had to subsidize debtors so they could fulfill their obligations. The program, called "preferential dollar," was one of the main quasi-fiscal transactions. It consisted in the sale of dollars to foreign currency debtors at a subsidized rate of exchange. The loss generated by the differential between the buying and selling prices was met by the central bank. At the early stages, the central bank sold the subsidized dollars directly. Later, the subsidy operated through a promissory note issued by the

central bank to the debtor, who in turn sold the promissory note on the due date of his or her foreign obligations.

Besides the support to foreign currency debtors, the central bank financed the reprogramming of local currency debts between banks and their debtors. The program took place mainly between 1984 and 1985, and its beneficiaries were productive sector debtors and mortgage and consumption loan debtors. This essentially enabled debtors to change short-term liabilities at market rates to long-term liabilities at subsidized rates. The program also benefitted banks inasmuch as it raised the quality of their portfolios.

Finally, two other-quasi fiscal transactions generated losses to the central bank through its intervention in the foreign debt crisis, although the transactions were not in the form of direct help to debtors or to the financial system. One was exchange insurance (swap transactions). By this system economic agents were allowed to sell dollars to the central bank at the current exchange rate, with the option of repurchasing them at the same rate of exchange indexed by domestic inflation and deflated by foreign inflation. In a period of strong real devaluations, it is obvious that the aforementioned mechanism involves a profit for the one who performs the operation. The second transaction involved the exchange loss the central bank had to meet due to devaluations as a result of the central bank's negative position in foreign currency after its intervention in foreign debt rescue.

The cost of the above-mentioned programs is estimated between US$7,000 and US$9,000 million. The central bank had to increase by US$5.7 billion its level of indebtedness between 1981 and 1990, when at the same time between 1983 and 1990 the collection through base money reached an annual average of around US$180 million.

What is remarkable is that in the period following the crisis the rate of annual inflation did not surpass 30 percent and the real interest rate stabilized at an annual rate of 8 percent. The following question arises: how was it possible to conciliate the financing of these quasi- fiscal operations with macroeconomic stability?

Several reasons explain this apparent contradiction. The first refers to the low level of public debt that existed in the early 1980s. In fact, during the second half of the 1970s the state carried out a very austere policy (contraction of expenditures and tax reform), that resulted in fiscal surpluses. Contrary to most Latin American countries, foreign indebtedness in the early eighties was due to private rather than public sector debt. Thus, at the moment of the large increase of the quasi-public debt caused by rescue operations of the central bank the initial public debt stock was very low. This kept the economic crisis from carrying over to the second half of the 1980s. In addition, due to the social security reform that started operating in 1981, an important portion of the public sector income (compulsory deposits of active workers) went to the private sector, while expenditures (pensions of passive workers) remained in the public sector. That is, the effort of public savings was even greater than shown by fiscal deficit figures. This also generated private savings funds that were very important at the onset of the crisis as absorption sources of the new public debt. The large institutional investors of the Chilean financial market (pension funds and insurance companies) that appeared

because of social security reform were forced in the beginning to invest a great portion of their funds in public debt instruments.[62]

The second explanation concerns the Chilean financial system which had gained some depth due to financial liberalization during the 1970s (see table 8.1). This made it easier for private agents to take the public debt that was being issued. Incidentally, the appearance of the above-mentioned institutional investors in the country was also of great importance in this financial deepening.

A third factor is related to strong real devaluations that occurred from 1982 onward. These devaluations helped relax the external gap, which during that period was by far the most relevant gap. They also permitted a less restrictive monetary policy than would have been necessary without those devaluations, bringing about a positive effect on the collection of both seigniorage and taxes. At the same level the flexible wage policy, together with scarce negotiating power and union pressure (given the political organization of that period), allowed real wages to drop. Had this not been the case, nominal wages would have followed nominal devaluations very closely, which would have resulted in a much lower real devaluation and much higher inflation. Finally, the fall of the investment rate and credit rationing, applied by a very strongly non risk-taking financial system after the crisis, also helped in freeing resources to finance the quasi-fiscal deficit.

One of the important lessons resulting from the Chilean experience is that an austere fiscal program is not sufficient to succeed in a process of financial opening. Excessive expenditure and high internal and external indebtedness were caused by the private sector in Chile. As discussed previously, one of the fundamental causes of the financial crisis was related to an inadequate financial legislation that allowed and stimulated private over indebtedness, which eventually had to be taken over by the state. It is possible that the other basic cause of the crisis was related to the inadequate management of the exchange policy.

Today the inheritance of the financial crisis is expressed in the fact that the central bank debt generates a cash flow deficit[63] equivalent to approximately 2.0 percent of GDP. Given that the debt represents nearly 40 percent of GDP, a 5 percent rate of growth allows the financing of this deficit, keeping constant the proportion of debt to 6

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62. Social security reform consisted of the privatization of the pension system and in a change from the distribution system to an individual capitalization system. That is, workers started deposits in private pension institutions, which in turn invested these funds in various instruments. The state solely set the regulatory conditions but did not administer these funds. Each worker accumulated his or her funds in an individual account in an institution of his or her choice and had the right to put these funds (plus their yield) toward retirement. The fiscal problem arose because there were already retired individuals or individuals on the verge of retirement that still belonged to the old system that the state had to finance. In other words, the state was responsible for the pension expenses while waiving the right to the income for this same source.

63. This figure includes promissory notes for US$7,000 million that the state transferred to the central bank in order to absorb part of the losses. these notes yield a Libor rate plus 0.5 percent, even though the state has the obligation to pay a minimum of 2 percent per year while the balance capitalizes.

Table 8.1 Indicators of Financial Depth: Financial Assets 1969-82 (pesos and percentages)

	Balance at end Year (Pesos, Billion)		Percent of		
				Total Assets	
Year	Current Value[1]	Constant Value (1977)[2]	of GDP[3]	Monetary[4]	Non-Monetary[5]
1969	0.1	48.7	17.6	49.7	24.5
1970	0.2	56.4	18.9	52.3	23.2
1973	0.5	43.1	14.9	53.0	14.3
1974	3.0	58.2	20.0	27.7	14.0
1975	11.4	49.8	19.7	26.1	16.2
1976	33.8	49.7	19.0	24.4	25.0
1977	75.8	60.6	21.0	24.1	38.6
1978	123.1	71.7	23.0	24.6	48.6
1979	237.8	99.7	29.6	21.1	50.1
1980	395.7	126.4	34.9	19.8	59.8
1981	510.8	149.0	39.0	14.7	69.8
1982	578.4	158.8	48.1	14.0	70.7

Source: Arellano 1983.

1. As per data of the Central Bank, Monthly Bulletin, several issues. Excludes public sector deposits and stocks of corporations.

2. Corrected CPI

3. Figures in 1977 pesos are used in order to calculate the percent and reduce distortions introduced by inflation.

4. Bills and coins in circulation plus private sector money orders.

5. Documents issued by commercial, development and financial banks.

percent of GDP. Given that there is an inflation tax as well, it is expected that debt will fall as a proportion of product in future years. This would indicate that the central bank debt, within the context of sustained growth, should not be a direct obstacle to achieving lower inflation. This does not mean that the central bank deficit is not important. Strictly speaking it is just as important as public sector debt, that is, the higher the public debt the higher the real interest equilibrium rate. If the central bank can be consistent with that equilibrium rate in its monetary policy and if debt levels are not high enough to cause a confidence crisis, the central bank debt would not be an obstacle for the decrease in the inflation rate. Nonetheless, that consistency is no small problem within the context of globalized financial markets, as will be shown later in this paper.

The new banking law

Once the worst part of the crisis had been overcome and calm returned to the financial system and the economy in general, the following questions arose spontaneously. What was the problem? Why did the economic crisis reach such high proportions? The answers were no doubt related to a deficient legislation and supervision of the system, and with certain signs given by the authority that translated into a perverse structure of incentives. First, as already mentioned, Chilean banking legislation before 1986 did not contemplate an explicit insurance on deposits. Nevertheless, in practice different signals given by the authorities had produced a private perception of an implicit insurance. In the second half of the 1970s the state intervened due to solvency problems of various banks, preventing depositors of those institutions from suffering losses. Thus, there was a generalized belief among depositors that their financial investments were not risky. In that case the competition for funds was based only on expected return. This is particularly relevant when institutions run into trouble, making it profitable for them to take deposits even at a higher rate than the rest of the system and placing them in high-risk loans. As pointed out before, this separation between risk and return of bank liabilities seems to have been one of the most important factors that explains the frail situation the financial system found itself in at the beginning of the crisis.

In addition, regulation and supervision of the system was inadequate because it was inconsistent with the existence of an implicit insurance. Thus, in practice, legislation was weak regarding supervision of the financial system and crisis prevention. There were no regulations to ensure continued supervision of portfolio quality and risk, credit concentration, and the economic capital of the bank. Problems such as high credit concentration, massive renewals of loans, and increases in passive interest rates of banks with the purpose of solving liquidity problems are really indicators that show the absence of legislation of a preventive nature.

Finally, legislation was not clear regarding the situation of institutions facing problems. In practice, this meant that, in the end, the state took control of the institution in question when its situation was already a disaster; that is, when there was no other alternative but to take control and then sell. There was no supervision that allowed the

detection of problems with some anticipation. Going even further, there were no mechanisms to encourage recapitalization of an institution facing problems.

The new banking legislation established in 1986 attempted to develop a framework that could resolve those problems that somehow had an influence on the generation of the crisis of the early 1980s. First, great importance was given to supervisory activities. Thus, the Superintendency of Banks and Financial Institutions (SBIF) gives to the public detailed information on financial conditions of each entity. Moreover, it is established that the SBIF must publish in a newspaper, at least three times a year, its opinion on the state of affairs of each banking institution. The private sector is also allowed to participate, allowing private specialized agencies to classify the quality and risk of bank assets. Currently, each bank must have at least two private appraisers.

Even more interesting is the way the law handles a bank's possible solvency problems. In general terms one could say that the aim has been to try to reach a private solution, making state intervention by means of forced liquidation a tool used only in extreme cases.

The new legislation also places great emphasis on regulation of activities. From it one can infer that banks' activities are mainly attracting deposits and investing them in loans, credits and investment in central bank documents, mortgage financing, contingent operations such as letters of credit, futures, exchange operations, and other services such as collections and discounts.

These activities are subject to a number of regulations. For example, there are limits to loans that may be granted to the same debtor, limits to position in different currencies (U.S. dollar), limits to mortgage financing against available funds, and others. Regarding related credits, it was ruled that no credits to individuals or corporations connected directly or indirectly to the property or management of the bank would be granted in more favorable terms than those approved to third parties in similar transactions.

The 1986 law also progressed significantly in terms of new businesses that banks were allowed to develop. Banks were allowed to open different branches, which are grouped into two categories: intermediation of securities; and rendering of financial services. Among the first group are securities agencies, stockbrokers, mutual funds, and investment fund managing companies. Among the second are leasing companies, credit card managers, and financial consulting firms. In the second category we find "societies for banking support," under which bank branches are grouped together. In this group are companies devoted to collection administration and electronic transfer networks.

The expansion of banking activities was done maintains a strict separation between what is called a "traditional" business and branch businesses. To do this the law uses different kinds of rules. First a branch must be created with what is called "segregated capital" of the bank. That is, if a bank wishes to invest part of its own capital in a branch, the contribution is deducted from the bank capital for the calculation of different ratios (debt/capital, etc.). Second, the law establishes the separation between the bank and its branches in terms of personnel and equipment. Third, bank credits to branches as a whole are subject to limits.

One of the main innovations in the 1986 legislation is related to provisions the banks have to make for their risky credits, something that had already started earlier through administrative measures. Banks must write down those unpaid credits and other deposits that are estimated to have higher than normal risks. The purpose of the rule is to estimate the bank's economic capital rather than the book capital, which is clearly the relevant one in order to implement an efficient legislation.

To protect the payments system, it was decided to completely guarantee demand deposits. The banking law points out that if a bank runs into trouble, the central bank must provide at the earliest possible time the resources to take responsibility for these deposits. In the case of a forced sale, the central bank will have preference over other creditors.

It was also thought convenient to grant insurance on deposits for the small saver. Thus, the legislation includes a guarantee that covers 90 percent of term deposits of individuals for a sum less than 120 UF (around US$2,500) per person for one year (articles 141 and 142 of the General Banking Law). To tone down the problem of "moral hazard," two new elements were introduced. First, the state only covers a percentage of deposits (90 percent). Second, there is a limit on the amount per individual. It is important to note that this limit includes the individual's deposit in the whole system; therefore, the rule cannot be avoided by distributing deposits in different banks. Both elements imply that the depositor runs a risk and therefore should somehow be aware of the solvency of the institution where he or she deposits funds.

Finally, it is established that banks may have a maximum debt to capital ratio of 20. Should this limit be surpassed it is assumed that the bank has engaged in activities that might endanger its financial situation, and procedures provided by law are then initiated to normalize its situation.

The 1986 banking law substantially improved former legislation. This, obviously, does not mean it is perfect. For example, many argue that it is still a very restrictive legislation regarding activities that banks may carry out. Even though these liberties have increased lately, many argue that part of the de-intermediation process faced today by the financial industry is linked with the legal impossibility for banks to venture into more businesses.

On another subject, the convenience to levy a premium on the insurance on bank deposits has been suggested. Strictly speaking, this premium should vary; that is, banks with higher risks should pay more for this insurance than banks with lower risks. It might be worthwhile to study the possibility of establishing capital requirements on the basis of risk of the assets, as was agreed by the industrial countries in the well-known Basle Agreement. These and other matters will probably be on the future agendas of financial policy discussions.

Monetary Policy in a Context of International Financial Integration

Globalization of financial markets

One of the trends that has appeared lately in the financial sector is globalization; that is, country frontiers have become increasingly hazy and capital has begun to move freely among countries. What follows is not meant to analyze the challenges to regulation and supervision that this tendency implies, but rather to think, from the position of the monetary authority, what this means in terms of policy. Concretely, a case is being studied whereby incentives have been granted in order to move financial savings toward the country, such being the case that affects Chile and some of the Latin American countries at present.

It seems important to highlight that in a static model that lacks any market imperfections, the opening of the capital account is beneficial for a developing country, because it allows financing a higher rate of investment and at the same time it replaces relatively scarce internal savings by cheaper foreign savings. In other words, an improvement in efficiency in the allocation of savings and investment resources takes place, and at the same time it increases the possibilities of risk diversification of different agents. The problem with this approach is that it does not take into account costs associated to the transition period between an equilibrium with, and another one without, the open capital account, nor the institutional development required for that transition. These costs, which will be discussed later, are those that lead us to think that even though it is desirable to tend toward an opening of the capital account, it is necessary to be extremely careful with the speed that this process is undertaken; a gradual and selective opening appears to be the most reasonable one. The experience of a few Latin American countries in the early 1980's illustrates this point. In fact, the foreign debt crisis is in many instances associated with sudden and indiscriminate openings to foreign indebtedness.

Chile has advanced significantly, though gradually, in the process of opening its capital account. This implies that there are still some restrictions, including the existence of a reserve requirement for foreign credits during their first year in the country; the limited access to the formal exchange rate market (a market composed by the financial system and the central bank whereby the latter is under the obligation to sell or acquire international reserves at determined prices fixed in advance) to meet and refund foreign debt; restrictions to the issue of stocks and bonds in foreign countries by Chilean companies; restrictions to investments in the country by foreigners contained in decree with force of Law 600 and in legislation on investment funds of foreign capital and some restrictions to individuals and companies' access to the formal exchange rate market to carry out foreign investments and capital contributions or simply to purchase hard currency for portfolio considerations.

Policy dilemma

Let us return now to the problem of monetary policy. The basic objective of a central bank is price stability. The recent consensus reached on this subject is outstanding. Nevertheless, the monetary authority has other objectives as well, such as stability of internal and external payments which are certainly also related to the anti-inflationary objective. To achieve this last objective many countries, among them Chile, have deemed it important to maintain real exchange rate stability. Real exchange rate stability is also an objective in itself, since instability of a key price such as the real exchange rate may have adverse effects on investment and growth. The point is, financial integration with the rest of the world could make price and exchange rate stability two opposing objectives.

The opening of the country to international capital flows within the context of a fixed or predetermined exchange rate reduces the influence in interest rates by the monetary authority, and therefore, its capacity to slow down the level of spending in the economy. Thus, if the domestic interest rate (defined as that which keeps aggregate demand compatible with inflationary goals) is higher than the international interest rate, there will be an influx of capital that will bring greater liquidity into the economy. Interest rates will go down and there will be an increase in aggregate spending, which could finally result in an accelerating inflation. In such a case, the entry of capital will result in a drop of the real exchange rate because inflationary pressures will come from the nontradable sector. This will result in a higher current account deficit, which, in turn, is the counterpart of capital entry. It is very clear that with the purpose of maintaining control over inflation, the authorities can prevent the interest rate to drop by completely sterilizing the monetary effect of capital inflows. Nevertheless, in this case it must be prepared to purchase foreign currency in large amounts. Evidently one could settle for a combination of sterilization and appreciation. One must be aware, however, that if the last option is selected it is dangerous to adjust the exchange rate very gradually, since this introduces revaluation expectations that worsen the problem even more by giving more incentive for the inflow of foreign currency.

Before going further, it is necessary to make clear the arbitrage relationships in connection with capital flows. Capital will enter from foreign sources if the internal interest rate is higher than the external one adjusted by the expected devaluation of the exchange rate and by country risk; that is to say, if the expected cost, in local currency, of obtaining a loan in the international market is lower than the cost of getting the same credit in the domestic market, or if the expected yield of investing in the country in question, adjusted by the country risk, is higher than the expected yield of investing in the country from where the capital originates. A combination of an increase in domestic interest rates, a smaller country risk, and a decrease of international interest rates or expectations of revaluation (due to improvements in foreign accounts, or because it is believed that the exchange rate will be used as an anti-inflationary instrument, for example) has a positive impact in capital inflows, because it increases the expected return to invest in such a country.

Thus, it is easy to realize the policy dilemma faced by the central banker who, on one hand, has an inflationary objective and, on the other hand, has an objective of a real exchange rate or commercial equilibrium. If the interest rate consistent with the inflationary objective is higher than the international interest rate, then the capital inflows that will occur will drop the real exchange rate. If the real domestic interest rate is allowed to drop, then both objectives will be sacrificed, because greater spending induced by lower interest rates will inflict pressure on prices and will also make the real exchange rate appreciate.

The importance of the real exchange rate

Why should the central bank worry about the real exchange rate? Why not let it simply fall until it reaches such a level that expectations of devaluation become sufficient to counteract the differential between internal and external rates of interest? The answers to these questions are related to the nature of forces that are inducing the capital inflow, and thus the real exchange rate appreciation. If the forces are related to structural elements, such as, for example, the permanent improvement in the current account or greater permanent access to international markets due to a political change, for example, then there is no sense in artificially sustaining the former real exchange rate. Nevertheless, if the nature of pressures on the real exchange rate is temporary, then the analysis changes.

In fact, the volatility of a key price, such as the real exchange rate, often has adverse effects on the level of trade and on investment, due to uncertainty. Less investment and trade, likewise, negatively affect economic growth. This is the reason it is preferable to soften those changes in the real exchange rate that, due to their temporary nature, will reverse in the near future. To support this conclusion it must be pointed out that there is ample empirical evidence regarding the negative effects of the volatility of the exchange rate on investment. In any case, it is clear that the greater the development of the capital market in relation to instruments of risk hedging (options, future, etc.) and the greater the diversification and integration of the economy with the rest of world, the less will be the need for, and the efficiency of, exchange rate intervention.

Likewise, it is important to mention that from a macroeconomic point of view, not only the volatility of the real exchange rate is relevant, but also its level. If the real exchange rate remains below its equilibrium level for too long, then at least two undesirable types of effects will occur. First, one runs the risk of severely affecting the development of the tradable sector of the economy, which in many cases has been the leading sector regarding increments in productivity and technological innovations. Second, sooner or later the value of the currency will return to its long-term equilibrium level, which will exert pressure on prices, thus risking the inflationary objective.

The current situation of the Chilean economy and some other Latin American economies contains elements that cannot be considered permanent, even though they have

remained for a long time. In fact, the United States rates of interest are the lowest in decades, causing an important inflow of dollars into our economies. Sooner or later those interest rates will have to rise, which will reverse the capital flows. If we allowed the real exchange rate to fall in order to adjust the difference of interest rates existent at the moment, permanent damage would occur in certain sectors of the economy.

When the rate differential reduces and, thus, the real exchange rate rises, it will take several years before these sectors recover. This phenomenon of bulk hard currency entry and its effects on real activity is particularly serious in the case of a small economy such as Chile's, where an amount of capital that for larger countries may seem insignificant has a dramatic effect on the real exchange rate whose import is magnified if the elasticities associated with foreign trade are low as they are in many developing countries.

Policy alternatives

If it is desirable to prevent temporary fluctuations in the real exchange rate, the question that follows is, how should it be done without compromising the inflationary objective? A first option is to increase domestic savings. A higher internal savings rate makes a lower rate of interest feasible, which reduces the incentive for the influx of capital, thus preventing currency revaluation. Even though the alternative of an increase in internal savings is certainly attractive and everything possible should be done to implement it, it is also necessary to be realistic about this subject. Private saving is slow to respond; therefore, it is difficult to get it to react in order to lighten temporary fluctuations. Public savings can be a more adequate tool, although many times it is not easy to change a budget once it has gone through legislative channels. In addition, many items of the budget are quite inflexible, at least in the short term.

It is also unclear if altering the government spending policy on the basis of temporary events is the best thing to do. On the other hand, the effort of fiscal savings that is necessary to increase the real exchange rate by a few points may not be politically and economically feasible. Further, fiscal savings is not in the hands of the monetary authorities.

Another option is that the central bank simply purchase the hard currency that enters the country and sterilizes its monetary effect through the placement of instruments of internal debt. This is the most natural way to act during a temporary phenomenon of capital entry. Nevertheless, the situation becomes complicated if the amounts involved are large and if the capital inflow extends for a period longer than initially planned. If so, this intervention could become an important patrimonial cost for the central bank. This is because the central bank invests the hard currency it receives at the international interest rate, which is, by definition of the problem we are referring to, less than the rate at which it can place its internal debt. These losses contribute to the quasi-fiscal deficit previously mentioned, which corresponds to a negative savings of the entire public sector which implies higher internal expenditure with its corresponding inflationary pressures.

It is a complex situation. The central bank loses control of its monetary policy while it accumulates reserves in amounts beyond those desired. It has already been said that because the situation and the probable extents involved are of a temporary nature, it is not desirable to allow the exchange rate to decrease up to the point where it completely stimulates the inflow of capital. In addition, it is not desirable to lose control over short-term monetary policy. This is why countries that have faced this situation have used a series of measures to discourage the influx of capital and thus increase the control of monetary policy.

These measures increase the cost of external debt in order to inhibit the inflow of hard currency. In other words, these are measures that in some way do not allow immediate and total opening of the capital account. The most typical are taxes or cash reserves on foreign credits, which diminish the difference between the relevant internal and external rates of interest, thus curbing the capital entry. In this way, a wedge is introduced between both interest rates, thus giving the bank control over monetary policy without sacrificing the exchange rate objective.

It is interesting that taxes to foreign credits, besides increasing the control on monetary policy, have two additional advantages. First, they allow time to find out if a situation is temporary or permanent. Second, they allow, at least to a point, discrimination between short-term speculative capital and long-term capital oriented toward productive investment. These taxes also carry costs. Among those that stand out are, first, that the effects of these taxes are decreasing in time; that is, as time goes by the rate of tax evasion increases; and second, it encourages illegal activities because individuals are prepared to risk breaking the law.

Finally, it is important to point out that many of the arguments used here are applicable to the opposite situation, that is, to the case whereby incentives are given for the outflow of significant amounts of capital. In fact, much of the current exchange restrictions in Chile is really designed to diminish the negative effects of an eventual crisis in the balance of payments by imposing certain obstacles that will prevent massive outflows of capital.

Conclusions

Even though the objective of opening the capital account is highly desirable, one must be careful in its implementation. Globalization of financial markets certainly offers opportunities, but one must know how to use them profitably. If opening the account is done hastily and a massive inflow of capital occurs, the real exchange rate will fall and, consequently, the current account deficit could reach unsustainable proportions in the medium term. If this is so, sooner or later the country risk or the expectations of currency devaluation will increase, and the flow of capital will revert. This will bring a severe recession with inflation.

The authorities must watch to make sure that the opening of the capital account does not translate into current account deficits untenable in the medium range, which not

only bring about negative consequences on real activity when the capital influx stops but also produce a reaction against the opening. In effect, it is probable that if the opening process is done hastily, the final result will be completely opposed to the desired goal, that is, the economy may end up even more closed to the international capital markets.

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9

CAPITAL ACCOUNT LIBERALIZATION: THE INDONESIAN EXPERIENCE[64]

Syahril Sabirin

In today's world of electronic fund transfer, the movement of capital and other financial claims or liabilities from one distant place to another can be conducted very quietly in a matter of seconds. It seems rather impossible to control the flow of capital in such a situation, if it were to mean an airtight control. A limited control, however, can still be applied; for instance, on direct foreign investment, on offshore borrowing and lending by national banks, and on capital outflow through the application of foreign exchange control. Nevertheless, growing trade integration, the presence of multinational companies, and close family ties between businesses in one country and another as is the case in some East Asian countries, result in close financial links that open up ways of circumventing existing control on capital accounts.

Practically all countries, however, have some experience in capital account control, and many are still applying some kind of control today, including some advanced industrial countries. The trend, nevertheless, is towards liberalization. Economic theory and practical experience seem to have convinced many decision makers of the possible net benefit of capital account liberalization.

This paper reviews the experience of Indonesia with capital account control and deregulation. It also attempts to elaborate on the background of the decision-making, the accompanying policies, as well as their implications on economic and monetary management.

Control Versus Liberalization of Capital Accounts: Some Theoretical Background

The flow of capital from one country to another can take the form of (1) direct investment, in which the investor exercises a certain degree of management control over

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the investment; (2) portfolio investment, that is, through the purchase of shares; (3) lending and borrowing; and (4) investment in short-term financial assets.

In an ideal world, money and capital can freely move from one country to another so as to find the right place in which scarce resources are used in optimum ways. However, the world is not perfect. Many countries, both developed as well as developing ones, find it justifiable to exercise some kind of control or limit on the flow of resources into and from their particular countries. Various reasons underlie capital account control.

Control over incoming foreign direct investment, which is common in developing countries, is justified at least on two grounds. First, national companies need to be protected against too severe competition from foreign companies. Second, the country's interest should be protected from possible malpractice by foreign companies, such as transfer pricing, and so on. The reason behind control on incoming portfolio investment is similar to that on direct investment, that is, the protection of national interests. In some countries capital controls are also justified on the basis of infant industry arguments; in other words, controls are necessary during the transition period while the domestic financial sector is being developed to be competitive in the global market. Another reason is that controls are considered useful in preventing transitory strains and stresses in the financial market due to random disturbances that might occur.

Control of the outward flow of capital is often viewed as a means of ensuring that domestic savings are invested domestically. Given the scarcity of capital in developing countries, it would seem logical for the countries concerned to prevent the outflow of domestic savings.

Control over capital outflow is mostly through the implementation of foreign exchange control, although foreign exchange control usually covers not only capital account control but also control of current accounts. It is important to note that foreign exchange control generally implies control both on the capital account and the current account. Likewise, foreign exchange control is meant to deal with both the savings gap as well as the foreign exchange gap, at least in the sense that it prevents the gaps from widening. It was widely believed, at least until some years ago, that the balance of payments problem being faced by developing countries due to sluggish exports and high demand for imports, would become unmanageable if tight control was not exercised. On current accounts, control can be applied to both exports and imports. Regulations usually aim at ensuring that all foreign exchange revenues from exports are sold to the government, and the use of foreign exchange is determined by the government. On the import side, control has also been associated with the protection of domestic producers.

The experience of many countries suggests that there are serious short comings and adverse effects of capital account and foreign exchange controls. Foreign exchange regimes have been implemented in the first place because of balance of payments problems; that is, foreign exchange controls have helped narrow savings and foreign exchange gaps. Foreign exchange regimes, however, create distortions that further aggravate the problems of balance of payments. Restrictions on imports, especially imports of raw materials and components for domestic industries, create uncertainty as

well as price distortions, which worsen the competitive power of domestic industries and exert greater pressure on exports. Restrictions on capital and profit repatriations make investment in the country unattractive for foreign investors, which does not help narrow the savings and foreign exchange gaps.

Some countries have frequently used qualitative controls and differential taxation to influence the amount of foreign financial assets in the domestic resident portfolio. Such legal barriers are likely to result in price distortions in the form of premium on the domestic price of foreign securities and a discount on domestic securities (Rose 1990). Conversely, restricting domestic residents from borrowing offshore forces domestic borrowers to be satisfied with a below-optimum point in their effort to find the lower funding costs. This results in price distortions in the form of premiums on domestic funds.

The argument that capital controls could ensure that domestic savings are invested domestically is also questionable. A fundamental problem with this argument is that it assumes that capital not invested abroad would be invested domestically. It therefore ignores the possible substitution between savings and consumption. In particular, the announcement of capital controls might bring expectations of further government intervention, which would discourage domestic investment in favor of increased consumption. In addition, savings may be held in various inflation "hedges," such as real estate or inventories, that have little impact on productive capacity. Moreover, when capital controls are perceived as a policy instrument used on a discretionary basis, expectations of impositions of such controls can encourage capital flight. Therefore, the usefulness of capital controls over the longer term in promoting the availability of real resources for development seems questionable (Rojas-Suaring 1990, IMF 1987).

As has been widely acknowledged, controls on the capital account can be easily circumvented by the use of many illegal transactions, such as illegal licensing, smuggling, and faked invoicing. Illegal licensing has something to do with the integrity and honesty of civil servants. Many corrupt bureaucrats have benefitted form the cumbersome procedure in the licensing of foreign exchange, so that control of the capital account can be easily circumvented by collusion between government employees and businessmen. Smugglers also benefits from foreign exchange controls, because the risk of being caught and prosecuted is considerably smaller than the possible gains in the form of foreign exchange premium over the official rates. Faked invoicing is mostly in the form of over invoicing import transactions or under invoicing export transactions.

The control on foreign direct investment remains arguable. By and large, if the control is to be relaxed, the relaxation should not be done abruptly, as it exerts too great a pressure for domestic industries to withstand. A gradual relaxation may stimulate domestic industries to improve their efficiency and competitive power. Aside form that, regulatory and administrative arrangements need to be improved so as to eliminate the chance for foreign companies to avoid taxes.

The generally unsatisfactory performance of the economies undergoing tight capital account and foreign exchange controls in the past has stimulated the argument in favor of liberalization. In fact, it is nowadays commonly accepted that liberalization of

the capital account and foreign exchange has to take place. What remains an issue, however, is the speed and sequence of liberalization.

It is argued that the liberalization of capital flows and foreign exchange has to take place after current account (real sector) liberalization and the liberalization of interest rates and credit. For one thing, it is argued, liberalization of capital flows, (that is, capital inflow) is likely to put pressure on the domestic currency to appreciate, which may worsen the current account balance. Therefore, it is important to deregulate the current account first so as to improve its resilience to withstand the pressure of currency appreciation resulting from capital account liberalization. It is important to note, however, that this argument seems to assume there is a freely floating exchange rate system and furthermore that the exchange rate is determined by supply and demand rather than by its purchasing power parity. These assumptions do not always hold.

The argument that interest rates and credit have to be deregulated before the liberalization of capital flows and foreign exchange is based on the grounds that domestic financial assets have to be made competitive through deregulation to be able to compete with foreign assets as capital accounts and foreign exchange are liberalized. The reverse sequence, it is argued, may result in a massive capital outflow.

Indonesia's Experience with Capital Account Control and Foreign Exchange Regime

The policies on foreign exchange mechanisms and capital flows in Indonesia have undergone a dramatic change over time. Before 1970, and especially up to 1966, Indonesia adopted very tight control on foreign exchange transactions. The system had been centralized, and practically all foreign exchange revenues from exports or other had to be sold to a central government body, which was also the sole authority that could issue permits to use foreign exchange. Such a tightly controlled foreign exchange system was gradually liberalized within a relatively short time, that is, between 1967 and 1969, to become one of the most liberal systems in 1970. The policy on capital outflow was naturally embodied in the foreign exchange system. Concerning capital inflow, Indonesia had not been very friendly to foreign investment before 1967. In 1967, a new law that was more accommodative to foreign investment was introduced.

During the Dutch occupation, very strict foreign exchange controls were applied in Indonesia as stipulated in the Deviezen Ordonantie and Deviezan Verordening of 1940. The policy was naturally set up in favor of the colonial government. The government controlled all foreign exchange revenues of Indonesia to support the economic performance in its home country. Residents were classified into two categories: "foreign exchange residents" and "non-foreign exchange residents." Only foreign exchange residents were allowed to make transactions in foreign exchange, and permits from the government had to be obtained to do so.

Following Indonesia's proclamation of independence in 1945, the principles embodied in the 1940 foreign exchange control law continued to be adopted with minor adjustments now and then. The first law issued by the Indonesian government with

respect to the foreign exchange system was the Foreign Exchange Law of 1964. The spirit of this law, however, was similar to the colonial one, except that it did not classify residents into foreign exchange and non-foreign exchange residents. It was quite natural for the spirit of the law to remain one of a foreign exchange regime given the generally accepted view in developing countries at that time in favor of strict control, and taking into account the magnitude of the balance of payments problems being faced by Indonesia during the first half of the 1960s.

The general policy on foreign investment prior to 1967 was not very accommodating to foreign direct investment. In fact, in the second half of the 1950s and the first half of the 1960s the government took a much stronger stance against foreign investment, particularly investment originating form the Netherlands, and at a later stage, the United Kingdom. Many Dutch companies and some British companies were nationalized during the period.

After more than three centuries of Dutch occupation, the sentiments against colonialism were quite strong. At the same time, the national unity had been danger on several occasions, either because of separatist movements or political rebellion. "Nation building," therefore, became a very important task of the government. During most of the 1950s Indonesia also had to cope with frequent changes in the government. It was natural that the government was preoccupied with political problems, and consequently little attention was paid to economic matters. When the government became more stable after a presidential decree in 1959, however, it became obsessed with programs to build large projects. Some of the projects, in fact, had questionable economic benefits. The confrontation with Malaysia in the early 1960s aggravated Indonesia's economic problems. The result was a growing budget deficit and a deterioration of the balance of payments. The government financed most of the deficit by monetary expansion, which resulted in spiraling inflation.

Bad economic management and overregulation of foreign exchange and the capital account resulted in poor economic performance. Growth rates were very low, especially in the first half of the 1980s, and in one year it was even negative. Foreign exchange controls greatly increased uncertainty for domestic producers, especially those using imported items in their production. These producers would have to close their factories for several weeks in case their applications to buy foreign exchange for the importation of inputs were not approved. Naturally, the adverse effect of foreign exchange controls on overall production activities was very large.

Given the economic and political situation in the country toward the end of the "old-order" era in March 1966, there was no reason for capital to flow in. Short-term capital inflow through the banking system earned negative economic benefits, given the high rates of inflation and the relatively low, administered nominal interest rates. Similarly, investors were not interested in direct investments because of the unstable political situation and the severe attitude against foreign direct investment.

Capital outflow, on the other hand, was attractive. Although it is quite difficult to estimate, illegal capital outflow was recognized as a common phenomenon at that time.

Over invoicing of imports and under invoicing of exports were the chief means of smuggling capital out of the country.

Deregulation in Indonesia

The early years of the "new order" government can be described as a period of transition toward more national and prudent economic management. The last years of the old order government were years of economic chaos. The country was on the brink of political and economic bankruptcy. The first task for the new order government was to rehabilitate the economy. The Economic Stabilization Program was announced. It consisted of a balanced budget policy, a high interest rate policy, and the rescheduling of existing external debt. As budget deficits had been the main source of monetary expansion and spiraling inflation, budgetary discipline was naturally the primary target in controlling inflation. In addition, interest rates on deposits (and lending) were increased to make real interest rates positive. In the external sector, the immediate problem was the arrears in debt repayment. A series of negotiations with creditors, therefore, were conducted which successfully resulted in agreements to reschedule the existing debt. At the same time the creditors also agreed to extend new loans to help Indonesia redevelop the country. In a very short time the program succeeded in stabilizing the economy. After the triple-digit inflationary years of 1962-67, inflation rates dropped to 10 percent in 1969, 9 percent in 1970, and 3 percent in 1971. The successful rehabilitation program constituted a strong base for the start of a series of more realistic five-year development plans in 1969.

It was clear from the beginning of the new order administration that financial sector policy was in favor of more deregulation. Experience with tight foreign exchange controls and low interest rate ceilings accompanied by high inflation rates, had been a valuable lessons to consider in designing future policies.

The first concrete indication of a gradual reversal from the tightly controlled foreign exchange system to a free foreign exchange system can be detected in 1967. Exporters were allowed to hold a certain percentage of their export proceeds in the form of non-negotiable foreign exchange in an export bonus account in the designated banks. Such foreign exchange, referred to as the export bonus (BE), could be used to import commodities listed in the import program list. Aside from that, export proceeds above the amount calculated on the basis of the official price could be held by the exporters for their own profit. This type of foreign exchange, called the supplementary foreign exchange, could be freely used or sold by the exporters.

The foreign exchange bourse which was created in May 1967, was conceptually a major departure from the policy of requiring all foreign exchange to be sold to a designated government body. For the first time since the exchange control was established, it was possible to trade foreign currencies against rupiah legally in the bourse. This drastic change to a free foreign exchange system was introduced through Government Regulation No. 16 of 1970. This regulation stipulated that holding, selling,

and purchasing foreign exchange were no longer subject to restrictions. In the initial stage of the system's implementation, exporters were required to sell their foreign exchange receipts to a foreign exchange bank, although nothing prevented them from buying an even larger amount of foreign exchange at the same time. The foreign exchange banks, in turn, had to sell the amount of foreign exchange to the central bank - Bank Indonesia. Importers and those who needed foreign exchange for whatever purposes could buy foreign exchange from the banks that, in turn, acquired the foreign exchange from Bank Indonesia. For the capital account, the free foreign exchange system allowed for the transfer of capital into and out of the country.

More specifically, under the 1970 regulation the foreign exchange system sets no limits on capital outflow or inflow except in the form of direct investment and portfolio investment through domestic capital market. Individuals and companies are free to transfer capital out of the country without any limit since commercial banks are free to sell any amount of foreign exchange to them. In turn the central bank stands ready to sell any amount of foreign exchange to the commercial banks at the central bank's rates (which, especially since August 1971, have been equal, or very close to the market rates). Domestic and foreign individuals and companies are also free to transfer capital into the country without any limit. Offshore borrowings for individuals, companies, and banks are included in this category of capital inflow. It should be noted that the foreign exchange system was further liberalized in January 1982 by abolishing the requirement for exporters to sell their foreign exchange earnings from exports to the banks (which in turn were to be sold by the banks to the central bank).

Offshore borrowing by state-owned companies and banks

Offshore borrowings by state-owned companies are different from those of the private companies because creditors usually view the state-owned companies as being implicitly guaranteed by the government. The performance of the companies, in some cases, does not count in the decision-making process of the creditors. Therefore, it would not be prudent to let the state-owned companies seek offshore borrowings without any intervention form the government. It is for this reason that state-owned companies in Indonesia must have prior approval from the government in their offshore borrowing activities.

Such a requirement was recently broadened to cover state-related offshore borrowings. In this category offshore borrowing by, for example, a private company for a petrochemical project, for which the company signed a long-term contract wit the state oil company to supply a main raw material for the project, is included. Offshore borrowing for such a project would have to have prior government approval for essentially the same reason; that is, in such a case the decision of the creditor would somehow be related to a kind of implicit government guarantee.

Two aspects of offshore borrowing by banks should be noted. First, by and large, banks have more access to foreign borrowings than do nonfinancial companies.

This is because banks, by the nature of their business, would need business partners overseas as correspondent banks so that in general they have more established names among foreign creditors. In addition, also by the nature of their business, banks can earn public (including creditors') confidence more easily. Second, the activities of banks in offshore borrowings would have to be watched closely by the central bank as the banks' supervisor. Too much aggressiveness on the part of the banks may be dangerous to the banks' stability in terms of foreign (and foreign exchange) exposure, and it may also create a market distortion, which would be a disadvantage to national banks and other borrowers.

It was primarily for the first aspect that the government decided in 1974 to set the ceiling on foreign borrowings by banks and nonbank financial institutions (NBFIs). It was apparently the view of the government at that time that uncontrolled foreign borrowings by the financial private sector may bring too much pressure on monetary management because of too much liquidity.

Offshore borrowings (and potential offshore borrowings) by private nonfinancial companies did no endanger liquidity as much, because, apparently their access to offshore financial markets was still limited, and only one or two companies were sufficiently established in the market. Thus, such borrowing by the nonfinancial companies did not pose any problem to the monetary authority. The only instrument of monetary management at that time (aside from, of course, moral suasion) was the reserve requirement. This instrument was not sufficiently strong and flexible to neutralize the influx of liquidity arising from offshore borrowings, and therefore, the government resorted to ceilings on foreign borrowings by banks and NBFIs. Also in 1974, the government established ceilings on the net domestic assets (that is, domestic credits) of banks as an instrument of monetary policy. While this was a very powerful monetary policy instrument, it created distortions in the financial market.

Later in 1989, after the financial deregulations of 1983 and 1988, and when the available monetary instruments were considered strong and effective enough to manage liquidity, the ceilings on foreign borrowings by banks and NBFIs were abolished. Unfortunately, the liberalization made offshore funds appear quite attractive to the banks, especially when domestic liquidity was tight. This prompted banks to be too aggressive in the offshore borrowing market, which was a great concern to the central bank. It also caused the deterioration of offshore market conditions for national borrowers. Hence, the central bank established a rule - a kind of queuing system within a certain overall offshore borrowing limit - for the Banks and NBFIs.

Foreign direct investment

In the area of foreign direct investment, the spirit was to open the door more widely, but cautiously, to foreign investors. The Foreign Investment Law No. 1 of 1967, was the first cautious deregulatory measure. It allowed foreign investors to invest in various sectors in Indonesia in the form of joint ventures with resident businesses.

Various incentives were offered by the government to attract foreign investors, such as tax holidays and reduced or zero import tariffs.

Currently, the tax and other incentives are no longer offered to foreign investors. Various deregulations, however, have been put forward to attract more foreign investors. The last and most liberal regulation concerning foreign investment, Government Regulation No. 17/1992, was issued recently on April 16, 1992. Foreign investors are now allowed to invest in all regions in Indonesia in 100 percent foreign investment projects without a domestic business partner, with a minimum capitalization of US$50 million. In addition, foreign investors can also invest in 100 percent foreign investment projects without a minimum requirement of capital in fourteen provinces of East Indonesia.

The domestic financial sector

The domestic financial sector experienced two series of major liberalization. The first was implemented in June 1982, in which the interest rate ceilings on state-owned banks' deposits and loans were lifted. Before June 1982 the interest rates for both deposits and loans in state-owned banks were set by the government. In return the central banks provided a subsidized fund, the liquidity credits, to those banks on the basis of the loans they extended to priority sectors. As such, the state-owned banks, whose share in the banking system was around 70 percent, were not stimulated to mobilize domestic savings. With deregulation, however, all banks were free to set their interest rate for both deposits and loans. The liquidity credits were also gradually reduced, and therefore the state-owned banks were encourage to mobilize their own deposits to finance their loans. As a result, the competition among banks became tighter and the domestic fund mobilization increased at higher interest rates.

The second major deregulation of the domestic financial system took place in October 1988. Primarily this measure reopened the door for new banks to enter the market and simplified procedures for branch openings and foreign exchange licenses. As a result, the competition has been even tighter and the fund mobilization has been even larger.

The current account

After the deregulation through the free foreign exchange system in 1970, the current account seems to have been neglected for a number of years as far as liberalization is concerned. During the remainder of the 1970s and in the early 1980s the trend toward more protection of domestic industries through import restriction became apparent. In some cases, exports were restricted in favor of domestic industries that use the export commodities as inputs. In retrospect, such a trend might have been related to the blessing enjoyed by Indonesia due to the oil price hikes. The larger

increase in the government as well as export revenues due to the oil price hikes might have made the government feel that it was a good chance to develop the domestic industries through protection, even at the cost of exports and international trade. During that time, one major policy that may have helped the current account to some extent was the exchange rate policy. However, even this policy did not work on a continuous basis; rather it worked through large devaluations.

Indonesia continued to adopt the fixed exchange rate policy (fixed to the US Dollar) in the 1970s and the first part of the 1980s. During that time the domestic currency was devalued three times, in 1971, 1978, and 1983; each time by more that 30 percent. Since 1983 a more flexible exchange rate management was conducted. Existing public psychology, however, made it difficult to adjust the exchange rate sufficiently. Therefore, another large devaluation was made in 1986. From 1986 on, and particularly toward the end of the 1980s, a more flexible exchange rate - a managed floating rate - was adopted with a target to keep the real effective exchange rate stable. Overall the exchange rate policy has supported the current account or, at least, it has been neutral to current account.

In contrast to the trade and tariff policy of the 1970s and the early part of the 1980s, the policy in the latter part of the 1980s was in favor of the current account. The government has taken significant steps to remove some nontariff barriers, as well as to reduce and unify import tariffs. These policies have been regarded as important instruments for enhancing economic efficiency and competitiveness.

Capital Flow and Monetary Management

An open capital account adopted by Indonesia in the early 1970s provides individuals, business entities, and financial intermediaries virtual freedom in the management of their financial assets and liabilities. Since there is practically no borderline between domestic and offshore markets, investors and intermediaries have the option of holding their assets and maintaining their liabilities in either local or foreign currency, or in a combination of the two. Given this, market participants will have to pay greater attention to factors such as interest rate differentials and movements and expectations regarding the value of the rupiah. In its effort to maintain domestic and external stability, therefore, Bank Indonesia, as the monetary authority of Indonesia, needs to pay more attention to interest parity between domestic and overseas markets.

As a consequence, the task of monetary management is becoming more complicated. Monetary disequilibrium will be adjusted not only through prices or levels of activity, but also through the current and capital accounts of the balance of payments. The level of domestic interest rates depends on the interest rates in the international markets, because the domestic rates will have to be at a level that is necessary to prevent too large inflow or outflow of short-term capital.

On three occasions speculative short-term capital outflows have occurred: in the second half of 1984, the first half of 1987, and in 1990/91. In all three cases the capital

outflow was ignited by the issue of a large devaluation. Naturally, when the interest rate parity (between domestic and international interest rates) is not sufficient to cover the expected rate of devaluation (or depreciation), foreign financial assets will become relatively more attractive than domestic financial assets. In such a case there will likely be more capital outflow.

For monetary management two important aspects need to be taken care of. First, how to prevent widespread speculation for exchange rate devaluation. Second, how to strike a delicate balance in interest rate management so that the interest rate is not too high to depress the domestic currency-based economic activities while at the same time attract too much short-term capital inflow, and it is not too low to result in a large capital outflow. The first aspect is related to exchange rate management and domestic inflation rates. For the second aspect, one suggestion is to keep interest rates low enough to stimulate economic activity. Then whenever speculative capital outflow occurs, let the interest rate jump to a high level to counteract the speculation, but immediately after the speculative activities recede, bring the interest rate back to the original level. Although this recommendation seems very valid, in some instances it would be difficult to carry out.

It is argued that in an open capital account a certain (perhaps a significant) degree of freedom in monetary management is lost. In this regard, it is not easy to define what is meant by freedom in monetary management. Is it the freedom to manage the money supply, or interest rate, or credit, or some other variable? The definition is also made complicated by the existence of domestic banks' deposits and loans in foreign currency. A more relevant issue, however, is how to make the best use of the open capital account for the well-being of the country. The answer may be to keep the domestic inflation rate low and the exchange rate stable. After all, in an open capital account, the relative conditions of the business climate in the country and abroad is an important determinant. Relative stability and appropriate regulations are the salient factors that determine the business climate. One should aim at improving such a business climate without worrying too much about losing some freedom in monetary management.

A commonly-asked question regarding domestic price stability and exchange rate stability is whether the nominal exchange rate policy should play a determining role in achieving the domestic price stability, or alternatively should it adjust itself in line with the domestic inflation rates in order to maintain the real effective exchange rate stable. In the author's view, the answer depends upon the cause of the domestic inflation. In a situation where the primary cause of the domestic inflation is the nominal exchange rate movement, then the logical policy recommendation should be a stable nominal exchange rate policy. If the domestic inflation is caused primarily by factors other than the depreciation of the nominal exchange rate, then the maintenance of a stable nominal exchange rate would not solve the problem. In fact, if the primary cause of the domestic inflation is not sufficiently tackled, then the (fixed) nominal exchange rate policy will be destabilizing as well as unsustainable in the medium run. In such a situation, a fixed nominal exchange rate policy in time will build up expectations for an abrupt devaluation, and such expectations will induce a destabilizing capital outflow in a

deregulated capital account system, and ultimately the expected devaluation will have to take place. Therefore, a gradual and smooth adjustment of the nominal exchange rate is a better alternative to keep the real effective exchange rate stable, and is more compatible with a sustainable economic growth objective.

Deregulation in Retrospect

Macroeconomic indicators in the past twenty-five years seem to show that the removal of capital controls or the deregulation of capital account has something to do with the improvement of overall economic performance. It must be noted, however, that the deregulation of capital account was only part of the government policy package adopted during the period. At the same time, the domestic economy and external environment also underwent substantial changes. Under the circumstances, the appropriateness of any particular policy, and the deregulation of capital account in particular, needs to be viewed in the context of the overall policy stance, also taking into account internal and external developments.

More specifically, the effectiveness of capital account deregulation depends heavily on the monetary, fiscal, trade, and exchange-rate policies pursued by the government. It is interesting to note in this regard that in Indonesia, liberalization of the exchange system was introduced long before deregulation in the trade area. With the buoyancy of revenue from oil in most of the 1970s, trade policies, in contract, became more restrictive. The movement toward a free exchange system also came much earlier than the deregulation in the financial and banking sectors (1983 and 1988). The free exchange system was even introduced ong before the adoption of a more flexible exchange rate (after the 1986 devaluation). Whether the sequence is appropriate or not is open to discussion.

It is not the intention of this paper to prove whether or not the sequence matters, but two points are worth mentioning.

The first point concerns how far the liberalization policy sequence in Indonesia contradicts the generally recommended sequence; that is, capital account liberalization should follow current account (real sectors) liberalization, and capital account and foreign exchange liberalization should come after domestic financial sector liberalization. On this subject, one can make the following observations.

First, it should be pointed out that liberalization of the foreign exchange system generally implies both capital account and current account liberalization. This is particularly true if the system departs from a very strict one in which importers (including those importing commodities that constitute raw materials and components for domestic industries) have to obtain permits to buy foreign exchange from a designated authority for each and every import transaction. A departure from this system to a free foreign exchange system necessarily implies a current account deregulation, albeit to a limited extent. When Indonesia liberalized its foreign exchange system in 1970 it was indeed a departure from a very tightly controlled foreign exchange system and therefore

implied current account as well as capital account liberalization. This may have helped reduce, to some extent, the adverse effect of the "reverse policy sequence," although one may argue that such a current account liberalization may not have been enough to make the domestic real sector sufficiently resilient.

Second, the liberalization of the foreign exchange system and capital account in 1970 was part of a comprehensive package of economic policy, and domestic interest rate adjustment was an important component of this package. The bank deposit rate was raised in 1968 to 6 percent per month in an attempt to cope with the high inflation rate and to make the real interest rate positive. In the same package, the government also imposed a tight budgetary discipline to help bring down inflation rates. Thus, although the liberalization of the domestic financial sector came much later, in 1968 an attempt was made to improve the competitive power of domestic financial assets.

Third, the comprehensive economic policy package introduced by the new order government significantly improved public confidence in economic management. Whenever the inflation rate declined to a single-digit level, public confidence in the monetary and exchange rate stabilization improved considerably. Such improvement in public confidence seems to be an important factor that contributed to the success of the liberalization of the foreign exchange system in 1970. If the sequence does matter, then the three factors described above may explain why the liberalization of capital account in 1970 has not created serious problems for Indonesia.

The second point concerns whether the problems of capital flight that were experienced by Indonesia in 1984, 1987, and 1990, resulted from the policy sequence or whether they related more to exchange rate management. In today's world of floating exchange rate systems, and given that the domestic economy cannot keep the domestic inflation rate as low as those in trading partner countries, the suitable exchange rate policy should be managed floats one. Fixing the exchange rate to a particular currency for a basket of currency) after some time will bring pressure on the foreign exchange market (capital flight) because of the overvaluation of domestic currency and because of accumulated inflation rate differentials. A consistently managed floating exchange rate (which stabilizes the real effective exchange rate over time will bring about increased confidence in the relative stability of domestic currency. Such an increase in confidence is an important factor in preventing speculative capital flight. The experience in some countries, however - and Indonesia is among these countries - is that it is not easy to shift immediately from a fixed foreign exchange system to a flexible one. It takes time, perhaps a few years, to allow the public to adjust to the new environment. It was during such an adjustment time, perhaps, that speculative capital outflow became a problem.

In general, structural adjustment is facilitated if it takes place in an environment that promises macroeconomic stability. There is less certainty, however, about the appropriate pace and sequencing of structural reforms, including the deregulation of the capital account. Economic theory offers little guidance about the optimal sequence for removing market distortions. The experience from several cases suggest that the interaction among structural policies is complex and might not lend itself well to generalization. Broadly, the appropriate pace and sequencing of reforms in particular

situations is likely to depend on the magnitude of the initial imbalances, the comprehensiveness and balance of the policy package, and the political and social circumstances prevailing at the time of policy formulation.

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10

COMMENTS: FINANCIAL REFORMS AND CAPITAL ACCOUNT LIBERALIZATION

Carlos Massad

The subjects of financial and trade reform, deregulation, and liberalization have been thoroughly explored in the last fifteen years or so, and also shortly after the beginning of the Great Depression up to the beginning of the Second World War. There is a certain sense of deja vu when listening to the discussion of reform of the financial system.

Several issues have been thoroughly explored: the sequence of different reforms, the macroeconomic prerequisites for success, the degrees of freedom of monetary policy, the effects on interest rates, the transfers of external shocks to the domestic economy, and capital flight (inward as well as outward).

Some issues, however, seem to me to have been less discussed, even though they are mentioned frequently in studies on the subject of financial reform. One is the issue of exchange rate regimes. Should one prefer a nominally fixed exchange rate to serve as an anchor to domestic price levels, thereby "protecting" price levels from shocks? Or a purchasing power parity with gradual adjustments in the nominal rate so as to protect the trade account? Or an interest rate parity approach, so as to protect the capital account? Or a floating rate approach that would protect reserves, the global balance of payments, and the freedom of action of the monetary authorities? Under what conditions are one or the other of these approaches to be preferred? These are questions that merit further discussion.

Another issue requiring further discussion is that of capital gains and losses. In what follows, I will take up this subject very briefly, considering a sequence of events different from those of both Argentina and Indonesia.

Deregulation, as well as financial and trade liberalization, cause important capital gains and losses. On the one hand, under a repressed system rents arise that attract resources into rent-generating activities; rent values tend to be incorporated into the capital value of firms in those activities so that transfers of ownership imply a transference of the current value of expected future rents into capital costs. Usually a repressed system includes low or negative real interest rates, and therefore, current values of future streams tend to be overpriced compared to values obtained in a non-repressed environment. Under those circumstances, rent elimination by itself can cause important capital losses, which are difficult to digest if they are generalized.

On the other hand, changes in relative prices of goods and non-financial services that cause the elimination of rents also affect expected future flows. Through that effect, capital values are altered.

Capital gains and losses are usually treated as transfers in a very real sense. That is, capital gains and losses are not expected to make much difference in the productive process or in levels of employment. Once produced, the capital loss of one is supposed to be the capital gain of another, so nothing should change if preference functions and economic opportunities are similar across several individuals. Repeated experiences show that capital losses are difficult to digest. In fact, losers do not accept the loss too gracefully, usually on the grounds, right or wrong, that contrary to market expectations, capital loss-causing shocks or policies will be transitory.

Let us consider a case in which deregulation of the domestic financial system (not financial liberalization) occurs before trade liberalization, and the financial liberalization process follows the other two, at a slower pace. Connoisseurs will recognize this sequence as being of Chilean vintage.

As trade is opened, new opportunities of investment arise, as well as economic obsolescence in wide sectors of the economy. Relative prices cause changes not only at the margin, but also they create capital gains and losses. If D/K ratios are low in the economy as a whole and, particularly, in the capital losing firms, it will be very difficult for firms to transfer their losses to the general economy through the financial system. If D/K ratios are relatively high, it will be very difficult for banks to avoid general portfolio problems, and capital losses will be borne by the community as a whole.

As demand for credit rises - due to both distress borrowing as well as new investment opportunities - if the capital account is relatively close, interest rates shoot up, but expenditure is not reduced because the increase in interest rates is the result of a shift in credit demand rather than a drop in supply. Interest rates can reach unbelievable levels in real terms and the economy can still continue to grow until the number and relative economic importance of firms unable to serve their loans grow enough to affect general expectations.

As interest rates grow, the present value of firms generating a relatively stable real cash flow (such as those in utilities) goes down, and those having access to lower-cost foreign credit can make a killing. New fortunes and economic groups pop up.

The problem is further aggravated by changes in the exchange rate. In the beginning the domestic currency becomes over-depreciated because imports can grow faster than exports under the impulse of reduced protection. Eventually, however, as the capital account is gradually opened, foreign exchange begins to flow toward the country, attracted both by opportunities for real investment and by high domestic interest rates. As the currency appreciates, a further incentive to capital inflows is constituted.

At some point a deficit in the current account grows enough to be worrisome, say, over something like 7 to 10 percent of GDP. This deficit, by the way, implies that a debt equal to 50 percent of GDP will double in four to six years, which is obviously untenable.

Where is the flaw in the system that allows this undesirable sequence of events to happen? If, to begin with, capital losses had been absorbed by direct losers gracefully, an important factor in the excess demand for credit would be eliminated. Pressure on interest rates would be lighter and so capital inflows.

Accelerating the pace of capital inflows would not help much, because it would only anticipate revaluation of the currency in a sort of Dutch disease.

Let me stimulate discussion by presenting an extreme version of my view on this: capital losses could really become a transfer, the adjustment process to any and all structural changes in the economy would be smooth, and changes in output and employment would be minimized during the adjustment process. This view, I believe, has a bearing on the discussion that followed the excellent presentation by President Zahler.

In particular, differentiating the monetary management role from monetary transactions would certainly help toward a smoother absorption of capital losses. Credit would be in the form of paper sold in the market rather than in the form of fixed nominal value assets of the financial system or fixed real value (indexed) assets. But a consequence of this would be an increase in the cost of monetary transaction services, with a sharp widening of the spread between deposit and lending rates. In fact, demand deposit rates would become negative, because charges much higher than any existing today would apply (think, for example, of the 100 percent reserve requirement proposal). In open, globalized, financial markets, this is done either globally or not at all. Any small country trying to do it alone would need to accept the disappearance of its own financial system as it is overrun by others, or it would be forced to move back to a closed domestic financial system.

This way of looking at capital gains and losses also has a bearing on the argument in the extremely interesting paper presented by Mr. Sabirin, in which a sequence of events as that narrated above is presented as the consensus ideal.

The question of capital gains and losses is also closely related to changes in interest rates. I was very glad to hear Millard Long say that the World Bank now did not feel so uncomfortable with real interest rates slight below zero. After all, such rates prevailed during much of the post World War II period in the markets, at least in the US market, until the Volcker shock, which we might call "Volckerazo" in Latin America, changed the situation in the late 1970s.

How high real interest rates ought to be? Should interest rates alone be relied upon to clear the credit market under all circumstances? Although I do not have a full answer to this question, let me argue that the range within which real rates can move without disiquilibrating other markets is relatively narrow.

Even the concept of real interest rates is more complex than it seems. As relative prices change during inflation, real rates are not the same as seen by different sectors of the economy. As the variability of relative prices increases with inflation within certain limits, there would be a higher probability of finding negative rates as inflation rises, but those negative rates could be high positive rates for wide sectors of the economy. There is evidence, though, that the variability of relative prices may go down again as inflation

increases, but in the usually relevant ranges of, say, 15 to 35 percent inflation, relative price variability is in the high range.

On the other hand, low rates of inflation of, say 1 to 3 percent, may reflect changes in quality more than in prices, thus, real rates may be underestimated. These two factors are to be taken into account when evaluating the effects of real rates in the economy.

Furthermore, real interest rates in the financial market may differ from real rates of return on real assets, and the adjustment to such differences may occur either through the price of the assets or through the expected flow of income, depending on whether it is a fixed interest or floating interest asset. Fixed interest assets will vary in price, while floating interest assets will vary in income. Real assets may adjust either way depending on circumstances. For example, the increasing rates of return in the economy may be reflected in a drop in the price of a house or in an increase on rental values, depending on whether the increase in rates of return is a consequence of an increase in demand for housing services or a decreased supply of credit. Asset price bubbles may occur during the process of adjustment to a trade liberalization policy as interest rates go up sharply first and come back down later on. If the adjustment occurs through asset price changes, bubbles may, as is well known, complicate management of the economy.

I believe there are good reasons to act if interest rates in financial markets greatly exceed the rate of growth of output. At high levels, interest payments represent, at least partially, capital transfers that the system is not well equipped to handle. They do not represent an increase in the rate of return on real assets; thus, in order to pay such high real interest rates, capital transfers are required. Again, the system is not well equipped to handle capital transfers, and I suggest that an improvement in this regard will make an important contribution to stability. Handling capital losses is not only an economic policy problem, but also an institutional question linked to legislation regarding the handling of firms in distress.

11

INDUSTRIAL POLICY AND FINANCIAL REFORMS IN KOREA

Bon-Ho Koo

The Korean economy has experienced remarkable economic growth since it began implementing a series of successful five-year development plans in 1962. In a short time Korea and Taiwan achieved what industrialized countries had accomplished only over a long period of development. One of the main features of Korean development has been the adoption of "development-oriented" policies by the government. Financial policy has been used as a primary instrument to support economic plans. Financial institutions have often been asked to support the government's economic objectives. In the process, these institutions grew heavily dependent on government policies.

Despite Korea's success in rapid economic growth in a short time, its financial system was often criticized as underdeveloped and inefficient. Many of these shortcomings were blamed on the government's heavy intervention.

In the earlier stages of development, the use of direct and selective instruments of financial policy did not pose a threat to the efficient allocation of financial resources for economic development. However, as the economy grew in scale and structural complexity, such policy instruments became increasingly inefficient. As long as Korea's financial sector remains underdeveloped, and is unable to satisfy the financial needs of a rapidly growing and increasingly open economy, it will continue to constrain the growth of the Korean economy.

Thus, the basic orientation of the government in recent years has been to allow the market mechanism to work more freely. The primary objective of these liberalization efforts, particularly in the financial sector, has been to promote private initiative and competition through the market mechanism.

Industrial Development Strategy and Financial Policy

A financial system can influence the allocation of real resources by intermediating financial resources between surplus and deficit units. A financial system can also be used to channel financial resources to certain favored deficit units that are expected to use the resources for certain purposes. Furthermore, the terms on which the financial

resources are provided can be manipulated to influence the decisions of the potential users of the resources.

Few governments in developing countries seem to believe in the allocational efficiency of the financial system. The financial sector is perhaps one of the most heavily regulated sectors in the developing countries, since the governments intervene extensively, setting interest rates on both deposits and loans and allocating credit. The Korean government has been no exception.

Various policy instruments were necessary for the government-led development strategy that Korea adopted for rapid economic growth in the early 1960s. The policy instruments may be divided into two types: fiscal and financial. The fiscal tools had limitations that arose from low-income levels and the correspondingly low taxpaying ability at the time Korea launched its economic growth plan in the early 1960s. Consequently, the financial tools became more important.

Government Control of the Financial Sector

In the 1950s commercial banks were placed under private management, but in 1961 the privately owned bank stocks were confiscated by the government as part of a redemption policy that was implemented for illegally accumulated wealth. Moreover, in June 1961 the Temporary Law for Financial Institutions was introduced to restrict the voting right of the private majority shareholders. By this law, commercial banks became actual public enterprises, empowering the government to allocate resources selectively. The government's systematic control over the financial sector enhanced with the establishment of various special banks in the early 1960s. This indicated the government's intention to allocate funds for specific purposes.

Finally, the authority for monetary and credit policy was transferred to the administration. In 1962 and 1963, the Bank of Korea Act was revised to include a provision that allowed the Minister of Finance to exercise the right to make motions for reconsidering decisions made at the Monetary Board, the highest decision making organization regarding monetary policies. If a motion is vetoed by a two-thirds majority of all present, then the final decision is to be made by the President of the Republic.

These amendments signalled a shift towards reliance on financial policy as an the important policy tool for the government-led development strategy. Government controls over credit allocation in Korea were initially exercised through a system of guidelines that set forth loan priorities for different sectors and sub-sector.

Beginning in the early 1960s the government took a more active role in guiding resource allocation through the formulation of both five-year economic development plans and annual overall resource allocation programs. Taking this leading role, the government increasingly intervened in the allocation of credit. Over time the government also adopted a complex structure of interest rates intended to give varying amounts of favored treatment to different categories of borrowers.

Policy Loans and Discretionary Allocation of Funds[65]

Policy loans were widely used for allocating funds to specific industries, economic sectors, and at times, to specific corporations with favorable provisions for availability and cost. What is especially noteworthy is that not only policy loans occupied almost half the gross loans extended, but because of the lack of fiscal funds, financial funds were major sources for policy loans. For instance, the average ratio of policy loans for the manufacturing sector by deposit money banks during 1962 - 1980 was 70 percent, compared to 23 percent for fiscal funds. The majority of financial funds that were mobilized were linked to policy loans.

Allocation of low-interest funds means that the interest rate charged is below the market clearing interest rate, despite the fact that Korea's interest rates are rather high. Because of the adoption of the low interest policy, the demand for loans became excessive, and consequently necessitated discretionary allocation of funds at all times.

In Korea, discretionary allocation of funds is particularly significant, because funds are allocated as discretionary under the average condition of over 400 percent liability ratio. It signifies that the relative weight of the debt procured from the government-controlled financial sector is high and indirectly is highly dependent on the government (Sakong 1982). Therefore, discretionary allocation of funds may be considered the basic instrument that can be used in implementing government policies. It can be used as a way to increase responsiveness from a corporation. The corporate sector's debt to equity ratio is rather high. With the cost of this high liability ratio, a corporation is paying the government in the form of responsiveness, because the corporation is quite vulnerable from government's unfavorable measure. This high liability ratio provides a basis for such policy measures. High liability ratio and discretionary allocation of funds have, among other things, the implication of policy measures. Hence, an understanding of such financial relations is essential in comprehending the relations between the business and the government.

Banking, Finance and Industrial Policy

In a financially repressed regime in which banks are often the major source of industrial financing, access to bank credit could be critical for a firm's expansion and survival. A preferential treatment in credit allocation could be a valuable subsidy that cannot be easily quantified.

I would now like to talk about major problems that have occurred as a result of the Korean government's use of the banking system as one of its principal instruments of industrial policy. Given a dualistic financial system and inadequately developed financial markets, financial repression buttressed by persistent inflation and continued low interest rate policy, the growth of the financial sector was much hampered. These were

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65. Policy loans as referred to in this paper mean directed credit.

the problems Korea faced in the course of implementing financial policies for government-led development strategy.

Another problem was created during the course of implementing those financial policies; that is, the weakening of the corporate financial structure. In the early 1960s when we began to make rapid economic growth, our corporations were small and had very limited accumulated funds to start with. Yet we achieved rapid growth. To achieve our goals we had to make large investments. Because our firms had no accumulated funds, they had no choice but to depend on external funds. However, the capital market was not adequately developed; they had to depend on both domestic financial institutions--in most cases banks--and on foreign capital. In this regard the financial structure of our corporations was destined to become highly leveraged.

Financial Reforms: Liberalization and Obstacles

After almost fifteen years of uninterrupted rapid economic growth, during which the government played a dominant role in promoting export-led industrialization, the Korean public became increasingly concerned about the rigidity and pervasiveness of government control and its allocative implications during the latter part of the 1970s. The sheer size and increasingly complex and sophisticated structure of the economy obviously reduced the scope of government control and its ability to administer a system of rigid controls. This skepticism concerning the role of government was further deepened by the excessive investment in heavy and chemical industries during the 1975-79 period that resulted in huge idle capacities in some of the industries. This accelerated inflation and caused a growing current account deficit.

With the promotion of heavy and chemical industries in the 1970s, the advantage of an export-led development strategy became less visible than before in the Korean economy. Instead, economic policy became increasingly rigid and revealed many of the features that are usually associated with import substitution regimes. Korean policy makers had to tighten their control over finance to allocate resources to those heavy industries, because private firms were reluctant to undertake investments with a long gestation period and uncertain rates of return. The government had to provide more incentives to the private investors through preferential loans. To facilitate such a resource allocation, the government had to keep the nominal bank lending rates below the market level with intensive credit rationing, leading to negative real interest rate with rapid expansion of the curb market.

These macroeconomic and policy developments convinced the Korean public, as well as the planners, that a major shift in industrial policy was overdue. Reflecting this need for change, the Fifth Plan (1982-86) emphasized stability, efficiency, and social equity as the basic objectives of economic policy. First priority was given to price stability because it was imperative then to arrest the marked deterioration in Korea's export competitiveness. This objective was followed by economic liberalization, which

would encourage greater openness, autonomy, and decentralization of decision making in all sectors of the economy.

The economic liberalism that swept the nation in the early 1980s was a reaction to the interventionist regime that became rigid and weakened the economy. The setback in the promotion of investment in the heavy industries and the associated misallocation of domestic resources prompted a debate on the need for an overall economic liberalization toward the end of the 1970s. It was then argued that such a massive misallocation of resources in heavy industries could have been avoided had the management of the financial system been left in the hands of the private sector.

Liberalization of the Financial System

Efforts to improve overall economic efficiency through competition and private initiative have led to recent liberalization and reforms of financial systems. In the past, in spite of numerous attempts at reforms, there has been limited liberalization of the financial system. Reforms have focused on freeing both deposit and lending rates; removing some of the entry barriers, reducing the control over financial institutions - both banks and nonbank financial intermediaries - to give more autonomy in day-to-day operations and asset management.

In line with these reform objectives, the government divested its equity share of the five nationwide commercial banks to the private sector. Subsequent to the privatization of the bank, the government also announced its plan to charter joint venture commercial banks with Korean and foreign partners to promote competition in the banking industry and to establish a linkage with international financial markets. One bank was established in 1982; the other opened its doors in 1983.

In 1982 the government also considerably relaxed the requirements for establishing nonbank financial intermediaries, in particular short-term finance companies and mutual savings and finance companies. Within a year, twelve new short-term credit companies and fifty-seven mutual savings and finance companies were chartered. The privatization of nationwide commercial banks continued and was followed by the abolishment of various government directives regulating personnel management and budgetary and other operational matters of commercial banks. The General Banking Act was also amended to limit the maximum ownership of a single shareholder of a commercial bank to 8 percent of the total number of shares, and guarantees and acceptances for a single beneficiary to the maximum of 50 percent of a bank's net worth. These limitations were introduced to prevent any individual or business group from exercising control of a bank so that commercial banks would not be dominated by those large business conglomerates that could easily control the financial institutions. To provide a more competitive environment in the financial market, entry barriers were further relaxed; three new commercial banks were chartered in 1989 and two more in 1991.

In a similarly motivated development, a number of additional nonbank financial institutions were also established. Five regionally based securities investment trust companies were set up in 1989, and in the four-year period from 1987 to 1990, eighteen life insurance companies were established, comprising thirteen domestic companies and five joint venture companies. In addition, four foreign life insurance companies were allowed to open branches in Seoul.

Along with the relaxation of entry barriers and control over bank's asset management, the monetary authorities have diversified the financial services supplied by financial institutions. Commercial banks now issue CDs and sell public debentures under repurchase agreements and the commercial bills they discount. They handle trust business, issue credit cards, and own nonbank financial intermediaries and even securities companies as subsidiaries. In 1981 the monetary authorities established a commercial paper market that was not subject to government control. This market was expected to serve as a bridge between the curb market and the organized financial system and to provide a reference point for setting official interest rates.

Significant progress has also been made in interest rate and credit management. By June 1982 most policy loans were no longer extended at preferential interest rates. The relative share of policy loans has declined as the National Investment Fund, and more recently, short-term export credit has been reduced. Since early 1984 flexibility has been introduced in interest rate management to allow financial intermediaries to set their own lending rates within a given range.

At the end of November 1979 the average required reserves stood at 23 percent of deposits at the deposit money banks that include commercial banks and government-owned special banks. The ratio was gradually reduced to 3.5 percent a year later before it was raised again to 5.5 percent. The substantial reduction was aimed at giving more freedom to the banks in their management of funds and easing the strain on bank profits.

In 1982 the monetary authorities abolished direct control over bank lending through credit ceilings and quotas in favor of an indirect reserve control. This change also signaled the government's intention to refrain from interfering with banks' credit allocations.

These financial reform measures were significant and refreshing developments in Korea that long suffered from financial repression. Most of all, the measures reflected the government's determination to develop a more liberal financial system in which the price mechanism prevails and to open the financial system to foreign competition. Nevertheless, the various reform measures did not alter the modus operandi of financial control to any significant degree. Rather they indicated the direction the financial reform was going to take.

Although Korean policymakers have taken a number of deregulation measures, there has been limited progress toward a fully liberalized financial regime during the past several years. All deposit and lending rates, both at commercial banks and nonbank financial intermediaries are controlled, and the entry requirements are as restrictive as they were in the 1970s. The government has also not been able to forsake its intervention in the asset management of banks and nonbank financial institutions.

Obstacles to the Process of Financial Liberalization

Park (1985) suggests several structural constraints that have hindered financial liberalization in Korea. The government controls finance to influence the allocation of resources in the desired direction. Insofar as the government is prepared to intervene in the allocation of resources, the financial system is likely to be repressed--with government control over the interest rates and asset management of financial institutions --to supplement or substitute in part for the commodity market intervention.

The second reason for insignificant financial liberalization in Korea could be traced to the role of the government as the monopolistic intermediary for international financing (Park 1985). Practically all foreign loans have been guaranteed by the government itself or the financial institutions directly owned or controlled by the government. In case a private borrower defaults, the government is liable for the payment of the private foreign debt. The role of the government as a guarantor of foreign loans provides a rationale for the government to intervene in the domestic financial market.

The third reason for the limited financial liberalization is partly related to the promotion of Korea's export-led growth strategy. Korean policy makers have not been confident about replacing export subsidies with a flexible exchange rate policy. At the same time, it has become increasingly difficult to support exporters in terms of tax exemptions and interest rates and other direct subsidies, because these subsidies could easily invite antidumping and countervailing duties on Korean export goods by the foreign government. One way of avoiding this type of retaliation has been to accord exporters with a preferential treatment in credit allocation, a credit policy that is widely practiced throughout the world.

The fourth reason is the industrial restructuring necessitated by the unsuccessful investment for the development of the heavy and chemical industries. The investment adjustment in these industries that was first implemented toward the end of the 1970s has been the most serious constraint on financial liberalization.

Much of the investment in the heavy and chemical industries was undertaken by Korea's major industrial groups, who dominate the manufacturing sector. Besides, much of the investment that turned into idle capacities was carried out under government direction and inducement, and as such the government could not disavow its responsibility altogether. The government has therefore had to play an important role in the industrial restructuring process. It has used finance as a means for facilitating the restructuring process, thus continuing with its intervention in the financial industry.

Although there was a clear need for overall industrial restructuring, the government has been indecisive and slow in taking necessary measures for fear of the social and political problems, in particular the unemployment issue that the restructuring may cause.

Implications of Korean Experiences and Prospects for Further Liberalization

Korea has achieved rapid economic growth over the past three decades with an outward looking development strategy. The financial policies implemented by the Korean government have played an important role in Korea's economic development. The government chose to manage the financial system, using it to mobilize both domestic and foreign financial resources and allocate these resources in ways to support its high-growth policies. The centralized approach reflected a desire for rapid growth and industrialization, as well as a lack of confidence in the efficacy of a free market.

The structure of the financial system in Korea exhibits several unusual characteristics. Korean firms depend heavily on external financing. As a result, direct financing has been relatively unimportant. In the 1980s, however, the equities market has grown rapidly. Reliance on foreign financing has been large but not unusual for a small, open, and developing country. The mechanism for channeling foreign funds through the domestic banking system was made necessary by the weak credit standing of Korean firms in international financial markets. Korea has had a dualistic financial structure. The informal financial market has played an important role, despite the growth of the formal market and repeated government efforts to suppress the informal market.

Government control of banking institutions had been a principal instrument for guiding and regulating private firms. Most large businesses have ben heavily indebted to one or more banks. While some of the bank loans have been long term, many have been nominally short term with their renewal subject to bank or government discretion.

One lesson worth learning from Korea's experience is that Korea set a good example of controlling inflation successfully by raising deposit interest rates in its early stage of financial reform. The government's experiments with high deposit interest rates in the latter half of the 1960s seem to confirm the efficacy of such policies. The move from a negative to a positive real interest rate on longer-term time deposits in September 1965 led to a dramatic and continuous rise in time deposits for the next several years. When nominal deposit rates were lowered and real deposit rates became negative in the 1970s, the growth of time deposits declined.

Maintaining positive real interest rates is conducive to the mobilization of domestic savings. The low inflation rate and the high real rate of return on financial assets since 1985 have augmented the demand for financial assets relative to the demand for real goods. This has contributed to the stability of the price level.

The establishment of many nonbank financial institutions in Korea has contributed significantly to the stimulation and mobilization of savings. Despite constraints on some financial sources, Korea's financial system grew remarkably in the 1980s, due mainly to the rapid expansion of investment and finance companies and insurance companies dealing in corporate debentures and commercial papers. These non-bank financial institutions were not heavily restricted in the allocation of their funds, and were free, or more capable than banks in circumventing interest rate ceilings on both the sources and uses of their funds. The mobilized large amounts of financial savings and extended much

of the new financing to support the growth of the Korean economy. The shift in financing channels from the highly controlled banks to the much less controlled non-bank financial institutions seems to have contributed considerably to the liberalization of Korea's financial system as a whole.

The control of the interest rate and selective credit rationing policies had been criticized in Korea as the causes of resource misallocations, in particular over investment in the heavy and chemical industries. With the government playing the role of an implicit risk partner, performances of some heavy and chemical industries were disappointing, and creditor banks suffered from large financial losses associated with their restructuring. The cost of excessive government intervention in resource allocation was shared by credit banks, the central bank, and the government, but it fell most heavily on the banks. As a result, the development of the Korean banking system was seriously hampered because of a lack of competition, accumulation of nonperforming assets, and delays in financial liberalization.

The process of financial liberalization has not gone far enough in Korea, and progress has been reversed occasionally. Nevertheless, financial liberalization remains a serious and clear objective in the years to come. Under a gradual process of financial liberalization, a number of deregulatory policy measures are envisaged, of which the most important are as follows.

Interest rates of financial institutions, including banks, will be gradually deregulated. The monetary authorities will deregulate deposit and lending rates of nonbank financial institutions. Lending interest rates of banks will first be deregulated, but their deposit rates will not currently be deregulated to prevent excessive competition among commercial banks to take more deposits by raising deposit rates. Foreign exchange and capital transactions will be liberalized gradually.

The government plans to privatize the Citizens National Bank and Korea Exchange Bank by putting its shares to public subscription. Business conglomerates will be strictly restrained from dominating nationwide commercial banks. Along with financial liberalization, the government also plans to introduce the deposit insurance system or another guarantee fund to protect bona fide depositors in case of bank's bankruptcies.

Pressure for further financial liberalization may come from a number of sources. It may be strongest from foreign sources that may want to have access to the Korean financial services market in return for having allowed access to Korean firms and banks to their own goods and services markets. Pressure to liberalize further liberalization may be maintained by the evolutionary momentum of the rapidly industrializing Korean economy. The considerations that induced the initiation of financial liberalization in the early 1980s continue to be relevant today and will remain so in the 1990s.

The Korean financial market, however, will definitely become more open to foreign investors and financial institutions, while Korean financial intermediaries will also look increasingly to international financial markets to meet the needs of their customers under the new environment of relaxed regulations on foreign exchange and capital transactions. This progress in external financial liberalization will have important implications for reshaping the Korean financial system.

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12

FINANCIAL AND INDUSTRIAL POLICIES: COLOMBIA'S CHALLENGES AND DILEMMAS

María Mercedes de Martínez

Since the beginning of 1990 Colombia initiated a process of profound structural reforms that have involved both the real and financial sectors. Additionally, investment in transport infrastructure to support foreign trade was established as a priority in the development plan. For decades Colombia based its development in the protection of domestic production from external competition and in the promotion of nontraditional exports through various direct subsidies to sales abroad.

The above development scheme enabled the country to grow at accelerated rates up through the decade of the 1970s, reaching an average annual growth rate of 5.5 percent. However, since the beginning of the decade of the 1980s, the economy began to lose its dynamism, with productivity stagnating, and the effort to maintain the growth rate of the economy became more costly both in terms of capital and labor. This led to the conclusion that the development capacity of the country based on import substitution was near an end and that it was necessary to introduce structural reforms to eliminate the anti-export bias inherent in such a policy.

Thus in 1990 a process of import liberalization was initiated, with a reduction and harmonization of import tariffs and the elimination of non-tariff barriers. In this way, items subject to previous license that comprised 41 percent of all tariff items in 1990 and prohibited items, which comprised 1 percent, were transferred to the free import list by the middle of 1991. In December 1989 tariffs on imports were at an average level of 44 percent, including surcharges, and were reduced to an average level of 14 percent by September 1991. In addition, tariff categories were reduced from 22 percent to 4 percent. Thus, in a period of only eighteen months a radical change in the rules of the game for the productive sector was introduced.

Until the end of 1990, this process was accompanied by a devaluation of the real exchange rate of seventeen percent. This devaluation was designed to avoid past experiences in the sense that when similar processes of opening the external sector had been initiated, the surge in demand from imports and speculation against the peso led to a deterioration of the external balances and the subsequent reversal of policies.

Administrative price controls, which may have been justified because of the

monopolistic structure that the previous trade mechanism generated, were eliminated. Simultaneously, the financial sector was submitted to a series of reforms. This sector was characterized by fragmentation, interference in resource allocation, barriers to entry, and, consequently, by an oligopolistic management. Additionally, because of the crisis at the beginning of the 1980s, more than fifty percent of the financial sector was under state control.

Reforms in this sector were oriented on the one hand, to achieve greater competition within the sector and, on the other, to ensure that the allocation and cost of resources responded to market forces. With these objectives forced investments were gradually eliminated and interest rates were freed, particularly those related to credits to the manufacturing, housing, agriculture, and export sectors. Currently, only the cost of credit to small farmers is below the market level, although the differential has been reduced substantially.

Furthermore, new financial intermediaries were authorized, fusion and transformation of existing ones were facilitated; and foreign investment in the sector, which had been restricted since 1975, was opened. Several banks, which came under state control due to the 1982-83 crisis, were privatized. Currently, three of these banks have been sold to private investors, some of whom are foreign.

Regarding exchange rate policies, Colombia was characterized by a severe control mechanism in which the only buyer or seller of foreign exchange was the central bank. Operations had to be channeled through it, and any authorized operations were restricted and subject to all sorts of controls. Without eliminating exchange controls, a freer and more flexible regime was introduced. Two markets were established: a free one for trade in some services, and a controlled one for the rest. However, with regard to the latter, financial intermediaries were given the function of a buying and selling exchange and Colombian citizens were allowed to open and manage accounts abroad, eliminating in this way the previous requirement to reintegrate to and draw from the country all exchange operations.

Complementing the above, restrictions on foreign investments and profit remittance limitations were lifted, and Colombian investment abroad was liberalized. Also, the government decreed a fiscal and exchange amnesty for repatriated capital in order to achieve a greater flexibility of capital markets and, particularly, to strengthen its mechanisms against fiscal evasion.

With regard to the labor sector, a whole series of restrictions, that had existed for decades and that had theoretically been designed to protect labor stability, were eliminated. Through time these had become factors of instability for the labor force. In practice, the impossibility to fire a worker after ten years on the job and the difficulty for employers to determine the cost of labor led the private sector to design all sorts of mechanisms to escape from permanent work contracts and led the public sector to the ruin of many of its companies.

Policy Results

From the point of view of macroeconomic management, the implications of the reforms just discussed are complex. In particular, several unexpected and, to a degree, unexplainable phenomena have appeared that may be partially linked with the sequence of the reforms introduced. There is evidence to suggest that the economy's response capacity is sensitive to this sequence. Noted economists such as Sebastian Edwards consider that trade reforms must precede exchange rate reforms. In Colombia, these reforms were made simultaneously.

It is worth mentioning, first, that imports, which were expected to increase considerably, did not react. On the contrary, they fell 11 percent. Several arguments have been put worth to explain this situation. One is that the private sector, facing a gradual tariff reduction program, postponed its imports in anticipation of further reductions. It has also been affirmed that because of the previous regime, the productive sector maintained high inventories and that, in view of the new policies, it simply increased its rotation. On the other hand, it has been pointed out that the government radically changed the orientation of public spending, reducing the importance of imports. Other explanations are related to the cost of resources. However, none of the above seems fully satisfactory, especially given the fact that Colombia - unlike what has happened in other countries that have introduced similar reforms - has maintained positive growth rates. GNP increased 4.1 percent in 1990 and 2.4 percent in 1991.

Second, nontraditional exports began to grow at unusually high rates from an annual average of 18 percent during the latter half of the 1980s to nearly 40 percent in 1991. Last, the inflow of foreign capital increased dramatically from the end of 1989, which led net foreign exchange resources to increase US$634 million in 1990 and US$1.909 million in 1991. By December 1991 they had reached US$6.420 million, the highest level in the history of the country.

The considerable influx of capital has been partially attributed to interest rate differentials that favor holding assets in Colombian pesos, and partially to the inflow of narcotics related resources.

Short-Term Policies

To confront this situation, which became evident since the beginning of 1990, and given an acceleration in the rate of inflation, which had reached 32 percent in annual terms at the end of 1990, several measures were adopted to prevent the foreign sector expansion from becoming a factor of monetary disturbance that would undermine the stabilization policy.

Measures adopted covered several fronts. The policies discussed above were reversed in some cases and accelerated in others. On the foreign trade sector, while initially the liberalization scheme was to be gradual and culminated in four years, the process was reduced to eighteen months. On the monetary front it was decided to

neutralize the increase in international reserves through active open market operations, which pressured market interest rate levels to 50 percent by midyear, nearly 20 percent in real terms. Domestic credit was severely restricted, and the nominal devaluation of the exchange rate was decelerated. As a result, the differential between internal and external interest rates rose, additionally stimulating capital inflows.

Given the above situation a radical change of policy was introduced in the second half of 1991. First, interest rates were pressured downward by reducing the central bank's demand for funds. Second, several restrictions on domestic credit operations introduced at the beginning of the year were lifted. Third, the Colombian peso was revaluated at 9 percent in real terms.

As a result, by December the bid rate of the Banco de la Republica had been reduced by 13 points, but resources channeled to the bank continued to increase, reaching US$1.650 million at the end of December, which was 76 percent of the monetary base. The fall in the central bank's borrowing rates led to an immediate reduction in the market borrowing rates; market lending rates, however, did not show the same downward flexibility. On the other hand, the combined effect of monetary and exchange rate management led to a considerable reduction of the differential between internal and external interest rates and to a reduction of capital inflows in the last months of the year.

By the end of 1991 the inflation rate, while above the 22 percent target set by the government, had been reduced to 27 percent. On the other hand the producer price index showed a decrease, reaching 23 percent at the end of the year.

Current Economic Management

The principal problems that economic policy faced in 1991 originated in the modifications introduced to the exchange and foreign investment mechanisms. Initially there was no perception that the changes of the nature described above implied changes in the way in which the instruments of economic policy operate.

In the past, under a closed economy with strict exchange control mechanisms and severe restrictions on capital movement, it was possible to manage the exchange rate while simultaneously controlling monetary aggregates. The reforms introduced signified the loss of an instrument of economic policy through the conflict that arises between devaluation and monetary control.

It is well known that in an open economy, when exchange rate targets are set, there is only one level of interest rates compatible with the capital movements required to achieve those targets. Consequently, if interest rate targets are also established, the amount of currency in circulation cannot be simultaneously controlled.

Abandoning control of monetary expansion simply constituted a heresy, given the significance that for decades the country has given to this variable because of its relation to the rate of inflation. Consequently, in front of public opinion, permitting high rates of monetary expansion signified the abandonment of inflation targets, thus failing to take

into account the fact that under the new conditions of the economy there is a weakening of the linkage between prices and quantity of money in circulation.

Under the new scheme, changes in the amount of money in circulation tended more to reflect financial decisions related with portfolio modifications rather than changes related with the purchasing capacity of households. Taking into account these premises and seeking to open a broader space for private investment, but without completely abandoning the thesis that monetary expansion has an incidence on price behavior, a consistent macroeconomic program was designed for 1992.

The economic authorities established a target of 22 percent in the growth rate of consumer prices for the year. To achieve this objective an additional adjustment to the exchange rate policy was programmed, with the purpose of reducing the real rate to levels similar to those of 1986-88, which were considered equilibrium levels. This translated into an additional real revaluation of 5 percent in February, for a total of 17 percent in comparison with July 1991. In this way the exchange rate policy was essentially established to protect the income of the export sector. Consequently, it was determined that any additional adjustments that might be required to achieve consistency in the management of the economy should be handled through interest rate and fiscal policies.

To this end the government has targeted for 1992 a fiscal surplus equal to 0.5 percent of GNP, and has submitted to Congress a fiscal reform package that would increase taxes on the order of 2 percent of GNP. In relation to monetary policy, further reductions in the interest rate of funds borrowed by the central bank were programmed. In fact, this rate has become negative in real terms. It is currently on the order of 18 percent, equivalent to a negative real rate of 9 percent. In addition, the private sector was authorized to contract external credits for a term of more than one year in order to increase competitiveness in the domestic financial markets and lower lending rates. While these have showed a reduction of 8 percentage points in comparison with the highest levels reached in mid-1991, they have not shown the same flexibility as borrowing rates, which have been reduced 15 percentage points.

Regarding inflation, from the cost side there is no reason why the target should not be met, as import and financial costs have been reduced considerably. In addition, imports are totally open, so any surge in speculative actions should be neutralized. However, it is necessary to neutralize the inertial factor - typical of highly indexed economies like the Colombian one - and the trend in the prices of non-tradeable goods, particularly those of public services. These are being adjusted at levels above inflation in order that they reflect the operating and financial situation of these companies, which had substantially deteriorated due to subsidized tariffs, particularly in the energy sector.

Although, as mentioned, the response of wholesale prices has been favorable, consumer prices have been slow to react, and monetary expansion has been higher than what public opinion considers adequate to meet the inflation targets. Thus, the different economic agents doubt the benefits of the economic policies and tend to bet against them. Expectations regarding a further revaluation and a reversal in interest rate policies, in spite of the fact that the authorities have made explicit their decisions to maintain the

income of exporters, have complicated the management of the economy. This point is of utmost importance because of its implications on economic results, and leads me to comment on the basic problems currently affecting the Colombian economy.

First, there is the behavior of private investment, which fell 6 percent in real terms during 1991 and has not shown signs of recuperating in 1992. This situation has considerably affected the demand for imports that, as mentioned above, has been depressed. Surveys of the productive sector attribute this situation to the prevailing uncertainty regarding the changes in economic policy. The reforms, as noted previously, have been far-reaching, and thus it is not surprising that the different economic agents should expect their stabilization before making their investment decisions. However, those same expectations produce disturbing factors to economic management.

Second, capital inflows have increased during the first months of 1992. Because of this and the stagnation of imports, the increase in international reserves, which had tended to subside at the end of 1991, has once again begun to surge. By the end of April the country's external assets were above US$7.000 million, increasing the pressure on the external sector of the economy.

The above situation has led to pressures for changes in economic policy. The debate is already open. There are those who consider that if private investment does not recuperate rapidly it will be necessary for the public sector to occupy, through more investment spending, the space that is not being used by the private sector in order to avoid a future deterioration of the growth rate of the economy and of employment.

Others consider that the inflow of capital will continue, notwithstanding the reduction of domestic interest rates, because these continue to favor the holding of assets in pesos. This perception is intimately related to exchange rate expectations. As previously mentioned, there are those who expect a revaluation. For those who consider that the variation of the nominal exchange rate will approximate the nominal devaluation rhythm of the last few months, which could be considered the most favorable in terms of expectations, savers would still receive more than 7 percentage points for their deposits in pesos in comparison with dollar deposits.

For borrowers, the differential against debt in pesos is around 16 percentage points. Given these significant differentials, those who favor the latter thesis consider it necessary to make additional efforts to reduce domestic interest rates, even suspending borrowing by the central bank and reducing reserve requirements on financial sector deposits. This would not only serve the purpose of reducing capital inflows, which would reduce the pressure on the external sector of the economy, but would be a stimulus to private investment.

Confronting this position, there are those who consider that the inflow of capital is basically related to drug activities or to the fiscal amnesty granted by the government, having nothing to do with interest rate differentials. Those who support this theory favor the introduction of differential exchange rates. In this respect it is worthwhile mentioning that in the tax law, which is being considered in Congress, the proponents have included an article that would authorize the introduction of a 30 percent withholding

tax on income from external services. This initiative has naturally generated great expectations and has contributed to the growth of international reserves.

Finally, others consider that the economic policy is a failure and should be reversed, returning to the previous development scheme. Proponents of this idea include the leaders of the labor and agricultural sectors.

While recognizing that the economy has been subjected to enormous policy changes, and taking into account criticisms that are being formulated and the proposed reforms, the economic authorities, in particular the board of directors of the central bank, are convinced that the economic policies being implemented are the correct ones.

It is obvious that the changes described generate nonconformity and uncertainty. However, there is also an awareness that the response of the economy is not immediate. Consequently, the basic directives cannot and should not be modified in the light of criticism derived from short-term problems.

The credibility of the economic policies depends on the policies' permanency and especially on the results within a prudent time span. These will necessarily be a reduction in inflation and the recuperation of investment, and consequently of imports. These have recently begun to increase. If this trend should consolidate, the economic future will be clarified, as there would be less pressure to revaluate the Colombia pesos, which is the principal factor disturbing economic management.

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LEGAL REFORMS IN THE BRAZILIAN FINANCIAL SYSTEM

Luiz Alfonso Simoens da Silva

In the wake of the process of industrial and financial globalization that began in the 1960s, it was clear that Brazil's financial system was totally inadequate for the new economic stance the country was seeking. Brazil had recently concluded its phase of heavy industrialization and had thus adopted the profile of a mature country. However, it still lacked financial instruments capable of stimulating its growth.

A financial system should have three objectives: to create a broad credit base among companies, businesses and financial institutions; to mediate transfers of loan capital through diversification and accumulation of financial assets that can be used by companies and institutions with surplus positions; and to manage and channel capital into large-scale projects with long maturation terms.

The reform implemented at that time responded to the first two functions. From the point of view of the functional specialization of credit, the financial system reached the point of financing urban real estate expansion and consumption of durable goods. The third function was supplied by the State, particularly through agencies such as the National Bank of Economic Development and some Banco do Brasil financing lines. This occurred because Brazil's financial system did not have a sufficiently large base in the medium- and long-term investment flow, notwithstanding the sharp growth registered by the financial market during the period.

At the end of the 1970s, exhaustion of the development cycle resulted in the financial weakening of the public sector, as evidenced in the fact that its process of internal and external indebtedness became self-generating. During the course of the 1980s constant and growing public deficits drastically reduced loans to the productive sector while increasing volumes of resources were invested in the financing of these deficits. Consequently, the financial system abandoned its role as catalyst of economic development and was reduced to financial broker of public securities.

The degeneration of the financial system's role led it into a situation of decapitalization, illiquidity, and high-credit risk, particularly in the case of public sector banks. As a result, the 1988 Constitution required that new financial system legislation be elaborated. Six months ago, this became a dominant subject of discussion at the National Congress, and innumerable substitute bills have been presented with the intention of regulating the matter.

The considerations presented next will deal with the external panorama: floating interest rates versus securitization and deregulation versus re-regulation. Following that, the paper concentrates the debate on four fundamental points:

- financing of development: financial market versus capital market; the need for macroeconomic coordination
- the functions of the Central Bank
- the safety net; deposit insurance
- foreign capital

World Trends

Floating interest rates versus securitization

In the 1970s, Brazil's private banking network utilized the Euromarket and floating interest rates as long-term financing instruments for the first time in history. Notwithstanding their limitations, law 4595/64, which regulated the national financial system, and law 4131/62, which regulated the movement of international capital, were consistent with developments on the international scene.

Today's tendencies are quite different. The current process of financial globalization is part of the world scale mediation of financial savings, particularly through institutional investors. On the one hand this process and the growing sophistication of financial instruments have contributed to a diversification of risks while, at the same time, they increased the vulnerability of the system, because banking activities could evade national supervisory systems. These new banking activities encompass the futures, options, and swap markets, gratings of guarantees in the form of standby loans and other operations registered off-balance-sheet, many of which are typical capital market transactions. Credit risk was replaced by negotiation of bonds, creating a large secondary market through the pooling of the banking system.

On the basis of studies dating to 1975, some countries are already unifying supervision of financial institutions and the capital market. Under the auspices of the Bank for International Settlements (BIS), creation of the Basle Committee defined guidelines for the division of responsibilities among national supervisory authorities known as the Basle Concordat.

Thus, it is understood that the developed world stimulates international cooperation in an effort to impede institutions from arbitration among distinct national regulatory structures. Many of these countries have gone so far as to elaborate new banking laws recently, in an effort to standardize rules. In Western Europe, for

example, all financial institutions authorized to operate in one country may, as of January of next year, open branches in any other member country of the community. Such branches will operate in such a way as to obey the precept of national treatment. Minimum capital, leverage, and risk concentration are also being standardized.

Prudential regulation

In the wake of innumerable and not always successful deregulation efforts, a debate began in 1986 on the need for re-regulating financial institutions. The term re-regulation should not be understood in the sense of returning to the former type of controls applied by the state, but rather the adaptation of regulatory systems "to a more sophisticated, flexible, diversified and internationally integrated financial environment," with the aim of reforming and enhancing preventive and protective supervisory mechanisms.

Basically, preventive financial regulation deals with market access conditions, the activities permitted to banking institutions, adaptation of capital and liquidity, concentration of loans and risks in a country, the degree of exposure in foreign currency, and periodic inspection. What this represents is a strengthening of the requirements for operational authorization and liberalization of economic activity in the strict sense.

It is not enough to apply preventive measures. Regulations must also encompass protective measures to safeguard interests whenever prevention is not sufficient, though this could result in increased risk of moral hazard. Some countries, such as Chile, the United States, and Japan, place inspection at the center of the supervisory system. Adopting a contrary stance, the United Kingdom has abandoned inspection in favor of a supervisory system based interviews with managers of financial institutions and backed up by data bases.

A synthesis

Securitization has resulted partially from macroeconomic conditions, advances in the information sciences, deregulation of national financial systems, and the emergence of institutional investors as controllers of international liquidity.

The inflationary instability of the 1970s introduced an element of volatility into interest and exchange rates, increasing the market and credit risks of financial and non-financial companies. This, in turn, led to cutbacks in the terms of asset and liability operations and increased competitiveness among banking and nonbanking institutions in those countries in which institutional segmentation predominated. This was the launching platform of the rapid growth of the universal banks.

Technological progress created new and lower-cost financial services, benefiting institutions operating on the capital market (stock and bond subscriptions) and in the direct flow of resources among nonfinancial companies (commercial papers and medium-

and long-term bonds). This revolution resulted in a narrowing of the role of commercial banks as the institutions responsible for channeling capital flows. Syndicated loans declined as operations with bonds and other papers expanded. If floating interest rates were the great innovation of the 1970s, securitization was the key word in the 1980s. Consequently, banks have ceased dedicating their efforts to the traditional functions of receiving deposits and supplying credit and have become typical investment banks and brokerage houses, while other institutions have assumed the roles attributed to banks.

For Brazil analyzing the impact of all these external factors on the domestic economy, particularly in the framework of national financial legislation is important. We will now discuss this matter, though not in an exhaustive manner.

Financial and Capital Market Integration: The Legal Aspects

In the context of Law 4595/64, which remains in force, a National Monetary Council, subordinate to the executive branch, regulates the national financial system, and the central bank is the executor of its decisions.

Having expanded to an inordinate number of members in response to the pressures applied by different interest groups, the National Monetary Council has deviated from its original functions, particularly in releasing funding to innumerable economic activities without adequate budgetary coverage. For this reason, the council was abolished by the new Constitution and will remain active only until a new complementary financial system law is promulgated.

In practical terms there are two currents of thought that seek to resolve the problem. On the one hand, the rapporteur of the congressional committee now dealing with the problem has assumed a liberal stance aimed at sharply reducing - though not excluding - the model of public and development banks, particularly in the areas of agriculture and housing. This system was plunged into a crisis at the same time that the federal and state governments that control these institutions went into financial bankruptcy. In this case it is thought that the levels of planning should be informal, for it would not make sense to regulate the financial and capital markets in a single complementary law.

At the same time, there are bills -- which I would term structuralist -- that recreate the National Monetary Council under the name Financial Policy Board. The board is composed of eight members: four from the ministry of the economy and four from the central bank. Central bank directors would have a fixed tenure, and the minister would be given tie-breaking power. The boards of directors of the central bank, the Securities and Exchange Commission (responsible for regulating the capital market), and insurance, capitalization and open private social security institutions would be subordinated to the Financial Policy Board, which would regulate the national financial system. This system would provide macroeconomic planning and coordination, and would include the financial system and capital market. The most frequently used argument in favor of this position is that Brazil is now swimming against the tide of

international tendencies and this system deals with the financial and capital markets as if they were separate and independent entities, without giving due consideration to the fact that in Brazil the capital market is commanded by five or six large banks.

Functions of the Central Bank: A Degree of Autonomy

In the structuralist framework, aside from coordinating the different segments through the Financial Policy Board, currency, credit, and exchange should be integrated. In view of the increasing weight of institutional investors, there must also be concern with the long-term, and not only with short-term monetary policy. Integration of the executive branch and the central bank is a consequence of the rejection of an autonomous central bank that would be charged with monetary, credit, and exchange policy.

For the most part the central bank would be restricted to the classic function of stabilizing currency. As an institution it would not have the task of intervening in other spheres. However, as a member of the Financial Policy Board it would exert strong influence on those policy decisions that would have to be taken to stabilize the long-term trajectory of the economy. The central government would be composed of the treasury and the central bank. The board would be seen as a level of the central government, and membership would not be extended to the private sector. Though the central bank would not be independent, it would certainly be strong.

In the liberal view the autonomy of the central bank in the administrative, financial, asset, and technical fields is made explicit. Administrative autonomy is sought by granting fixed tenures to a Deliberative Council and, therefore, to the Executive Board of Directors. The council would be composed of eleven members who would be proposed by the president of the republic of Brazil and nominated by him once they have received approval of the Federal Senate in secret voting, preceded by public hearings. Their tenure would be six years, and renomination would be permitted. The Executive Board of Directors of the central bank would be composed of five members, all of whom would also be members of the Deliberative Council. Among them would be a director-president, who would also preside over the council. The nomination to this post would be proposed by the president of the republic for approval by the Federal Senate in secret voting, after public hearings.

In most central banks there is considerable financial and asset autonomy in relation to the government, based on the fact that the monetary authority has its own assets and elaborates and executes its own budget. At the international level one does not question the validity of transferring central bank profits to the treasury, for this is seen as offsetting its power of issue monopoly. In the Brazilian case, however, there are peculiarities which will be discussed later.

Finally, technical autonomy means the freedom to perform its functions in relation to the government. In the international context there would seem to be a high degree of independence only in the central banks of Germany, Chile, and the United States. However, this does not mean that there are no coordination mechanisms, nor that these

institutions are immune to political pressures. In the Brazilian case, monetary policy is seen, above all, as an area for which the central bank is specifically responsible.

Independent of the content of the complementary legislation, three major concerns rooted in past policies will have to be resolved for the Central Bank of Brazil to attain a position of autonomy: (a) its relationship with the national treasury; (b) its relationship with the state treasuries, thus involving the activities of the state banks; and (c) its relationship with the market.

In comparison with other countries, the federal treasury/central bank relationship in Brazil has some peculiarities. During the process of federal government assumption of the debt in the 1970s and 1980s, a major part of the external debt was taken on by the central bank. The dollarization of the liabilities of the central bank balance sheet generated the need to constitute a federal security portfolio in the central bank's asset structure so that it could hedge its operations. The break in the bond between liabilities pegged to the dollar and assets indexed by internal inflation led to the generation of either very large profits or sharp losses.

In more specific terms, the profits registered by the central bank have two components: the first, just as in the case of any other central bank, is the result of seignorage, while the other is born of the specific symbiosis of its accounts with the treasury and consists exclusively of book profits. The first component can and should be transferred to the treasury, which will make use of it in the manner deemed most adequate. Until the transfer of the external debt to the Treasury is resolved - a process now under way - the second component should be used exclusively for the purpose of reducing the bank's public securities portfolio, to avoid the possibility of it becoming a form of indirect financing for the treasury.

In any document under discussion today, there is a broad consensus with respect to this matter. The central bank must transfer its external liabilities to the treasury in such a way that the transfer of results be restricted to that derived from its issue power. Evidently, a period of transition will be necessary, since this is a question of interest to foreign creditors, who seem receptive to the concept.

The second major problem faced today is the central bank's, relationship with state governments. Also as a consequence of past policies, the state governments are burdened by voluminous securities debts, coupled with a low degree of market confidence. Any state that does not liquidate its daily securities position has that debt automatically debited against the reserves of the state bank, thus obligating the central bank to broaden its rediscount operations. From this point of view, the standard of public sector financing inherited from past governments makes the state banks passive and subverts central bank monetary policy from within. However, one should emphasize that there are inefficiencies in the public financial sector that are camouflaged by the state debt, thus creating a perverse vicious circle in which the state weakens the bank and, in turn, is weakened by the bank.

The solution to this question is not to be found in financial system legislation. Renegotiation of the security debt of the states is a prerequisite for the regulating of this

law. Without this renegotiation, which is already under way, the central bank will be unable to achieve the degree of freedom required to conduct monetary policy.

Basically, independence in relation to the market involves the composition of the Deliberative Council of the central bank. The proposal put forward by the rapporteur defines eleven members, as stated above, of whom five would be members of the board of directors of the central bank. No mention is made of the origin of the other members of the council. Proposals have been brought forward calling for equal membership on the part of the executive branch, the central bank, and the private sector, as stated in the original version of Law 4595/64. Other proposals would divide the powers of the Financial Policy Board between the central bank and the ministry of finance, though this would certainly jeopardize the intended independence of the bank. In the light of the lack of definition of the specific responsibilities of the council, one could also opt for a board of directors with five or six members and an informal coordinating committee with executive branch representation, as exists (or existed) in Chile. In this case, the Deliberative Council would be redundant.

The bill under discussion would seem to incorporate the latter suggestion by determining that the ministry of the economy will preside over that body, with the objective of coordinating financial and exchange policies and making them interactive with central bank monetary policy. However, there is a potential conflict between the council of the ministry of the economy and the Deliberative Council of the central bank.

Protection Mechanisms and Deposit Insurance

In Brazil, implicit insurance has always been provided by the monetary reserves in the central bank to financial institutions in crisis. However, the Constitution has determined that this will no longer occur and that a deposit fund or insurance system should be regulated. This does not mean that the country is obligated to have a fund composed of explicit resources, since it is possible to base insurance on the commitment of ad hoc coverage on the part of associate institutions as needed. Therefore, a discussion is now going forward on the role and principal characteristics of this insurance (both implicit and explicit), evidently involving its legal nature (public or private), the conditions for adherence (compulsory or voluntary), the scope of coverage (total or partial), and the form of charging the premiums (fixed or variable, according to the degree of risk).

The current trend is toward a private and compulsory mechanism. Definitions have yet to be reached on its characteristics, scope of coverage, and charging of premiums. Though the existence of complex problems is acknowledged, implementation is considered a priority matter. Among the complexities is the system's interaction with the central bank inspection system.

International experience in the area of inspection demonstrates that a number of central banks, such as those of Germany, Canada, Norway, Sweden, and others, have no inspection. The central bank has intervention powers in countries such as England,

Italy, and Japan. In the United States, inspection authority is shared by several government and market levels.

There is an article in the bill under discussion at the National Congress that, just as in the past, grants the central bank specific authority to inspect financial system member institutions. However, based on a constitutional impediment, the central bank can no longer channel monetary reserve funds into the reorganization of bankrupt financial institutions (implicit insurance). Consequently, the protection mechanism (explicit insurance) will have to be composed of private resources. Obviously, a private institution, operating with private resources, will desire to participate in the system with its own inspection mechanisms.

Thus, one can conclude that institution of a deposit insurance system will alter the entire structure of inspection of national financial institutions. This does not necessarily mean that inspection will no longer be a central bank function, thus transforming it into a classic institution. However, it will certainly lead to a profound review of the current inspection system, for it would not make sense to reserve this function exclusively to the central bank.

Treatment of Foreign Capital

The treatment to be dispensed to foreign banking institutions must be seen in light of two principles: reciprocity and national treatment. Both apply as much to access conditions as to the criteria of prudential regulation.

The concept of reciprocity is highly complex, because it implies restricting the activities of foreign banks in the country to those permitted to national banks abroad. The complexity of the matter increases when one perceives that the criterion can be applied unilaterally. On the other hand, the principle of national treatment refers to a non discriminatory rule or, in other words, that the laws on foreign banks are similar to those applied to national banks, thus creating greater competitiveness in a traditionally oligopolistic sector.

In the bill under discussion in Congress, there is a clear tendency toward the criterion of reciprocity. "With due observance of international treaties and agreements, particularly with respect to the criteria of reciprocity," the executive branch will be empowered to authorize financial institutions, investment companies, and insurance companies constituted abroad, to operate within the country. It will also have the power to authorize the participation of persons resident or domiciled abroad as controlling partners in the capital of such institutions.

It may perhaps be preferable to adopt national treatment as the objective to be pursued, while applying the principle of reciprocity only to those cases in which the regulations of the foreign country are more restrictive than those in effect for financial institutions in Brazil.

Conclusions

At the external level the globalization and internationalization of domestic financial systems point to an increasing degree of integration between financial and capital markets. This would seem to indicate the need for complementary legislation that provides for a level of planning and coordination of macroeconomic policies. In the structuralist framework under analysis, this level exists, though it is not included in the document being debated in Congress. In the liberal version presented to Congress by the rapporteur, coordination should only exist between the ministry of the economy, which is responsible for fiscal policy, and the central bank, which implements monetary policy. There is no bond between the latter and the capital market and insurance, capitalization, and open private social security companies.

This difference leads one back to the discussion of the independence or autonomy of the central bank. If emphasis were to be given to a level of broad coordination, this would apparently diminish central bank autonomy. However, at the same time, one could imagine a strengthening of the monetary authority, provided that it restrict itself to classic functions in its operations and participate in the process of macroeconomic planning alongside the ministry of the economy.

On the other hand, it may well be impossible to grant autonomy to the central bank without first resolving problems rooted in the past that have vastly enlarged the dimensions of the central bank's functions. One must be attentive to the fact that, at the internal level, the financial imbalance of the public sector hampers renewal of the economic development process as well as implementation of central bank monetary policy. Only after defining the central bank's relationship to the national treasury and state banks will it be possible to reflect upon the autonomy of monetary policy.

Another highly important concern is the implementation of a system of protection for savings. The fact that most deposit insurance systems were implemented in the 1970s and 1980s and that the Federal Deposit Insurance Corporation is in a process of restructuring clearly points to the increased risk of banking activities. The days in which the private banking network, operating in the Euromarket framework, assumed the role of financing agent of long-term operations on a world scale are long past. The current tendency is to give enhanced value to financial mediation operations and the strengthening of the capital base. Coexisting with permanent instability, the Brazilian financial system will also have to adapt to these new trends: greater capitalization and rapid regulation of deposit insurance.

Finally, to speak of the increasing participation of foreign capital in the national market is to deal with access criteria and the scope of its activities. There is a consensus on the need for liberalizing access. What is under discussion is its sphere of operation and a period of transition in which the country will have to adapt to the new rules of the world community.

14

THE PROVISION OF LONG-TERM FINANCE IN POSTWAR JAPAN

Masahiro Sugita

In Japan's postwar economic history, it is generally considered that the 1946-55 period corresponds to the reconstruction era and 1956 to the latter half of the 1960s, the high-growth era. In the latter era, Japan achieved almost 10 percent year-to-year average real GNP growth based on fixed capital formation in heavy industry and related exports. Various factors contributed. Among them, the supply of long-term low-cost funds to industry played an especially important role.[66]

The mechanism by which long-term finance from private and government financial institutions was channeled to industry during these periods might be of interest to seminar participants. First, the categories of financial institutions charged with providing long-term finance will be described; second, the economic and financial circumstances under which such financial institutions were established; third, the mechanism of extending long-term finance; fourth, the results of such financing; and lastly, an evaluation.

Financial Institutions Responsible for Long-Term Finance in Both Eras

The general background to the economic and financial situation was as follows:

- The corporate business sector suffered a fund shortage, as did the personal sector, in the first half of the reconstruction era. This shortage, however, turned to surplus thereafter.

- Indirect financing predominated, principally because the capital market was not fully developed. The stock market tended to be speculative, and the bond market was underdeveloped due to government regulations.

66. The fulfillment of postwar economic plans, such as the income doubling plan depended on the political stability that was realized by the ruling conservative party.

Therefore, banks and other financial institutions played a pivotal role in providing finance for industry.

- Financial institutions specifically charged with providing long-term finance included both government and private institutions (Figure 14.1).

In the reconstruction era (1946-55), it was mainly government financial institutions that provided the bulk of the necessary financing, including the Reconstruction Finance Bank (stipulated to function for only three years), the Export-Import Bank of Japan, and the Japan Development Bank (which succeeded the Reconstruction Finance Bank in 1952), among others. During the period, private long-term financial institutions, such as long-term credit banks and trust banks, did not fully function. Long-term credit banks had only just been established, and trust banks had only just introduced their main fundraising instrument. In the meantime ordinary banks could not provide long-term credit, because the funds they handled in this period were only short-term, although they historically dealt with long-term and short-term funds.

In contrast, during the high-growth era, private financial institutions played the principal role. During the first ten years, long-term financial institutions came into their own and fulfilled their original function. These institutions were joined by the ordinary banks thereafter, meaning the simultaneous supply of long-term credit by two categories of private financial institutions. Meanwhile, government financial institutions generally played a qualitative complementary role by meeting fund demands from various areas not adequately serviced by private financial institutions.

Economic and Financial Circumstances

Reflecting the fund shortage in the personal sector, the Reconstruction Finance Bank was established in January 1947 as a temporary government financial institution entrusted to make new loans. Its establishment also mirrored a big drop in industrial production, rampant inflation, and the malfunctioning fund supply through existing financial institutions. Its aim was to provide finance according to the government's priority production policy.

At the end of the war Japanese industrial production was only 10 percent that of the average achieved during 1935-37, and inflation was rampant due to the payment of wartime indemnities, which added to swollen assets coming from the payment of wartime wages. Under these circumstances it was feared that the Japanese economy would collapse due to a vicious circle stemming from the contraction of production reflecting the slow recovery in key industries such as coal mining, iron and steel, and chemicals. Accordingly, at the end of 1946 the government adopted a priority production policy and a corresponding financing scheme. Insufficient production by the coal mining and iron and steel industries hindered the overall recovery of industrial production and hence, the

Figure 14.1 Finance Mechanism Through Financial Institutions in Postwar Japan

		Supply of Finance: Institutions	Mechanism	Reciepiants of Finance
Reconstruction Era (1945-55)	Government financial institutions	Temporary institutions (Reconstruction Finance Bank)	Issue of debentures underwritten by the Bank of Japan	Industries, the focus of priority production policy (coal mining, iron and steel, etc.)
		Permanent institutions (Ex-Im Bank, Development Bank, others)	Borrowing from the Trust Fund Bureau	Four key industries
	Private financial institutions	Specialized long-term financial institutions (especially long-term credit banks)	Specialized long-term financial institutions ← Ordinary banks ↑ Maturity transformation	Large enterprises (private financial institutions, mechanism not working well)
		Ordinary Banks	Raising deposits from the private sector	
High-growth Era (1955 - latter half of 1960s)	Government financial institutions	Permanent institutions (Ex-Im Bank, Development Bank, others)	Borrowing from the Trust Fund Burea	Declining industries, small and medium-sized enterprises, new companies, social infrastructure
	Private financial institutions	Specialized lon-term financial institutions (especially long-term credit banks)	Specialized long-term financial institutions ← Ordinary banks ↑ Maturity transformation	Heavy industry, especially chemical companies and large enterprises
		Ordinary banks	Raising deposits from the private sector	

first priority went to reducing this obstacle. The private sector was not able to generate necessary funds for equipment investment and working capital under severe inflation and the limited supply of central bank credit.

Subsequently, in 1950 and 1951 other government financial institutions, such as the Export-Import Bank of Japan and the Japan Development Bank, were successively founded. The background to the establishment of these two banks reflected several factors, such as the suspension of new loans by the Reconstruction Finance Bank in the fall of 1949, the lack of export finance, obsolete equipment in key industries, the desirability of utilizing budget surplus associated with the Dodge Plan (a wide-ranging program of stringent fiscal and monetary policies effected by order of the Supreme Commander for the Allied Powers in March 1949), and other factors. The Dodge Plan also advocated the promotion of exports at the expense of satisfying domestic demand.

In the process of economic expansion, triggered by special procurements by the United States and the increase of exports following the outbreak of the Korean War in June 1950, key industries felt the need to replace obsolete plant equipment. On the financial side, as tight money and the suspension of new loans by the Reconstruction Finance Bank (under the Dodge Plan) interrupted the supply of funds for fixed investment, the authorities recognized the necessity of promoting capital accumulation. In addition, on the fiscal side the budget surplus following implementation of the Dodge Plan gave birth to the idea that the surpluses should be appropriated to set up government financial institutions to meet the growing financial needs of industry.

Furthermore, in 1952 long-term credit banks (LTCBs) were reorganized. Functionally, they appeared similar to the prewar specialized banks established by special laws (other than the banking law) and under the control of the government to accomplish national objectives. LTCBs appeared on the stage to support postwar reconstruction. Also in 1952, trust banks, converted from prewar trust companies in 1948, were allowed to sell loan trusts to gather long-term funds. These moves were intended to not only cope with the big increase in fund demand from heavy industries (chemical and electric power in particular) for investment in plants and equipment necessitated by special procurement and export increases in the wake of the Korean War, but also to separate their own business fields from those of other types of financial institutions.

During the High-growth Era, the pursuit of export and fixed investment-oriented economic policies resulted in a greater fund shortage in the corporate business sector. On the other hand, financial assets were mostly short-term in nature[67]. This led to the formation of a financial system with functional segmentation and various regulations. Among them, interest rate regulation was the most influential. The heart of interest rate regulation was that of affecting deposit rates based on the Temporary Interest Rate Adjustment Law (effective December 1947). This resulted in an artificially low interest rate policy, under which private financial institutions could gather low-cost deposits and in turn supply the corporate business sector with low interest rate funds.

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67. This was partly influenced by sluggish consumer loans at that time. The public had to keep financial assets of a short-term nature in the event of unexpected expenditures.

The Mechanism of Extending Long-term Finance by Government and Private Financial Institutions

During the reconstruction era, government financial institutions raised funds and extended financing on the basis of overall national policy, and hence the Reconstruction Finance Bank operated mostly outside the market.

In principle the Reconstruction Finance Bank's funds were to come totally from government subscription to its capital, but this was far less than originally planned. Instead, the private sector was expected to become the main source by subscribing to the bank's one-year discount debentures. Rampant inflation, however, prevented individuals and private financial institutions from underwriting these debentures, and hence the Bank of Japan mainly took them up in response to a government request for cooperation. As a result, by the end of March 1949, the Bank of Japan underwrote more than 70 percent of issued debentures exceeding 109 billion yen (US$300 million), with the rest underwritten by the private sector (issues were effected for two years from February 1947 to March 1949). Funds raised were extended to four key industries (coal mining, electric power, fertilizers, and iron and steel) under the priority production policy. Reconstruction Finance Bank funds were used for both equipment investment and operating capital, with the bulk of the latter being used to cover business losses. Lending rates were determined with the approval of the Reconstruction Finance Committee, headed by the minister of finance, and levels were kept lower than those prevailing at private financial institutions.

At the Japan Development Bank (representing, in this paper, a proxy for all government financial institutions from the latter half of the reconstruction era), interest rates applied to funds raised, and loans were politically determined; business fields and loan amounts were planned every fiscal year in consultation with the government authorities concerned (as part of the Fiscal Investment and Loan Program),[68] in accordance with social needs and the government's policy objectives. The Japan Development Bank thus operated outside the market.

Initially, sources of its funds were limited to government capital subscription and internal funds such as retained earnings. In the second year, however, borrowing from

68. It is said that the artificial low interest rate policy was systematized around 1957, when the so called "window guidance" of the Bank of Japan commenced for private financial institutions. The choice of a low interest rate policy was made possible by such factors as the existence of financial regulations and the low level of financial assets held in general (thus, deposit volume did not decline as opportunities to utilize financial assets were limited under interest rate regulation).

the government [69] was allowed upon amendment of the Japan Development Bank Law. Because of this, the Trust Fund Bureau of the Ministry of Finance, mainly financed by the postal savings system, became the bank's principal source of funds. Lending rates were the basic rate and the special rate[70] (lower than the basic one). The basic lending rate level was determined considering the rates of private financial institutions, so there was not wide differential between them (later, in the high-growth era, the basic lending rate was set at the same level as the private financial institutions' prime rate for long-term loans). The special lending rate, introduced in fiscal year 1952, was applied to specific industries.

Cofinancing[71] with private financial institutions (especially long-term credit banks and city banks) was, from the beginning, considered an important lending technique, since the Japan Development Bank was set up to supplement and encourage private financing. The cofinancing interest rate of private financial institutions was the long-term prime. The Japan Development Bank drew its resources from the Trust Fund Bureau[72] which in turn relied on various resources, including post office life insurance

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69. Upon establishment of the Japan Development Bank, the borrowing of funds from outside sources was prohibited. This stemmed from the fear that, if implemented without limit, borrowing could impair the economic stability, causing inflation, as in the case of the Reconstruction Finance Bank's financing. In 1952, however, the Japan Development Bank Law was changed and only borrowing from the government and overseas financial institutions was allowed. When borrowings were effected from the government it could control loan amounts from a budgetary viewpoint, thereby avoiding aggravating inflation, depending on the kind of resources that were mobilized. It was also considered that borrowings from foreign financial institutions through the Japan Development Bank (which would serve as a core institution for introducing such capital) could make up for the low level of capital stock in Japan (Japan Development Bank 1988).

70. Principles regarding application of the special lending rate were as follows: (a) industries to which it was applied were key ones specified by the government; (b) a lower rate could lead to lower costs; and (c) its application should not jeopardize profits of either the Japan Development Bank or private financial institutions (Japan Development Bank 1976).

71. The lending policy set forth in April 1952 by the Japan Development Bank adopted a positive policy regarding cofinancing, recognizing that one of its main purposes was to supplement the roles of private financial institutions by catering to areas they had difficulty in looking after (Japan Development Bank 1963).

72. In the Fiscal Investment and Loan, which supplies funds to government financial institutions, the Trust Fund Burea's wight increased from 51 percent in 1955 to 74 percent in 1970, reflecting the increase inpostal savings and welfare pension. In the meantime the weight of funds from Postal Life Insurance declined from 16 percent to 11 percent and that of the Industrial Investment Special Account from 5 percent to less than 1 percent for the same period (Teranishi 1982). In addition the Japan Development Bank's own capital 234 billion yen since 1955) existed for financing. it is said that in the latter half of the 1950s borrowings from the Trust Fund Burau and own capital became fixed as financing funds (Japan Development Bank 1976).

and welfare pension, but whose main source of funds was postal savings.[73] The postal savings' deposit rate was lower than that of the five-year coupon debentures, the main source of funds for LTCBs. Thus, the Japan Development Bank was able to extend loans at relatively low rates, lower than those of private financial institutions.

In the high-growth era, private financial institutions, especially specialized long-term financial institutions, were very active while government financial institutions complemented them "qualitatively" in the sense that they met business and social needs left untouched by profit-oriented private financial institutions.

The fund-raising mechanism of LTCBs was that of the maturity transformation of short-term liabilities of other financial institutions to the long-term liabilities of LTCBs. In practice, LTCBs issued five-year coupon debentures[74] and ordinary banks (among others, city banks[75] purchased them with short-term funds (absorbed in the form of short-term deposits). Here it should be stressed that the mechanism was supported by interest rate regulations and other economic policies that generated an ascending yield curve between short- and long-term interest rates.

The maturity transformation mechanism of trust banks was their selling loan trusts (two- and five-year terms) to nonfinancial sectors, mainly individuals, to directly raise stable funds. Trust banks, as well as LTCBs, provided industry with funds to meet long-term investment and operating capital requirements.

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73. Of the fund resources of government financial institutions, the issue of government guaranteed bonds is the most costly and issuer's interest rate is close to the market rate. From the viewpoint of cost, borrowings from the Trust Fund Bureau and General Account and Industrial Investment Special Account subscriptions are preferable. Of these, capital subscriptions are in fact used as free funds for government financial institutions. Among total fund resources the weight of borrowings from the Trust Fund Bureau and the issue of government guaranteed bonds increased while that of others decreased. Thus, funding costs rose, leading to direct subsidies from the General Account to government financial institutions (Teranishi 1982).

74. Bank debentures were exempted from as many institutional constraints as possible to facilitate issuers' fundraising; for example, with regard to the upper limit on total issue amount they were permitted to be issued up to thirty times an issuing bank's capital and reserves, whereas ordinary industrial bonds, in principle, up to the lower of either the total of capital and reserves or net assets (exemption from Article 297 of the Commercial Code (Nihon Keizai Shimbun 1982).

75. City banks were the biggest absorbers of five-year coupon bank debentures issued by long-term credit banks. The background was as follows: as they were traded in the market and accepted as collateral for Bank of Japan loans as well as being collateral in the call money market, city banks held these debentures to meet any unexpected fund demand; and city banks also wanted long-term credit banks to finance their own *keiretsu* companies by acquiring bank debentures so as to avoid a deterioration in their overborrowed positions (Long-Term Credit Bank of Japan 1977).

Results of Long-term Financing

In the case of the Reconstruction Finance Bank, its low lending rates created huge loan demand, and a great portion of its loans were disbursed during 1947-49. In march 1949, outstanding loans reached 132 billion yen, corresponding to one-third the total loans (408 billion yen) of all banks, city, regional, long-term credit, trust banks, and one specialized foreign exchange bank). In retrospect, it could be considered that the Reconstruction Finance Bank provided an impetus to the recovery of production of key industries but failed to control inflation.

The bank's financing methods were undeniably the main cause of rampant inflation. Loans were funded mainly through the Bank of Japan's underwriting of its debentures; half of the funds extended for operating capital was used to make up for business losses just to keep corporations afloat. The bank's lending operations led to an increase in high-powered money and the aggravation of inflation. (Postwar inflation was later controlled through rigid fiscal policy focusing on budget surpluses under the Dodge Plan.) Moreover, the Sho-Den scandal, a bribery case, was made public.[76] All this reinforced the negative image of Reconstruction Finance Bank loans.

In the latter half of the reconstruction era, government funds were an important element of financing. Of the total supply of new funds for industrial equipment investment in fiscal 1952-55, government funds (including those of the Japan Development Bank) accounted for almost 30 percent on an all-industry basis and almost 40 percent for four key industries (table 14.1), much higher than figures (almost 20 percent) in the high-growth era. In addition to the four key industries,[77] the Japan Development Bank initially made extensive loans to the shipbuilding, automobile, electric machinery industries, and others to increase productivity, rationalize production, reduce imports, and improve economic self-sufficiency.

After the enactment of the Long-Term Credit Bank Law of 1952, the Japan Development Bank began focusing its loan objectives on reinforcing electric power supply, promoting the capacity of Japanese shippers to carry Japan's exports, rationalizing production in such industries as coal mining and steel, and fully exploiting agricultural, fishing, and synthetic fiber resources to improve self-sufficiency. This change stemmed from a clear division between government and private financial institutions regarding corporate investment financing from 1953 onwards. Meanwhile, special lending rates of the Japan Development Bank were applied to almost 70 percent

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76. Showa-Denko Inc. obtained large loans from the Reconstruction Finance Bank in 1947 for reconstructing a fertilizer plant. The inflation at that time caused the company to again seek another large amount loan (2.6 billion yen) from the Reconstruction Finance Bank. In winning approval, the president of the company was suspected of bribing politicians, high officials, and businessmen, and the case became a political issue in 1948. It became so heated that the Cabinet was forced to resign.

77. During fiscal 1951-56 over 80 percent of loans made by the Japan Development Bank went to key industries such as electric power (40 percent) and marine transport (20 percent) while less than 20 percent to other industries). (Japan Development Bank 1963).

of its loans; in fact, they were applied mainly to loans to the electric power and marine transport industries. Beginning around 1955 financing by specialized long-term financial institutions got under full steam. At the end of March 1955, long-term loans (loans of more than one year) of long-term credit banks reached almost 90 percent of their total loans (table 14.2).

The relationship between LTCBs and city banks, in terms of maturity transformation, differed in the 1955-65 period from what it became in the latter half of the 1960s. In the former period, city banks provided LTCBs with funds for long-term lending by buying LTCBs' long-term debentures for their portfolios. In return, city banks asked LTCBs to lend to their customers. In the latter half of the 1960s, as city bank purchases of LTCB debentures declined (table 14.3), owing to efforts to absorb government bonds newly issued from 1966, LTCBs had to find buyers for their debentures among nonfinancial institutions like institutional investors and business firms.[78] This change induced LTCBs to find borrowers for their funds among small and medium-size companies, at the same time reducing reliance on enterprises belonging to city bank groups (keiretsu) as borrowers.

Table 14.1 Supply of Investment Funds (FY 1952-55)

	All industries	Four key industries
Stock Market	11.9	6.5
Stocks	10.0	4.8
Industrial bonds	1.9	1.7
Private Financial Institutions	59.8	56.3
All banks	38.8	46.7
Others	2.0	9.6
Government financial institutions	28.3	37.2
Japan Development Bank	13.3	24.1
Others	15.0	13.1
Total	100.0	100.0

78. In the decade from 1965, the ability of nonfinancial institutions to absorb LTCB bank debentures expanded relatively well, since the yield to the subscriber was higher than that on long-term government bonds. In addition, the liquidity of the former was the highest among all debentures and bonds (Nihon Keizai Shimbun 1982).

Table 14.2 Weight of Long-Term (over one year) Loans to all Loans of City Banks and Long-Term Credit Banks

Percentage

End fiscal year	City banks	Long-Term Credit Banks
1948	1.6	13.3
1949	2.0	14.9
1950	2.1	38.8
1951	2.8	41.0
1952	4.2	35.7
1953	5.3	44.4
1954	5.8	51.6
1955	5.1	87.2
1960	6.4	93.5
1965	10.0	91.7
1970	13.6	93.6
1975	29.3	92.5

Source: Juro Teranishi, "Economic Development and Finance in Japan."

Table 14.3 Weight of Purchases of Bank Debentures by Financial Institutions

Percentage

Fiscal year	Financial institutions				Institutional investors
	City banks	Regional banks	Others	Subtotal	
1960	50.4	19.3	0.3	70.0	30.0
1961	51.5	19.2	0.3	7.0	29.0
1962	53.1	15.5	0.2	68.8	31.2
1963	49.9	15.6	11.5	77.0	23.0
1964	48.9	13.5	12.4	74.8	25.2
1965	43.3	12.6	13.4	69.3	30.7
1966	43.1	11.8	11.6	66.5	33.5
1967	40.7	11.5	13.6	65.8	34.2
1968	36.4	11.9	13.9	62.2	37.8
1969	36.6	10.7	16.6	63.9	36.1
1970	32.7	10.3	16.9	59.9	40.1
1975	16.4	9.4	15.9	41.7	58.3
1980	11.5	9.8	13.7	35.0	65.0

Source: Bond Underwriters Associations.

City banks, on the other hand, gradually increased their weight of long-term lending in the first half of the 1970s. This phenomenon was seen against the background of city banks being allowed to deal in long-term deposits (one-and-a-half year deposits approved in 1971 and two-year deposits approved in 1973), a measure introduced against their underwriting of a huge amount of government bonds. It can be said that the similarity of business increased and subsequent competition between LTCBs and ordinary banks, especially city banks, intensified with respect to long-term loans.

It was in the latter half of the 1950s that the long-term financing of trust banks began to increase. Their major fund raising instrument was naturally the loan trusts.[79] The weight of loan trusts to total raised funds (deposits in their banking accounts and monies in trust and loan trusts) reached 30 to 40 percent in the latter half of the 1950s and rose to 60 percent around 1965. From 1955, trust banks (such as LTCBs) supplied fixed investment funds to heavy industry (electric power, iron and steel, chemicals, transport machinery, and others). From 1965, they began expanding to such areas as residential development, reflecting a pause in electric utility development projects and iron and steel industries.

In the high-growth era, government funds met approximately 20 percent of the fixed investment fund needs of major industries (table 14.4); this was lower compared to the latter half of the reconstruction era, reflecting the expanded financing capacity of private financial institutions.

In 1955 the Japan Development Bank changed its loan conditions in relation to lending rates, redemption terms, and sphere of lending activities. In particular, financing targets changed from basic industries to social infrastructure, public facilities, regional development, and strategic industries, such as petrochemicals and automobiles, to promote exports. In this process the bank assisted structural adjustment among declining traditional industries, which including were apt to left behind, and it financially supported activities of small and medium-size firms, including new ones. Loans by government financial institutions to such business areas were qualitatively supplementary to private sector loans, which tended to focus on heavy industry firms.

Evaluation of Long-Term Financing Mechanisms in the Reconstruction and High-Growth Eras

In evaluating the long-term financing mechanisms of government and private financial institutions, criteria such as efficiency, stability, and impartiality could be used. It is, however, perhaps premature and inappropriate to pass judgement on the long-term finance mechanisms; hence, our views and evaluation will necessarily be general.

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79. At the end of fiscal years 1966 and 1971 the personal sector accounted for approximately 60 percent of the total of outstanding funds raised through loan trusts. Five-year term funds accounted for more than 90 percent of the total, indicating the long-term and stable nature of such funds (Mori 1973).

Table 14.4 Weight of Government Funds to All Equipment Investment Financing

(Fiscal Year, Percentage)

Industry	Average 1954-60	Average 1961-67
Mining (including coal mining)	25.7	39.9
Coal mining	37.2	65.9
Iron and steel	4.6	03.6
Machinery	11.3	9.5
Chemicals	8.1	7.1
Textiles	14.2	14.7
Agriculture and fisheries	52.9	47.9
Electric power	32.4	19.7
Marine transport	33.9	50.9
Land transport	10.4	21.9
Total	21.6	15.7

Source: Juro Teranishi, "Economic Development and Finance in Japan."

The establishment of the Reconstruction Finance Bank under the initiative of the government reflected the malfunctioning of financing by private financial institutions, the short-term character of available finance, and general fund shortages just after the war. It could be considered that under these circumstances no other alternatives existed, and that establishment of the bank was the only measure the government could take. However, the institution was beset with various deficiencies: artificially low lending rates failed to impose discipline on borrowers; there was no strict screening of loan applications;[80] the Reconstruction Finance Bank did not request collateral when making loans, and borrowers were not prepared to present repayment plans; and the Bank, being a temporary institution, was staffed by those seconded from the ministries and banks concerned. Not only did the staff have different backgrounds and qualifications, but there were not enough employees to deal with so many loan applications.

Its successor, the Japan Development Bank, supplemented the shortage of funds provided by private financial institutions in the latter half of the reconstruction era. In the high-growth era, the bank, through its lending principle of cofinancing, succeeded in mobilizing private financial institution funds, not only for social infrastructure and

80. Many managerial level staff of the Reconstruction Finance Bank were on secondment from ministries and banks. This fact, a sort of organizational deficiency, gave rise to struggle among the staff to expand the sphere of influence of their respective ministries and banks. This caused ambiguities in the responsibility for loan decision-making (Arisawa 1977).

public facilities, (where financing was not forthcoming at market interest rates), but also for economically strategic sectors (such as petrochemicals and automobiles). In this regard it should be considered that the long-term financing mechanism led by the Japan Development Bank worked well.

Why is it that the Japan Development Bank functioned well, while the earlier Reconstruction Finance Bank aggravated inflation and failed to work well? Some points put forward as contributing to the Japan Development Bank's success are as follows:

- For fund raising, the Japan Development Bank borrowed from the Trust Fund Bureau with no new money creation involved. On the other hand, the Reconstruction Finance Bank relied on the central bank's underwriting of its debentures as its source of funds, thus leading to the creation of high powered money.

- With regard to loan objectives, the Japan Development Bank lent money to corporations for plant and equipment investment and operating capital so as to induce further production, while the Reconstruction Finance Bank, in many cases, made loans so that companies might compensate for business losses.

Looking at reasons why the Japan Development Bank did not suffer big loan failures or losses, two points could be cited. First, strict screening of loan applications was implemented; second, its decision to make loans to competent borrowers encouraged private financial institutions to participate in cofinancing, achieving a sort of pump-priming function in relative to private financial institutions.

During the high-growth era specialized long-term financing institutions functioned well, at least in supplying and allocating requisite funds for industries. These institutions were operating under the policy of low interest rates and within the functional segmentation of short- and long-term finance.

The yields to subscribers of coupon debentures and the prospective dividend rates of loan trusts of specialized long-term financial institutions were expected to be determined by issuers on the basis of market conditions. In reality, however, under the policy of low interest rates and taking other rates into account, yields and dividend rates were set within a narrow band. The long-term lending rate, however, was free, because the upper limit under the Temporary Interest Rate Adjustment Law did not apply to it. In fact, determination of the lending rate was left to market forces and it was set at a somewhat higher level than the long-term prime rate (being the lower limit), which was adjusted by the individual credit standing of borrowers.

Conclusion

In the case of Japan, overcoming rampant inflation by enacting the Dodge Plan in the early stage of the reconstruction era was a cornerstone of the subsequently stable supply of long-term funds by financial institutions. Because inflation makes it more difficult for financial institutions to supply long-term funds, financial assets held by individuals decline, as do funds available to financial institutions.

After inflation was brought under control, government financial institutions came to bear the responsibility for long-term financing in the latter part of the reconstruction era, as did private financial institutions in the high-growth era. The principal mechanism of long-term financing by private financial institutions was the maturity transformation wrought by city banks and the new specialized long-term financial institutions (especially long-term credit banks). The mechanism was sustained by interest rate regulation, together with other policies, which led to maintenance of an ascending yield curve between short- and long-term interest rates. Government financial institutions supplemented the role of private financial institutions by providing policy based lending.

The above-mentioned financing mechanism may have outlived its usefulness and is currently facing comprehensive review. Government financial institutions are not an exception. Among others, postal savings, a major fund source for government financial institutions, are being subjected to mounting criticism that they offer unduly advantageous financial products compared to private financial institutions. Functional segmentation of short- and long-term financing has lost much of its significance in increased internationalization and securitization. The pace of reform has been subjected to somewhat lengthy negotiations among interested groups. But the Japanese financial system is transforming itself to meet the current needs and is breaking away from the legacy of the postwar period.

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15

THE INSTITUTIONAL PERSPECTIVE OF FINANCIAL MARKET REFORM: THE MALAYSIAN EXPERIENCE

Lin See Yan

Banking in Malaysia can be traced back to 1859 when the first commercial bank in Malaysia, a branch of a foreign bank, was established. It was not until 1913 that the first domestic bank was incorporated. And it was only much later, in 1959, that the central bank opened its doors. The Central Bank of Malaya (renamed Bank Negara Malaysia, or BNM, in 1963) was established on the recommendation of the World Bank Mission Report in order to "permit a measure of deliberate management of the money and credit situation, with the object of fostering a more favorable climate for the further development of domestic enterprise." In the early years foreign banks dominated the banking establishment (eighteen foreign and eight domestic banks in 1959) and were engaged primarily in financing plantations, agriculture, tin mining, and international trade. The structure of the Malaysian financial system in 1959 was very simple: it comprised several commercial banks, provident and pension funds, insurance funds, a post office savings bank, and a few other minor financial intermediaries.

The genesis of the current financial structure, which is considered modern and rather sophisticated, began when the central bank undertook institutional building in the early 1960s. BNM had consciously and systematically developed and established institutions in the Malaysian financial system to provide the basic infrastructure for effective monetary management. The institutional framework was recognized as an important starting point in meeting the objectives of BNM as enshrined in the Central Bank Ordinance of 1958, which provides for the central bank to promote monetary stability and a sound financial structure and to influence the credit situation to the advantage of the country.

This paper provides an overview of the Malaysian financial system, and financial reform in Malaysia since the early 1960s. Next it delves into the evolution of the major groups of financial institutions and their roles in meeting the nation's financial and economic needs. Then it examines the current trends toward reform: promoting an integrated regulatory regime that would have a major impact on the structure and operating landscape of the financial system in the years ahead. Finally, the paper summarizes the contributions of the central bank in financial reform and in building the country's financial infrastructure, and it highlights the key lessons of Malaysia's experience.

Overview of the Malaysian Financial System

The Malaysian financial system can be broadly categorized into three groups: the banking system, the nonbank financial intermediaries, and the capital market (see table 15.1).

The banking system today comprises BNM at the apex, thirty-seven commercial banks, one Islamic Bank, twelve merchant banks, forty-one finance companies, seven discount houses, and eight money and foreign exchange brokers. The commercial banks are the primary mobilizers of deposits and the main source of credit in the economy. They provide retail banking services with a branch network of 1,066 (as of March 1992) spread throughout the country. The Islamic Bank, on the other hand, provides banking services that are in line with the Syariah, which prohibits transactions on the basis of interest rates. The finance companies are the second major mobilizers of deposits and provide mainly consumer and housing credit to individuals. The merchant banks were established to supplement and complement the facilities provided by the commercial banks and the finance companies. They function primarily as specialists in the money and capital markets, offering services such as corporate advisory services, underwriting of new issues of shares and bonds, and the conduct of flexibility studies. Discount houses, on the other hand, specialize in short-term money market operations. They provide a ready avenue for other banking institutions and larger enterprises to better manage their liquidity position through short-term transactions in deposits. The money and foreign exchange brokers function merely as agents in the interbank foreign exchange market to bring the buying and selling banks together (only commercial banks are allowed to deal in foreign currencies). All these institutions are supervised by BNM. Total assets of the banking system amounted to 71 percent of the total assets of the financial system, or 214 percent of GNP.

Nonbank financial intermediaries

The nonbank financial intermediaries basically serve specific financial needs not generally provided (or inadequately provided) by the banking institutions. They are classified into five broad subgroups: the development finance institutions, the savings institutions, the provident and pension funds, the insurance companies, and a plethora of credit institutions. These institutions mobilize nearly 30 percent of the total assets of the financial system and, hence, are a formidable financial force as well. The specific activities of each of these groups of institutions vary, ranging from specialized lending for specific sectors to provident and pension funds management. For example, the National Savings Bank was set up to fill the gap in mobilizing small savings from the rural areas, in particular, with the backing of the government. The development banks were established to provide long- and medium-term financing to specific areas of the economy targeted as being crucial for the development of the country.

Table 15.1 Assets of the Financial System

	As at end of				
	1960	1970	1980	1990	1991
	($ million)				
Banking system	2,356	7,455	54,336	226,965	265,622
Monetary institutions	2,346	6,882	45,180	171,584	198,066
Central Bank	184	2,227	12,994	40,914	44,559
Currency Board[1]	930	195	0	0	0
Commercial Bank[2]	1,232	4,460	32,186	130,670	153,507
Non-Monetary institutions	10	573	9,156	55,381	67,556
Finance companies	10	531	5,635	39,448	49,039
Merchant banks	0	0	2,229	11,063	13,260
Discount houses	0	42	1,292	4,870	5,257
Non-bank financial intermediaries.	1,197	4,167	19,817	96,320	106,593
Provident, pension and insurance funds	836	3,156	13,846	61,055	69,979
Employees Provident Funds	633	2,265	9,481	46,734	53,251
Other provident funds	100	452	1,889	4,823	5,306
Life insurance funds	83	324	1,657	7,097	8,384
General insurance funds	20	115	819	2,401	3038
Development finance institutions[3]	1	133	2,193	6,253	6,496
Savings institutions[4]	267	645	2,463	8,489	9,198
Other financial intermediaries.[5]	93	233	1,315	20,523	20,920
Total	3,553	11,622	74,153	323,285	372,215

1. Malaysia's estimated share of assets of the Currency Board. The Currency Board ceased to function with effect from November 30, 1979, following its liquidation and the final distribution of its assets to the three participating Government of Malaysia, Singapore and Brunei.

2. Include Bank Islam Malaysia.

3. Include Malaysia Industrial Development Bank Berhad, Sabah Credit Corporation, Development Bank of Malaysia and Industrial Development Bank of Malaysia Berhad.

4. Include National Savings Bank, Bank Kerjasama Rakyat and the co-operative societies.

5. Include Unit Trusts, Building Societies, Pilgrims Management and Fund Board, Credit Guarantee Corporation and Cagamas.

The capital market

The capital market in Malaysia refers to the market in longer-term financial assets, comprising all public and private debt instruments with maturities exceeding one year, corporate stocks and shares for which there is no fixed maturity period, and commodity futures. The capital market comprises three exchanges, namely the Kuala Lumpur Stock Exchange (KLSE), the Bumiputera Stock Exchange (BSE), and the Kuala Lumpur Commodity Exchange (KLCE); the principal dealer network for Malaysian Government Securities (MGS); several unit trust funds; a credit rating agency that rates private debt securities; and, in the course of this year, the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE) for derivatives instruments. Within the financial system the capital market in Malaysia serves two main purposes: it assists in the process of economic development by mobilizing medium- and long-term funds from a cross-section of the population to finance public development, and promotes private enterprise by providing intermediary services to raise funds for corporate investment and expansion and by changing the ownership structure of companies.

Development of the Banking System

The early phase of development of the Malaysian banking system was largely associated with the growth of foreign trade and general commerce. The banking system was dominated by foreign banks established in the trading and commercial centers of Penang, Malacca, and Kuala Lumpur to serve the interests of British and European establishments in Malaysia The banks primarily financed of external trade, which mainly involved transactions in foreign exchange, remitting and receiving funds to and from abroad, and short-term financing of foreign trade. The domestic banks were initially formed as small family concerns and were largely clanbased to service trading, mining, and plantation needs of businessmen essentially from the same clan. The growth of the domestic banks was slow, as they were disadvantaged in terms of capital, experience, and credentials in relation to their more established foreign counterparts. For instance, in 1959, of the 111 branches throughout the country, foreign banks accounted for 99 of them.

Recognizing the need to develop a truly Malaysian banking system to facilitate balanced economic development, BNM had, as a matter of policy, systematically nurtured the development and expansion of domestic banks throughout the country. The central bank also embarked on the reorientation of the operations of the foreign bank branches toward meeting Malaysian needs. A domestic-oriented banking system is more in tune with government policies and more sensitive to the needs of the Malaysian economy. The bank recognized very early on that a sound and strong domestic banking industry is a necessary precondition for steady and balanced economic and social development in a young country like Malaysia.

Domestic banks

The first step in structural development undertaken by BNM was to encourage the establishment of domestic-owned banks and to regulate branching. A branching policy was designed to achieve two purposes. First, to counteract the competitive disadvantage of the domestic banks, the foreign banks operating in Malaysia have not been allowed since 1966 to set up new branches in the country. Second, for a banking system to effectively perform its intermediary function, particularly as the nation's primary mobilizer of savings, it is necessary that banking facilities are made available all over the country. Hence, BNM's policy consciously directs domestic commercial banks to expand their branches throughout the country, especially to small towns and rural areas where banking facilities are generally lacking or inadequate. As an inducement, banks willing to branch out to the rural areas are given approval to establish urban branches. Furthermore, the licensing fees for rural branches of banks are set at a lower rate than those for urban branches. The locations of proposed branches are also assessed so as to avoid oversaturation of banking offices in a particular area.

Currently there are 21 domestic commercial banks in Malaysia with 920 branches, as opposed to against 16 foreign banks with 146 branches. The domestic banks expanded rapidly over in the past three decades and carved for themselves a firm niche in the banking system. At present the five largest banks in Malaysia in terms of total assets are domestic banks, in sharp contrast to the position at the end of 1959, where the five largest banks in the country were all foreign controlled. As the World Bank Mission had observed in 1959, ".... four or five overseas banks account for about two-thirds of the total deposits and over 80 percent of the overseas assets, but for only about half of the local advances." The success of BNM's strategy in changing the operating landscape can best be appreciated in the following numbers. At the end of 1991, the domestic banks accounted for 77 percent of total assets and 76 percent of total deposits of the commercial banks. Credit now covers a wider range of activities, and at the end of 1991 it accounted for 65 percent of the total assets of the commercial banks, while foreign assets accounted for only about 4 percent. Nevertheless, the foreign banks remain a significant force in the country. At the end of 1991, foreign banks accounted for 23 percent of the total assets of all banks, 24 percent of total deposits, 27 percent of total bank credit, and 30 percent of total equity (defined to comprise shareholders' funds of domestic banks and net working funds of foreign banks) of all banks.

The next step in structural development was to review and reform the ownership structure of the domestic banks. In the initial setup, most domestic commercial banks were family-owned institutions, which resulted in dominance by a single person or group of related persons. Naturally, the banks would be unduly influenced to provide credit to companies belonging to the owners. To better serve the needs of the country, a banking system can ill-afford to be the captive of a particular person or corporation. It is crucial that the bank be managed in a professional manner. Furthermore, a rapidly

growing economy necessitates a rapidly expanding banking sector, which is not possible if the banks are constrained by the limited funds available to a single family. Hence, BNM encouraged the dispersion of bank ownership and the separation of ownership from management. The banking law was amended in 1985 to prohibit a corporation and its related interests from owning more than 20 percent interest in a bank, while the limit for an individual and his or her related interests was set at 10 percent. BNM also actively encouraged banking institutions to seek public listing because this would be an effective way to "spread out" their ownership and permit ready capital expansion. Over time, the family-owned shareholding structure of the domestic banks gradually diluted. Currently, only a handful of domestic banks remain family owned, while eight domestic banks are already listed on the Kuala Lumpur Stock Exchange (KLSE). At the same time, the banking law was amended to require all foreign banks to locally incorporate (within a period of five years from October 1989) to level the playing field for both the domestic and foreign banks and to foster a more Malaysian outlook in bank management. Foreign banks would be allowed to retain 100 percent ownership after local incorporation. However, those foreign banks that chose to restructure would enjoy the privilege of being on the same footing as the domestic banks.

While BNM exercises deliberate policies to promote the growth of the domestic banks, a large part still depends on the initiative of domestic banks to improve and to push forward on their own accord. The central bank can only exhort the commercial banks to be active and responsive in seeking customer needs and to be innovative in creating economically beneficial products or services to improve the standard of banking service in the country. The basic banking services of early years, such as over-the-counter deposit taking, overdraft and trade financing facilities, and foreign exchange and money remittance services, have since undergone radical transformation, particularly in the last twenty years. Today with the benefit of computer technology, banking services have been improved and expanded to provide automated teller machines (ATMs), payment of daily interest, on-line terminals linking the bank to the home or office, telephone banking, courier banking, auto debits, accelerated rate multi-tiered deposits, money market deposit funds, swaps, and flexible repayment housing loans. Competition has proved to be the best incentive for improvement in banking services. The latter half of the 1980s registered the greatest spurt in innovative banking facilities to effectively compete for both the retail and corporate businesses. This period coincides with the current phase of the central bank's reforms in removing structural barriers to competition and minimizing hindrance to free market forces.

Finance companies

Finance companies first emerged in the 1960s to play a complementary role to the commercial banks in lending to consumers, homeowners, and small businesses. Finance companies engage primarily in lending money for the purchase of consumer durables, particularly motor vehicles, and long-term end financing for the purchase of

houses, as well as providing short- to medium-term credit (mainly leasing credit) for small businesses. Some commercial banks also set up finance company subsidiaries to tap deposits from the market because finance companies were able to offer higher deposit rates than commercial banks, whose rates were then constrained by the ceiling set by BNM. Because of their increasing importance in deposit mobilization and, hence, their growing impact on the domestic monetary situation, the government decided to place finance companies under the control of BNM in 1969.

For the most part, BNM policy on the development of the finance company industry was to supplement and complement the services offered by the commercial banks in a competitive environment. In fact, the bigger finance companies are comparable in size and strength to some of the smaller banks, and many have branches throughout the country. In recent years the smaller and weaker finance companies were also encouraged to merge with or, in the case of the ailing ones (which were unable to remain financially solvent), compelled to be taken over by the financially stronger and well-managed banking institutions. Following an active consolidation exercise in recent years, the total number of finance companies now stands at forty-one, compared with forty-seven in 1988. The finance company industry is now more resilient and should be able to play a more effective role in an increasingly competitive banking system. Despite the decrease in number, the finance companies' branch network had increased from 486 in 1988 to 603 in 1991, reflecting a wider geographical coverage for their services to consumers. The growing competition in the market had also spurred the finance companies to upgrade their products and services. In October 1987 several large finance companies participated in a shared ATM network with commercial banks. At the end of 1991 the total number of ATMs operated by the finance companies stood at 142, compared with 47 at the end of 1988. In recent years as the line separating finance companies and banks has become increasingly blurred, keener competition is expected to result in further consolidation in the finance company industry as the smaller finance companies, without sufficient resources and innovative management, will face increasing difficulties to retain their market share.

Merchant banks

Merchant banks were introduced in the 1970s to fill a gap in wholesale corporate banking services. It was recognized that the corporate market had then reached a level of sophistication that required more than just the normal banking services. The growing sophistication of the market had called for a full range of specialized services in corporate financing, financial investment, and management advice, as well as investment portfolio management. The existing commercial banks that dominated the banking scene then had tended to concentrate their activities in traditional areas of trade financing and normal banking but were not adequately equipped to meet these specialized needs. BNM assumed an active role in promoting the establishment of local merchant banks, mostly with equity participation from foreign investment banks to tap their expertise.

Since their establishment the merchant banks contributed much toward the modernization of the Malaysian financial structure by increasing the sophistication and effectiveness of the money and capital markets as well as wholesale and corporate banking in the country. To ensure that the merchant banks do not lose sight of their primary role in providing specialist corporate services, they are required to derive a minimum level of 30 percent of their total income from fee-based activities. This would ensure that the merchant banks do not concentrate on the relatively straightforward and more lucrative fund-based activities. The merchant banks are also expected to play an active role in innovating and promoting new capital market instruments and making a secondary market for these instruments. As the country becomes more affluent and sophisticated, the role of the merchant banks can be expected to become increasingly more prominent.

Discount houses

The first discount house in Malaysia was established in 1963 to create a market in the shorter-term government securities (less than three years). They mobilize funds from other financial intermediaries and large enterprises with sizeable liquid funds in the form of short-term deposits (mainly overnight and call deposits), which are invested mainly in marketable Government securities. The discount houses, over the years have served as a useful, convenient and reliable channel for investing very short-term funds and as dealers in money market papers.

The importance of the discount houses, however, has diminished with time. Their role in the financial market has been gradually eroded by deregulation and competition from other interbank market players. With the current emphasis on the development of the private debt securities market, BNM took the opportunity to review the role of the discount houses to turn them essentially into market makers for commercial papers and corporate bonds. Several reforms governing the operation of discount houses were thus introduced in 1991 to allow discount houses to invest in high-quality corporate bonds and commercial papers and to underwrite issues of such private debt securities.

Islamic banks

Islamic banking was introduced in 1983 to provide an alternative to the Muslim population in Malaysia to benefit from modern banking facilities, but without using the interest rate mechanism, which is forbidden in Islam. Currently there is only one Islamic bank, Bank Islam Malaysian Berhad (BIMB), which operates twenty-nine branches throughout Malaysia and is listed on the KLSE. While BIMB performs the same functions as commercial banks, its activities are non-interest based; for example, lending is based on profit sharing rather than interest. To further promote Islamic

banking in the country, the Islamic Banking Act of 1983 and the laws governing non-Islamic banking institutions are in the process of being amended to pave the way for the introduction of Islamic banking units (counters) by the conventional commercial banks (if they so wish). In the coming years Malaysia will be one of the first countries in which the same banking institution is able to offer dual banking facilities operating under conventional as well as Islamic principles.

Offshore banks

Another milestone in the development of the Malaysian banking system was set when the Federal Territory of Labuan was launched as an International Offshore Financial Center (IOFC) in October 1990. The establishment of the Labuan IOFC is intended to complement the operations of the onshore financial system of Malaysia and represents another step toward developing a complete package of sophisticated financial services in Malaysia.

Offshore banks in Labuan are allowed to operate under a generally liberal and relaxed regulatory regime. However, at the point of entry care will be taken to ensure that only banks of good international repute and quality are granted the license to operate in the IOFC. To date, licenses have been issued to seven offshore banks (including five domestic bank subsidiaries) in Labuan, six of which have commenced operations. The first three offshore banks recorded profits in their first year of operation. To enhance the attractiveness of Labuan as an IOFC, wide-ranging infrastuctural facilities in Labuan, including telecommunications, transportation, housing and health facilities, are currently being upgraded.

All offshore banks are expected to operate from Labuan on a functional basis, with business negotiations and development conducted in Labuan. However, in view of the existing inadequacies in infrastructure facilities, offshore banks may, for the time being, apply for permission to operate a temporary management office in Kuala Lumpur until the end of 1993. During this interim period, the offshore banks would still need to maintain an office in Labuan, which will be the head office. The management office in Kuala Lumpur would serve as a base for the chief executive officer from which to perform such functions as maintaining business contacts, negotiating and closing deals, conducting marketing and business development, and managing the office in Labuan. The office in Labuan would serve as a booking center and perform such administrative functions as business documentation, filing of statutory returns, maintenance of records, and operation of the management information system. Upon expiration of the exemption period (by then, the necessary infrastructure facilities would be available), all offshore businesses and activities would have to move to Labuan.

Measures to develop a more competitive and sound banking system

The central bank did not stop at actively promoting the establishment of a sound banking structure to serve the varied and growing financing needs of the nation. In the process BNM recognized the need for market forces to ultimately provide the main impetus for the future development of the banking system into one that is innovative, responsive, and competitive. Since the latter half of the 1970s and with greater momentum in the late 1980s BNM has concentrated its efforts in promoting greater competition in the banking system. In this regard artificial barriers or controls set up in the early years to minimize competition to protect the growth of the various new breeds of domestic institutions have been and are being removed in stages to create a more level playing field in the market place. Major measures or reforms undertaken to promote such a level playing field and to sharpen competition have included the following:

- Realigning the statutory reserves requirement for the different types of banking institutions to eliminate any uneven advantage in terms of cost of funds;

- Allowing banking institutions to comply with the statutory reserve and liquidity requirements on an average basis to enhance efficiency and flexibility in funds management;

- Abolishing the two-tier liquid asset ration (that is, the primary and secondary liquid asset ratios) in favor of a single liquidity ratio to enhance flexibility in liquidity management;

- Allowing a free interest rate regime whereby the banking institutions are free to determine both their lending and deposit rate;

- Introducing a uniform capital standard for all banking institutions based on the BIS standard;

- Requiring foreign banks to incorporate locally so that they would be supported by permanent paid-up capital in Malaysia and be subject to the same capital adequacy requirement (foreign banks have five years, until September 1994, to locally incorporate);

- Liberalizing the rules governing the deposit taking activities of the merchant banks and finance companies; and

- Allowing finance companies to conduct selected fee-based activities, including the provision of financial guarantees, hitherto the domain of banks.

The ongoing process of structural deregulation, however, is undertaken judiciously to ensure that efficiency and sophistication can be enhanced in a competitive environment without jeopardizing the safety of the banking system. As the banking system becomes increasingly more competitive, prudential standards must be upgraded whenever appropriate in order to preserve stability. As a matter of policy, BNM will continue to re-regulate on the prudential front as and when necessary to complement measures intended to further deregulate and, whenever needed, reform the banking industry to promote greater competition.

Development of Non-Bank Financial Institutions

BNM has been a catalyst in the development of domestic nonbank financial institutions (NBFIs). Indeed, BNM had, since its inception, played a pivotal role in the establishment of many of these special purpose financial institutions. From its vantage point, BNM views the smooth functioning of an efficient network of NBFIs as an integral part of the effective transmission mechanism that must be built up and nurtured to support monetary policy in its quest to promote monetary stability.

Development finance institutions

The Development Finance Institutions (DFIs) emerged in Malaysia, as in most developing countries, to fill a gap in the supply of financial services that are not adequately provided by the conventional banking system. For example, many small and medium-size enterprises crucial to the long-term development of the economy often encounter difficulties in obtaining financing from the commercial banks or in sourcing funds directly from the capital markets. Hence, DFIs served a niche market in providing medium- to long-term funding to many sectors of the economy. These DFIs are often given financial and technical assistance by BNM or the government in order to inject a degree of public confidence in their activities.

The first two DFIs were established in the mid-1950s to assist in the economic diversification of the predominantly agricultural states of Sabah and Sarawak. In 1960 the Malaysian Industrial Development Finance Berhad was set up following a World Bank recommendation to provide medium- to long-term capital for industrial enterprises through loans and direct equity participation. Other major DFIs include the Agricultural Bank of Malaysia, to mobilize resources for agricultural development; the Development Bank of Malaysia, to promote the participation of the Bumiputera [indigenous] community in commerce and industry; the Sabah Development Bank to provide medium-

and long-term loans in Sabah to private and state enterprises; and the Industrial Bank of Malaysia, as a long-term credit bank to finance the expansion of capital intensive and high technology industries with a long gestation period).

Apart from these DFIs, many public development agencies, which are largely funded by the federal or state government's development budget, also extend financing to individuals and enterprises for investment in commerce, agriculture, and industry. These include the Council of Trust for Indigenous People, the Urban Development Authority, the Federal Land Development Authority, the Rubber Industry Smallholders' Development Authority, and the various state economic development corporations. Although the resources of all these DFIs constitute only 2 percent of the total assets of the financial system, they have played, and will continue to play, a special and crucial role in financing the social-economic development of the young nation, with emphasis on project financing, venture capital activities, and the financing of nontraditional industrial and services projects with long gestation periods.

Savings institutions

Besides the commercial banks and finance companies, the savings institutions function to mobilize savings, especially among the middle and lower income groups in the rural areas not adequately served by commercial banks and finance companies. The main savings institution in Malaysia is the National Savings Bank (NSB), established in 1974 through a reorganization of the former Post Office Savings Bank system. The other group of savings institutions are the cooperative societies, which pool small individual savings for on-lending to members. The urban credit cooperative societies established by members on a voluntary basis to meet their own credit needs have been the core of the cooperative movement in Malaysia.

In the 1970s and early 1980s, the number of these cooperatives expanded rapidly by accepting deposits, opening branches throughout the country, and embarking on commercial activities such as leasing and trading, as well as share and property investments on a large scale. However, many of these deposit-taking cooperatives (DTCs) were poorly managed and worse, many conducted fraudulent and unscrupulous practices. The failure of one major DTC in July 1986 due to liquidity problems triggered a massive run on the other DTCs, including the major DTCs. To safeguard the interest of the depositors and to avoid systemic failure, BNM was requested by the government to resolve the DTC crisis through a series of direct rescue schemes to prevent widespread financial collapse.

Arising from this painful episode, the law has since been tightened to prohibit any nonlicensed institutions from accepting deposits from the public. The activities of these cooperatives are now confined to their targeted members. Legislative changes are now under way to further strengthen and tighten the regulatory framework governing the cooperative movement. Broadly, the proposed reform seeks to improve provisions for the constitution, registration, control, and regulation of cooperative societies and to

promote the development of genuine cooperative activities and mutual self-help in Malaysia.

Provident and pension funds

In the Malaysian context, provident and pension funds comprise the Employees Provident Fund (EPF), the Teachers Provident Fund, the Social Security Organization, the Armed Forces Fund, as well as other approved statutory and private provident and pension funds. The EPF is the largest provident and pension fund in Malaysia and perhaps the largest institutional investor in the country. At the end of 1991 it represented the second largest group of financial institutions in Malaysia in terms of total assets, lagging only behind the commercial banks as a whole. In the early years, the EPF was required by statute to invest its entire resources as deposits with the commercial banks. Subsequently, it was permitted to invest in MGS, deposits with banks, and loans to approved companies in the form of private debt securities and trustee shares. It was also subject to a statutory requirement to invest at least 70 percent of its annual investible and cumulative funds in MGS.

In recent years, however, due to the downsizing of the government's domestic borrowing requirement, the new issues of MGS were not sufficient for the Employees Provident Fund to fulfill its 70 percent statutory requirement. Recognizing the investment constraints faced by the fund, the new EPF Act of 1991 has widened the scope of the fund's permissible investments to cover new areas, including real property, privatized projects, joint ventures, and bills of exchange. In addition, the new act requires the EPF to invest only 50 percent of its annual investible funds in MGS, provided the outstanding amount of MGS does not fall below 70 percent of EPF's cumulative investible funds. The new investment powers would enable EPF to use its resources more effectively for the benefit of its members and at the same time continue to be the key provider of non-inflationary financing for the government and to assume its new role in channeling its surplus funds to help finance private fixed investment outlays.

Insurance companies

Historically the bulk of the insurance business in Malaysia was dominated by the branches of British, American, and other foreign insurance companies in the urban centers, specializing in the insurance of merchandise trade. With the emergence of greater insurance awareness and the rapid progress of national development, a number of small indigenous insurance companies were established in the 1950s and 1960s. The number of domestically incorporated insurance companies increased rapidly from the 1960s through the 1980s, from only six in 1963 to fifty-one by the end of 1987.

Prior to 1961 the operations of insurance companies in Malaysia were governed by the Life Assurance Companies Ordinance of 1948 and the Fire Insurance Companies Ordinance of 1948. The inadequacy of this legislation had led to malpractice by a number of companies. These companies eventually went into liquidation or defaulted on their claims. Consequently, the government enacted the Life Assurance Act of 1961. In the following year an insurance commissioner (situated in the treasury) was appointed to supervise and regulate the activities of the insurance companies. This was followed by a comprehensive review of the legislation, leading to the enactment of the Insurance Act of 1963.

The year 1988 marked the watershed for the insurance industry when the supervisory function was transferred from the treasury to BNM. The principal rationale behind the relocation was to streamline and adopt an integrated approach to the supervision of the entire financial system in the country and to realize economies of scale in regulation and supervision. The move was also prompted by the increasing convergence of cross-holding and integration of interest between the banks and insurance companies.

In essence, insurers are recognized as important financial intermediaries. In addition to their function as hedgers of risk for the community, they are also custodians and mobilizers of public funds. It is this fiduciary responsibility that necessitates the placement of the insurance industry under the same supervisory umbrella as the banking industry. Under a common supervisor, potential problem areas in any segment of the financial system can be speedily identified and resolved before such problems are transmitted to other sectors in the economic system.

The supervisory tasks undertaken by BNM are indeed challenging. There remains a number of structural issues and deep-seated problems that have beleaguered the industry for some time. Currently fifty-eight insurers are registered under the Insurance Act of 1963, comprising thirty-nine general insurers, three life insurers, fifteen composite insurers carrying both life and general business, and one reinsurer.

The general insurance market, in particular, is highly fragmented, with a large number of small undercapitalized firms (mainly Malaysian owned) vying for a relatively small premium rate. Intensity of competition has led to undercutting of premium rates and the payment of excessive commissions in an effort to secure business, without due regard to underwriting standards, thereby resulting in losses. The weak structure of the general insurance sector is aggravated by, among other things, the existence of fraud, agency-related problems, claims under-provisioning, high intermediation costs, and a lack of professionalism in management.

The life insurance sector, on the other hand, has its own strengths and weaknesses. One of its strong points is its vast growth potential because the insured population constitutes only 13.4 percent of the total population. That is to say, only one in every seven Malaysians owns a life policy. However, to harness this potential, the life insurance industry will have to tackle head on the operational and structural problems besetting it.

One of the key problems faced by the life insurance industry is its inefficient distribution system (that is, the delivery mechanism). The industry traditionally depended on its multi-tiered agency force to market its life policies. This had in turn given rise to a myriad of problems, including, among others, high operating costs and low persistency of policies. There was also public dissatisfaction with the image and quality of service of the industry.

Recognizing the problems in both the general and life industry, BNM has since taken action to establish a reliable data base to facilitate effective monitoring. In addition, an early warning system was developed to detect financial distress; a set of uniform accounting standards on disclosure in financial statements was implemented; a code of ethics to govern the conduct of staff was introduced; the agent commission structure was reviewed; and a comprehensive review of the insurance laws was conducted (see the section on supervision for details on the reform of insurance laws).

Cagamas Berhad

Another significant milestone in the development of the Malaysian financial system was the establishment of the national mortgage corporation (Cagamas) as a special purpose vehicle to raise medium- to long-term funds to refinance mortgages and, in the process, create a secondary mortgage market in Malaysia. Cagamas purchases housing loans from the banking system and the government (civil servants housing loans), funded by the issue of mortgage-backed securities to medium- and long-term investors. The establishment of Cagamas marked the first step toward the securitization of bank assets. Cagamas was established with equity participation from all banking institutions, including a 20 percent equity stake by BNM. At the end of 1991 Cagamas has issued MS$2.9 billion of bonds to fund the purchase of MS$3.06 billion in outstanding housing loans from the banking system and the government.

The Development of the Capital Market

The main purpose of developing an efficient capital market is to assist the process of economic development by mobilizing medium- and long-term funds from a cross-section of the population to finance public development programs and to fund private corporate investment and activities, as well as to assist the banking system in securing its assets. Indeed, an effective capital market is often among the major objectives of financial development in developing countries.

In Malaysia the central bank has, since its inception, been actively involved in the developmental process of the capital market. Being the banker to the government, BNM has a direct interest in promoting an efficient market for government domestic debt issues. A developed equities market, on the other hand, facilitates companies to raise new capital as well, and this is crucial in maintaining a healthy, balanced and

prudent level of leverage in corporate borrowing from the banking system. This being the case, the central bank, as the regulator of the banking system has an interest in ensuring the balanced development of an active and efficient stock market.

More recently, BNM recognized that the financing needs of Malaysian enterprises will become increasingly more complex and more demanding as the pace of industrialization accelerates. Reliance on bank credit alone will not suffice. There is definite scope for the development of corporate debt securities, hedging instruments, and other innovative (and derivative) capital market instruments. The developments in the government securities market, equities market, private debt securities market, and new capital market instruments are briefly discussed below.

The government securities market

The MGS market experienced significant growth since the 1970s, particularly in the 1980s when the amount of government securities increased steadily due to the rise in the government's development spending. In the early years, to ensure a sufficient and reliable flow of funds to the government, the development of the MGS market was geared toward creating a demand for such securities. To make government securities a more attractive investment instrument and in order to widen the ownership and develop a secondary market in these securities, the following measures were undertaken in the first stage of development over the period 1950 to 1980.

- The MGS was issued at varying maturities and yields.
- A minimum requirement was introduced for investment in MGS by the EPF, the banking institutions, and a number of other financial institutions, including the insurance companies.
- MGS was made tenderable as payment for estate duty at par value.
- Transactions in MGS were exempted from stamp duty, and incomes from the holdings of MGS by individuals were exempted from income tax.
- A higher commission was paid to brokers to encourage their interest in promoting greater activity in MGS.
- MGS was designated as a "trustee" instrument eligible for investment by trust funds under the Trustee Act of 1942.
- No limit was placed on banking institutions in the amount of MGS held that is eligible for inclusion as secondary liquid assets in meeting liquidity requirements.

By the end of the 1970s the volume of MGS leapfrogged to MS$14.2 billion from only MS$120 million at the end of 1960, and by the end of the 1980s it had quadrupled to MS$58.2 billion.

While creating the required volume is a necessary condition, it is certainly not sufficient to create a viable market. Active secondary market trading is needed. A major drawback was that the rate of return on MGS was then regulated by the government, whereby MGS was sold at par on a subscription basis at a preannounced rate. Although the annual coupon rates payable on MGS were changed from time to time, the rates generally lagged behind the market rates. Due to a lack of movement in yields, portfolio preferences remained stable, resulting in the creation of a highly captive market in which the original subscribers held the securities until maturity. As a consequence, secondary market trading was underdeveloped except for papers nearing their maturities.

To develop the market it was imperative that the yields on MGS were market-related. Hence, in late 1986 BNM undertook several measures to liberalize the MGS market. The measures introduced were aimed at creating more stable short-term money market rates structures, shortening the maturity periods of the papers, and increasing the role of market participants in providing liquidity for MGS. The following supportive financial reforms were implemented:

- Unpegging interest rates on deposits;
- Realigning the statutory reserve ratio of banking institutions;
- Allowing the banking institutions to maintain their liquidity and statutory reserve ratios on an average basis;
- Expanding the number of money market participants by allowing well-capitalized finance companies with shareholders' funds of not less than $30 million to participate in the interbank market; and
- Using the KLIBOR (Kuala Lumpur Interbank Offered Rate) as the official indicator of conditions in the interbank money market.

In 1987, the central bank made its first move to issue MGS with market-related coupon rates. As a major step in promoting the development of an active secondary market in MGS, a system of principal dealers for government securities, comprising designated commercial banks, merchant banks, and discount houses, was introduced in January 1989. These principal dealers (twenty-three at the present) underwrite the primary issue of MGS and are obliged to provide two-way quotation for MGS in the secondary market. Only the principal dealers have access to BNM's rediscount window, and BNM's open market operations are undertaken through them. At the same time, an auction or bidding system for MGS, with maturity periods of up to ten years, was also

implemented with prices determined by market forces. As such, the previous practice of advance subscriptions for MGS was no longer accepted, except from the EPF and the National Savings Bank. However, longer dated issues will continue to be offered on a subscription basis for the time being.

To further improve operational efficiency of funds and securities transfer, a scripless book-entry securities trading and funds transfer system, called SPEEDS, was implemented by BNM in January 1990. SPEEDS comprises the following:

- The Scripless Securities Trading System (SSTS), an on-line book entry system that effects and records the trading of government papers, BNM certificates, government Investment certificates, and Cagamas bonds between member institutions.

- The Interbank Funds Transfer System (IFTS), an on-line electronic interbank transfer system to expedite and efficiently process daily interbank funds transfer and settlement between BNM and participating institutions and among participating financial institutions.

At the end of 1991 total MGS outstanding amounted to MS$ 65.3 billion and the average monthly traded volume for 1991 was MS$ 642 million. In the years ahead BNM will continue with its efforts to promote increasingly more active secondary market trading in MGS.

The equities market

Public shares trading in Malaysia only began in 1960, when four stockbrokers gathered together in the clearing house of the central bank to mark prices. In the 1960s, the types of equities traded were limited to those of plantation and mining companies, because these enterprises formed the backbone of Malaysia's economic activity then. As the pace of industrialization picked up, the profile of equities in the market also changed, displaying a growing preponderance of commercial and manufacturing companies. The buoyant external demand provided a major impetus for corporate and business expansion and, coupled with a concern to keep gearing ratios at a prudent level, companies found it expedient to resort increasingly to financing from the equities market.

While the equities market enjoyed rapid growth in the 1960s and 1970s, it was only in the 1980s that far-reaching changes were made that brought the KLSE to its current level of sophistication. The reforms in the exchange were mainly to enhance operational efficiency, permit effective surveillance of the exchange, and improve the professional conduct of its members. These included:

- Setting-up a clearing house, SCANS (Securities Clearing Automated Network Services) in 1984;

- Establishing the Research Institute of Investment Analysis Malaysia in 1985 to help the industry raise its standard of securities analysis and research;

- Introducing the concept of corporatization of stockbroking companies in 1986 to allow corporations to own stockbroking firms in order to enhance the industry's financial strength and professionalism. To allow the industry to tap foreign expertise, foreign corporate equity ownership was allowed; first up to 30 percent and, later in 1988 up to 49 percent provided the foreign corporate shareholder is able to bring in a certain volume of foreign business;

- Launching of the KLSE Composite Index in 1986, which represents a cross-sectoral analysis of companies listed on the KLSE. It is widely used locally and overseas as the barometer of investors' views of the market performance. In October 1991 the exchange launched the KLSE EMAS index, which represents the KLSE main board all-shares index. It is an additional tool to gauge market performance;

- Installing of a real time share price reporting and corporate announcement system (MASA) for brokers and subscribers. This system was further enhanced with MASA II (in 1990), which provides additional corporate information to users;

- Forming an Advance Warning and Surveillance Unit in 1988 to alert the KLSE on problems facing stockbroking houses and listed companies;

- Launching the Second Board in 1988 to enable smaller companies with good growth prospects to have access to the capital market. In January 1991 the KLSE launched the Second Board Index (SBI), which provides investors with a performance indicator for companies listed on the Second Board and, at the same time, assists smaller companies listed on the Second Board to attract investors;

- Implementing a semi-automated trading system, SCORE (System of Computerized Order Routing and Execution), in 1989 to increase efficiency and liquidity of the market;

- Delisting all Malaysian incorporated companies from the Stock Exchange of Singapore (SES) in 1990. The main rationale for this was to confine

dealings in Malaysian counters to the local exchange, to attract international investors, and to reduce the KLSE's vulnerability to unfavorable developments on the SES. In the long run it would enable the KLSE to develop into an internationally recognized independent exchange;

- Ensuring that the stockbroking companies are well capitalized by requiring all stockbroking companies to have a minimum paid up capital of $20 million by December 31, 1991;

- For a more efficient settlement system, implementing the daily netting system in 1990 to help reduce the physical delivery of shares between the stockbroking firm and SCAN. In the same year the Fixed Delivery and Settlement System (FDSS) was implemented for a more organized system pertaining to scrip movement and for the stockbroking companies to better manage their cash flow; and

- To further improve the settlement system, a scripless trading system called the Central Depository System (CDS) will be introduced soon. The CDS would eliminate the need for the physical delivery of scrips and help to expedite the settlement of share transactions. Besides doing away with scrip problems, such as forgeries, stolen or misplaced certificates, and delay in registration, the successful implementation of the CDS will also enable the KLSE to handle a greater volume of trading than presently possible.

As at the end of 1991, 324 companies were listed on the KLSE, with a total market capitalization of MS$161 billion or 130 percent of GNP. For the year 1991, 12 billion units valued at MS$30 billion were traded on the KLSE. The equities market is expected to grow rapidly in tandem with the rapidly expanding economy, particularly with the government's policy to promote private initiative as the main engine of growth.

The private debt securities market

Until recently no significant efforts were directed at developing the private debt securities (PDS) market. Increasingly, however, the PDS market has become an attractive alternative avenue for corporations - apart from the traditional method of bank borrowing and the issue of shares - to raise funds for investment, especially for large-scale industrial projects with long gestation periods. The downsizing of the government's operations to allow private initiative as the main engine of growth provides another impetus, because the captive purchasers of MGS now need an alternative source of investment in quality debt securities. Thus, considerable attention

is being directed by BNM to promote an orderly development of a viable and stable PDS market with active secondary trading.

The emergence of Cagamas bonds in 1987 marked a significant milestone in the development of the PDS market. It was also the first attempt made at asset securitization. The role of Cagamas is to purchase housing loans from the loan originators and repackage them into fixed rate bearer bonds (Cagamas bonds), which are issued to the investing public. The success of Cagamas has encouraged several large corporations with good credit standing to raise funds by issuing term notes on a floating or fixed rate basis. To facilitate the orderly development of both the primary and secondary market for PDS, BNM introduced a set of administrative guidelines in December 1988 to clarify the basic legal and administrative framework for bond issuance. Funds raised through the PDS market rose to MS$6 billion in 1991, from only MS$225 million in 1987. Although the development in the PDS market has been most encouraging, the market is still small, with sluggish secondary market trading activity.

In an effort to spur the development of the PDS market, BNM has reduced, since January 1990, the minimum size for the issue of debt securities from $50 million to $25 million, while the lead manager of an issue will be eligible to be appointed as an authorized depository. Furthermore, since 1989, issuance and trading of PDS have been exempted from stamp duty. In 1991, to promote individual investment in PDS, interest earned by individuals from bonds (other than convertible bonds) issued by public listed companies were exempted from income tax. The KLSE has also allowed the listing and trading of debt securities with detachable transferable subscription rights (TSR) as well as convertible unsecured loan stocks (CULs). The development of these instruments enable the public listed companies to issue debt securities bearing a lower than market interest rate by offering investors an opportunity to gain from the perspective price appreciation in the value of its shares. Another significant development in the PDS market was the issuance of bonds based on Islamic principles - on the basis of Al-Musharakah (joint participation) and Al-Bai-Bithman-Ajil (deferred payment sale) - which made its debut in 1990.

As part of BNM's continuing efforts to develop the PDS market, a credit rating agency (Rating Agency Malaysia, or RAM) was established in November 1990. The main function of RAM, which is jointly owned by all banking institutions in Malaysia, with the Asian Development Bank having a small share, is to provide independent credit rating to the bonds and commercial papers of corporate issuers. This is to provide investors with timely, reliable, and appropriate information on the quality of a particular issue to assist them in making their investment decision. At the same time, the rating would enhance the attractiveness of bond financing, since a good rating improves the corporation's prestige, leading to potentially significant savings in their funding costs. Moreover, in the rating process, the management of a company being rated would receive important signals about the company's effectiveness and efficiency, which can form the basis for any necessary rationalization and external adjustment. In the years

ahead, RAM is expected to play a major role in promoting the development of an efficient PDS market, including an active secondary market.

Introduction of new capital instruments

As the industrialization process accelerates there is a need to further develop the Malaysian capital market in order to meet the increasingly complex and more diverse financing needs of the private sector. This requires the introduction of a wider range of instruments and the evolution of a market with greater depth and liquidity. This is particularly important considering the continuing downsizing of the government's operations through the privatization of public enterprises and the emphasis on the private sector as the main engine of growth.

Hedging instruments, such as options and financial futures, are now being prompted to add depth and breadth to the capital market. Malaysia is in the process of establishing its first privately funded exchange, the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE). KLOFFE is expected to become operational in late 1992 once the legislative framework is finalized. KLOFFE would initially trade in equity related options, but other options and futures related instruments will be introduced in due course, not only in KLOFFE, but possibly in other exchanges as well, such as KLSE and KLCE. The existence of a viable options and futures market should help accelerate the process of financial deepening. The availability of a cost-effective hedging vehicle would enable the efficient transfer and distribution of financial risks in the economy.

Another important area for development are unit trust funds, which include property trusts. These funds play an important role in the development of the capital market because they permit the mobilization of small savings for active participation in corporate securities and prime commercial property. It is imperative that unit trusts are managed professionally and that investments are made within the bounds of prudence. Comprehensive guidelines for the operation of unit trusts have been introduced recently to pave the way for the purposeful development of the industry.

Of late, considerable attention has also been focused on the development of venture capital. An interesting feature of venture capital financing is that it provides many investment options within the lifecycle of a new business into which a venture capitalist can commit funds, such as from the embryonic stage up to the expansion and advanced stage before public listing. Venture capital financing is now increasingly recognized as an alternative form of financing in the economies of the Asia-Pacific countries. In Malaysia, the venture capital market started when the country's first venture capital firm, Malaysia Ventures Sendirian Berhad (MVSB), was established in 1984 with an initial fund of MS$13.8 million. Since then the venture capital industry has slowly gained a foothold in the country.

Though still in its infancy, opportunities abound for further development as the nation strives to become an industrialized state by the year 2020. To ensure active development of this market, the local business community needs to have a better

understanding of this nature of financing. The government has shown its commitment in promoting venture capital financing as outlined in its Sixth Malaysia Plan. A package of tax incentives to boost project financing by venture capital companies, including allowing losses from disposal of share to be offset against tax liabilities in the equity holders' other activities and exempting tax for gains from the disposal of shares, has been introduced. In the coming years, as Malaysia moves rapidly toward high value-added manufacturing, the venture capital industry would play a key role in mobilizing private risk and seed capital for investment in innovative high technology projects, especially to support the rapidly growing electronics industry, as well as in the resource based high value-added industries.

Development toward Integrated supervision

To a large extent the laws and the structure and functions of regulatory bodies affect the framework within which the financial institutions operate and develop. At times, conflicting or cumbersome requirements from numerous regulatory bodies or laws impose practical difficulties for innovations and may even retard the efficiency of a market. Hence, in most cases, regulatory reform becomes an integral part of any successful financial sector reform. In Malaysia the banking laws underwent a major reform in 1989, and major reforms are in the pipeline for the securities and insurance industries as well as the cooperative societies. The trend is toward a more integrated approach to supervision in the face of further deregulation in an increasingly competitive environment.

Consolidation of the banking system's legal framework under the BAFIA

In the early years BNM's focus was on building a supervisory framework to regulate the mobilization of domestic deposits and to control credit direction. Individual legislation or operational guidelines were introduced on a piecemeal basis to place the major deposit mobilizers under the ambit of the central bank. The commercial banks were brought under the ambit of BNM under the Banking Ordinance of 1958 (subsequently revised to become the Banking Act of 1973) and the finance companies under the Borrowing Companies Act of 1969. The merchant banks, when first set up in 1972, were governed by a set of operational guidelines issued by BNM and in 1979 were brought under the ambit of the Banking Act of 1973. The discount houses and money-brokers were also regulated by operational guidelines implemented by BNM without any formal legal basis.

Although under a single supervisory authority, such a fragmented legislative and operational regime gave rise to asymmetry in the course of time. At the early stage of development, structural barriers ensured that each set of institutions operated in their respective markets. As there was no encroachment of activities, asymmetrical

regulations would not give rise to unfair competitive advantage. However, as BNM embarked on the second stage of financial reform by removing structural barriers and leveling the playing field to bring about greater competition to create a more efficient and more responsive and innovative banking system, it was clear that major regulatory reform was imperative. With the rapid blurring of demarcation lines between the three traditional groups of banking institutions (commercial banks, finance companies, and merchant banks), the methodology of supervision of these institutions had to converge. A level playing field cannot be achieved without the harmonization of supervisory regulations.

Furthermore, the various pieces of legislation enacted over the years were specific to particular types of institutions and, thus, did not provide the central bank with an effective overall power to regulate the activities of the various nonbank financial institutions operating at the fringe of the regulated banking sector. The various fringe financial institutions, such as the development finance institutions, specialized credit institutions, credit firms, and cooperatives, had expanded rapidly in the 1970s and 1980s. Although the operations of these institutions may be relatively small in comparison with the size of the banks and finance companies, their combined operation nevertheless has important implications for monetary policy and financial stability as a whole over the long run. Some of these institutions, such as the development finance institutions, the National Savings Banks, and provident and pension fund institutions, are, moreover, government related and, therefore, have the predictable backing of the government.

However, the others, which take deposits from the public, were treading in dangerous waters as they operated as financial intermediaries outside BNM's safety net. In the case of the deposit taking cooperatives (DTCs), adverse developments in their operations in 1986 had actually undermined public confidence in the soundness of the country's overall financial structure. The collapse in 1986 of the DTCs due to widespread mismanagement, fraud, and malpractice had threatened a crisis of confidence in the banking system as depositors drew a parallel conclusion about the health of the supervised banking sector. The DTC episode clearly illustrated that the central bank must have the authority to monitor, supervise, and regulate all deposit taking activities in order to effectively promote monetary stability and a sound financial structure.

Consequently, BNM undertook a major review of the regulatory regime governing the financial system, culminating in the enactment of the Banking and Financial Institutions Act of 1989 (BAFIA). The BAFIA modernizes and streamlines the laws relating to banking and other financial institutions to provide for an integrated supervisory regime for the financial system. Formulated on the basis of experiences of the bank for the past thirty years, the act provides a framework that enables BNM to supervise three broad groups of financial institutions, namely, licensed institutions, scheduled institutions, and non scheduled institutions. By design, the bank's powers under the act over each group of financial institutions can be distinctively different and yet similar.

The first group comprises the licensed institutions, which are involved in money or near-money creation or act as key intermediaries in the money and foreign exchange markets. It includes all the institutions that form the core banking system, mainly commercial banks, merchant banks, and finance companies. They are closely supervised by BNM and are subject to the same regulatory requirements set out in the BAFIA.

The second group of institutions, known collectively as scheduled institutions, are the major nonbank sources of credit and finance. They comprise credit and charge card companies, building societies, factoring and leasing companies, and development finance institutions. Also included under this group are representative offices of foreign banks or foreign institutions that carry on the business or activities similar to the scheduled institutions. Although scheduled institutions are not subject to BNM's formal regulation at present, the act is in place to bring them within the central bank's ambit. If deemed necessary, the minister of finance may, on the recommendation of the bank, extend in whole or in part the regulatory regime to any of these scheduled institutions. For monitoring purposes these institutions are required to be registered with the bank and submit certain statistical information on a regular basis as may be deemed necessary by the bank for monitoring.

The BAFIA also provides BNM with a unique power not usually found in any other banking legislation, that is, the power to investigate and take corrective actions, including assumption of control, over the third group of institutions called nonscheduled institutions. These comprise financial institutions set up by statute and supervised by the various government ministries, and any person or corporation that is not under the first or second group mentioned above, but that is are engaged in the provision of finance.

Arising from the experience of the DTCs, the BAFIA specifically outlaws the taking and solicitation of deposits by any person other than licensed institutions and certain nonscheduled institutions permitted by statute to take deposits. Comprehensive powers have also been incorporated in the BAFIA to enable BNM to deal with illegal deposit takers, including powers to investigate and prosecute offenders. The bank's investigating officers are given powers of entry, search, seizure, detention, and examination of suspects and their business associates. The rationale for such enhanced powers is to enable BNM's officers to gather the necessary evidence in order to undertake direct prosecution (if necessary) of any person for contravention of the BAFIA, with the consent of the public prosecutor.

The other significant provisions in the BAFIA include the power for BNM to approve the appointment of directors and a chief executive officer of a licensed institution, and to require the external auditor of a licensed institution to report directly to BNM if in the course of his duties he discovers any contravention of the BAFIA or any other law by the institutions. Such contravention would include losses that had been incurred by that institution to the extent of reducing its capital funds by 50 percent or more; and any irregularity that had occurred that would jeopardize the interests of depositors or creditors of that institution.

There is also the stipulation that persons "acting in concert" would be deemed to be a single shareholder for purposes of share acquisition in a financial institution, while provisions are also in place to enable BNM to approve, supervise, and regulate an electronic fund transfer system in Malaysia, besides the requirement for all branches of foreign banks operating in Malaysia to incorporate locally by September 1994. All in all, the BAFIA is expected to play a significant role in reforming and shaping the landscape of the Malaysian financial system for many years to come.

Review of insurance legislation

Since assuming its supervisory role over the insurance industry, the bank has critically reviewed the strengths and weaknesses of the industry. The objective is to forge a stronger, more resilient industry that will grow and become a vital part of the nation's financial system. Strategically, BNM seeks to bring the insurance industry back to sound finances, healthy profits, prudent practices, and stable growth. On the expenditure side, the industry is being guided toward cost reduction, especially excessive commissions, high management costs, and large losses brought about by bad debts and fraud. The two-pronged approach of enhancing income and reducing expenditure, in the backdrop of fostering sound management, will eventually lead to a healthier and more stable industry.

Applying the experience of bank supervision, BNM has identified several problem areas that need to be addressed on a priority basis. In this respect the insurance law is being revamped to provide for a more effective supervisory framework as well as to incorporate appropriate provisions to improve operating efficiency, financial strength, and public accountability of the industry. In the interim, various amendments had been made to the existing act, among the more recent of which was the Insurance (Amendment) Act of 1991, which reinforces the supervisory powers of the minister of finance and BNM on the insurance industry.

The new provisions empower the minister of finance and BNM to institute appropriate measures against an insurer that is carrying on its business in a manner detrimental to the interests of its policyholders, its creditors, or the public, or an insurer that is insolvent or is likely to become unable to meet all or any of its obligations. To safeguard the interests of the public, BNM is empowered to assume control over whole or part of the property, business, and affairs of an insurer, or appoint a receiver or manager to manage the insurer, or, as a last resort, present a petition to the court to dissolve or wind up the insurer.

A comprehensive revamp of the insurance legislation in the form of a new insurance act is now in the final stages of drafting. Painstaking care is taken to ensure that inconsistencies or lacunae in the existing insurance legislation are remedied. Provisions of the BAFIA relating to regulation and supervision will be incorporated into the revised insurance legislation to facilitate effective execution of the bank's powers, duties, and function. Among the major proposals are stricter solvency margin

requirements to ensure adequate capitalization of insurers, guidelines on investment of the statutory funds of insurers to ensure quality of assets both in terms of yield and spread, and greater transparency in the conduct of insurance business. It is envisaged that the revised insurance law will not only better protect the public but also facilitate an orderly advancement of the Malaysian insurance industry.

Proposed establishment of a securities exchange commission

The Malaysian capital market is now at the threshold of a strong expansion phase as part of the evolution of the financial system. In this regard it is crucial that the regulatory system is coherent and able to promote the long-term orderly development of a sound and dependable market, with a balance between commercial expediency and prudential management. Over the years, the legislative framework governing the capital market has developed on an ad-hoc basis into an arrangement of multi-agencies, with each agency overseeing a limited and, often, overlapping area of the market. Unlike the banking system, which is supervised by the central bank acting as the one-stop agency (as the regulator and developer), the supervision of the capital market is highly fragmented. As a result the underlying development function was generally neglected over the years.

At present, at least six main agencies regulate the capital market. Their functions are as follows:

- The office of the Registrar of Companies is responsible for the enforcement of the Securities Industry Act of 1983 and the Companies Act of 1965.

- The Capital Issues Committee examines and approves new issues of securities for listing on the KLSE. Its policies were first formalized in 1986, with the publication of a set of operational guidelines. The guidelines set out the CIC's policies on public issues or offers for sale of securities, as well as issues of securities by public limited companies arising from acquisitions of assets and interest; from mergers and takeovers; from rights, bonus, and special issues; and from schemes of arrangements and reconstruc-tion and share option schemes. Guidelines on the revaluation of assets by public limited companies were also set out.

- The Foreign Investment Committee, established in 1974, is responsible for issues pertaining to foreign investment in Malaysia. With respect to the securities industry, it

coordinates and regulates the acquisition of assets or any interests, mergers, and takeovers of companies and businesses in the country.

- The Panel on Takeovers and Mergers was established in 1986 to assume the Foreign Investment Committee's functions in administering the Malaysian Code on Takeovers and Mergers, as provided under the Companies (Amendment) Act of 1985. The code (enforced in 1987) sets out the principles and procedures for takeovers and mergers and lays out the code of conduct for observance by parties involved in takeover and merger transactions, with the objective of protecting the investing public from abuse.

- The Commodities Trading Commission is the principal regulator of the commodities futures market in the Kuala Lumpur Commodity Exchange.

- BNM is the principal dealership system for the trading of MGS. The principal dealers are banking institutions under the supervision of BNM. The bank also approves issues of private debt securities and regulates the margin financing facilities provided by stockbroking companies.

Given the increasingly important role of the capital market in the years ahead, an urgent need for an integrated supervisory framework to oversee the overall development of the capital market is clearly recognized. Taking cognizance of this development, the government is now in the process of setting up a Securities Exchange Commission (SEC) as a single one-stop regulatory body to supervise and develop the capital market. The proposed SEC can be expected to: facilitate the effective supervision of the various exchanges and avoid jurisdictional questions that may arise where areas overlapped; permit the effective supervision of persons (including intermediaries) who deal in more than one exchange, thereby fostering effective systemic risk management; facilitate the orderly development of new capital market instruments, including derivatives; and ensure that the objective of protection of investors could be undertaken on an integrated basis.

The establishment of a Securities Exchange Commission, which would streamline and strengthen the regulatory regime governing the capital market, is expected to help accelerate the development of the Malaysian capital market into a prudent and mature market that is capable of meeting the increasingly sophisticated needs of a rapidly industrializing economy.

Conclusion

In the developed financial centers there is a wide spectrum of established financial institutions aggressively initiating and developing new products and facilities to meet growing market needs. Generally the central bank will focus more on prudential conduct and financial integrity, with the objective of maintaining the stability and enhancing the efficacy of the monetary transmission mechanism. However, in most developing economies the strategy is expected to go further. The development of financial institutions generally lags behind economic needs and the lack of an effective financial infrastructure is constantly one of the inhibiting factors holding back sustained economic expansion. Thus, it is imperative, at least at the initial stage, for the central bank of developing countries to play a proactive role in institutional building within the financial sector in the context of the wider objective of promoting stable economic development.

In the case of Malaysia, BNM has come a long way in providing the necessary financial infrastructure foundation during the past 30 years. At a glance, the key aspects of BNM's direct contribution in institutional building in the financial sector include the following:

- Creating an efficient and diversified domestic banking system (in the face of a continuing strong and growing foreign presence) that can be said to effectively serve the national interest;

- Building up a nation wide and well-distributed banking network, which provides modern and wide ranging-banking facilities and services that are effective in mobilizing financial resources throughout the country for productive use;

- Fostering the growth of a rapidly growing and increasingly more professional, innovative, and competitive banking system that is sensitive to rapidly changing financial needs and is responsive to the social needs of a multiracial society;

- Developing a viable market for government debt securities that permits noninflationary funding of public development programs that tend to provide basic infrastructure and social capital to promote balanced economic development; and

- Promoting a dynamic market for the issuance and trading of corporate debt securities to complement the traditional use of equity (in the context of a liquid stock exchange) and bank borrowings, especially to fund long-term investment projects.

In areas where it has no direct responsibility, the bank has nevertheless played an active role in advising and promoting the development of new institutions, markets, and arrangements that are valuable in enhancing the nation's economic and financial development.

But the building of a sound financial structure is not quite enough. No doubt, BNM spent the greater part of the 1960s and 1970s pursuing this objective (Phase I in financial development). The efforts were necessary but not sufficient to promote financial stability and foster balanced economic growth. In those early years just as much effort was put into building a dynamic regulatory and supervisor framework, both legal and administrative, to ensure that institutions, markets, and arrangements were managed prudently and in accordance with the objectives for which they were established. More important, this additional effort was needed to ensure that the persons responsible for their good conduct (whether owners, managers, or nominees) act with integrity and professionalism; and (2) promote social responsibility so that financiers have a direct role in providing ready access to credit at reasonable cost to home buyers (to promote a property owning democracy) the disadvantaged bumiputras (sons of the soil) as part of an affirmative action program (to restructure society) and small businesses (to eliminate poverty regardless of race and build a prosperous and large middle class).

Despite rapid economic growth in the 1960s and 1970s, accompanied by monetary stability and much improved social conditions, the early 1980s marked a watershed in financial development brought about by the government's "Big Push" in 1980-82 in the face of a severe world recession where the prices of all the nation's commodity exports fell twice within five years: in 1981 and again in 1986. The voluntary structural adjustment program that followed involved a fundamental change in development strategy and public policy, that is, to provoke private sector initiative as the engine of growth and downsize the role of government (mainly through privatization), accompanied by the implementation of the polity to "Look East" (to adopt the virtues of hard work and become more competitive through rising productivity) and of "Malaysian Incorporated" (for the government to work hand-in-hand with the private sector to raise profits and productive capacity).

For the financial system this new thrust of development meant significant change in order to effectively cope with the new situation. For the greater part of the 1980s Phase II of financial development was set in place. Phase II included: deregulation (to level the playing field and make the system more liberal and competitive); reform of institutions, markets, measures and regimes (the most important being the freeing of the base lending rate to ensure that the financial structure and regulatory framework are

conducive to the growth of private initiative and the taking of risks); re-requlation (for prudential reasons in order to strengthen the financial system and avoid systemic failure, through the adoption of adequate capital ratios, single customer limits, provisions for nonperforming loans, and the like); and rescue of ailing financial institutions (whether or not supervised by the bank) as a consequence of the severe structural adjustment and the excesses of rapid growth in earlier years.

With the resumption of sustained rapid real growth since 1987 (8.5 percent annually in 1987-91) and the radical transformation of the structure of the national economy toward increasing industrialization, the financial system entered Phase III of institutional development and financial reform in the late 1980s and early 1990s, namely with the consolidation of institutions (mergers and acquisitions to form stronger and more resilient units), legislation (BAFIA and the proposed new integrated insurance legislation and stronger cooperative laws), and operations (bank management consolidating and "re-engineering" to become more competitive and productive). In addition, as the extension of jurisdiction, the bank assumed the supervision of insurance (both general and life) in 1988.

Looking ahead, the pursuit of vision 2020 (to be an industrial state by the year 2020) will mean the launching of Phase IV to prepare the financial community for further change in institutional development and financial reform. This phase will undoubtedly involve further deregulation as financial institutions (banks in particular) move to become flexible and more diversified supermarkets involved in the widest spectrum of financial activities from loans to stocks to futures to insurance, in the face of the prospect of possible intense new competition in the event the current General Agreement on Tariffs and Trade round of negotiations toward freer international trade in services succeeds. With rapid industrialization (exports of manufactures will account for 75 percent of exports by 1995), Malaysian banks in particular will become increasingly global, certainly more regional in outlook. Indeed, this process has already begun. But as a practical matter Phase IV can be expected to evolve step-by-step, ensuring that the next step will only be taken when the preconditions for the next move have been met.

In the final analysis, the Malaysian experience over the past thirty-odd years has been sobering, with valuable lessons that are rather obvious and should surprise no one. These included the following ideas:

- Good management cannot be legislated. Indeed, legislation, no matter how comprehensively conceived, will not bring about good behavior in bank operators. Ethical standards need moral responsibility to nurture in order to mature.

- Ultimately, the financial system is as sound as the persons who manage it are honest, professional, and dedicated. This implies purposeful and persistent preoccupation with

human resource development, which holds the key to the promotion of a sound financial structure.

- Deregulation is like motherhood; few disagree with it. Deregulation makes sense when implemented with discretion: ensuring that each deregulatory move proceeds only when the preconditions that underlie it are satisfied. Often deregulation needs to be accompanied by some form of prudential re-regulation in order to ensure that the deregulation process remains stable.

- The price mechanism (interest rates) works best when there is perfect or near-perfect competition, which hardly ever exists in practice. Reliance on its functioning only makes sense when there is reasonable assurance (if necessary through market intervention) that the adjustment mechanism is systematic in its impact.

- The maintenance of price stability requires a well-developed and stable domestic financial (especially banking) system, backed by a solid network of financial institutions and markets operating within a sound regulatory framework. The foreign presence, no matter how attractive is usually unreliable.

When it comes to institutional development and financial reform, the central banker today works in an imperfect world, with institutions, markets, and regimes that are at best imperfectly understood. The central banker seeks to attain objectives that can usually be experienced only in broad general terms. In the process, central bankers need the courage to accept what cannot be changed, the commitment to change what cannot be accepted, and, it is hoped, the talent to distinguish one from the other.

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16

FINANCIAL SECTOR REFORMS AND PRIVATIZATION: THE PHILIPPINE CASE, 1986-1992

Jesus P. Estanislao

The pursuit of a reform agenda cannot be undertaken in a vacuum. The political will to formulate and implement reforms is conditioned by a broad set of factors, which make it easy or difficult to pursue reforms to their successful conclusion.

The Philippine experience with financial sector reform and privatization from 1986 to 1992 can be presented only in the context of a broader Philippine economic and political environment. This paper therefore is divided into three main sections: the environment for reforms, financial sector reforms, and privatization. A set of tentative conclusions is in the last section.

The Environment for Reforms

The economy the Aquino administration inherited in February 1986 had been mired in recession for two and a half years. Moreover, high levels of inflation approaching 50 percent per year were pushing the economy down further. Drained by crony capitalism practiced over two decades, the economy was weakened further by a heavy foreign debt, made more debilitating by the loss of the government's credibility and the subsequent withdrawal of international support in the wake of political developments in late 1983.

The priorities the Aquino administration set were dictated by the economic conditions it found upon assuming office. A high priority was thus given to bringing the economy back to growth, to securing stability through strict observance of prudent macroeconomic balances, and to promoting greater equity. An early decision was also taken to manage the foreign debt problem responsibly through marketdriven, voluntary agreements with the country's creditors and to reacquire credibility and international support for the economy.

Underpinning the microeconomic concerns that had to be attended to immediately were a set of basic premises that included the following: the country's major public financial institutions had to be rehabilitated; the private commercial banking sector had to be strengthened; other reforms had to be introduced to correct the critical weaknesses in the financial system; and those elements of the financial and production sectors that

had fallen under government control had to be privatized.

Many other equally pressing concerns engaged the early attention of the administration that was suddenly thrust into power, without the benefit of a smooth transition. These gave rise to the perception of confusion and lack of vision. Despite the negative image that has been reinforced by continued reports of indecision and policy waffling over the past six years, still the record speaks positively of performance actually posted relative to its initial economic priorities.

Within nine months after its assumption of office, the Aquino administration brought the economy back to positive economic growth and to overheating by 1989. Real economic growth averaged 5.9 percent per year in the 1987-89 period. Inflation was brought under control, averaging 9.5 percent per year during this initial period. Despite the intense domestic political debate over the foreign debt issue, the administration pushed for agreements with commercial bank creditors under the Brady Program, with official creditors under the Paris Club, and with providers of ODA resources under the umbrella of consultative group meetings chaired by the World Bank.

By the end of 1989 the two major public financial institutions had been fully rehabilitated, and both the Philippine National Bank (PNB) and the Development Bank of the Philippines (DBP) were already well on the way toward becoming feathers on the cap of the Aquino administration. In the meantime the private commercial banks, under the environment of economic growth and freedom of private enterprise, were permitted to earn high returns and thereby to strengthen their books. A program of financial sector adjustment had been formulated, while the initial results of the privatization program exceeded the modest expectations that realism suggested in early 1986.

On the surface, both the macroeconomic and microeconomic priorities were being pursued and achieved. Even the equity indicators were pointed in the right direction: the percentage of families with incomes falling below the poverty line dropped by close to ten points. International support was strong, to a point where some ministers were starting to believe their rhetoric about a second wind that could propel the Philippines to high sustained growth and into the status of a newly industrialized country (NIC) within a decade.

But the wind was taken out of the sails, apparently in abrupt fashion by the attempted coup in December 1989, but more substantively by the unsustainability of growth along the path traveled since 1986. The fiscal position was weakened by the populism that delayed pricing decisions on oil products, added costly items for which expenditure cover had to be provided, and eroded the revenue base of the national treasury. By 1990 the precarious state of the national government's finances was fully revealed. At the same time an overvalued currency had taken its toll on exports, the current account balances, and the country's international reserve position. Moreover, the central bank, hobbled by its weak net income position, had extreme difficulty pursuing proper monetary and exchange rate policies.

As macroeconomic balances were weakening, the long, past neglect of public infrastructure finally caught up with the economy. The long delays in constructing alternative electricity generation capacity to substitute for the loss arising from the brave

decision to mothball the Bataan nuclear plant, and the tedious debates that blocked the immediate expansion of telecommunication and other public infrastructure activities finally took their toll. Electricity went into short supply. Costs escalated due to inadequacies of public support services. Uncertainties grew because of a few Supreme Court decisions, congressional inaction on vital bills, and irresponsible use of media by an unscrupulous few with narrow agendas of their own. Investments thus failed to give a sustained wind to the economy, buffeted as it already was by adverse external factors (the Gulf crisis) and by a series of internal natural disasters.

Clearly, the economy had to be stabilized. Its growth had to slow down, and the process of adjustment and reform had to be made more painful by the temporary recession that had to be endured. Although the priorities remained and initial performance relative to these priorities looked promising, focus had to be shifted to containing the public sector deficit and bringing the macroeconomic balances back under firm control.

Against this broad background, the task of financial reforms and of privatization had to be pursued. On the surface, the pace was rapid while the economy was going through a recovery; and it slowed down as the economy went through a recession in 1990-92.

Financial Sector Reforms

Financial reform efforts in the Philippines consist of two cycles superimposed on one another. There is a long wave, which proceeds at an evolutionary pace toward liberalizing of financial markets and promoting the efficiency of the financial intermediation process through competition. There is a shorter wave that is more abrupt and often interrupts the steady progress toward financial development. This is the cycle of financial crises: episodes of extreme difficulty followed by urgent efforts to rehabilitate and strengthen financial institutions.

There have been three major episodes of the long wave of financial reforms in the Philippines. In the early 1970s a package of reforms was put in place to strengthen the control of the central bank over the entire financial system. The reforms sought to regulate a very active money market that had developed beyond the central bank's control. At the same time the anti-usury law was repealed and arbitrary ceilings on interest rates were lifted. The 1970 reforms sought to put order into the financial system by tightening entry and regulating more consistently and effectively the various types of financial institutions.

The next package of financial reforms in the early 1980s sought to enhance competition and improve mobilization of term funds by removing all remaining interest rate ceilings reducing the regulatory distinctions among banks and allowing different banks to compete in various markets, relaxing rules on equity investments into allied and non-allied undertakings, and increasing the minimum capital requirements to strengthen banks in what was presumed to be a more competitive banking environment.

These reforms, however, were overtaken by the broader developments in the economy that revealed the remaining weaknesses in the financial sector and put it under an irresistible strain. The issue of insider abuse could no longer be swept under the rug in the face of failure of 4 private commercial banks, 32 savings banks, and 146 rural banks. The proliferation of rediscounting windows at the central bank through which subsidized loans were provided to preferred industries, sectors, and individuals became the openings for putting large segments of the private sector under government control.

In the late 1980s another round of reforms was introduced to strengthen prudential regulations and make central bank supervision of commercial banks more effective. Henceforth, weak banks would not be supported by the central bank for unduly long periods, and financial assistance would be given only to banks facing liquidity, and not solvency, problems. Capitalization requirements were further increased, and improvements in reporting requirements as well as uniform guidelines for asset valuation and loan loss provisions were introduced. The remaining special loan programs being administered by the central bank were transferred to the appropriate financial institutions: the agricultural loan fund to the Land Bank of the Philippines, and the industrial loan programs to the Development Bank of the Philippines. These are now based on market-oriented interest rates.

Through these waves of financial reforms, the Philippine financial sector has been undergoing an all too gradual process of liberalization. The long-term direction had been inexorably set in the early 1970s, and every six to eight years a new set of measures have been formulated and implemented, taking advantage of the opportunities for added reforms brought about by crises that help define what the new measures should be.

The Aquino administration has not bucked the trend toward greater financial liberalization. But it had to define its own program of action in the context of the environment it inherited.

The rehabilitation of the Philippine National Bank (PNB) and of the Development Bank of the Philippines (DBP) was undertaken not for the sake of these two government financial institutions alone, but above all for the sake of the entire financial sector. PNB was rehabilitated so that as a viable commercial bank it could be privatized and thereby become a strong, sizable pillar in the Philippine financial system. DBP was rehabilitated so that as a wholesale bank it can work together with private commercial banks in the provision of medium- and long-term funds for the continuous restructuring of Philippine industry.

The rehabilitation program of both PNB and DBP was successfully completed in record time. Their books were cleaned up, morale was boosted, and both banks started to perform way above targets early into their rehabilitation programs. But as to the broader objectives behind their rehabilitation there has been far less of a sense of urgency: PNB has yet to take the final step of going beyond the 50 percent threshold nor has its equity been sold to the private sector; and DBP has yet to make the final decision of deliberately limiting its retail lending to a minimal percentage of its portfolio.

The Land Bank of the Philippines, surprisingly, has decided on its own to move aggressively toward wholesale lending for agriculture. It has been giving much greater emphasis to indirect lending to farmers through rural banks, cooperatives, and other people's organizations that are helping farmers to form cooperatives. It is in the forefront of strengthening the rural banking system, and it has taken justifiable pride in the excellent record of its lending operations through cooperatives.

A financial system that has been subjected to severe shocks can hardly benefit from the more medium-term orientation that stability brings. It is no surprise that the Philippine domestic financial market has an excessively short-term orientation. While accepting this as fact, the two major sources of long-term funds, the social security system and the government service and insurance system cannot rest until they take a more active lead in helping develop the more medium-term funds markets. Initial steps have been taken to successfully launch limited amounts of three-year notes and to lay the groundwork for the development of the capital market. Agreements on which tentative steps to take have just been forged.

The short-term impetus for reforms given in 1986 led to quick, decisive moves that need to be sustained and given a fresh shove. It should not take another crisis to complete the reforms that have been initiated and to hasten the liberalization of the financial sector that has already taken two decades of effort.

Privatization

The privatization of PNB and the conversion of DBP into a predominantly wholesale bank working closely with private financial institutions were meant to show the way out of crony capitalism into a more market disciplined, private sector driven economy. A complementary step had to be the privatization of government corporations and of government-owned assets that could serve the economy better if transferred to private control and ownership.

Government-owned and controlled corporations proliferated under the previous government as it attempted to control strategic areas of the economy. When the Aquino government assumed office in 1986 there were about 300 government corporations engaged in a whole range of activities, including hotels, gambling casinos, sugar milling, printing, mining, shipping, air transport, commercial farming, textile manufacturing, stevedoring, land reclamation, poultry, refrigeration, coffee plantations, fishing, genetics, and shipbuilding. These corporations and the nonperforming assets that PNB and DBP transferred to the national government had many common characteristics. They emphasized process rather than results. Corporate objectives were subsumed under broader goals dictated by higher authorities pursuing narrow, selfish interests. Financial losses were tolerated for broader social considerations. Reliance on rents and subsidies were endemic. Straight and honest competition was to be avoided and therefore shunted away. Naturally, the majority of these corporations was losing money, requiring financial support from the national government in the form of equity

and net lending. In 1985 these corporations incurred an overall net loss of P6.4 billion, representing 29 percent of the NG budget deficit.

The Aquino government promptly adopted a straightforward policy on privatization: to dispose of those assets that could be best handled by the private sector, and to maximize the cash recovery for the government.

The policy worked. After six years, in value terms, 65 percent of the portfolio to be privatized was already disposed of. Gross revenues for the government generated by these privatization transactions have reached P50 billion, P29 billion from the sale of transferred assets, and P21 billion from these corporations.

The largest privatization transaction has been the sale of 67 percentof Philippine Airlines in early 1992. The other major transaction was the privatization of up to 43 percent of PNB. The sale of PNB shares in 1989 constituted the largest initial public offering issue in the Philippine stock market.

The privatization program has been beset by many challenges. Its pursuit has been far from smooth and easy. Disposition policies had to recognize that the true realizable and fair value for most assets would be generally below boor value. Thus, independent appraisals of value had to be undertaken, and public bidding had to be conducted. These functions were both time consuming and energy draining. The process could be questioned and stopped at any time by almost any group. Legal impediments and court challenges slowed the rate of asset disposal. General economic conditions also determined the price which government could obtain from the market. Disposition entities had varying dispositions and interest in speeding up sales.

Yet, despite all the difficulties the privatization program has helped to give credence to the policy of widening the opportunity for the private sector to take the economic initiative. In this respect the Philippines has been fortunate: it has an active private sector - from which many of these assets were previously taken - that was prepared to take them back; and government policy during these past six years has consistently been for privatization. These two positive elements need highlighting because, with respect to the Philippines, the negative elements that have slowed down privatization have thus far been given greater attention.

Conclusion

The Philippine experience from 1986 to 1992 once again calls attention to the need for sustainable growth as the favorable environment for introducing reforms. Growth facilitates the introduction of reforms. The sustenance of growth helps ensure that the momentum of initial reforms is kept.

But sustaining growth requires a strategic discernment of what is critical for the long-term improvement of economic efficiency. Macroeconomic balances must be respected, and therefore fiscal conservatism must be observed. Within these broad parameters, critical infrastructure support facilities must be provided, and these must be put in place well before they are absolutely needed. Hidden subsidies must be avoided,

and the price for strategic goods and services must be market determined to ensure long-term availability.

The lack of grit to observe the above conventional wisdom imposes enormous costs. Any lack of persistence, any dropping of the guard can revive issues about credibility, clarity of vision, and commitment to economic fundamentals. Such issues beget instability, which demands a lot of effort and time to extinguish; and instability takes the wind out of the sails of reform.

Within an environment conducive to reforms there is also the need for a clear mind and a strong heart for the broader objective behind the immediate reforms. The initial thrust can be made, and the immediate objectives can be achieved, but the imperative is to stay the course until the reforms are successfully completed.

The first quick successes can dull the reformers into a false sense of security. They can be used as excuses for slowing down the drive toward the final objectives. They can be presented as evidence that indeed a turnaround has already been made and that there is no more need to move so quickly with more changes that can only unsettle what obviously is already a good situation.

The natural tendency toward smugness, under whichever guise it comes, should be resisted vigorously. We must beware of the seeds being sown for a future crisis, which will come in a different form from what has been solved but which will have to be faced only at a considerably higher cost.

Finally, we must all learn to combine pragmatic flexibility with clarity of direction. It is not enough to know the problems; solutions must also be thrown at problems in order to get to bottom line results. There can be enough obstacles to daunt any reformer, but the commitment to a broader policy should drive the reformer to get around the obstacles and get ahead on the path to reforms.

In the end it is a matter of recognizing the many negative elements that stymie our efforts, and of discerning the positive elements that can be put to use for the cause of reforms. The former we take as a matter of course and as irritants that nonetheless can be spirited. The latter are the straws we hang onto so that progress is made and a definitive difference can be made.

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THE MODERNIZATION OF THE MEXICAN FINANCIAL SYSTEM

Guillermo Ortiz Martínez

This paper reviews the modernization of the Mexican financial system undertaken by the administration of President Salinas de Gortari. It includes a summary of the macroeconomic framework in which modernization efforts were implemented, including changes in the bank regulatory framework and the bank privatization process.

Mexico's Macroeconomic Adjustment: 1983-92

The debt crisis that began in August 1982 marked a turning point for the Mexican economy. Inflation soared and four decades of uninterrupted growth came to an end. These events induced a drastic changes in government policy. The De la Madrid government adopted a strategy that was based on macroeconomic stabilization and the transformation of a highly regulated and protected economy toward a market oriented one.

Mexico adopted a major adjustment program to stabilize the economy. During 1983 to 1987, fiscal and monetary policies were tightened, with particular emphasis on fiscal corrections. The program's early achievements were considerable: the primary fiscal balance, which excludes interest payments, moved from a deficit of 5 percent of GDP in 1983 to a surplus of 5 percent in 1987; 80 percent of the correction came about through reduced expenditure.

The fiscal effort, however, was offset by high inflation and high interest rates. Domestic imbalances were exacerbated by the collapse of oil prices in the mid-1980s, the unwillingness of foreign creditors to extend further credits, and a large transfer of resources abroad to service the external debt at the high real interest rates then prevailing in international markets.

In December 1987 Mexico introduced a comprehensive economic program to correct imbalances and, in particular, to sharply reduced the inflation rate. Fiscal policies were further tightened, and a wide-ranging wage, price, and exchange rate freeze was introduced.

The administration of President Salinas, which took office in December 1988,

further refined the prior administration's economic strategy, emphasizing macroeconomic stabilization and structural reform. Moreover, the new strategy adopted as its main guidelines the reduction of the role of the state in the economy, which was deemed fundamental for economic modernization and the reduction of poverty.

The stabilization strategy was based on macroeconomic programs that included tight fiscal and monetary policies, a revised wage and price control agreement between the government, business and labor, and the strengthening of the balance of payments. The stabilization policies that were implemented were designed to increase the primary balance in the public sector, reduce domestic credit to the public sector, and maintain a crawling exchange rate to further reduce inflation.

The different sectors agreed to distribute the social cost of adjustment more evenly. Relative prices were adjusted to demand and supply conditions to promote economic efficiency.

The renegotiation of Mexico's foreign debt signed in 1990, allowed for debt and debt service reduction packages. The comprehensiveness of the debt reduction package convinced international investors that the operation was a "once-and-for-all" deal, and that thereafter the country would be in a position to meet all scheduled debt service obligations on newly contracted debt. The debt package was followed very rapidly by a sharp reduction in the risk premia, by significant inflows of foreign direct and portfolio investment and the repatriation of flight capital. Debt reduction enhanced the credibility of Mexico economic policy in international credit markets and reduced the excessive transfer of savings abroad.

The results so far have been positive. The economy grew at an annual average rate of 3.8 percent between 1989 and 1991 and is expected to grow 3 to 4 percent in 1992. The rate of economic growth will be higher than the rate of population growth for the fourth consecutive year. Private investment, which increased at an average real rate of 13 percent over the past three years, has been the main source of economic growth. The rate of inflation fell from almost 200 percent during the fourth quarter of 1987 to 18 percent in 1991 and is expected to reach less than 10 percent in 1992. The 1992 public sector budget will show a surplus for the first time in recent Mexican history. Excluding privatization revenues, the surplus is 0.8 percent of GDP. The expected revenues in 1992 from the privatization amount to about 2 percent GDP. Additionally, the increase in financial savings has permitted a large accumulation of international reserves and a further increase of credit to the private sector.

Profound reforms aimed at increasing efficiency and improving overall competitiveness complemented the macroeconomic stabilization program. The program is based on several strategies: trade liberalization, fiscal reform, promotion of foreign investment, privatization of state enterprises, deregulation, and financial sector reform.

Today Mexico is an open and competitive economy. Trade liberalization policies evolved from a system based on import permits and quantitative restrictions to a general system based on tariffs. As a result, resources have been reallocated to competitive sectors, and profits enjoyed by protected industries have been eliminated. Companies based in Mexico have access to raw materials and other inputs of production at

international prices. This has allowed industry to become competitive, fostering the growth of non-oil exports, which have increased at an average yearly rate of 12.5 percent since 1989.

Our fiscal reform objective is to increase the efficiency and fairness of the tax structure. Accordingly, tax rates have been reduced to a maximum of 35 percent, which is considered to be internationally competitive. Conversely, the tax base has been increased by including sectors that were traditionally excluded. Tax evasion has also been reduced. Lower rates and a broader base tend to increase the fairness of the system, resulting in higher public revenues as a percentage of GDP. These policies have resulted in improved fiscal performance and the growth in primary sector surpluses in recent years.

Foreign investment plays an important role in Mexico as it complements domestic capital. To promote foreign investment, the government revised regulations and simplified administrative procedures for approving foreign investment projects. Foreign investment is encouraged because it complements domestic investment with new technology, efficient market strategies, and modern management. It also enhances Mexican export capacity and provides domestic employment.

Deregulation is another important element of the economic strategy. Our objective is to create rules that promote business and entrepreneurial activity. As long as an economy remains overregulated, the cost of doing business is higher. The Mexican goal is to continue liberalizing the economy as well as improving resource allocation and efficiency. This policy has helped curb domestic price increases through greater competition. In short, it has contributed to the establishment of a competitive market structure for the private sector.

Privatization has also played an important role in the overall economic strategy. The public sector will maintain control only of those strategic sectors defined by the Mexican Constitution. The privatization policy has several objectives: to increase aggregate economic efficiency and productivity, to promote private investment and technological change, to reduce pressure on the public budget and to make public resources available to increase infrastructure and social investments.

Modernization of the Banking System and Bank Privatization

Commercial banks are not like any other enterprise, simply because their role in the economy is not limited to the service they provide. The way in which they operate can have a great impact on macroeconomic stability and long-term growth given their role as suppliers of liquidity, intermediaries in the process of saving and investment, and fund managers. Therefore, the strategy of privatization that was followed was different from the one applied to other government-owned companies.

First, the basic framework for the privatization of commercial banks had to be put in place by a careful definition of the operational and legal foundations for a modern and efficient banking system. In April 1989 the authorities initiated an important phase

in the process of banking liberalization through the gradual elimination of the mandatory reserve requirement, which ended in September 1991. Of similar importance was the regulatory decision to allow banks to freely determine their borrowing and lending interest rates by the end of 1989. As a result of this the market for banking services became increasingly competitive, which is an indispensable precondition for privatization.

In addition to these changes in May 1990, President Salinas submitted a bill to Congress to amend Articles 28 and 123 of the Constitution, permitting full private ownership of commercial banks. The government also launched two major initiatives to establish the legal framework for the operation of private commercial banks and the formation of integrated financial groups, envisaged as the main organizational structure of financial markets.

The new Credit Institutions Law, enacted in July 1990, allows commercial banks to be majority owned and controlled by the private sector. Foreign ownership is restricted to 30 percent. The law regulates banking and establishes the terms under which the state exercises supervision and control over the banking system. Regulatory provisions are intended to limit the concentration of credit risk; to ensure the separation of interests between banking, industry, and commerce; and to avoid conflicts of interest in the management of banks.

Mexico adopted a financial legislation that opens the possibility of establishing a system of universal banking. The law pertaining to financial groups regulates and permits the formation, under a common structure, of groups of companies performing different functions, such as banking, insurance, brokerage, and other services. It ends the traditional separation of banking from other types of financial activities, and in particular it allows banks and brokerage houses to come under the control of a single holding company. To limit the concentration of risk, ensure the adequacy of capital, and prevent the pyramidation of capital, the legislation restricts the participation of more than one type of intermediary within a single financial group and prohibits members from investing each other's or the holding company's stock.

The new legal framework of the Mexican financial system can be regarded as one of the most advanced in the world, because it allows the offer of universal financial services while fostering openness, competitiveness, and efficiency. It also enables the authorities with the necessary capacity to ensure appropriate regulation and supervision of the whole financial system.

Once the legal framework was ready, the privatization of commercial banks began according to the rules set by a decree of President Salinas on September 5, 1990. This decree created the Bank Privatization Committee and established the following conditions to be satisfied by each and every operation:

- Contribute to the creation of a more competitive and efficient financial system;

- Guarantee a diversified participation in the capital of banks to foster investment in the banking sector and guard against ownership concentration; and

- Promote transparent and sound banking practices;

The Bank Privatization Committee is a collective body comprising representatives from all government entities that are related to the process and highly regarded individuals from other sectors. The committee has as its mandate to establish the general criteria and policies for the process and develop a selling strategy. With the objective of maintaining full disclosure, the committee periodically informed the public of each and all the privatization stages and on the progress of the process. The committee also hired outside advisers and obtained international experiences in bank privatizations.

Looking at the international experience, it was found that governments follow essentially two different approaches regarding the sale of banks. One is that banks play such a strategic role in the economy that the highest bid price cannot be used as a criterion to assign it to an interested party. Therefore, the dominant criterion of selection will have to do with the seriousness and personal prestige of the candidates to buy the institution. The second technique is that, provided the mechanisms of bank supervision work reasonably well, there is no reason to worry about prestige, and banks should be sold to the highest bidder. In principle, there should be no reason to discard any one of these points of view for having a transparent standard to differentiate among parties, getting rid of subjectivity, and reinforcing the confidence in the divestiture process. It is also true that banks have to be trusted to responsible entrepreneurs who have a reputation of knowledge and honesty in the financial sector. This is why instead of choosing to follow one approach against the other, the privatization of Mexican banks took the best of both approaches.

Therefore, at the beginning of a privatization operation the role of the committee was to receive and register the applications of groups of entrepreneurs who were interested in buying a bank. These applications were then evaluated on the basis of probity and experience of the interested parties, and only those who were considered suitable were allowed to register. Here, all groups that registered were allowed to participate in the actions for the banks. The only prevailing criterion that applied was the price. Thus, the bank went to the prequalified group that offered the highest amount.

In addition to the two-stage sale strategy, some other principles also influenced the scheme of the bank privatization. For instance, in compliance with the basic privatization criteria of the president decree, sales were implemented in such a way that the structure of control combined a small group of responsible and clearly identified shareholders with a large number of small investors who were able to contribute to strengthen the capital base of the institution. That was the case of BANAMEX (the

largest commercial bank); its holding company is constituted by nearly 35,000 individuals, including a large number of employees.

Moreover, to the extent that one of the main ingredients that makes retail banking not only efficient but also effective in the task of bringing the opportunity for economic progress in all parts of the country is the bank's proximity to the needs of a particular region. The sale strategy has not been limited to waiting for clients to come and buy the bank, but has relied on a promotion effort by the authorities in order to reach and get the interest of successful local businessmen.

The outcome has been very encouraging. Half the banks have gone to regional groups, while those institutions with national coverage have made the commitment to form regional boards of shareholders to gain a better understanding of the specific needs of their clients. For example, with respect to this last point, in the cases of BANAMEX and BANCOMER (the second largest commercial bank), a large number of local businessmen from different parts of the country got together and set up regional trust funds through which they bought an important portion of the capital of the banks, and with that the right to have an impact on the business strategy of the institution. In fact, it is expected that in the eighteen banks whose privatization process will soon be finished, the number of individual investors involved will be more than 130,000 (including employees).

One closely related issue has to do with the valuation technique, which was intended to be more complete and detailed than in the standard cases, not only because some of the banks are very big, but because it is acknowledged that firms in the financial sector are affected differently by changes in expectations and macroeconomic fundamentals than the rest of the economy. In this way, before the committee determined what it considered an adequate reference price, it looked carefully at three separate internal valuation studies produced exclusively for this purpose. The first was a financial valuation based on accounting information of the bank and elaborated in accordance with strict guidelines set up by the National Banking Commission. The second was an economic valuation prepared by an external consultant that described the business profile and presented an evaluation on the future performance of the institution, based on individual and market trends. There was finally a third valuation prepared by the banks themselves in which they look and evaluate their market position and business opportunities.

In preparing for the sale process of each bank, a prospectus was prepared to describe the bank's principal characteristics. Once the Bank Privatization Committee had decided on the specific timing of the sale of each bank, a notice of sale was published so that interested and qualified investors could participate in the auction. To participate in the bidding process for a specific bank, the interested groups made a deposit to guarantee their participation in the auction. To ensure fairness and disclosure in the due diligence process, each bidder group signed a confidentiality agreement, the committee guaranteed that all the bidders were given access to the same information, and representatives of the committee directly supervised the due diligence work.

On the date of the auction, the bidders simultaneously presented their bids in the presence of notary publics. The Bank Privatization Committee reviewed the bids. In the event of a tie, the factors, such as business plan, capitalization, and regional participation, were taken into account. The committee made its recommendation to the government as to the awarding of shares. The government delivered its shares to the winning bidder once the final payment had been made.

In terms of the sales conditions, the bank privatization program has been very successful. The entire sale process was carried out in less than thirteen months, which implies that on average one bank was auctioned every three weeks. Total proceeds from the sales as contracted are over $13 billion. The government still keeps minority participation in three banks, which will be sold at the right moment according to conditions prevailing in domestic and international markets. This participation has been valued at $1.5 billion.

In addition to the positive economic environment and favorable regulatory framework, several factors explain the high level of interest by investors in acquiring ownership in Mexican banks:

- Mexico's financial markets have an outstanding growth potential since currently the economy has a low financial penetration relative to other countries. Mexico's ratio of financial savings (M4) to GDP in 1991 was 45 percent as compared to 74 percent in the U.S. and 80 percent in Europe. Mexican banks have an average 18,000 inhabitants per branch, while the U.S. banks have 4,000 and European banks have 2,000 inhabitants per branch.

- Margins for the Mexican banking system continue to be internationally attractive. In 1991 Mexican banks had a net interest margin of 5.61 percent higher than 3.6 percent of U.S. banks and 2.8 percent of European banks.

- Mexican banks are more profitable relative to the international market, with an average ratio of net income to assets of 1.09 percent, while U.S., European, and Japanese banks have 0.53 percent, 0.41 percent, and 0.19, respectively.

- Mexican banks have a strong financial position since accounting regulations are stricter than those in the United States and Europe, and banking capitalization regulations are stricter or just as strict as the Basel Accord. Mexican banks are expected to reach ratios of capital to risk adjusted assets of 7 percent in 1992 and 8 percent in 1993.

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CLOSING ADDRESS

Alejandro Foxley

I want to begin by congratulating the organizers of this conference for bringing such a distinguished group to Chile to discuss a timely and important topic. Currently, we are witnessing a global convergence in development strategies and economic policies. That means, among other things, that we face many of the same problems. It would be very inefficient for each one of us to try to reinvent the wheel, and proposes wholly new solutions to well-known and common problems. In today's world countries can learn from one another - we can learn from our successes but also from our mistakes. It is in this context that seminars such as this one become particularly useful.

Today in Chile we are living through an interesting and, I believe, fairly successful economic experience. On the macroeconomic front, we have enjoyed some success at taming inflation while continuing to grow at a substantial rates. Last year we grew 6 percent while bringing inflation down a third to eighteen percent. This year we are forecasting growth of around 6.5 percent with inflation falling below fifteen percent. Unemployment is hovering around five percent - the lowest in many decades. Behind these numbers lies a disciplined fiscal policy, involving operating surpluses in every year since President Aylwin came to office, and a willingness to use a tough monetary policy to control aggregate demand, as we did in 1990 and part of 1991.

On the external front, the shortage of foreign exchange has been overcome, with the country posting a very strong performance in all components of the balance of payments. With exports growing at twelve percent in real terms, Chile enjoyed a trade surplus of 1.5 billion dollars in 1991. This, in turn, meant a small surplus in the current account. The capital account has exhibited a large surplus, owing both to very high levels of foreign investment - 1.2 billion dollars, or five percent of GDP last year - and short term capital inflows prompted by attractive domestic interest rates and a strong stock exchange. Finally, the debt problem seems to be over, with commercial bank debt having been fully and voluntarily restructured in 1990. That deal also brought the return of Chile to the voluntary capital markets: a bearer bond issue of 320 million dollars was subscribed by a club of eighteen leading international banks.

In short, a great deal has been accomplished, but a great deal more remains to be done. A number of challenges still face Chile. Today, much of the public debate centers on how to increase savings and investment rates in order to sustain fast growth into the future. In that debate, the theme of this seminar - financial sector policies and

their impact on development - becomes crucial. There is another issue of concern in Chile today - exchange and interest rate management at a time of large capital inflows - that is also central to the discussions you have had here. In the next few minutes I would like to discuss three points of financial-macro management, stressing the lessons I feel Chile has learnt over the last few years.

First in the course of financial management, liberalization should not be confused with the absence of adequate regulation. Financing investment and growth is easier with a deep, flexible and highly developed domestic capital market. In turn, the liberalization of interest rates, elimination of centralized credit controls, flexibility in the range of operations that can be undertaken, etc. - these have obviously been steps in the right direction. But the credit market is not the market for potatoes. Monitoring by individual depositors or investors is difficult, and the public trust is often at stake. Historically - whether in the S&L crisis in the U.S. or in the events of the Southern Cone of Latin America in the early 1980s - governments have found it hard to enforce ex-post prudential regulations in a credible way to avoid the threat of bankruptcy. Hence, a modern and efficient system of monitoring and prudential regulation is key. That is the only way in which a financial system can adequately attract and channel resources toward productive investment.

The lesson is also applicable to the regulation of international financial flows. I am not going to repeat here the troubled story of overborrowing and its consequences in the late 1970s and 1980s. But as Latin American and other countries reenter the voluntary capital markets, the lessons are worth remembering. When a resident of a developing country borrows abroad, two externalities are potentially present. First, markets do not discriminate very well among different borrowers from the same developing country: hence, a borrower who makes a mistake in the markets can worsen borrowing conditions for all. Second, the costs of overborrowing can easily be "socialized" and passed on to the taxpayer as, once again, the experience of countries such as Argentina and Chile showed some ten years ago. Hence, policymakers have here a dual role. On the one hand, they must open up access to foreign capital market by overcoming the "old debt" problem and establishing a good credit record. On the other hand, there is a warranted supervisory role to ensure that access to the capital market is carried out in an orderly way.

The second observation is that the deepening and modernization of capital markets does not always happen automatically, but must be helped by a coordinated policy effort. Let me mention some efforts under way today in Chile, which I think are illustrative of this situation. A typical problem of financial systems everywhere is that they are not very good at channeling funds to small firms with little or no collateral. The reaction is sometimes to have the government do the lending, but the government is not very good at it either. Collecting back the resources is much harder than lending them out. A better answer is to create a system to help small firms prepare investment projects and financial statements, in order to enhance their access to the private financial market.

A related problem is that, as bond markets develop, the older established firms often get the best credit ratings and therefore exclusive access to financing. But in a rapidly growing economy, sectors like infrastructure, energy, telecommunications or natural resources - are often the most dynamic. How do we make sure they find financing? The answer: develop a special rating system to evaluate the bonds issued by "companies without a financial history."

These two examples illustrate the same point: financial management is a hands-on job. Policymakers must actively seek out impediments to efficient market functioning, and then seek to remove them by a market mechanism.

Let me end by discussing a point from the area of macroeconomics. I will start with a controversial statement: LDCs cannot afford to have real exchange rates behave as variably as international capital flows do. In Latin America, the last fifteen years have seen two floods of external financing, separated by a period of rationing that lasted almost a decade. Similarly, we have seen very low international real interest rates in the mid-1970s, very high ones in the early 1980s, and again record lows replicate these cycles. Today, as this seminar has extensively discussed, almost every country in Latin America is experiencing massive inflows and a tendency toward real exchange rate appreciation.

Confronted with this tendency once again, one should not remain passive. It is easy (and sometimes popular) to let the currency appreciate and watch real wages measured in terms of importables rise sharply. It is much harder to reverse this appreciation later on, once the external shock is over, without imposing severe real costs. Of course, no one knows ex-ante whether an interest rate shock will be transitory or permanent. My conjecture here is that, confronted with such uncertainty, policymakers should act cautiously and avoid large swings that may be prompted exclusively by passing external phenomena.

How can one hope to do this? The available tool kit is limited - and of course the real exchange rate is a variable not easily controlled by policy - but some preliminary conclusions can be put forth. First, neither a fully fixed nor a fully flexible exchange rate system seems well equipped to cope with this situation. Versions of the crawling peg, with or without a bank, provide much-needed flexibility. Second, there are strong arguments in favor endowing countries with some freedom to target their domestic interest rates (in the short run) with a dosage of independence from world rates. Fully accommodating today's plunge in dollar interest rates, for instance, would take aggregate demand in a country like Chile above reasonable levels. If this partial insulation requires a wedge - whether a tax or a deposit - to keep domestic and foreign rates apart, so be it. A temporary deviation from perfect capital mobility is preferable, in my view, to exaggerated exchange rate or aggregate demand variability. Third, fiscal policy can provide some stabilizing influence, but not much. Clearly, the absence of a fiscal deficit and a moderate level of government expenditure are fundamental in sustaining an equilibrium real exchange rate. But I know of no country whose institutions would enable it to charge the level of expenditure in response to every

tremor in world interest rates. Therefore, fiscal policy can only be targeted at medium-term balance, not at short-term stabilization.

We have acted in this spirit in Chile over the last two years. By adjusting and widening the exchange rate band last January, we introduced greater flexibility into exchange-rate policy, acting upon the growing consensus that the foreign exchange surfeit is partially structural. Indeed, a stronger currency is the natural consequence of a successful export drive. At the same time, we have attempted to keep the exchange rate competitive - and I believe we have achieved this, as the vigorous growth of non-traditional exports attests. In doing so we have applied a tax on capital inflows and have kept a tight lid on government spending. It is a balancing act that requires permanent and careful attention, and upon which we will persevere.

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