Economic Development Institute
of The World Bank

Financial Sector Reforms, Economic Growth, and Stability

Experiences in Selected Asian and Latin American Countries

Edited by
Shakil Faruqi

EDI SEMINAR SERIES

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Contributors

Suman K. Bery
Binhadi
Choon Taik Chung
Michael Dooley
Mohammad Ashraf Janjua
Takashi Kanzaki
Ekamol Kiriwat
Guillermo Le-Fort
Ross Levine
Carlos Massad
Adrianus Mooy
Reinaldo Penner
Alan R. Roe
J. B. Sumarlin
Edgardo P. Zialcita

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Shakil Faruqi is principal financial economist in the Finance and Private Sector Development Division of the World Bank's Economic Development Institute.

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FOREWORD

This publication consists of the papers prepared for a senior policy seminar held in February 1993 at Bali, Indonesia. The seminar was organized by the EDI in collaboration with Bank Indonesia and with the support of the Government of Japan. Shakil Faruqi of the EDI was the seminar director.

This was the second seminar in a two part mini-series designed to share comparative experiences with financial sector reforms and issues of growth and stability in selected Asian and Latin American countries. The countries represented at this seminar were: Bangladesh, Indonesia, India, Japan, Malaysia, Pakistan, the Philippines, Thailand and Viet Nam from Asia; and Chile, Colombia, Mexico and Paraguay from Latin America. A distinguished group of ministers, central bank governors, their deputies and senior officials from these countries participated in this seminar

The first seminar in this series was held in May 1992 at Economic Commission for Latin America and Caribbean (ECLAC), Santiago Chile and was organized in collaboration with Central Bank of Chile and with the support of the Government of Japan. The proceedings of this seminar were published earlier as Shakil Faruqi (editor), *Financial Sector Reforms in Asian and Latin American Countries: Lessons of Comparative Experience,* EDI Seminar Series, No. 340/073, Washington D.C., 1993.

These seminars were 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.

I would like to thank Nicholas Hope, and Andrew Sheng of the World Bank, Syahril Sabirin and senior officials of Bank Indonesia for their support of the seminar.

The manuscript was edited and prepared for publication by Shakil Faruqi. The papers were copyedited by Jeannie Massie, Alice Dowsett and associates. The task of preparing and processing the text for publication was done by Elizabeth Crespo with skill and patience.

Ammon Golan
Director
Economic Development Institute

ABBREVIATIONS

AAB	authorized agent banks
AFP	pension fund agencies
ALADI	Latin American Integration Association
ARF	asset reconstruction fund
ATM	automatic teller machine
BIS	Bank for International Settlements
BLR	base lending rate
BNF	National Development Bank, Paraguay
BNM	Bank Negara, Malaysia
BNT	National Workers Bank, Paraguay
CAMEL	capital, asset, management, earnings, and liquidity
CB	central bank
CD	certificate of deposit
CPI	consumer price index
CRR	cash reserve requirement
DBC	dollar bearer certificate
DRI	dollar rate of interest
DTC	deposit taking cooperatives
EDI	Economic Development Institute
EFF	Extended Fund Facility
FCA	foreign currency account
FCD	foreign currency deposit
FCDU	foreign currency deposit units
FDI	foreign direct investment
FEBC	foreign exchange bearer certificate
FMC	foreign manufacturing company
FSR	financial sector reform
GATT	General Agreement on Tariffs and Trade

GDP	gross domestic product
GNP	gross national product
HCI	heavy and chemical industries
IFS	international financial statistics
IMF	International Monetary Fund
IPO	initial public offering
LRM	Letras de Regulación Monetaria
MAERS	market average exchange rate system
NAFTA	North American Free Trade Agreement
NBFI	nonbank financial intermediaries
NCI	net capital inflow
NIT	National Investment Trust
PDS	Philippine Dealing System
QR	quantitative restrictions
RBI	Reserve Bank of India
SAPV	Savings and Loan Association of Paraguay
SLA	savings and loans associations
SBI	Securities Bank Indonesia
SBP	State Bank of Pakistan
SBPU	Money Market Securities, Indonesia
SEC	Securities and Exchange Commission
SET	Stock Exchange of Thailand
SLR	statutory liquidity ratio
WPI	wholesale price index

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OPENING ADDRESS

Adrianus Mooy, Governor, Bank Indonesia

On behalf of the Government of Indonesia, let me extend to you a warm welcome to Bali. It is our hope that you will find the setting for this seminar conducive to a constructive discussion and a fruitful outcome. Your agenda for this seminar promises to be demanding for the next four days, but I trust you will be able to spare some time to enjoy the natural beauty of this island and experience the richness of its unique culture.

First I wish to express my appreciation to the Economic Development Institute of the World Bank for taking the lead in organizing this seminar and to the Government of Japan for its support. We at Bank Indonesia feel honored to be associated with this endeavor and we can only hope that the experience gained from this seminar will encourage further collaboration among developing countries on this and other topics of interest.

Perhaps it was not accidental that Indonesia was chosen as the host for the second seminar on Financial Systems Reforms in Asia and Latin America. Like our friends in Chile, who hosted the first seminar, we in Indonesia have undertaken major financial reforms over the past decade. I have had the personal satisfaction in my capacity as governor of Bank Indonesia over the past five years to have been directly involved in the formulation of policy and its implementation. It should come as no surprise if I say that carrying out financial reforms does not come easy or without pain. Let me cite an example from our recent experience. Following the 1988 financial liberalization, there was an explosion in banking sector activity in Indonesia; the number of banks and branches mushroomed in the euphoria of the time, but banks had not prepared the necessary infrastructure to cope with the volume of credit that followed. The consequence was an overheated economy during 1989–90, and the government responded by tightening financial policies. These policies, together with the introduction of prudential regulations to improve the soundness of banks, exposed the full extent of the weaknesses of banks that had indulged in excessive lending in earlier years.

In inaugurating this seminar, I am mindful of the progress achieved at the proceedings of the Santiago seminar. Those proceedings demonstrated a wealth of information available for analysis on financial system reforms undertaken over the past

decade in a number of Asian and Latin American countries. The specific reform packages vary from one country to another, as do the policy responses of individual countries. This diversity of experiences in financial reform provides lessons from which the countries engaged in reform effort could benefit, and which could be especially useful as models for those countries that may be contemplating such reform. The task for this seminar is to build on the useful work already completed in Santiago, and I' feel confident this seminar will contribute significantly to further our understanding of the issues involved and lessons to be drawn.

Before I discuss the reforms in the financial sector in Indonesia, allow me to touch briefly on some aspects of adjustment in the developing countries. Since financial reforms in developing countries generally constitute an integral part of an adjustment strategy, a proper understanding of the adjustment strategy adopted for each country provides a useful framework for assessing the substance of the financial reform itself and analyzing its impact on real economic activities.

The adjustment policies undertaken by developing countries over the last decade have been motivated by a need to restore domestic economic stability and to strengthen the capacity of the economy to deal with external shocks, be they favorable or otherwise. For Indonesia, external shocks came mainly from two sources: changes in global demand associated with variations in world economic activity and swings in the international price of oil. Indonesia's vulnerability to these shocks were reflected in sharp fluctuations in its foreign exchange earnings and government revenues, with implications for policy responses to ensure macroeconomic stability. Heavy reliance on a single commodity (oil), red tape, and overregulation, created impediments to achieve development objectives.

For Indonesia, the strategy embodies three national development objectives (the Trilogy Pembangunan) comprising equitable development, a sufficiently high level of economic growth, and a dynamically stable environment. In turn, our adjustment strategy consists of four intermediate targets: first, increased grass root participation of the public in the development process; second, acceleration of export growth, especially of non-oil and gas, through outward-looking strategies to tap export opportunities in world markets; third, a more diversified, broad-based and balanced economic structure to enhance our capacity to deal with external shocks; and fourth, improvement in the quality of development, including economic efficiency and the quality of human resources with a view to upgrading the quality of life.

In developing countries, policy adjustments covering various sectors are generally required to be undertaken simultaneously. This is especially the case in such areas as pricing and tariff policy, as well as exchange rate policy. In Indonesia, adjustment was initially directed at liberalizing prices and the exchange rate as well as promoting non-oil and gas exports. This was subsequently followed by banking deregulation (1983 and 1988), tax reforms (1984 and 1985), and at various times and in stages other deregulations, including trade, industry, and investment.

A closely related aspect of adjustment is how to minimize any adverse consequences on the vulnerable segments of the population. Experience has varied from one country to another. Some countries that initially resisted going through adjustment to avoid the negative short-term consequences found themselves in greater difficulties that ultimately forced them to take even more drastic measures later. The consequences of a delay in needed adjustment resulted in disruptive social unrest and disorder. In Indonesia the government has pursued a policy of responding promptly when the need for adjustment arises. In my view, this policy has served us well by helping to promote long-term growth and social harmony.

Let me now turn to financial sector reform. Past experience has shown that financial deepening is important in improving and sustaining economic growth in developing countries, and that poor economic resilience against external shocks is basically due to shallow finance, or financial repression, characterized by excessive regulation and control of interest rates and exchange rates. Interest rates fixed below equilibrium levels inhibit savings mobilization; if allowed to reflect market forces, higher rates will create incentives for depositors to save. In this case the adjustment policies in the financial sector will bring about a more efficient allocation of funds, whereby increased demand for investment can be satisfied by the higher savings generated.

A regime of artificially controlled low interest rates closely characterized what existed in Indonesia before 1983. But in June of that year the government embarked on a reform process designed to create a climate conducive to healthy competition among banks. The aim was to improve market mechanisms in ways that could lead to higher efficiency in savings mobilization. The liberalization involved not only the determination of interest rates but also the structure of the financial institutions themselves. Formerly, interest rates on both the deposit and lending sides were determined by Bank Indonesia by fixing rates for state banks, which accounted for the bulk of bank assets (60 percent). After June 1983 the determination of interest rates was left to each bank's discretion, relying more on market forces. The results were soon to follow with a threefold increase in savings over the next five years.

Although the market mechanism had improved, structural weaknesses still existed that inhibited the growth of a sound and efficient financial system. For example, the distribution of bank services was very limited, the efficiency and soundness of banks needed improvement, and nonbank financial institutions were not well developed. Therefore, in October 1988 we introduced further reforms aimed particularly at widening and improving the institutional structure of the financial system. This was primarily achieved by permitting entry of private banks, including foreign banks in a joint venture with national banks, and of rural banks, and by allowing the establishment of foreign-exchange banks as well as the opening of branch offices. An increase in the number of banks can induce efficiency through enhanced competition, thereby enabling the attainment of interest rates at a level that encourages savings and business activities. Widening distribution of banking services throughout

the country can promote an active role for banks to accelerate economic growth and its regional distribution. Furthermore, opening up foreign and joint venture banks as well as foreign branches of domestic banks can promote exports, especially non-oil commodities.

On January 29, 1990, we introduced further financial reforms to improve the credit system as well as enhance Bank Indonesia's role in monetary control. Bank Indonesia's liquidity credits were restricted to only four priority areas, that is, food production, food procurement, cooperatives, and selective long-term investment. By limiting their scope, Bank Indonesia has been able to minimize the impact of liquidity credits on domestic liquidity and inflation. The credit structure of banks has also been improved as banks diversified their activities to finance projects previously funded by liquidity credits. Furthermore, because interest on liquidity credits was subsidized, their diminished role strengthened the market mechanism in interest rate determination.

The rapid development of the banking industry in Indonesia has exposed a need for modernizing banking techniques, with emphasis on human resource development. In addition, the Indonesian banking sector also must adapt to the internationally prevailing regulations to face the rapid trend toward globalization of banking services. Therefore, in February 1991 we issued a package of prudential regulations for banks. Important elements of the package include the following.

- First, banking supervision was to improve early detection of problems and the disclosure of banks' financial condition based on objective criteria.

- Second, banks were to observe prudential practices of international banking standards, such as compliance with the minimum capital requirement as stipulated by the Bank for International Settlements (BIS), provisions concerning legal lending limits, and maintenance of adequate reserves to cover risk assets.

- Third, certain provisions were imposed for owners, boards of directors, and boards of commissioners of banks, concerning moral standards and banking experience.

- Fourth, banks were to undertake human resource development by providing a training fund of at least 5 percent of their personnel budget.

Finally, in March 1992 the government launched the new Bank Act, which provides a framework for the operation of the banking industry. It also set the general objectives of the national banking system, namely that its activities should support national development. Bank categories are simplified into commercial banks and rural banks, and the scope and activities of each category are clearly defined. The law also

stipulates basic requirements for the establishment of a new bank in greater detail and reiterates the mandate of Bank Indonesia over bank examination and supervision.

The thrust of the series of policy packages to reform the banking sector in Indonesia is directed to bring about higher efficiency in the mobilization and channeling of funds and to support the bottom-up development strategy based on equity, growth, and stability. Given this responsibility, the healthy development of a sound and reliable 'banking system needs to be supported by higher professionalism through training and strengthened bank supervision.

This brief elaboration is to stress that reforms in the banking sector in Indonesia constitute an integral part of our adjustment strategy. For us, adjustment is an ongoing process cautiously designed and introduced in a timely manner.

The next issue relates to the sequencing of adjustment policies in the various sectors, especially foreign exchange system liberalization in relation to domestic financial sector reforms. On this matter, it is generally recommended that the liberalization of domestic markets should precede the liberalization of the external sector, because the benefits of reforms in product markets cannot be realized if factor mobility is significantly impaired. Furthermore, it is also argued that the liberalization of the current account should precede the liberalization of the capital accounts, because asset markets generally adjust much faster than commodity markets. Thus, the general view is that capital account liberalization should follow current account liberalizaton, and both should be preceded bv domestic financial sector reforms.

In this regard it is interesting to note that the sequencing of liberalization in Indonesia appeared to have deviated significantly from the normal route. Indonesia's liberalization of the foreign exchange system was introduced in 1970, long before deregulation in the trade area. With the buoyancy of oil revenue, the trade policies during most of the 1970s were still restrictive. It was only in the second half of the 1980s that significant deregulation of trade began. Furthermore, the movement toward a free foreign exchange system also came much earlier than the deregulation in the financial and banking sectors. As indicated earlier, it was only in June 1983 that the ceilings on the deposit and lending interest rates of the state-owned banks were lifted.

Whether or not the sequence of policy liberalization applied in Indonesia is an appropriate model for others to follow is of course open for discussion. Our experience indicated that this sequencing contributed significantly to our economic development, especially in opening up the foreign sector. An alternative route may have resulted in less satisfactory results for us. However, applying our experience to other countries may have to be qualified for the following reasons. First, our liberalization of the foreign exchange system in 1970 was part of a comprehensive package of economic policy, of which adjustment in the domestic interest rate was an integral part. The consequent increase in the domestic interest rates supported by a successful anti-inflation policy during much of the 1970s helped prevent large capital outflows. Second, soon after the new order government took office, a comprehensive economic policy package significantly improved public confidence in economic

management. This effort helped to avoid destabilizing speculation and served as an important factor in the success of the liberalization of our foreign exchange system, which encompassed liberalization of both the current account as well as the capital account. Essentially, the sequencing issue of capital account in relation to the current account in Indonesia was not as clear-cut as it may have appeared.

Our experience in Indonesia illustrates that although the broad elements of the adjustment policies in developing countries may appear to be similar, the appropriate speed and sequencing of the liberalization process may vary from one country to another. The magnitude of the initial imbalances, the comprehensiveness and balance of the policy package, and the political and social circumstances in each country serve to fashion the specific actions that are suited to each country's circumstances. The experience of developing countries suggests that the interaction among adjustment policies is complex, thus we should be very cautious in making broad generalizations.

The Indonesian economy is now reaping the benefits from the structural adjustments that have been implemented in the course of the past several years. The economy has been expanding at an impressive rate amid price stability. The rate of growth was 5.7 percent in 1988, 7.4 percent in 1989, and 7.3 percent in 1990, while the rate of inflation was 5.47 percent in 1988, 5.97 percent in 1989, and 9.53 percent in 1990. Moreover, the economy has become progressively diversified and has moved toward a more balanced structure. It has achieved impressive growth in the manufacturing sector, which now accounts for nearly four-fifths of our non-oil and gas exports. Overall, economic development has been supported by a strong growth in non-oil exports through private investments, ample funds from banking credits, and equity participation through the stock market.

I should underscore, however, the success of our economic adjustments has not been achieved without problems. In 1989, unconstrained demand for goods and services, primarily for investment and consumption, rapidly exceeded the supply capacity of domestic production and imports. The inflation rate rose sharply, almost reaching double-digit figures in 1990. Significantly higher investment activity, especially in 1989 and 1990, also widened the savings gap, which was also reflected in a deterioration of the current account deficit in 1990. The situation was aggravated by investments in costly projects with long gestation periods and by bottlenecks in the supply of public utilities and other infrastructures. The widening internal and external imbalances ultimately became a threat that required prompt response. Growing foreign borrowing to finance the current account deficit exerted pressure on our balances of payments with implications for our capacity to continue to service our external debt. I would describe these developments as the problems of success that are to be found in one degree or another in any economy adjusting to cycles associated with waves of investment following structural adjustment policies.

To cope with these problems, in 1990 the government took measures to cool down the overheated economy and restore internal and external imbalances. We had to move swiftly to curb the expansion of domestic demand by introducing tight financial

policies. Monetary policy was tightened in mid-1990, followed by a rise in interest rates. These measures were reinforced by strict management of government finances as reflected in the establishment of a development budget reserve to help neutralize liquidity expansion from increased earnings from oil during the last two years. Furthermore, in September 1991 the government announced a ceiling on foreign commercial borrowing and set up a committee to coordinate and supervise commercial borrowing activities, especially by state enterprises and banking institutions.

These measures succeeded in containing inflation in 1991 at 9.52 percent. Although real GDP rose by an estimated 6.6 percent for 1991, the growth of real domestic demand fell to 3.4 percent from 12.2 percent in 1990. In US dollar terms, import growth slowed markedly to about 15.7 percent from 31.6 percent in the previous year. This was accompanied by a rebound of non-oil export growth to 22.2 percent. The resulting increase in foreign sector activity has helped maintain economic growth in 1991 at the relatively high rate of 6.6 percent.

We are proud to tell you that as a result of continued prudent financial policies, the Indonesian economy is in the "soft-landing" mode. In 1992 non-oil exports grew by 21.1 percent, which not only helped improve the balance of payments but also sustained economic growth at about 6.0 percent. Import growth fell further to 7.1 percent in 1992 from 15.7 percent in 1991. These developments helped reduce the current account deficit from US$4.4 billion in 1991 to US$3.8 billion in 1992. The inflation rate was more than halved; it fell from 9.52 percent in 1991 to 4.94 percent in 1992. During our twenty-five years of development, we were able to keep inflation rates below this level on only two occasions.

This is a brief review of our experience in formulating and implementing adjustment policies, with particular emphasis on the reform of our financial system. We are proud that these adjustment policies have served us well by sustaining a growth momentum that has left a visible impact on the welfare of our people. We are aware, of course, that adjustment policies are an ongoing process, but I think it is fair to say that our successful experience has bolstered our confidence and strenghtened our resolve to stay "the course" as we face the challenges of the future.

Thank you.

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SEMINAR PROCEEDINGS: A SUMMARY REPORT

Alan R. Roe, University of Warwick

Financial sector reform and the subsequent management and regulation of the sector is an extremely important aspect of economic policy in many of the countries supported by World Bank loans and technical assistance. The distillation of the lessons from such reforms has become an important element in the work of the Economic Development Institute (EDI) in recent years. This work, in turn, has shown that although the component problems often differ from country to country, there is a great deal of commonality across countries and even continents. This paper addresses the latest initiative of the EDI in this field of work and summarizes the papers and associated discussions presented at the Senior Policy Seminar held in Bali, Indonesia from February 8 to 11, 1993. The seminar was the second one organized by EDI on the general theme of comparative financial reform experiences in Asia and Latin America; the initial seminar held on this topic was in Santiago, Chile, in March 1992.[1]

Participants included ministers, central bank governors, and senior officials from a total of thirteen Latin American and Asian economies. The countries represented were Bangladesh, India, Indonesia, Japan, the Republic of Korea, Malaysia, the Philippines, Thailand, and Viet Nam from Asia; and Chile, Colombia, Mexico, and Paraguay from Latin America. The seminar was supported by the Government of Japan, organized by the Economic Development Institute of the World Bank in collaboration with the Bank of Indonesia, and directed by Shakil Faruqi of the Economic Development Institute.

As in the earlier seminar, the main purpose was to assess comparatively the wide range of country experiences with financial reform in the two regions and to attempt to identify any general lessons. On this occasion, however, a second objective was to assess the overall consequence for economic stability of reform measures in somewhat greater depth than had been possible in Santiago, where a broader topic had been adopted. Thus, a good deal of attention was directed toward the question of the sustainability of large capital inflows now being experienced by several participating countries and the consequences and management of financial bubbles. The topics of

1. The proceedings of the earlier seminar have now been published as Shakil Faruqi (editor), *Financial Sector Reforms in Asia and Latin American Countries: Lessons of Comparative Experience*, EDI Seminar Series, No. 340/073 Washington DC., 1993.

bank regulation and supervision were also accorded greater prominence than in the previous seminar.

Various speakers presented papers that supported discussions on a variety of sub-themes, including the problems and possibilities created by the liberalization of capital accounts; the issues arising from financial deepening and the regulation of securities markets; the impact on bank stability and the management of real estate and other financial bubbles; and the increasingly important role of strong bank supervision as a support structure for the overall reform of financial sectors. The presentations during the four days included papers on experiences in some or all of these areas in eight of the countries represented, as well as a number of papers of a more general and synoptic nature.

Opening Address

Several of the main themes of the seminar were identified and elaborated on in the opening address by Adrianus Mooy, Governor of the Bank Indonesia, the Indonesian central bank. Mooy noted that financial reform in his country, as in many others, had not been achieved without some pain. In particular, the explosion of banking sector activity that followed the financial liberalization of 1988 had occurred without the proper establishment of a supporting infrastructure of regulation. Hence, one consequence had been a seriously overheated economy by 1990 and difficulties for banks that needed to be addressed eventually through a major strengthening of the country's system of prudential regulation and supervision. This was now underway. (See also paper 4 on Indonesia.)

Mooy pointed out that the adjustment policies undertaken by many developing countries in recent years had been motivated by an anxiety to build up greater resilience to external shocks. Indonesia was no exception. There the most damaging shocks had normally been associated with general swings in the levels of world economic activity but more importantly with large movements in the international price of oil. Indonesia's vulnerability to these shocks had often resulted in large and disruptive swings in foreign exchange earnings and government revenues. Hence, a major component of the adjustment effort had involved attempts to achieve a more diversified, broad based, and, above all, outward looking productive structure to ensure that this vulnerability could be lessened significantly. This, however, had to be achieved in the context of the country's other development objectives, which included increased participation of the general public in the development process and a general improvement of the quality of development, such as giving greater attention to improved human resource capabilities. Mooy felt that his country's decision generally to respond promptly to adjustment needs as they arose had helped both the overall development of the country as well as the promotion and maintenance of equity and social harmony during the process.

As for the content of his own country's financial reform efforts, Mooy pointed out that prior to 1983 Indonesia's situation closely mirrored the McKinnon-Shaw representation of shallow finance caused by excessive regulation associated especially with controls on interest rates and exchange rates and, more generally, with financial intervention. The liberalization of interest rates and the fostering of a more competitive banking system began in Indonesia in June 1983 and led quickly to a substantial improvement in the country's savings performance and in the efficiency of use of available savings. But the financial system remained narrow. In October 1988 the government enacted further reforms to widen the system and generally improve its structure. This was done mainly by permitting the entry of new banks, especially through joint venture arrangements with foreign banks; establishing foreign exchange banks; and expanding bank branching. These measures were extended further in the early 1990s when steps were taken to limit Bank Indonesia's direct involvement in the provision of liquidity credits to priority uses, thereby limiting the central bank's impact on the expansion of domestic liquidity and according it greater control over monetary and inflationary pressures.

The rapid changes in the size and the roles of the Indonesian banking system that followed these reforms, together with the challenges associated with the parallel globalization of many banking activities and regulations, exposed the need for the modernization of banking techniques, including the control methods used by the monetary authorities. These matters and others were addressed in the further reform measures of February 1991, which redefined the prudential framework of banks in several main areas. First, it substantially strengthened bank disclosure requirements and bank supervision to ensure that the authorities were better equipped to detect problems earlier. Second, it introduced internationally accepted standards in the areas of capital adequacy, legal lending limits, and reserve cover for risk assets. Third, it defined new and tighter standards for the owners, directors, and managers of banks. Fourth, it recognized the human resource implications of the new environment by introducing a mandatory training obligation linked to a training fund equal to 5 percent of each bank's personnel budget. Finally, in March 1992, the overall framework for banking activity in the country was defined in the new Bank Act.

Cumulatively through these various reforms, Mooy felt that the Indonesian banking industry had been put in a position to support the country's bottom-up development strategy by ensuring greater efficiency in both the mobilization and channeling of funds to all sectors of economic activity and all segments of the population. Certainly the reforms that had been introduced had confirmed the authorities' belief that financial reform and modernization were integral parts of the country's overall adjustment effort.

On the matter of sequencing the various component reforms, Mooy noted that Indonesia appeared to have deviated significantly from the conventional approach to this matter. The general view is that capital account liberalization should follow

current account and trade liberalization, and that both should be preceded by domestic financial sector reforms. Indonesia, however, had significantly liberalized its capital account in 1970, many years before deregulation began in the area of foreign trade, which began only in the second half of the 1980s. Furthermore, the deregulation of the foreign exchange system had come much earlier than the deregulation of the domestic banking and financial sectors, which, as just noted, remained relatively restricted until about 1983.

Although this unusual pattern of reform worked well for Indonesia, Mooy did not expect that the experience could carry over easily in other country contexts. There were several reasons for this. First, foreign exchange liberalization in the 1970s was part of a comprehensive policy that had also included significant upward movements of interest rates. This, together with a generally successful set of anti-inflation policies at that time, had both prevented large capital outflows (in spite of the still-restricted domestic financial system) and had stimulated much greater public confidence in the government's overall management of the economy. In addition, the 1970 liberalization of the capital account had actually involved a significant relaxation of current account controls. Thus, the apparent separation of the current and the capital account reforms was not nearly as clear-cut as it may have appeared. More generally, Mooy argued, the interaction among different aspects of an overall adjustment program was extremely complex and often country specific. Hence, it was somewhat hazardous to make broad generalizations about issues, such as appropriate sequencing.

Indonesia has certainly reaped considerable benefits from the numerous reforms implemented during the past few years. Growth rates in the recent past, for example, have been between 5.7 and 7.4 percent, and inflation has been contained at the single digit level. Even more significant, the diversification necessary to provide better insulation from global shocks has certainly been achieved: the manufacturing sector now accounts for almost as large a proportion of total exports as does oil and gas. This diversification has been driven by private investment and the availability of ample credit from the domestic banking system.

The overheated economy in the late 1980s, already referred to, had created considerable difficulties for the authorities. Although associated with the country's success in stimulating new investment, it was nonetheless manifested in unsustainable external deficits and an accelerating upward movement of inflation. The government, however, had moved quickly to correct the imbalances. This had been done by enacting a tighter monetary policy in mid-1990 that included higher interest rates and a significant tightening of the government's own expenditures, especially on development projects. Although this caused a major slowdown in the growth of total domestic demand, especially in 1990, Mooy noted that the good performance of export activity meant that overall growth in both 1991 and 1992 continued to be high, at rates of 6.6 and 6.0 percent, respectively. This was achieved with a large fall in the external current account deficit and a decline in inflation to less than 5 by 1992.

In replying to Governor Mooy's introductory remarks, Guillermo Ortiz from Mexico addressed four main points. First, he agreed with Mooy that financial reform needed to be analyzed within the general context of a country's overall adjustment effort. Mexico, like Indonesia, had needed to diversify from an excessive dependence on oil exports. Subsequently, it was very successful in this regard, having reduced the share of oil in total exports from over 70 percent in the early 1980s to only 25 at the present time. Second, the traditional price stability of Mexico through the 1950s, 1960s, and part of the 1970s had been seriously interrupted until the end of the 1980s. An important consequence had been low or negative real rates of interest, which resulted in a considerable decline in the importance of the country's financial sector relative to GDP. This was reversed only by the reforms of the late 1980s.

Third, Ortiz argued that the experiences of Indonesia, Mexico, and other countries clearly demonstrated the importance of fiscal correction, including a far more disciplined use of central bank rediscounting as a major precondition for the successful liberalization of interest rates. Ortiz felt that a further important step was the simplification of systems of reserve requirements and, for Mexico, the elimination of the multiple reserve requirements and discount rates formerly applied to different sectors. Finally, Ortiz agreed with Governor Mooy that institutional reforms linked to a more competitive banking system constitute a very important second stage of overall financial sector reform. In the case of Mexico, strengthening competition, privatizing several banks, and generally opening up the financial system were associated partly with treaty obligations under the North American Free Trade Agreement (NAFTA), which played an important role in this process. Nonetheless, interest rate spreads remained too high partly because of the high ratio of overdue obligations, possibly associated with an excessively rapid growth of credit.

Mexican reforms, like those in Indonesia, had been followed by some overheating of the economy and had also generated the response from the authorities of a very substantial tightening and improvement of arrangements for prudential regulation and bank supervision. Ortiz noted more generally that traditional control systems would inevitably become outdated as domestic financial markets evolved in response to reforms and to financial sector globalization. Although both Indonesian and Mexican authorities had responded positively to these situations, many unanswered questions still remain about how these inherent dangers can be avoided.

Overview of the Paper

The remainder of this paper is organized into seven sections. Discussions are in the following sequence:

- The topic of capital inflow and financial bubbles, based mainly around the presentation given by Michael Dooley.

- The issue of capital account liberalization in the context of the reforms undertaken by Mexico and the Philippines, based around presentations by Guillermo Ortiz and Edgardo Zialcita.

- Certain institutional aspects of the financial reform process addressed in two sections. The first one discusses the issue of securities market reforms, with special reference to the experiences of Thailand as presented by Ekamol Kiriwat. The second one focuses on reforms in India and Pakistan, especially on the various aspects of the resolution of bad debt problems of Indian banks. This section is developed around presentations by Suman Bery and Mohammed Janjua.

- Certain aspects of the link between financial system performance and reform on the one hand and macroeconomic stability on the other, based on presentations by Guillermo Le-Fort, Lin See Yan, and Takashi Kanzaki.

- The issues that confront the tasks of bank regulation and supervision in a post-liberalization era, based on the presentation by Binhadi from Bank Indonesia.

- A few conclusions and contrasts from the four days of discussion.

Financial Liberalization, Capital Flows and Bubbles

Financial reforms in recent years in many of the countries represented at the seminar involved a significant opening to capital account movements. In several cases, for example Chile, Malaysia, Mexico, and Indonesia, this liberalization was followed by large- scale inflows of foreign capital. The most obvious and appealing explanation of these large inward flows is that they represent the response of international capital markets to the improved fundamentals in the reforming countries: that is the genuine pursuit by scarce international capital of the highest rates of return available. Participants generally acknowledged, however, that the true nature and motivation of these flows was often unclear to them; thus, the correct policy responses to large capital inflows remained a matter of considerable difficulty and disagreement. In this general context, it was the role of the first main area of discussion at the seminar to try to clarify the possible causes of large capital inflows and to assess the implications of this for domestic policy management. The discussion was led by Michael Dooley from the University of California.

Dooley began by noting the short-life of the prediction made in the darkest days of 1982 and the international debt crisis that debt distressed developing countries would be unable to regain access to international capital markets for a generation. In fact, large new capital inflows from abroad and associated boom conditions in emerging stock markets have become widespread since 1989. The Western Hemisphere countries, for example, attracted total inflows of US$24 billion, US$39 billion, and US$43 billion in the years 1990, 1991, and 1992, respectively, and had been able to build their international reserves by US$15 billion or more in each of those three years. The Asian countries, which had suffered fewer negative effects from the debt crisis in the early-1980s, had attracted private inflows in excess of US$40 billion in both 1991 and 1992 and had built foreign reserves by an average of US$32 billion in each of those years. In the Western Hemisphere the private inflows have been divided approximately equally between the buildup of international reserves and the accumulation of current account balance of payments deficits, while in Asia the impact on reserves has been proportionately higher. In both cases, however, it is clear that policy decisions to sterilize the private inflows have been an important feature of recent experience.

The magnitude of the inflows has varied considerably among the individual countries. Most dramatically, the inflows into Mexico in 1991 were the equivalent of 8 percent of GDP, which is a larger inflow than that recorded before the onset of the debt crisis. In most other Latin American economies, the recent inflows, though impressive, are smaller relative to GDP than the levels achieved before the debt crisis. Among the Asian economies the recent inflows to Indonesia and Thailand are proportionately larger than before the debt crisis, while the opposite tendency is evident for Singapore and, to a lesser extent, Malaysia.

Dooley suggested three possible competing explanations for these large inflows. The first is the one already mentioned above: the fundamentals of inflation and growth rates in the recipient countries may have changed for the better during the past two to three years. Together with low real yields on investment opportunities in the industrial countries, this could be a cause of the current large flows. In this case, though, the trend could obviously reverse when competing yields in the industrial world begin to recover.

Second, the inflows might be associated with a speculative bubble, in which relatively poorly informed private sector investors are merely playing a follow the leader game based peripherally, if at all, on fundamental factors. The anxieties to which this explanation would give rise if it turned out to be correct is that speculative bubbles eventually burst, giving rise to large-scale reverse flows. This second explanation appears to be consistent with the fact that many actual and potential foreign investors in the reforming economies have little or no experience in how such economies behave. Thus, as in other market situations, it is plausible to argue that market participants can get caught up in the excitement of the speculative move in

prices of some assets and can carry these asset prices even further upward and well beyond the levels that are consistent with the fundamentals. Because some market participants made money by buying the assets yesterday, others go along for the ride to make money tomorrow. For this to continue, someone tomorrow must be willing to pay a higher price for the asset than was paid today.

The third possible explanation, and the one that Dooley himself regards as the most plausible currently, is that the policies of the monetary authorities themselves may be creating arbitrage opportunities that the foreign investors are exploiting when they push large sums of money into some of the reforming economies. As in the case of speculative bubbles, these inflows may have little connection with the fundamentals in the economy. Unlike ill-informed speculative inflows, however, these inflows depend on the implicit guarantees that governments seem prepared to offer. In essence, the inflows will continue or reverse depending on the scale of the resources that seem likely to be available to support the implicit government guarantee.

The analogy with the 1980s debt crisis is usefully spelled out to explain this proposition. In the buildup to that crisis, the governments of debtor countries offered guarantees to foreign creditors on the dollar value of their own or domestic residents' liabilities to foreign creditors. Thus as debt accumulated during the 1970s, the government matched this actual accumulation with the buildup of large contingent liabilities. These became a little noticed but eventually important part of the governments' financial positions. Arguably, to some extent the offer of the guarantee may even have become the cause of many of the inflows.

By contrast, the more recent inflows have taken the form of foreign purchases of domestic currency instruments, and explicit government guarantees have been largely absent. Thus, as Dooley noted, if mistakes are being made, they are certainly different from those made in the 1970s and early 1980s. Instead, he argued, the implicit guarantees now being provided by many governments are of two main forms. First, by operating exchange rate policies linked to a fixed or managed exchange rate, many governments, in effect, provide investors in domestic currency-denominated assets with exchange rate guarantees.

Second, monetary authorities are limiting the decline in yields on domestic assets. In principle, large-scale inflows of capital should sooner or later give rise to falls in the rates of return on domestic assets, which will then discourage further inflows. This process was short-circuited in the early 1980s when large inflows into many countries were matched by large unrecorded private outflows. By contrast, in the early 1990s governments in many countries are showing a strong tendency to limit the monetary and inflationary consequences of large inflows by issuing securities to finance the purchase of large foreign exchange flows. In effect, the monetary authorities intervene in the foreign exchange markets to prevent too much appreciation of the domestic currency (fearful of the scale of the depreciation that would follow from a turnaround). They thereby recycle these funds back into the international

circuits. The authorities also intervene in the domestic money markets to prevent a large fall in interest rates.

Dooley contended that, unlike a speculatively motivated inflow, this process can go on for a long time because of the demonstrated willingness of central banks in recipient countries to pay a higher interest yield on its domestic currency liabilities than the return it earns on its accumulating foreign currency reserves. The implied losses to the central bank need not become constraining for some time. Also by contrast with speculatively based inflows, the process, whereby investors feed off implicit guarantees of governments, means that the turnaround, when it comes, imposes losses not on private speculators but on the government itself as its contingent liabilities are called. This arises because the turnaround involves both a rundown of foreign currency reserves in the central bank as well as probable assistance to the domestic banking industry to meet its domestic currency withdrawals.

The policy implications of all this are somewhat disturbing. It is unlikely that most governments, benefiting from large capital inflows, will be able to persuade investors that the implicit guarantee accorded to bank deposits will be withdrawn, because investors know that in most countries bank bailouts do and will happen. Therefore, the onus for exposing investors to more genuine risks (that is, limiting the one-way nature of their bets) has to lie with signals coming from exchange rate policy. More explicitly, Dooley argued, that governments should be prepared to allow capital inflows to have a more depressing effect on domestic interest rates by not sterilizing the inflows, or, alternatively, governments should allow the nominal exchange rate to adjust more to market forces (that is, appreciate more when there are large inflows).

In Dooley's view neither policy would be likely to seriously damage those capital inflows genuinely associated with improved investment climates in the reforming countries. It would, however, help to limit the "round-tripping" of foreign exchange that, in his view, has increasingly dominated fixed exchange rate systems since the onset of globalization in capital markets. The implication of Dooley's suggestion is that countries adopt more flexible exchange rate policies and develop some alternative target to control inflationary expectations.

Discussion from the floor generally confirmed the lack of consensus about how to deal with large inflows. It was noted, for example, that countries such as Mexico, Indonesia, and Malaysia, which have been explicitly working for a more diversified production and export base, cannot be entirely indifferent to the way in which the exchange rate is moving. However, it was agreed that complete sterilization will certainly cause interest rates to rise, which will intensify the attractiveness of investment in a country and so give rise to more inflows. The other extreme policy of doing nothing in response to the inflows was certain to result in serious exchange rate appreciation and damage to export prospects. It might also harm the prospects for attracting foreign direct investment in export-based industries. The implication seemed

to be that the correct policy was somewhere between these two extremes, but participants differed on how to determine the exact stance.

A number of people argued that an exchange rate target, preferably based on a degree of undervaluation, was necessary for reform. Associated with this, another participant suggested that a third policy instrument, namely fiscal policy, might be introduced for this purpose. Specifically, if there was some reluctance to abandon a fixed exchange rate target, then the dogmatism of near balance in fiscal accounts might be abandoned with the size of the fiscal balance being used explicitly as a counter-cyclical device to compensate for the appreciating effects of large inflows. An opposing view was that among the faster growing of the reforming economies it was inappropriate to try to maintain the same nominal exchange rate in the face of that fast growth. Indeed, the rate had to be allowed to appreciate to reflect the changes in the necessary structure of production associated with rising real wage levels.

Another aspect of the discussion related to Dooley's point about the implicit guarantees accorded to domestic currency liabilities in the banks. Participants generally agreed that such guarantees are indeed provided by the countries represented at the seminar and necessarily so. Bank failure in many of these countries can threaten the entire countries' payments systems. Because this must be avoided at all costs, the banking system itself has to be protected.

At the same time, participants argued, blanket commitments to bail out all banks in most circumstances were unnecessary and even damaging, as the earlier experiences in Malaysia had indicated. The current procedures for dealing with bank failures in Malaysia are more considered and they include arrangements to penalize shareholders and others for such failures. The practice in the United States of relying heavily on deposit insurance has been rejected, because it is taken to imply a lack of credibility in the central bank's overarching responsibility for the stability of the banking system. Nonetheless, depositors normally receive priority treatment in the event of failure; thus, Dooley's basic point about an implicit guarantee has validity.

An important practical implication that the discussion drew out related to the prudential regulation of banks. If banks are indeed able to attract large liabilities from foreign sources, then regulatory arrangements need to reflect the risks of this. The approach adopted in Mexico had been to require the dollar-denominated liabilities of the banks to be matched by loans and other assets by organizations able to denominate their earnings in dollar terms. While this approach did not completely remove the dangers of a reversal of capital inflows to the banks, it did provide the banks and the authorities with some risk limitation against such an eventuality.

The final point that was debated concerned the practical problems for central banks in managing large inflows, an issue that recurred in subsequent sessions of the seminar. Participants noted that the sterilization process was far more difficult when fiscal accounts were in balance or in surplus and there was no government issued paper to sell. In these situations the central banks themselves were having to issue paper as the medium for conducting the sterilization process. This was expensive given the

large volumes that had to be sold. Currently, returns on dollar-denominated reserves were only about 3 percent; far lower than the yields typically required to sell domestic paper. Thus, central banks were indeed incurring significant losses on these transactions. In an environment of steady currency appreciation, there is also a tremendous demand to sell export earnings forward. This can also expose central banks to substantial foreign exchange losses by providing the forward cover. Overall, the financial situation of central banks, as well as their ability to operate independently, are compromised by a situation of sustained capital inflows.

Capital Account Liberalization in Mexico and the Philippines

Following this general discussion of the possible determinants and dangers of capital account inflows, the proceedings of the seminar moved on to review and discuss the experiences of capital account liberalization in two specific cases, namely, Mexico and the Philippines. Mexico now has a record of sustained progress on economic reform spanning several years and including most major areas of stabilization and adjustment. By contrast, financial reforms in the Philippines date back only three years to 1991. Hence, while in both cases it was possible in the discussion to consider the content of some of the relevant reforms, there was a rather stronger basis for assessing the results of reforms, including capital account liberalization, for Mexico than for the Philippines.

Mexico

In introducing the topic, Guillermo Ortiz, Undersecretary for Finance and Public Credit, began by confirming that in the past few years Mexico has witnessed a considerable increase of capital inflows. From a net flow of minus US$1.5 billion in 1988, the figure has grown rapidly to a total of about US$20 billion by 1991. In 1992 private flows amounted to US$20.9 billion. In addition, the public sector reduced its own external debt by some US$2.8 billion. From 1991 to 1993 a total of some US$70 billion of inflows is anticipated. This is already having, and will continue to have, a profound effect on the country's ability to finance its investment programs. The reasons for the inflow represent a combination of the three factors indicated in the presentation by Professor Dooley, that is fundamentals of inflation and growth rates, speculative bubbles, and policies creating opportunities for foreign investors, but Ortiz stressed the important microeconomic reforms that have greatly improved the productivity of capital in Mexico's economy.

Ortiz stressed that, like Indonesia, Mexico had operated with a reasonably open capital account since the end of World War II. Although dual exchange rate

arrangements continued for a time, representing a tax on capital inflows, few formal restrictions existed on capital movements. Ortiz agreed, however, that the return of the country to a situation of voluntary lending in 1989-90 after the completion of the Brady debt reduction program has been equivalent in many ways to the opening of the capital account.

In Ortiz's opinion, the increased diversity of the financial and real productive assets available has motivated the recent large inflows. These assets now offer investors considerable scope for achieving various different combinations of risks and returns. The environment is now one in which fiscal deficits (excluding privatization revenues) have been eliminated and a variety of attractive new capital market instruments have been established. The flows have accrued mainly to the private sector. In both 1990 and 1991 significant inflows were channeled through the Mexican commercial banks, but in 1991 and 1992 the authorities imposed limits on commercial bank borrowing from abroad. This meant that in 1992 all the inflows went to the nonbank private sector. Indeed there was even a small reduction of foreign currency liabilities for commercial banks in that year. This evolution in policy was motivated by the anxiety of the authorities to avoid the lender of last resort obligations to foreigners that Dooley's analysis had indicated.

Ortiz noted that the inflows of the past two years (1991 and 1992) emphasized stock market instruments, including some government securities investment. Foreign direct investment (FDI) amounted to 25 percent of the total in that period against 40 percent for corporate stock market securities. This latter influence has resulted in a near quadrupling of the capitalization value of quoted securities on the Mexican stock exchange since early 1990. The value of securities now stands at about US$140 billion, including a US$25 billion element attributable to foreign investment. A foreign stake of approximately 25 percent in the outstanding issues of government securities also exists. Banking sector liabilities to foreigners grew by almost US$5 billion per year cumulatively in 1990 and 1991 but have fallen subsequently because of the recent restrictions on bank offshore borrowing.

Aspects of Mexico's Success. Ortiz attributed Mexico's considerable success in attracting increased foreign investment to a combination of three factors: the government's consistency in maintaining sound macroeconomic policies; the liberalization of the country's financial markets; and the country's ability to introduce a wide range of new and varied financial instruments able to tap the interest of a number of different types of investors. Regarding macroeconomic aspects, confidence had returned largely because of Mexico's ability to make deep fiscal adjustments, to reduce inflation dramatically, to move toward external account balance, and to achieve higher rates of economic growth. Some of the institutional changes behind these adjustments have also been significant, not least the liberalization of trade through the NAFTA agreement and the general retreat of government from many areas of economic activity where it had previously been a significant player.

Concerning new financial instruments, Ortiz noted that the private stock instruments that had been used had included American depository receipts, free subscription stock, Mexican funds, and Eurobonds. Government securities have included *cetes* (with maturities ranging from 28 to 364 days), bonds (floating rate notes with one and two year maturities), *ajustabonos* (yields indexed to the consumer price index), *pagafes* (yields indexed to the controlled exchange rate), and *tesobonos* (yields indexed to the free exchange rate).

Because of the generally favorable international perceptions of Mexico's reforms, the risk ratings attached to the country's financial paper have also improved considerably, which also helped stimulate the inflows. For example, the discount on secondary market pricing of Mexico's external debt fell from 35 percent to only about 16 percent from the beginning of 1990 to the end of 1992. Mexican Eurobond issues had become the actual benchmark against which other Latin American issues were judged and in 1991 and 1992 had accounted for almost 50 percent of all Latin American bond issues. Furthermore, the interest rates that the government needed to offer on its own paper had fallen considerably since the late 1980s. The average nominal rate on 28 day treasury certificates (*cetes*), for example, fell from over 100 percent at the end of 1987 to less than 20 percent by 1992. Maturities also lengthened, with about 59 percent of overseas holdings of *cetes*, having a maturity of 364 days by December 1992.

Some Macroeconomic Consequences. Ortiz applied to the Mexico situation some of Dooley's earlier analysis about the macroeconomic difficulties caused by large inflows. He reiterated that sudden and large inflows will make it far more difficult for the authorities to control inflation. Additionally, the authorities always need to consider that large inflows in one period could become large outflows at some later stage and will thus destabilize the economy. Relative to the two extreme responses considered in the earlier session (full sterilization giving rise to large central bank losses or no sterilization giving rise to economic overheating), Mexico tried to steer a middle course. This involved, above all, limiting external borrowing of domestic banks and adhering to structural reform policies that, among other things, sought to stimulate an increased flow of funds into productive investment. Ortiz emphasized that a great deal of the industrial restructuring currently taking place in Mexico required large-scale investment funds and high levels of imported equipment. The restructuring, however, did not necessarily give rise to instant improvements in overall growth rates of productive activity, partly because some unproductive industries were declining. This resulted in a large current balance of payments deficits.

Ortiz pointed out that while the authorities took measures to restrain inflows, the inflows continued on a substantial scale and had caused a very significant appreciation of the Mexican real exchange rate since 1987 (from an index value of 165

in 1987 to 108 by 1992: 1970 = 100). Although, officials decided late in 1992 to widen the bands within which the nominal exchange rate was free to move, thus far it has not made it any easier to avoid the appreciation of the real exchange rate. Thus, microeconomic reforms need to be sustained in an effort to generate average levels of improvement in productivity sufficient to validate the new and still rising level of the exchange rate. This, he noted, is an extremely demanding treadmill.

Much of the discussion following the Ortiz presentation focused on the sustainability of the successes and the large inflows so far achieved by Mexico. Several participants raised questions about the extent of the adverse effects that the appreciation of the real exchange rate has had on the country's export performance, especially in the *machialadores* sector, which had traditionally relied on its large wage cost advantages relative to the United States. More generally, participants noted that the tendency for productivity performance to adjust to reconcile the exchange rate with the level of capital inflows was very much a long-term phenomenon. In the short run it was more likely that wage rates and nontraded prices generally would rise as a consequence of large inflows and that this would undermine international competitiveness. Ortiz agreed but pointed out that in spite of this factor Mexican exports had risen quite rapidly in 1991 (13 percent) and reasonably fast (7 to 8 percent) in 1992 in the wake of the U.S. recession.

Also concerning sustainability is that in the long run the current account of the balance of payments must balance, which implies zero capital inflows (net) over the long term. Thus, the domestic savings rate must rise eventually to provide for an exportable surplus, which Mexico currently is not achieving. Ortiz agreed that domestic savings rates had dropped, although rates for the public sector, where interest payments were formerly much larger, had improved considerably.

Possibly the most controversial issue was whether the precautions Mexico had taken to limit capital inflows would insulate the stability of the domestic financial sector from the more serious potential consequences of an eventual reversal of flows. Ortiz argued that because so much of the corporate borrowing of the country was now done using the companies' own paper rather than borrowing through the banks, some of the earlier risks of external borrowing had been lessened. More specifically, he saw no particular reason why the commercial banks should bail out industrial companies that found themselves in difficulties because of international funds being withdrawn or drying up. Thus, the government too was insulated to some extent from the likelihood of turning implicit guarantees to banks into explicit payments if difficulties emerge in the industrial sector.

Other participants, however, argued that if loans to nonbanks were called, it might be difficult for domestic banks to avoid serious involvement because the companies in difficulties would turn to domestic banks for funds to replace those being withdrawn. This point, although unresolved, is clearly a significant concern in this area of policy debate. Ortiz's contention, if correct, implies that the form in which international capital flows accrue to a country can be important in diluting the problems

of the implicit government guarantees as explained by Dooley. Countries such as Mexico, in other words, can securely locate the risks of international capital transfers with the foreign lender and the domestic private corporate borrower. If that contention is incorrect it implies that some of the efforts being made by participants at the seminar to influence the types of capital inflows they attract may be less effective than they anticipate in limiting the risks of those inflows to the government and the macroeconomy in general.

The Philippines

The experiences of the Philippines were introduced by Edgardo Zialcita, Deputy Governor of the Central Bank of the Philippines. Zialcita began by briefly reviewing the history of exchange control arrangements in his country.

Exchange control had been introduced in 1949 in an effort to conserve scarce foreign exchange for the reconstruction of the country's war-damaged economy. The government finally achieved full convertibility of the current account in 1991–92 at the same time that it took significant steps to liberalize the capital account. Although there had been an earlier and initially successful liberalization of the current account in the 1960s, both an import surge and a deteriorating terms of trade soon forced the authorities to again introduce controls. Thereafter, until the early 1990s, reforms had been largely of a fine-tuning nature. Capital account restrictions had remained pervasive. For capital inflows, officials established criteria to channel both borrowings and direct investments by specified priority area borrowers. Registration was a strict condition for borrowers gaining approval to service debts and to make dividend payments. A few small windows of opportunity for foreign funds were nonetheless created in this generally restrictive environment. For example, in 1976 an offshore banking system was established to allow foreign banks a small base for operating in the Philippines in spite of a general block on the entry of foreign banks.

Zialcita explained that, in spite of this restrictive regime, the economy still proved susceptible to a series of balance of payments crises. These culminated in the crisis of the early 1980s, which eventually led to the debt moratorium declared in October 1983 and to an emergency package of further exchange controls. The International Monetary Fund (IMF), supported reforms that followed this crisis resulted in a floating exchange rate for the Philippine peso based on a freely determined interbank rate. Then between April 1986 and April 1988, the government undertook phase I of an import liberalization program, followed by a second phase. These two phases achieved a high degree of liberalization of exchange controls on trade. Little action, however, was taken at that stage on nontrade items, and the conditions under which the interbank foreign exchange market functioned continued to be restrictive.

Further economic difficulties in 1989, partly attributable to political factors, also confirmed the view of many that the economy was still failing to achieve its true potential for growth, especially in the areas of investment and exports. Thus, a new program with the IMF introduced a further effort to reform exchange controls, as well as to boost exports and foreign investment. These reforms were staggered through 1991 and 1992.

Recent Measures. Zialcita explained several of the main components of the reforms implemented since 1991. First, exporters were given full freedom to dispose of their own foreign exchange receipts. Second, restrictions on all methods of import and export payment were lifted, except payments through letters of credit. The central bank also lifted all prior approval requirements on export transactions. Third, restrictions on access to foreign exchange for service payments were lifted and free trade in gold was allowed. Fourth, exporters were allowed to hold foreign currency deposits in domestic banks and were given access to short-term foreign currency loans, including trade facility credits from domestic sources without central bank approval. This reform for exporters should produce much lower costs of trade finance with minimal foreign exchange risk. Fifth, most restrictions on foreign direct investment were removed and investors were granted full rights to make profit and capital repatriations, except when these are financed by borrowing from the domestic banking system. Equally, outward foreign direct investments were allowed without central bank approval, provided these come from foreign currency deposits or from nonbank sources. This reform is seen as a route to improve export performance by facilitating overseas export-related infrastructure and marketing alliances with overseas companies. Finally, the Philippines commercial banks are now allowed to hold short or long foreign exchange positions, subject only to limits imposed for prudential reasons. In addition, the earlier trading restrictions on the interbank foreign exchange market were lifted.

Although some of the components of this reform package appear similar to those attempted unsuccessfully on earlier occasions, there is now one distinctive strategic difference. Efforts this time focused on those aspects of exchange liberalization that can genuinely enhance the supply of foreign exchange, through, for example, lower transaction and financing costs, greater flexibility in capital expenditure decisions, and more efficient foreign exchange pricing and management arrangements. Some restrictions still remain. For example, outward direct investment is still subject to a US$1 million limit per investor per year. These arrangements, however, are subject to review and are likely to be removed in part if the current high level of capital inflows to the economy continue. In particular, the government is seriously considering liberalizing the entry of foreign financial institutions to futher improve the efficiency gains arising from the reforms, so far.

The Early Results. Zialcita explained that the reforms in his country are very recent, with some of them being completed only by the second half of 1992. Thus, it is too early for a full judgment about their effects. A few initial indicators of performance, however, are available already. First, flows of invisible receipts, such as travel and workers remittances, have surged since 1991, suggesting that the greater freedom to acquire foreign exchange combined with a market-determined exchange rate is making people more relaxed about bringing money into the country.

Second, preliminary data indicate a portfolio shift away from overseas deposits by residents and, to a lesser extent, a shift from local foreign currency deposits by residents. If confirmed, this would indicate that reform is improving the attractiveness of domestic relative to foreign financial instruments, a tendency clearly demonstrated in recent experiences in Mexico.

Third, there has been a large increase in the volume of interbank foreign exchange trading, from only about US$1 million per quarter in 1990 to almost US$1.5 billion in some recent quarters. Within this total the central bank has been very active, particularly in buying foreign exchange into official reserves, which now amount to almost US$10 billion (including commercial bank holdings).

Finally, the surge in import and service payments, one of the fears expressed before liberalization began, has not materialized, and 1991 and 1992 have shown no obvious deviation from past trends in payments either for merchandise imports or for services. Overall, it is a justifiable initial conclusion that reform has enhanced rather than diminished the availability of foreign exchange to the country. Unfortunately, this has not yet been matched by obvious success in attaining one of the two primary objectives, namely, that of enhanced export performance. Like Mexico, it seems possible that the appreciation of the real exchange rate combined with the early restructuring bias in productive sector investments have jointly contributed to a slower growth in this area than was hoped for. By contrast, investment has performed well with both portfolio and direct investments from abroad manifesting strong improvement through 1992.

Policy Dilemmas. The results for the Philippines are very similar to those experienced by Mexico. Specifically, the real exchange rate appreciation has resulted in pressures from exporters for a better deal. Although the central bank has responded to some extent by intervening in the interbank market, it is highly constrained in this area because of its monetary commitments to the IMF. Hence, interventions have largely been sterilized. This process is fiscally damaging, especially since the Philippines began with such a high level of domestic debt. Two solutions have been debated in the country to try to resolve these problems. The first is to impose some administrative restrictions on capital inflows, an action that could be ineffective given the liberalization of current account transactions. A second is to strengthen the stance of fiscal policy. This, however, is very difficult because of the enormous need to

replace and modernize much of the country's infrastructure. Possibly, the best approach, Zialcita argued, is to look for greater flexibility in monetary policy, especially now that inflation is tending downward (8.2 percent in December 1992 compared to over 20 percent in mid-1991).

Commentary from the floor focused first on the crucial need to get export growth under way. It was noted that the Philippines' export sector was handicapped not only by the high exchange rate but also by the world recession and the poor state of the country's public capital. This last point was certainly an argument against an excessively tight fiscal stance in the immediate future. Participants also pointed out that from sometime in 1991 the general perception had been that a currency devaluation was unlikely, and this had resulted in a big increase in capital inflows from abroad.

Other participants referred to the difficulties the authorities have had in relinquishing some of their traditional controls. Four main fears seem to underly this: the fear of losing control of monetary policy, the fear of outflows leading to a complete loss of foreign reserves, unpredictabilities associated with imperfect markets, and fears associated with the inherent uncertainties of the global environment. Some countries, such as Indonesia, had begun to liberalize when their reserves were extremely low; thus, it could be argued they had nothing to lose. Looking at Malaysia's experiences, participants argued that it was largely unnecessary to retain controls on payments and that it was in any case a good principle to allow people to do whatever they liked with their own money. A number of critical controls on receipts, however, had proved useful for Malaysia. These were that all export proceeds come back to the country, that offshore borrowing be subjected to some limitations, and that regulations be maintained to deter the fly-by-night type of inward investor.

Finally, participants noted that liberalization has an extremely important informational content. In particular, in highly controlled environments the information that the authorities accrue is likely to be seriously incomplete and subject to major error. The liberalization of formally controlled activities is likely to improve the willingness of the public to divulge information about most aspects of its transactions and balance sheets. Hence, the necessary residual regulations of the post-liberalization period are likely to be far easier to monitor and enforce than those of the earlier era!

Securities Market Reforms: The Experience of Thailand

The seminar moved on to debate a variety of themes around the general topic of institutional development or deepening, and reform. The first of these themes, discussed mainly in the context of the Thai economy, related to securities market developments and explicit attempts to dilute the relative importance of commercial banks within the overall financial system. The second addressed the more general question of how a country such as India that is still in the relatively early stages of its structural reforms should approach financial institutional reform given that such a large

part of its overall financial system still operates on a socialized basis and is plagued by high ratios of non-performing loans. This discussion continued into a discussion of a rather broader set of reform issues in the context of Pakistan's reform measures. This section focuses on the security market issues; the broader issues pertaining to countries such as India and Pakistan are set out in the next section.

The issues of the reform and management of domestic securities markets were seen as important from the viewpoint of the reform programs of many of the countries represented at the seminar. However, these issues were discussed centrally in only one paper, namely, that presented by Ekamol Kiriwat, Deputy Governor of the Bank of Thailand. Kiriwat noted that the extremely high growth rates in his country through part of the 1980s had been achieved in spite of a number of significant weaknesses in the financial sector. These had included a very minor role for money and security market instruments in the process of corporate financing. He also pointed out that, by contrast with the Philippines, where financial reform took place against a background of macroeconomic crisis, the financial reforms implemented in Thailand were undertaken more in anticipation of difficulties to come rather than in response to immediate problems.

Specifically, the government designed a comprehensive reform program at the end of the 1980s to cover the three-year period from 1990 through 1992. This was after the authorities had already achieved a balanced fiscal position and a strong export orientation in trade policies. The first step toward reform was an important prerequisite for the liberalization that the authorities introduced. This first step began in June 1989 when the financial authorities freed interest rates on time deposits with a maturity of more than one year, then abolished interest rate ceilings on all time deposits in March 1990, and, in January 1992, removed ceilings on savings deposit rates.

Although the heavy dependence of Thai business on finance from a small number of domestic banks represented a potential break on the pace of possible development, the authorities nonetheless decided not to expand the financial system by allowing the entry of new banks. This is in sharp contrast to the situation in many other reforming economies where such an opening up has been seen to be an important influence on the competitiveness of banking institutions. Instead, the authorities were reasonably satisfied that the old style of family managerial control in the banks had been replaced by more modern approaches and that the capital adequacy and portfolio quality had also significantly improved.

On this basis the authorities then encouraged a significant expansion of new bank branches. Thus, the number rose from some 600 in the 1970s to over 2,000 by the end of the 1980s. The capitalization in banks increased significantly in support of this expansion when the authorities required banks to access the stock market to increase their capital. This further diluted the ownership influence of the largest and most powerful owners, and injected some good quality new paper into the markets.

The share of bank capital attributable to the largest owners is now reduced to only about 20 percent of the total. In most cases, too, the tradition of owners also being presidents of most banks has given way to a high incidence of well-qualified professional managers in the top jobs. Although Thailand has had some distressed banks, Kiriwat explained that the small number of banks in total had made it relatively easy for the regulatory authorities to deal with these problems on a case-by-case basis rather than through any systemic approach.

Concerning securities markets, Kiriwat explained that before the new Securities and Exchange Act of 1992 there had been numerous weaknesses in the Thai legal system regarding the issuing of securities and their trading. Numerous laws emanated from different official bodies. Participants in securities markets needed to observe each of these laws, which were often poorly coordinated and inconsistent with one another. Furthermore, a number of different supervisory agencies oversaw different aspects of the securities market business. This led to considerable inefficiency and confusion. Above all, the role of the stock market in corporate financing had remained marginal, with only public companies authorized to make public offerings of their shares, and only some thirty-three public companies actually in operation in the country ten years after the enactment of the Public Company Act of 1978.

The Thai authorities felt that securities market development was crucial to (a) provide some counterweight to the power of the large banks; (b) provide managers in a more deregulated environment with more and better instruments to enable them to manage their cash flows and risk; and (c) above all provide a more secure and transparent medium for investment financing and the channeling of foreign as well as domestic savings into corporate investments.

The Securities and Exchange Commission (SEC) set up under the 1992 Act represents a radical improvement on previous arrangements. Kiriwat explained that this Act now unifies under SEC control most of the regulatory and supervisory functions pertaining to the securities business that had previously been dispersed over a number of different agencies. He explained that the SEC comprises eleven members appointed from the various bodies that used to participate in securities market regulation. Because these include the governor of the central bank and the Minister of Finance, the SEC has clearly been constituted as a body that is potentially able to achieve consensus among all the top people involved in the running of the Thai financial system. Its work is supported by a secretariat of full-time professional lawyers and accountants. The SEC is now required to supervise all types of public offerings, thereby closing the earlier loophole in which sales through existing shareholders of a company could easily bypass stock exchange scrutiny. The stock exchange itself remains responsible for the operational work of the exchange, but regulation and enforcement now fall under on the SEC.

The 1992 Act also includes many requirements to improve investor protection. These include the requirement to obtain SEC approval prior to any issue; the requirement to disclose correct and full information prior to any public offering; severe

penalties for insider trading; and a very strong emphasis on the importance of capital adequacy of the participating dealers.

An early priority under the new arrangements, Kiriwat explained, is to try to achieve higher levels of activity in issuing and trading domestic debt instruments, which in Thailand have been used even less than have equity issues. To this end the Act stipulates that debt instruments can be issued by both public and limited companies, subject to SEC approval (equity issues are still restricted to public companies). The Act has also provided a comprehensive definition of the term "debenture" to include all types of debt instruments, including long-term and most short-term debt. This is to avoid the problem of borrowers circumventing the regulatory rules by calling basic debt instruments by other names.

The discussion focused on a number of issues brought out by Kiriwat's presentation. Some participants wondered whether, in a banking system that had been so dominant in the provision of finance, there had been significant problems of banks moving into securities market development, and whether there had been significant problems of bank distress. Kiriwat explained that although some banks had gained control of finance companies, some of which were active in the securities markets, the significance of nonbank financial institutions in the economy was still relatively minor (only 7 percent of the overall system). He also confirmed that some three or four of the country's sixteen banks had been in difficulty from time to time. These problems, however, had been resolved on a case-by-case basis with some occasional recourse to the country's fund development institution, which was set up originally to support financial sector development and still operates with a degree of independence from government. Thailand did not operate a deposit insurance system because it was assumed that the government would not allow a bank to fail. The one case in recent years where the difficulties of a bank proved to be serious had resulted in actions to effectively close that bank through a merger process. Kiriwat emphasized that in the recent past the minimum capital required of banks has doubled and that their provisions for doubtful debts have increased. He felt that with these two prudential measures strengthened, all other aspects of bank stability were reasonably well assured.

On the question of fiscal and other incentives to stimulate securities market development, Kiriwat explained that no such incentives had been used in Thailand in spite of the clear objective to achieve a more important role for the securities markets. Kiriwat felt that most companies in the country now understood the need to achieve better debt to equity ratios and that fiscal incentives in that context would be unnecessary. Indeed, the current arrangements whereby equity issues are only permitted to public companies who in turn face very onerous disclosure requirements means in practice that the incentives to list are somewhat negative.

Institutional Reform: The Cases of India and Pakistan

India

Suman Bery from the Reserve Bank of India explained that India is currently engaged in a wide-ranging program of reform and deregulation, not only in the financial sector but in many other areas, such as trade. Although these reforms began in the early 1980s, they had been intensified significantly since July 1991 after the political crisis that followed the assassination of Rajiv Ghandi. With a number of seriously negative external factors-the Gulf Crisis and the turmoil in the former Soviet Union-to contend with, it became apparent that the economy could no longer cope with the severe inefficiencies of its old protective arrangements. Although financial reform was not given top priority in the early stages, a series of events since the middle of 1991 have brought it to the forefront. These include the report of the high-level Narasimham Committee that is highly critical of the state of the country's depository institutions; the international pressures for improved capital adequacy, at least in Indian banks operating abroad; and the evidence emerging in April 1992 of major irregularities in the behavior of some Indian banks and their systematic violations of Reserve Bank regulations. As a result of these various factors, Berry explained that now there is a broad-based recognition in the country of the need to change the role of the public banks from one of bureaucratic channeler of funds to public sector activities, to one involving full commercial assessment of private sector loans and risks.

Like the Philippines, India's reforms are set in the context of broad-based stabilization and structural adjustment programs supported by the IMF and the World Bank. Bery explained that the main components of these have been fairly standard and have focused on two major elements. The first has been fiscal retrenchment with the target being to reduce the overall public sector deficit from the equivalent of 10 percent of GDP (6.5 percent for the central government alone) in 1991–92 to 5 percent for the central government in 1992–93. The second has been a set of structural measures to establish more transparent and less distorting trade and foreign exchange arrangements. The program includes the elimination of quantitative restrictions on trade and the replacement of a highly complex administrative allocation of foreign exchange by a much simpler dual exchange rate system for current account transactions.

In the financial sector, much of the emphasis has quite naturally been on the banking system, which accounts for some 70 percent of the overall financial system. As a result of the 1969 nationalizations, about 90 percent of the assets of the banks fall under direct state control with some limited competition coming from a number of foreign-owned banks. For at least twenty years, Bery explained, the banks have been regulated more by the achievement of quantitative targets for lending to priority sectors, including the government itself, than by normal standards of financial soundness. This has resulted in some deepening of the financial sector, for example, a

better branch network and the marginalization of money lenders, but, has led to a very poor record on allocation performance and financial soundness.

Diagnosis. Against this background, the first and obvious step toward institutional strengthening has involved a diagnostic exercise to establish the true financial condition of the Indian banks. In April 1992 more stringent standards of income recording and asset classification were introduced for incorporation in the accounts for the financial year 1992–93. For example, a non-performing asset is now defined as one in which interest has remained unpaid for a period of four quarters after the date it became past due. Banks are now instructed not to book interest on non-performing assets. Assets now have to be classified into four categories, namely, standard, substandard, doubtful, and loss assets. Banks are also required to make provisions against substandard assets and those in the lower classifications according to clearly stated rules. Concurrently, capital adequacy requirements linked to risk-weighted assets now are: 4 percent by March 1993 and 8 percent by March 1996. Foreign banks operating in India needed to hit the 8 percent ratio by March 1993.

Preliminary estimates suggest that the total of the domestic non-performing assets in the banks could constitute about 7.7 percent of total domestic deposits. Relative to the new capital adequacy and provisioning requirements, there is probably a provisioning gap of some Rs. 100 billion (US$3.3 billion) and a capital gap to achieve even the 4 percent target, of some Rs. 40 billion (US$1.1 billion). Bery felt this indicated an aggregate situation that is serious but not unmanageable.

Suggested Solutions. Bery's discussion of the likely resolution of this problem of bank restructuring covered five main areas: capital injections (including bad loan recovery), the restoration of bank profitability, interest rate policies, the regulation and supervision of banks, and bank management.

Bery noted that direct capital injections from the budget were largely ruled out by the fiscal constraints referred to earlier. Hence, the Narasimham Committee recommended that the stronger banks be given access to the capital markets. While this is a technically realistic suggestion, as the Thai experience indicates, in the Indian case it would require existing legislation governing bank nationalization to be amended. In response to questions on this particular point, Bery stated that India is now witnessing a definite move from state-led to market-led development, but that the dismantling of the old state system still constitutes an enormous problem. The Narasimham Committee also proposed an asset reconstruction fund (ARF) along U.S. lines that would capitalize the banks with its own bonds and then collect the bad loan component of bank portfolios. Bery noted that this idea had met little favor because it was recognized that in a country the size of India it would be impractical to expect a new organization to be effective in collecting loans on behalf of numerous and

dispersed banks. Additionally, it was unclear how selling bank assets at a considerable discount through the ARF could serve to inject sufficient funds into distressed banks.

Regarding bank profitability, Bery noted that restructuring the Indian banks would not be sustainable unless their profitability could be restored to reasonable levels. The Narasimham report, in its examination of the reasons for unsatisfactory rates of profit, had ascribed most of the blame to the massive preemption of bank funds by the government through the statutory liquidity ratio and the cash reserve requirements imposed on the banks at generally increasing rates through most of the 1970s and much of the 1980s; and to the losses associated with much of the directed lending to priority sectors. Action so far taken has reduced the combined burden of liquidity and cash reserve requirements from 63.5 percent of incremental deposits to about 25 percent by early in 1993. While the large number of different concessional rates for priority sectors has begun to be rationalized to some extent, no reduction in the 40 percent of total loans targeted to these sectors has yet been approved. Thus, with more funds available to the banks there is some danger that the absolute amount of lending to priority sectors could rise rather than fall.

As regards interest rate policy, Bery noted the considerable anxiety about allowing too much freedom in determining interest rates until the fiscal deficit is somewhat reduced and the situation of distressed banks is closer to resolution. Pending this, the government continues to control the situation mainly by setting maximum interest rates on longer term deposits and minimum lending rates on loans. This system is partly motivated by the government's desire to keep its own funding costs low. However, it also reflects the situation of distress in many banks and is thought to be likely to deter deposit mobilization at very high interest rates for the purposes of meeting the needs of distressed borrowers. For the moment, this system of interest rate control has resulted in wide spreads between deposit and lending rates, mainly because of the continuing high implicit taxation of the banks.

Although the Narasimham Committee recognized the fundamental need to shift the regulation and supervision system of banks from one based on quantitative lending targets to one based on the financial soundness of banks, no decisions have yet been made to implement this suggestion. The Reserve Bank, however, has announced new guidelines for establishing new private sector banks designed to increase the overall competitiveness of the sector. These new banks will be required to achieve the 8 percent capital requirement from the outset, but they are also subject to the same priority sector lending ratios as the established banks.

On the topic of bank management, the Narasimham Committee clearly recognized the need to upgrade the organization and management of the banks to make them more globally competitive and to move them away from the bureaucratic banking, which merely channeled funds to public sector institutions and highly protected private sector clients. Although the committee argued that upgrading would be best achieved by leaving full operational autonomy to individual banks, Bery doubted whether this approach could work unaided, especially for weaker banks. Instead Bery wondered

whether there was not a basic role for public policy to help organize and implement such a major organizational change.

Comments from the floor further emphasized the basic difficulties in building a strong financial system when the commercial banks themselves are forced to be so heavily involved in subsidizing public sector activities. For example, someone referred to the basic difficulty of building a secondary market in government securities when so much of the primary issue of those securities is sold at below market prices on a captive basis. One participant pointed out that it was inherently difficult in such an environment to have any real idea of the basic technical efficiency of the banks because this was obviously not indicated properly by their profitability performance.

Other participants questioned whether the technical reforms to which Bery referred could really be effective while the statist culture of the Indian banks remained in place. Someone drew the analogy with the one large Thai bank specialized in mobilizing savings deposits. These deposits had routinely been channeled to the government, but now that the government's own financing needs were much lower, the staff of the bank were having considerable difficulty managing its asset position. Few staff members had any real experience in evaluating commercial lending prospects and hence, they were taking the safe route of channeling large volumes of resources through the interbank money market. Similarly, the agricultural bank in Thailand was fairly good at evaluating loans to farmers but was really rather poor at mobilizing deposits. In short, the types of interventions that Thailand and, to a greater extent, India had faced were likely to have resulted in the emergence over time of one-sided banks that were poorly equipped to operate in a market environment.

Some participants expressed surprise that the Indian reforms had not embraced the privatization option more centrally since this might be seen as the basic precondition for achieving change in the attitudes and culture of banks. Bery's own view was in accord with that of the Narasimham Committee, namely, that private ownership was not an absolutely necessary precondition for successful bank restructuring. Bery observed that some of the Indian public banks were moderately efficient. He pointed out too that India had always had a vibrant private sector and that it was only in the last twenty years that this aspect of its culture had been repressed. In this sense India was more like Latin America than the former Soviet Union: its problem was largely one of reactivating the market-based instincts of its economic agents. Bery pointed out that while there was in India a basic consensus in favor of more private ownership, especially in the area of state manufacturing enterprises, this did not extend necessarily to support the outright sale of institutions, especially those in the financial sector.

Concerning capital adequacy, it was also suggested that in this climate of continuing state involvement there was possibly less of a need rigidly to enforce capital adequacy requirements because the government presumably stands as the guarantor for the loans extended to public sector bodies. Bery rejected this viewpoint, explaining

that because bank loans to state enterprise did not carry formal guarantees, they involve full commercial risks. Thus, loans need to be fully accounted for in the determination of the capital adequacy of banks. In any event, a soft line on capital adequacy could not be extended to Indian banks that have a significant part of their operations overseas.

Pakistan

The comparable case of Pakistan, where reforms in the financial sector had started slightly earlier than in India, was explained by Mohammed Janjua, from the State Bank of Pakistan. In Pakistan, the serious efforts to liberalize the country's traditionally highly regulated system began in earnest with a comprehensive medium-term program of trade liberalization and tariff reduction and rationalization initiated in 1988. This set the scene for the financial sector reform (FSR) program that had commenced one year later. The foreign exchange liberalization, in turn, began by slimming down the list of restricted imports and replacing many quantitative barriers to imports with still high import tariffs. In February 1991 these reforms were further extended to cover several important aspects of the country's capital account transactions. This new and more liberal regime included the following:

- Allowed direct foreign investment in most Pakistani businesses
- Allowed dividend transfers outside the country without prior permission
- Enabled foreign residents to hold special convertible rupee accounts for the purchase of shares on the stock exchange
- Allowed unlimited domestic borrowing for working capital purposes by foreign-controlled manufacturing companies
- Allowed overseas borrowing on unrestricted terms for business setup and expansion where no government guarantees are involved
- Permitted foreign currency accounts (FCAs) by residents of Pakistan on the same basis as nonresidents
- Introduced dollar bearer certificates with a one-year maturity, and five-year foreign currency bearer certificates denominated in dollars, marks, pounds, or yen, which supplemented the rupee-denominated foreign exchange bearer certificates (FEBC) first issued in 1985.

Janjua noted that these reforms, although relatively recent, had already begun to affects aspects of Pakistan's balance of payments performance. For example, foreign direct investment in 1991–92 amounted to US$335 million as against US$246 million during the previous year. The new freedom on portfolio investment attracted inflows of some US$219 million during 1991–92. The international borrowing by Pakistani companies increased to US$559 million in 1991–92, compared to US$158 million in the previous year. The new dollar and foreign currency bearer certificates attracted sums of US$53.1 and US$62.7 million, respectively, by December 1992. Finally, the widening scope of the foreign currency accounts system since February 1991 that included accounts of resident Pakistanis resulted in a very sharp rise in the total amounts outstanding. From a figure of some US$2,346 million at the end of March 1991, the total rose to over US$3,800 million by the end of December 1992.

Janjua noted a sharp contrast between some aspects of the starting conditions for financial sector reform in Pakistan relative to, for example, Mexico and Malaysia. In particular, Pakistan started out with a large fiscal deficit and was having great difficulty in reducing it from the equivalent of 7 percent of GDP to 5 percent. The country's large debt overhang as well as its substantial external and savings, and investment gaps were also unfavorable conditions for reform.

The FSR program had five main components. First, improvements had been made in domestic debt management with greater reliance placed on market-determined interest rates. This, however, had exerted a significant negative impact on the government's own difficult fiscal position, because the resulting increase in interest charges raised the deficit by about 1 percentage point of GDP.

Second, bank credit allocated by the government was significantly reduced. However, as one participant noted, because some of the directed funds still go to finance the deficit, the reforms so far introduced have failed to eliminate the hidden subsidies organized through the financial system. Hence other borrowers were undoubtedly having to pay unnecessarily high interest rates. This is merely one example of why it is advisable to achieve a serious fiscal adjustment before undertaking a major liberalization of finance.

Third, the State Bank had shifted its method of monetary control from one based on quantitative limits to one dependent on indirect methods using market mechanisms. To this end an open market policy had been put in place. The problems so far experienced with this in Pakistan were those associated with the thin money markets in the country and especially with the very small size of secondary market activity for treasury bills and other short-term securities. As in many other countries that had long been dependent on direct methods of monetary control and the captive sale of government securities, banks and other institutions were too wedded to the practice of buying securities and holding them through to maturity. It was difficult for an active market to emerge while these behavior patterns persisted. One participant

noted that the thin secondary markets are likely to result in undesirably large movements in the prices of the underlying securities.

Fourth, in Pakistan many banks had been nationalized about twenty years ago. The country now recognized some advantages of greater private ownership and had already moved to privatize two state banks. In response to questions, Janjua confirmed that the three main banks still under state control accounted for about 50 percent of all bank deposits. Two of these, however, are expected to be privatized.

Finally, as in most other countries at the seminar, the liberalization process had been accompanied by serious efforts to strengthen the regulatory and supervisory framework governing banks and other financial institutions. A particular feature of this had been to bring nonbank financial institutions under explicit central bank control for the purposes of regulation and supervision.

Many of the comments from the floor focused on the knock-on implications for financial reform of the continuing large fiscal deficits in Pakistan. Participants noted, and Janjua agreed, that these deficits were caused in large part by high military expenditures and high debt service payments: both difficult elements to cut. Others observed that the import liberalization program had also led to a significant loss of revenue in spite of some surge of imports. More generally, it was pointed out that before liberalization, in Pakistan and elsewhere, external creditors had often succeeded in receiving the payments due to them but only because domestic creditors were required to forego the payments due to them altogether or accept very low rates of interest. With the end of financial repression, this implicit seniority of creditors must change but, unless properly managed, can result in a new type of risk to external creditors. Looked at from another perspective, very large falls in the real interest costs of the government are a possibility if fiscal reform is put firmly in place. Mexico in recent years is a leading example of a country that has derived substantial benefits in this way. Pakistan, by contrast, has left itself with substantial difficulties for successful financial reform because it has not established this precondition of fiscal adjustment.

Financial Systems and Macroeconomic Stability: Experiences from Chile, Malaysia, and Japan

Various topics involving the interdependencies between macroeconomic policies and financial sector reform emerged at some point in most sessions of the seminar. For example, the successful opening of the capital account in countries such as Mexico and Malaysia has clearly been possible because of the generally sound macroeconomic policies pursued in these countries in recent years. By contrast, some of the difficulties with financial reform in, for example, Pakistan relate very directly to certain weaknesses in macroeconomic policies and especially to the problems of reducing the fiscal deficit. In this section of the paper, we summarize three presentations and

associated discussions that focused more directly on the topic of the links between macroeconomics on the one hand and financial reform policies on the other.

First, Guillermo Le-Fort, Research Manager of the Central Bank of Chile, presented a broad-based analysis of the links between financial systems and macroeconomic stability in Chile. Then, Lin See Yan, Deputy Governor of Bank Negara, Malaysia (BNM), discussed a number of key aspects on the same broad topic from the perspective of the Malaysian experiences. Finally, on a somewhat narrower front, Takashi Kanzaki, Chief of the Bank Supervision Department of the Bank of Japan, considered the problems created in the banking sector by Japan's speculative bubble in asset prices and the eventual collapse of that bubble.

Chile

Le-Fort's remarks focused on three main aspects of recent Chilean experiences:

- The effects of the aborted mid-1970s liberalization in creating the crisis of the early 1980s;
- The impact of the crisis on banks and the post-crisis financial reforms; and
- The general lessons from this concerning the linkages between macroeconomic stability and financial sector reform.[2]

Liberalization and Crisis. Mr. Le-Fort noted that the Chilean financial system in 1973 was highly repressed, with most banks under state control, negative real rates of interest, and ubiquitous quantitative controls on credit. The 1974 reforms involved the privatization of banks, liberalized interest rates, and the licensing of new financial institutions. Capital controls, however, were retained until mid-1979 and were not completely removed until April 1980. The financial liberalization program in turn was designed as a part of a broad program of economic deregulation that encountered a variety of extremely serious and ultimately fatal problems. First, in the period 1975–78, the system sustained the collapse of the whole savings and loan system, several unregulated financial institutions, and one medium-sized bank, namely Banco Osorno. In November 1981 the authorities had to begin rescuing banks through takeovers,

2. Le-Fort's paper as circulated to participants also included a substantial section on various aspects of the post-reform financial system. This, however, was not discussed during the seminar and is not included in this paper.

accounting for about 8 percent of private bank deposits. This process reached its peak by January 1983, by which time all remaining private sector banks had become insolvent and had been taken over by the authorities.

In this early and disastrous experiment with financial liberalization, the comptroller of banks in effect failed to exercise any real regulation of the financial system. In what amounted to a chronic misunderstanding of the true meaning of liberalization, many influential people were prepared to argue that regulation was no longer necessary. Thus, some banks operated with little or no capital, and the incidence of connected lending within financial-industrial groups was very high. The rescue of Banco Osorno in 1977 made matters worse by creating the false impression among bank depositors that their funds were insured by the government and they had no need to concern themselves with the solvency of banks and the types of uses to which their funds were being put. This event reinforced the conditions for a substantial moral hazard problem and is critical, in Le-Fort's view, in understanding the crisis.

The serious but manageable difficulties of the pre-1981 situation were intensified by the recession of the early 1980s and especially by a serious deterioration in Chile's external terms of trade. This rendered an already large current external deficit, fueled by large capital inflows, quite unsustainable, and made some form of macroeconomic adjustment unavoidable. As this became clear to almost everyone and capital flows began to reverse, the bad debts in the banking system accelerated rapidly, especially because of the losses sustained by clients heavily exposed to interest rate and currency risks.

Le-Fort noted some of the microeconomic incentives that had allowed the initial basic problems of that period to become so severe. From the viewpoint of many debtors, the early elimination of most of their equity meant that they had nothing to lose by borrowing more and hoping for some recovery. From the viewpoint of the banks, their strong interlinking with industrial conglomerates put them under strong pressure to grant risky loans to benefit the conglomerate as a whole. Bank regulators, as noted earlier, had neither the weapons nor the authority to stem the tide. Thus, by September 1982, loans in arrears net of provisions amounted to no less than 181 percent of the total banking system's capital and reserves. For a while, real interest rates were extremely high because of the reversal of foreign capital flows, the high demands from distressed borrowers, tighter monetary policy, and strong expectations of a peso devaluation. When that devaluation actually occurred in mid-1982, the risk premium built into interest rates was replaced by realized foreign exchange losses incurred by many of the clients of the banks. This, further compounded the extent of the banks' financial distress.

Le-Fort argued that three factors in particular had created the conditions for the crisis:

- The disassociation between the risks attached to bank loans and the yields paid on bank liabilities;

- The excessive optimism about the economy's growth prospects including overinflated views about the real value of assets and the real burden of accumulated debt; and

- The strong interlinking of banks and the large conglomerates that rendered the capital of most banks virtually marginal within the context of decisions made by the conglomerates.

Cleanup and Reform. Le-Fort explained that in dealing with the crisis, the authorities had four possible options: The liberal option of allowing widespread bank failure; the inflationary option that would, in effect, melt the debt; a monetary reform designed to write down the value of depositors' claims on banks; and the socialization of losses through a debt restructuring program financed by the central bank. This last option was the one actually chosen.

The core of the cleanup operation was the purchase by the central bank of non-performing bank loans at par in exchange for promissory notes of the central bank. This required banks to eventually buy back some part of these bad loans using their own profits. Le-Fort indicated that the extent of such a buy-back was likely to be small. Additionally, the central bank subsidized the interest rates on the promissory notes by offering a higher rate than its normal borrowing rate. The approach that was eventually chosen avoided the collapse of asset prices that would have been associated with any attempt to simultaneously sell a large part of the assets of the bad debtors. It also avoided a run on the banks. This approach, however, had the serious disadvantage of putting little immediate pressure on debtors to settle their obligations, and it may have created some expectations of debt forgiveness. It also involved a substantial short-term transfer from taxpayers to banks and debtors and allowed many firms to remain in business even though they had negative capital.

The major change in macroeconomic policy that accompanied this rescue of the banks involved a sustained real currency depreciation that more than doubled the relative price of tradables in the years between 1982 and 1988. There was also a considerable number of fiscal and quasi-fiscal implications. Most directly, there were two implicit subsidies involved in the portfolio purchase program. The first arose, because the new promissory notes carried a higher interest cost to the central bank than its average cost of funds at the time when the notes were issued. The second arose from the gap between the interest rate on the commercial banks' obligation to repurchase their portfolios and the discount rate applicable to bank profits. For banks under government control, the central bank had to absorb these losses, and it also incurred some subsidies in the process through its efforts to encourage new shareholders in the process of privatizing some of the banks.

Additionally, when the real currency depreciation started in 1982, the government decided to help foreign currency debtors through a system of exchange

subsidies (that is, sales of dollars at an exchange value substantially lower than the prevailing official rate). This arrangement, operated through the central bank, resulted in substantial quasi-fiscal losses on its books. These losses were further increased by the central bank provision of foreign exchange arrangements that linked sales of foreign exchange to central bank repurchase agreements at the prevailing exchange rate, which, at the time, was depreciating strongly.

The estimates of the cumulative costs of these various interventions amounted to somewhere between US$7 and US$9 billion. The ongoing annual deficit of the central bank is about 1.5 percent of GDP. It is financed through the issuing of new debt and through inflation tax collections. With falling rates of inflation in the recent past, the contribution of the latter has been declining. It is estimated that the domestic debt to GDP ratio is currently about 40 percent, and that an annual GDP growth of about 4 percent is sufficient to keep that ratio stable. Because Chile's growth prospects are somewhat better than this, the debt ratio can be expected to decline.

Because of the clear diagnosis that inadequate banking regulation was strongly implicated in the Chilean crisis, Le-Fort emphasized that the establishment of a new framework of banking legislation, especially the Banking Law of 1986, has been a very important part of the reform package. A central and unusual feature of these new arrangements is that the Comptroller of Banks must publish in the press at least three times a year its opinion on the state of affairs of each banking institution. In their traditional activities of intermediating between deposits and loans, the commercial banks are now subject to regulation in a number of aspects. These include limits on loans to individual debtors, limits on loans in particular currencies, and limits on connected lending. Provisioning arrangements have also been greatly tightened. Banks are now forced to write down non-performing loans that have higher than normal risks and to inject additional capital to compensate for such provisions. Capital adequacy is now assessed relative to the economic rather than the book value of the banks' assets and in that sense is sensitive to the differential riskiness of different types of portfolios. A parallel limit on bank debt to equity is used as a further indicator of bank viability.

The new law is also very explicit about the basis on which banks can participate in nontraditional activities such as stock trading, mutual and investment fund management, and leasing. Banks can perform these activities but must be operated through subsidiary companies using segregated capital. For example, any bank using part of its capital to set up such a subsidiary must deduct this from its own capital when calculating capital adequacy and debt to equity ratios.

Lessons in Macroeconomics and Financial Reform Linkages. The Chilean experience provides very important lessons: The reforms of the 1970s eventually led to the worst recession in the country since the Great Depression, as well as to the insolvency of the whole banking system. By contrast, the reforms of the 1980s are generally regarded as successful. Le-Fort described the crisis of 1981–82 as being created through the interaction of inappropriate macroeconomic policies on the one

hand and significant structural weaknesses in the financial system on the other. It follows that actions in both areas were necessary to ensure the improved performance of the more recent reforms.

Regarding the macroeconomic dimensions of the problem, Le-Fort noted that the reforms introduced in the mid-1970s generated three types of macroeconomic disturbances and inconsistencies. First, there was the shock to productive sectors when the current account of the balance of payments was opened and competitive imports became more available. Second, but somewhat later in time, was the shock associated with the liberalization of the capital account and the greatly expanded availability of foreign borrowing. Third, there were the problems arising from the inconsistencies of some aspects of macroeconomic policies. In particular, a continued rapid expansion of aggregate demand coexisted with high domestic interest rates. With very liberal capital movements, high domestic real interest rates did little to discourage expenditures, and monetary policy interventions were largely impotent. Equally, although the narrow fiscal accounts were in surplus after 1978, the contingent fiscal transfers to the private sector were perceived to be large; hence, many borrowers believed that they would be able to defer debt service or be bailed out. Finally, the combination of an appreciating real exchange rate and a rapid growth of aggregate demand produced a large current account deficit that was unsustainable on a long-term basis.

The financial sector origins of the problem can be traced to the particularly risky behavior of financial market participants (borrowers and lenders), much of which was derived from problems of moral hazard and agency in the financial system. While the explicit deposit insurance was perceived to be available, Le-Fort noted that the moral hazard problems associated with this could have been avoided if there had been adequate bank regulation and supervision to defend the solvency of banks. Hence, deposit insurance does not need to be eliminated. Significantly, the later Chilean reforms preserved an arrangement for explicit deposit protection.

The final link between the macroeconomic and the structural dimensions involved the macroeconomic problems associated with excessive growth of aggregate demand that can be blamed partly on structural weaknesses in the financial sector. In particular, while economic agents believed that the government was insuring their banks deposits as well as their foreign currency exposures, the implicit transfers of wealth related to this insurance, helped to both foster excessive aggregate demand and weaken the effects of high interest rates.

An important issue raised in the discussion that followed Le-Fort's presentation concerned the scope of bank supervision in dealing with fundamental sources of financial instability of the types experienced in Chile. Participants argued that in the laissez-faire atmosphere that prevailed in Chile at the beginning of the 1980s, even a good system of bank supervision would have been powerless to stop what occurred. The microeconomic decisions that were made at that time were entirely rationale given the then-prevailing set of macroeconomic policies. Even a good system of bank

supervision could have succeeded in arresting the crisis only if it had been able to, for example, end the policy of fixing the exchange rate something that is clearly beyond its powers. More generally, participants noted that the domain and influence of even a good regulatory system is limited to that which is consistent with the prevailing policies of the country. Such a system certainly cannot go against, or compensate for, serious errors in macroeconomic policies.

In relation to the specific issues raised by Le-Fort on the fiscal deficit, some participants were uneasy about the notion that the contingent insurance provided through various acts and statements of the government could be construed as some form of hidden fiscal deficit. For at least one participant, it seemed that the operational significance of this concept was very limited because it was only after the event (and maybe tautologically) that one could establish that such insurances were actually available! Others noted the dilemma that exists for fiscal authorities in a country that is attracting large capital inflows in the way Chile did, and indeed still is. Specifically, while rapidly growing aggregate demand indicates an overheating economy and suggests the need for a fiscal tightening, the rapid accretion of international reserves creates very considerable pressures to increase spending.

A further point on bank supervision, which was also made earlier in the seminar, related to the increased problems of both banks and supervisors in a newly liberalized environment. It was pointed out that in Chile before 1974 real interest rates were generally negative and, with credit rationing as the norm, bankers did not have to do much work to allocate credit. At the same time as in India, bank supervisors could concentrate on monitoring certain quantitative targets. With liberalization, all this changes. The bankers have to become much more alert to the commercial returns and risks of competing loans, and supervisors have to focus much more on the quality and risks of bank portfolios if the solvency of banks is to be protected. The reforms in Chile during the 1970s obviously failed to consider this point. However, even today this message may not be fully appreciated and one participant noted that his country was still being advised to forego banking regulation and supervision during the process of financial system reform!

Malaysia

A further perspective on some of the issues discussed by Le-Fort was provided in the presentation given by Lin See Yan, Deputy Governor of Bank Negara, Malaysia (BNM).

Lin See Yan commented that by contrast with most other countries, Malaysian economic and financial policies were now guided by a clear long-term (twenty-year) vision of what the country wished to achieve. At the basis of this vision was the objective of sustained long-term growth at an average annual rate of about 7 percent, with inflation maintained at about 3 to 4 percent. Furthermore, the BNM, since its

establishment in 1959, took the view that long-term macroeconomic stability in an environment of considerable economic change required a financial system that was both diverse and stable. Because only a very simple financial sector existed in the early 1960s, Lin See Yan explained that it had been a fundamental task of the BNM to establish and nurture almost all the new institutions now operating in the sector.[3] He then considered two particular aspects of the BNM management of the financial system. The first was the reorientation of the sector toward more support for the private sector. The second was the measures required to respond to the economic and banking crisis of the mid-1980s.

Aspects of Financial Sector Reforms. Lin See Yan noted that the BNM's pro-active role in financial sector development had involved problems that other countries shared. Specifically, for about twenty five years the system had the strong need to mobilize noninflationary funds for government use. Only after the serious economic deflation of the mid-1980s did it become fully apparent that the government could no longer be the engine of growth and that a far greater private sector involvement would be needed to achieve the economy's ambitious growth targets. Since then, authorities have made many attempts to downsize the government and learn some of the lessons from Eastern neighboring countries, especially Japan. In particular, the concept of "Malaysia Limited" had emerged with the government in effect benefiting as a shareholder in most economic activities by extracting approximately 30 cents in taxes from each US$1 of profit realized. Seen narrowly from the perspective of the financial sector, this change generated the need for far greater diversity in the range of financial institutions and instruments and, above all, for the development of more active and efficient capital markets.

The Malaysian reforms to achieve these broad objectives had had some of the same stop-go characteristics of the Chilean experience, although the intensity of the drama was somewhat lower. At a relatively early stage, officials recognized that the objective of capital market development would require the end to many of the traditional government controls, especially the controls on interest rates. These were freed in October 1978, but because many of the preconditions for effective free markets in financial instruments were absent at the time, the liberalization proved to be short-lived. Controls were reintroduced early in the 1980s mainly because the reforms at that stage did nothing to address the problems of limited competition in the banking sector. Thus, interest rate movements tended to be asymmetrical: rates rose freely in

3. For details see Lin See Yan, "The Institutional Perspective of Financial Market Reform: The Malaysian Experience." Shakil Faruqi (editor), *Financial Sector Reform in Asian and Latin American Countries: Lessons of Comparative Experience,)* EDI Seminar Series, No. 340/073 Washington D.C., 1993.

response to tighter monetary conditions but did not fall correspondingly when conditions were relaxed.

Eventually the government introduced the base lending rate (BLR) system in November 1983. This anchored the lending rate of each bank or finance company to a declared BLR, which was calculated by reference to the cost of funds to the institution concerned, plus a markup that covered the costs of statutory reserves and overheads but not bad debt provisions. Lin See Yan explained that, following some experimentation with the management of the BLR system, all institutions are free to set their own BLR and their own lending rate, but they must adhere to an unchanged formula. Thus the central bank retains some influence over rates even though institutions are decontrolled. In Lin See Yan's view, it was a good example of a flexible form of intervention, capable of redressing the limited enthusiasm of banks to indulge in real price competition. Over time it has certainly led to a reduction in the margins of the Malaysian banks.

Resolving Banking Sector Distress. The second main topic discussed by Lin See Yan was the serious banking sector crisis experienced in Malaysia in the mid-1980s. He noted that this could be traced to the collapse of the prices of most of Malaysia's main commodity exports and the resulting sharp decline in the economy's overall growth rate. The banking system, as in the case of Japan, was seriously affected by the collapse of property and stock market prices and by the abrupt end to a long period of very rapid deposit growth. Specifically, from a rate of growth of 20 percent in 1984, the growth of deposits declined to less than 4 percent on an annual basis by the end of 1986. Loan growth, however, did not contract commensurably so the loan to deposit ratio in the banks rose sharply to almost 100 percent and liquidity became extremely tight. Banks also sustained a rising burden of non-performing loans and falling profitability as their customers faced the triple shock of lower asset prices, higher interest burdens, and sluggish or negative growth in their income flows. Bad debt provisions, equal to 3.5 percent of loans in 1984, increased to almost 13 percent by 1987 even before taking account of the significant failure of some deposit taking institutions to fully provision for bad debts.

Although the incidence of these financial sector problems in 1987 was not high, public confidence in the system was seriously eroded when some illegal deposit taking institutions failed and then large-scale withdrawals were made from the deposit taking cooperatives (DTCs), which with over one million depositors occupied an extremely important role in the overall deposit mobilization of the financial system. The run on the DTCs prompted the enactment of emergency legislation and the suspension of the activities of most of the thirty five DTCs. Twenty-one of these were subsequently shown to be insolvent.

Lin explained that the BNM reaction to this crisis was prompt and multi-faceted. The crisis arose from a series of macroeconomic disturbances and its resolution also had significant macroeconomic feedbacks. For example, the bank acted

quickly to loosen monetary controls to ease the liquidity constraints. It also adopted or strengthened a whole range of regulatory and supervisory measures to further limit bank insolvency. Lin, however, concentrated his remarks on the measures that were taken to redress the accumulated problems of bank distress and to rescue at least some of the banks that found themselves in difficulty.

The essential point on this topic was that the BNM adopted a wide variety of different interventions to deal with different aspects of the problem. These approaches, however, were tailored to the needs of different banks. The BNM needed to get very close both to the banks and to the private sector in general. Institutions that had preserved their capital were allowed a relatively free hand, but a tough line was taken with banks that had lost capital. Although the resolution of the problem in Malaysia did not involve the wholesale state takeover of banks, as had been necessary in Chile, nonetheless the law was changed to allow BNM to hold bank shares. This in turn helped BNM expedite the amalgamations of some banks by becoming a temporary owner of banks on its own account. Since this might have involved a conflict of interest with the BNM's regulatory responsibilities, distinct organizational arrangements were set up to deal with the BNM's shareholdings.

Six further examples of the range and flexibility of the BNM approach are as follows:

- In the cases of the worst affected banks, the BNM required the replacement of existing managers and also organized the injection of new funds to cover accumulated losses;

- The Bank called on existing shareholders to subscribe new capital through rights issues supplemented as necessary by direct injections of funds from the BNM, with options available to existing shareholders to buy back BNM shares at a later stage;

- For DTCs that had relatively modest problems, the BNM provided loans on relatively soft terms;

- For other DTCs, depositors were assured a US$1 for US$1 payment, but part of this was provided not as cash but as equity holdings in some other licensed financial institution(s);

- In the cases of some DTCs, the BNM directly acquired the net assets and liabilities through a small holding company;

- The BNM established an Enterprise Rehabilitation Fund to directly support the financial and economic restructuring of some of the productive sector clients of

the distressed banks, and established an Abandoned Housing Fund to undertake loan recovery for housing loans.

Overall, the BNM needed to invest large volumes of funds to resolve the problems of distress but used a variety of approaches to achieve this. It was significant that through the vigorous pursuit of bad loans, the resale of its shareholdings, and in other ways the BNM succeeded over time in recovering a significant part of that investment. Thus, the burden of bad debts of the banks had not had the ongoing implications for fiscal and macroeconomic management that had been noted in the case of Chile.

Japanese Banks and the Speculative Bubble

Some of the same issues discussed concerning Malaysia recurred, but in a somewhat different form in the presentation by Takashi Kanzaki about the effects on Japanese banks of the recent collapse in that country's speculative asset-price bubble. Kanzaki was particularly concerned with assessing the manner in which the Bank of Japan responded to this crisis in order to defend the stability of the banking system and the macroeconomy. The contrast with the Chilean case in 1981 and 1982 is sharp. When the bubble burst in Chile it imposed considerable costs and distress on both the banking system and the real productive sectors. In Japan, by contrast, the authorities seem to have handled the bursting of the bubble in such a way as to achieve a soft landing for both financial and productive sectors as well as for the economy as a whole. What, if anything, does this say about the behavior and performance of the regulators?

In explaining the background to recent problems, Kanzaki noted that the rapid rise in asset prices (especially real estate and stock market securities) during the 1980s prompted intense competition among Japanese banks. The competition focused mainly on a scramble for quantitative expansion rather than portfolio quality. Kanzaki also took the view that the Japanese experiences in this area were part of a global phenomenon caused by the increased openingup of capital account transactions through the 1980s and the resulting globalization of many real estate and financial sector transactions. Specifically, in France, the United States, the United Kingdom, as well as in Japan, the late 1980s saw common patterns of inflationary expectations about asset prices prompted by expansionary monetary policies but perpetuated in all cases by high levels of speculative transactions in these assets.

In the case of Japan and with the benefit of hindsight, three types of risk were inherent in this behavior as far as the banks were concerned. The first of these was the credit risk, the risk of relying excessively on the asset values that were apparently securing most of the loans at the expense of proper attention to credit analysis and loan follow-up and management. The consequences of this were manifest in the

considerable increase in non-performing loans when asset prices began to decline in the early 1990s. The second was the market risk. Interest rate liberalization, implemented gradually over the fourteen years since 1979, raised funding costs for the banks. Many small and medium-size banks increased their exposures to high risk-return securities in an attempt to cover these higher costs. Unfortunately, they frequently lacked the knowledge and experience to make these investments successful. Finally, the management risk was associated with the excessively fast expansion of many banks. This behavior pushed more responsibilities onto less experienced branch managements, weakened bank compliance with internal controls, and gave rise to a significant increase in financial irregularities.

The very large falls in real estate and stock market prices that have occurred during the past few years have exposed the true nature and extent of these risks. Kanzaki, however, explained that many Japanese banks had a good cushion of revenue reserves to help them withstand the higher incidence of non-performing loans, and their excesses of the past have now been reined in by a series of reform measures guided closely by the on-site inspections of the bank supervisors. First, capital adequacy requirements, as laid down in the Basle Agreement, have been enforced. For many Japanese banks whose unrealized capital gains on security holdings fell sharply as a result of the stock market collapse, this has meant significant restraint on asset growth in an attempt to rebuild Tier-2 capital. Second, the banks have been encouraged to give much more attention to the analysis of creditworthiness and the financial condition of their borrowers. In some banks this has been done by giving credit analysis departments greater independence, including the ability to reject inappropriate loan applications.

Third, the banks have significantly reinforced their internal audit and other internal controls, including the use of dual responsibility controls. A question from the floor inquired as to the extent to which internal auditors can ensure detection of problems if they themselves are integrated with the general management of the bank. Kanzaki confirmed that internal auditors in Japan report to bank managements, but in most cases they provide bank managements with some independent advice about how internal controls are working. Kanzaki agreed that in the final analysis the onus for detecting blatant abuses would lie with Bank of Japan supervisors.

Finally, to respond to the extremely rapid expansion of real estate loans by poorlycontrolled subsidiaries of banks in the late 1980s, the banks have been guided to substantially improve the control that they exert over such subsidiaries.

Although the combined efforts of the banks and the supervisors had so far avoided any major financial collapse, Kanzaki felt that there were still some further important steps that banks needed to take. They needed, for example, to pursue more vigorously the liquidation of collaterized real estate lending and the collection or write-off of other bad loans. They needed to review their own structures in order to concentrate activities on core profitable banking business and eliminate unprofitable

activities. Kanzaki also felt that banks would benefit eventually from a fuller disclosure about their own affairs, including information that could communicate something about the quality of their underlying assets. He noted that under recent new arrangements, twenty-one of the big money center banks were now required to disclose loans where interest is past due for six months or more. Although the regional banks faced less demanding guidelines, the general move in the arrangements was toward more disclosure. In response to questions, Kanzaki, however, felt that it would not be appropriate in the Japanese case for the bank supervisors to adopt the very explicit publication of status reports on banks in the manner in which this is now done in Chile. He felt that this might precipitate too great an influence on banks in difficulty and could compromise the confidence in the relationship between banks and their supervisors.

Kanzaki then used the experiences that had followed the bursting of the bubble to draw out several main conclusions about the manner in which bank supervisors need to conduct their work in Japan and elsewhere in the 1990s. First, it was increasingly important in his view for supervisors to conduct regular and full scope on-site examinations. The heightened importance of portfolio quality could not be over emphasized, but this could not be monitored without regular on-site inspection. Kanzaki argued that such inspections ought to accord a great deal of discretion to the supervisors about the precise manner in which they should be conducted. Supervisors needed the freedom to make judgments that were both fair and fully cognizant of the prevailing macroeconomic situation as well as the circumstances of particular banks. Again this raised questions like those raised in the Chilean context about how far supervisors can go in discouraging banks from loans that are viable but reflect poor macroeconomic policies or speculative epidemics. Kanzaki's advocacy of an approach to supervision that includes some flexibility to changing macroeconomic conditions accords with the earlier conclusion about the severe limits on the scope of what supervision can actually take on.

Finally, Kanzaki strongly emphasized the need for supervisors to conduct their work on a consolidated basis. More specifically, supervisors need to monitor the financial condition of all parts of a bank, including all its subsidiaries, because, whatever the organizational arrangements, a contagion of risks between different arms of the same bank is unavoidable. Furthermore, this consolidated approach certainly needs to include the overseas branches of a bank. The Bank of Japan itself has greatly increased its on-site supervision of the overseas branches of Japanese banks in recent years. It sends examiners abroad to assess loan quality and other aspects of bank performance. In the case of medium-size banks, examination teams are sent four times each year to conduct on-site examinations of several selected banks in each major financial market. The Bank has also been progressively increasing its exchange of supervisory information about individual banks, with overseas monetary authorities.

In the case of the domestic nonbank subsidiaries of the banks, the Bank of Japan is not authorized to conduct on-site examinations directly. Thus, it relies on the

detailed information it receives about such subsidiaries when conducting its examination of parent banks.

The discussion following Mr. Kanzaki's presentation did not definitively identify the reasons why the Japanese banking system had proved to be resilient to the shocks associated with the major fall in asset values of the early 1990s, while the Chilean system had proved so vulnerable to the shocks that it had faced one decade earlier. It was noted, however, that the Chilean financial system itself had shown far more ability to withstand shocks, such as the large 1989 fall in the price of copper, after it had implemented the banking reforms of the mid-1980s. This indicates the considerable importance of such reforms in building the resilience of the system. It is presumed also that the avoidance of chronic macroeconomic management errors in the Japanese case, as well as the absence of some of the Chilean structural weaknesses in the financial system, have a large part to play in explaining the differences.

Bank Supervision in an Era of Deregulation: The Indonesian Case

The final substantive topic of the seminar extended the discussion of bank supervision by considering the role and processes of bank supervision in a deregulated environment. The topic was introduced in a comprehensive paper presented by Binhadi, Managing Director of Bank Indonesia. Binhadi organized his remarks around three main themes, namely, the nature of the Indonesian deregulation process, the impact of this on the banks and the macro-economy, and the changing nature of bank supervision in the post-regulation era.

Financial System Deregulation

Binhadi explained the reforms that had been introduced both in the country's management of foreign exchange and in its operations of the monetary and banking systems. The first of these two elements of reform had been initiated in 1967 with the establishment of a trading center for foreign exchange transactions, namely, the Foreign Exchange Bourse. As early as 1970 the restrictions on the holding, selling, and purchasing of foreign exchange were removed, although for some years export proceeds still needed to be surrendered to a foreign exchange bank. From 1978 to 1982 the pegging of the rupiah to the dollar was replaced by a more flexible policy of pegging to a basket of currencies. From 1982 onward, exporters were no longer required to surrender export proceeds, and any transactions using these proceeds or involving the purchase of imports could be arranged through foreign exchange banks.

Then in 1989, the authorities abolished the Bourse and established new arrangements, whereby all foreign exchange transactions between Bank Indonesia and

the foreign exchange banks were done through the foreign exchange dealing room. At about the same time, the authorities removed the restrictions on foreign borrowing by domestic banks but introduced prudential arrangements (a net foreign exchange open position providing daily squaring for the banks) designed to minimize bank risks. Officials also adopted a variation in the managed floating exchange rate system by defining the rate set by the central bank as an indicative rather than a mandatory one. In 1991 the authorities introduced various types of swap facilities and began to refine the central bank intervention procedures in the foreign exchange market. Intervention, however, is still organized around the guidepost of the indicative rate and the managed float.

The monetary and banking reforms came somewhat later, starting in 1983 with the removal of interest rate controls on state banks and the elimination of the quantitative ceilings on bank credit. These reforms in turn made it possible for Bank Indonesia to begin using indirect methods of monetary control based on reserve requirements, open-market operations, and central bank discount facilities. Partly to support this development, a variety of money market instruments were developed in the mid-1980s. These included Bank Indonesia certificates (SBIs) and money market securities (SBPUs).

As Governor Mooy noted at the beginning of the seminar, these various early reforms had been successful in stimulating the growth of the economy and also in assisting its diversification away from oil dependence. Partly because of this success, the ongoing development and improvement of the banking industry has come to be regarded as one of the keys to the continued rapid growth of the economy. This was the background to the most substantial series of deregulation measures in the financial, monetary, and banking sectors that were introduced in October 1988 (that is, the measures referred to as PAKTO 27). The general aims of these further reforms were to improve resource mobilization, to further improve the efficiency of banking institutions partly through enhanced competition, further develop non-oil export sectors to improve the effectiveness of monetary policy management, and deepen the domestic capital markets.

Resource mobilization was pursued by expanding the opportunities to open new bank and nonbank financial intermediaries (NBFI) branches, by giving banks more freedom to develop new savings schemes, and by allowing NBFIs more freedom in deposit mobilization. Export diversification was pursued by opening opportunities for new foreign exchange banks, establishing improved swap facilities, removing the offshore borrowing limits for banks, and requiring joint banks and foreign banks to provide a substantial part of their total credits for export purposes. Improved bank efficiency was pursued by allowing banks to create new products for fund mobilization and credit expansion, and also by allowing state enterprises to deposit a substantial part of their available funds with the private banks. Monetary control was enhanced by unifying the reserve requirements for banks and NBFIs. Capital market development was fostered by equalizing the tax treatment of income from deposits with that from

securities. Banks and NBFIs were also encouraged to issue new shares through the stock market. In December 1988 the government made what Binhadi called a giant step toward stronger capital market arrangements. At that time it established a private stock exchange, opened the exchanges outside Jakarta, and established finance companies and other institutional arrangements to support the market.

Binhadi noted, however, that these arrangements had all gone ahead without any real changes in the Bank Indonesia policy of requiring the allocation of liquidity credits for particular purposes. The inherent inefficiencies associated with such arrangements, however, are recognized by the authorities as are the difficulties they cause for effective monetary control. Hence, in the PAKJAN 29 measures of January 1990, the authorities sought to make some improvements in national credit arrangements. Above all, the policy now is to gradually reduce the scope of liquidity credits and allow the commercial banks more influence in providing funds and allocating credit.

Finally, many of the reform measures just described were consolidated in legislation in the new Banking Act, Insurance Act, and Pension Fund Act, all of 1992. The Banking Act defined the scope of banks in an essentially universal way and extended to foreigners the rights to buy commercial bank shares through the stock exchange.

The Effects on the Banking Sector and the Macroeconomy

This extremely comprehensive package of reforms has had both quantitative and qualitative implications for Indonesia's commercial banks. In terms of quantity, between the date of the main deregulation measures in 1988 and December 1992, the number of new banks in the country rose from 122 to 221. This included 144 private national banks, 10 foreign bank branches, and 20 joint banks. Bank branching also expanded substantially with the 1988 number of 2,045 expanding by no fewer than 3,681 new branches in the same period. Together with some new smaller rural banks and village units, the country can now claim about one banking office per 10,000 people, a doubling of the coverage relative to the pre-reform period. Savings mobilization has also increased considerably with banks experiencing 44 percent and 51 percent increases in their deposits in 1989 and 1990, respectively, before the leveling off associated with tighter macroeconomic policies in 1991. In the same two-year period, total bank credits increased by 37 percent and 51 percent, respectively

As for the qualitative dimension, there has been a major increase in the range of bank products on offer as each bank has tried to develop its own products to attract customers. The number of different savings schemes, for example, has increased to a total of about 140. The products available in the foreign exchange markets have expanded to now include swaps, forward contracts, options, and margin trading. The

interbank money market, the short-term securities market, and the foreign exchange market have all seen very large increases in their trading volumes.

As in Malaysia and Japan, this rapid expansion of the sector and its qualitative deepening has contributed to a significant shortage of trained personnel. One unfortunate consequence of this has been considerable poaching from bank to bank. In spite of an intensified human resource development effort initiated before deregulation began, shortages of qualified staff have remained a problem.

The impact of the reforms on macroeconomic performance has also been considerable. As Governor Mooy noted earlier, the high growth rates achieved in 1989 and 1990 (more than 7 percent in both cases) were welcome but also symptomatic of an overheating of the economy which accelerated inflation. At the same time, the diversification of the economy has been well served by the reforms, after slow growth in 1990, non-oil exports increased by 22 percent in 1991 and 21 percent in 1992. The greater openness of the Indonesian economy in general was indicated by the rise in the export to GDP ratio, from 18.2 percent in 1986 to 25.4 percent in 1991, and by increases of a similar order of magnitude in the ratio of imports to GDP. Finally, the confidence placed in the economy following the reforms is indicated by a rise in annual average investment approvals (foreign and domestic), from US$1,311 million in the five years from 1983–87 to no less than US$7,122 million in the next five years to 1992.

Implications for Bank Regulation and Supervision

Binhadi explained that the essential philosophy of bank supervision had remained unchanged after deregulation. The essential objectives were to sustain a sound and efficient banking system that could retain the confidence of the public; grow at a satisfactory rate; and support economic development and the implementation of sound monetary policies. The scope of bank supervision, however, has become very much wider as a result of the expansion of the numbers of institutions and the range of financial products.

Bank Indonesia's strategy to deal with the new situation was introduced in February 1991, and has since been consolidated in law through the new Banking Act of March 1992. The strategy incorporates what Binhadi referred to as six main areas, as follows:

- *Improved prudential regulation as a guide for bank operations.* This is fundamental and covers rules about the licensing of new banks and branches, including the requirements for owners and managers; improvements in operational guidelines such as capital adequacy, asset quality, and provisioning; and an improved rating system that complements the quantitative checks on banks based on the CAMEL system, with further qualitative checks on bank

soundness.[4] Under the terms of the 1992 law, licenses for new banks and branches are the responsibility of the Minister of Finance on the recommendation of the central bank. The information flows to support bank supervision are ensured by a legal requirement that banks shall submit all information and clarifications required by the central bank. All such information, however, is to be kept confidential.

- *Supervisory monitoring as an early warning system.* This relates essentially to improved information flows on matters such as bank finances, peer group analysis, and economic sector development, all designed to assume prompt adjustments to the rating of any bank and corrective actions as required. This has involved improved computerization and telecommunication systems linking the banks and the supervisors.

- *Improved procedures for bank examination.* This has included systems of asset evaluation, flexibility to anticipate the consequences of new banking products, and the quality and timeliness of reports.

- *Discussion with banks.* Improvements here were sought to enhance the benefits of periodic discussions between banks and supervisors. The objective has been to improve the openness of such discussion by making full use of the early warning system and the results of on-site examinations to achieve the highest possible level of bank cooperation in developing proposed solutions to problems. This open attitude to discussion is also seen as one way of amending the thinking and the attitudes of bank owners and managers in the interest of protecting bank soundness.

- *Enforcement of sanctions, including cease and desist orders.* Sanctions available now include fines for breaches of regulations, but also various types of instructions to banks to change their organization or behavior. For example, banks can be asked to restrict the development of new branches and products and to make changes in their own management. In serious cases, a bank can be instructed to merge with a second bank or to transfer all or a part of its bank shares to new shareholders. All these powers were legislated in the 1992 Act, which also gives the central bank the ultimate right to recommend the revocation of the license of a bank to the minister. Criminal sanctions are also available to deal with cases of fraud and other breaches of legal duties.

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4. CAMEL means capital, asset quality, management, earnings, and liquidity.

- *Support to bank efficiency and effectiveness.* This has mainly involved certain institutional developments, including the establishment of a clearing house, a centralized credit information system, money and foreign exchange markets, and a code of conduct for bankers linked to the establishment of the Indonesian Bankers Institute.

Binhadi recognized that the various changes in the strategies and techniques of supervision required an appropriate number and quality of bank supervision staff with high levels of skill, dedication, morality, and integrity. Additionally, the substantial widening of the geographical network of banks required that a greater decentralization of bank supervision was also required. The increased numbers of supervisors needed had also necessitated attention to a good recruitment system, as well as to the selective use of other types of expertise to supplement the supervisory skills available. A final aspect of the necessary improvements is related to the greater international cooperation among the supervisors from different countries. Indonesia was very alert to this need and participated actively in a variety of international cooperative arrangements.

Finally, Binhadi drew the attention of the seminar to the close relationship between effective bank supervision on the one hand and the conduct of sound macroeconomic policies on the other. He noted that the tighter monetary policies followed in 1991 had worsened the condition of some banks and had also increased the burden of bank supervision. This outcome led to some criticisms directed at bank supervision. The enforcement of sound prudential arrangements would sometimes be construed as a restriction on the growth of credit at rates that were otherwise possible. To the extent possible, the supervisors had to ignore such criticisms, recognizing that over-rapid credit expansion in the short term often results in a deterioration in the quality of bank assets and problems for the banking system in the longer term.

Conclusions

In the final session, Alan Roe presented a summary of some of the main issues and contrasts that emerged during the four days of the seminar.

He noted that the discussions indicated considerable similarities in the motivations behind the financial reform efforts of most of the countries represented. From the beginning of the 1980s, if not before, the majority of the countries had recognized two basic realities: (a) sustained rapid growth in the future would imply a substantial dependence on exports and so a considerably enhanced need for flexibility and diversity in productive sectors; and (b) large inflows of inexpensive external finance could no longer be relied upon to supplement domestic savings. Significantly, such points were stressed equally forcefully by representatives from some of the larger countries, such as Mexico and Indonesia, as well as by those from smaller economies. But in nearly all cases this line of reasoning had resulted in financial sector reforms

being embedded firmly within the broader programs of productive sector adjustment and restructuring and within the context of a significant general liberalization of commodity, labor, and other markets.

The implications of this diagnosis for the types of financial reform undertaken also indicated considerable similarities across the countries represented. First, most countries accepted the fact that the preferential financial treatment of large public sectors had resulted in the past in overly rigid productive systems inadequately equipped for the speed of responses necessary for successful exporting. Hence, most countries represented at the seminar had taken steps to limit the extent of such preferences. Second, because domestic savings was going to assume greater relative importance, it was widely agreed that reforms had to ensure the more efficient mobilization and use of savings. The irony, of course, from the vantage point of countries such as Mexico, Chile, and Malaysia that have been most successful in improving the efficiency with which saving is mobilized and allocated, is that these countries now face capital inflows that are proving to be embarrassingly high. Third, the long-established practice of cheapening credit to a few favored or priority sectors was widely regarded as incompatible with the main objectives of reform because of the increased financial costs this normally imposed on the non-preferred sectors and the substantial rigidities and inefficiencies in production it encouraged. Though generally accepted, it is noteworthy that a few countries represented at the seminar, such as India, were still ambivalent about the merits of this particular point.

Next, Roe drew attention to some small differences of opinion regarding the necessary preconditions for successful financial reform. The strongly articulated point of view from some participants, notably those from Mexico and Thailand, had been that a serious effort to bring fiscal deficits under control was one of the vital preconditions for liberalizing domestic financial markets. There were two main reasons for this. First, large deficits normally result in an undesirable large preemption of available financial savings for the use of governments. Second, large deficits normally result more or less directly in high rates of inflation, which is inimical to the desired improvements in productive sector performance.

The operational difficulties in actually applying this precondition, however, had been noted, especially for the case of Chile where the fiscal accounts, narrowly defined, were roughly in balance when the unsuccessful reforms of the mid-1970s began. In that case, it was the quasi-fiscal deficit of the government, associated partly with the contingent liabilities the government was accumulating, that were one of the main factors responsible for the ultimate collapse of the reform program. Both India and, to a greater extent, Pakistan had embarked on their reforms at a time when fiscal deficits were still high. This, however, did not necessarily represent a counter-example to the general proposition. Indeed, the representative from Pakistan had spoken explicitly of the considerable difficulties caused by interest rate reforms in his country because of the greatly enlarged interest burden this had imposed on the fiscal accounts.

In Mexico, by contrast, the greatly reduced interest charges in the fiscal accounts had been one of the beneficial results of the efforts made in that country to address the debt overhang and make deep cuts in the fiscal deficit.

Turning to the main components of a reform program, the seminar had provided considerable similarities but also some important divergencies among countries. The similarities uniting the experiences of most of the countries included moves to liberalize access to and control of foreign exchange, shifts from quantitative to indirect methods of monetary control, the removal of controls on most interest rates, efforts to extend and diversify the range of financial institutions and instruments, and steps to strengthen arrangements for bank regulation and supervision. While some countries had also sought to encourage greater competition in banking, mainly by means of freer entry to the sector, others had regarded this step as unnecessary. Thailand, for example, explicitly sought to increase competition within the financial sector by encouraging the increased branching of existing banks and by encouraging a larger and more active securities market. Similarly, in some countries, such as Mexico and Chile, the privatization of banks had been a key element of overall reform. In others, such as India, radical changes in the ownership of banks had been either rejected or delayed.

Roe noted that a central and recurring theme of the seminar had been the role of capital account liberalization and the associated difficulties of managing large inflows where they were occurring. The merits of such liberalizations were well understood and included factors such as improved access to capital funds, greater availability of the managerial and technological skills often associated with new foreign direct investment, and enhanced financial sector competition associated with the entry of foreign banks and other foreign financial institutions. These advantages, however, accrued only in those cases where capital account liberalization led to increased inflows of funds. In countries such as India where there were still serious distortions in domestic financial markets, the authorities were justified in their concern that liberalization might lead to large outflows. Roe felt that countries such as these ought to be able to draw lessons from several other countries at the seminar, such as Mexico and Malaysia, about the steps required before liberalization could be contemplated seriously.

Other risks of full capital account liberalization had also been articulated during the course of the seminar. Although few governments were now giving explicit foreign exchange guarantees to those borrowing in foreign currencies, Professor Dooley's presentation had indicated that some of the large inflows currently being experienced could be explained by various implicit guarantees available to lenders because of current government policies and especially policies toward exchange rates. Together with the strong possibility that interest rates in the major industrial countries would sooner or later become much more attractive, this situation indicated a significant risk of a large reversal of inflows at some future date. For example, of the three hypotheses put forward to explain Mexico's recent success in attracting foreign funds, two would be likely to lead naturally to a subsequent reversal of such flows. In addition, the account of the Chilean financial crisis in the early 1980s had shown the

manner in which such a reversal might come about and what its consequences could be. Seminar participants, however, were divided as to the relevance of such experiences for the current situation. Some argued that the safeguards that had been put in place in terms of improved prudential management of bank risks, limits on the overseas borrowing of banks, the avoidance of explicit government guarantees on overseas borrowings, and the greater relative importance of private sector borrowing should all contribute to the greater resilience of the economies concerned to unfavorable external developments. Others doubted this. Nor was there any obvious unanimity about the manner in which fiscal, exchange rate, and monetary policies might best be arranged to try to limit the dangers that Dooley had highlighted.

All the countries currently benefiting from large inflows, however, were agreed about the substantial economic management problems these flows created. From the viewpoint of central banks, it was noted by almost everyone that the expansionary monetary effects of the inflows had to be avoided, either because of commitments to the IMF or because of national anti-inflationary policies. Additionally, the negative impact on the profitability of the central bank associated with the high interest costs of the sterilization operation was seen as a major difficulty in many countries. Opinion, however, was divided about the extent to which the appreciating exchange rates in such countries were inimical to the export diversification, which was one of the central objectives of overall economic reform. Some countries, such as Indonesia and Mexico, that had experienced very large inflows and upward pressures on exchange rates had nonetheless been able to achieve extremely impressive shifts of production structures in the direction of manufactures for export. Many participants felt that upward pressures on exchange rates would be too large to be compensated by the productivity gains that were feasibly attainable in the countries concerned. This was partly because the exchange rate pressures come in the short term, whereas the productivity gains necessarily need lengthy time periods and large restructuring investments before they can be achieved.

Overall, Roe commented, it was not entirely clear from the seminar whether capital account opening was always and reliably advantageous. The safeguards and restrictions, like those now employed in Mexico and Chile, were yet to be fully tested. It was also difficult to articulate the full set of preconditions for liberalization that countries still under monetary restrictions, such as India, needed to achieve before moving forward.

On the subject of securities market development, the Thai paper had illustrated the potential role of such developments for the diversification and improved competitiveness of the financial sector as a whole. It also provided an interesting illustration of how the pressures on banks to build their capitalization had also served to dilute the power and influence of the large traditional family owners of the banks. In the case of Mexico in particular, emphasis was placed on the major role that an extensive privatization program can play in helping to develop the securities markets

and diversify the range of available financial instruments. In the course of several presentations, emphasis was given to the safeguards required to ensure that banking operations in securities markets did not threaten the safety of bank payments and other operations. In Chile this is done by requiring banks to run their securities business through separate companies with segregated capital. More generally, it was observed that bank regulation and supervision needs to deal with institutions on a consolidated basis. This is because it is virtually impossible to prevent problems in one line of business from spreading contagiously to damage other lines, even though they may be organized in apparently separated companies.

Finally, Roe noted the very considerable attention that the seminar had devoted to the topic of bank supervision and regulation and to the considerable advances in practice in this area that the seminar discussion had revealed. The analysis of the Chilean crisis of the early 1980s had drawn explicit attention to the need for financial reform to be accompanied by tighter and better prudential regulation and had clearly exemplified the folly of the alternative viewpoint that liberalization should incorporate the removal of such regulation. Most countries represented at the seminar had taken this lesson fully on board, although the discussion had also revealed at least one case where contrary advice had continued to be offered. There was also some danger that the current enthusiasm for tighter supervision arrangements would lead to overinflated expectations about the extent to which supervision alone could alleviate the dangers of financial sector instability. In reality, supervision also needed continued sound macroeconomic policies.

Seminar participants emphasized several important aspects of good practice in this area. The first is that capital adequacy is the main foundation of prudential regulation, and this must be interpreted relative to the riskiness of bank asset portfolios. Hence, approaches such as those in Mexico and Chile where increased capital is required to match higher levels of portfolio risk are increasingly the norm. Second, integrated approaches to regulation and supervision are increasingly advocated implying standardized reserve and capital requirements across most financial institutions and the gradual downgrading of the distinction between banks and nonbanks. This also implies a consolidated approach to supervision, including the extension of the supervisors' influence to bank branches operating offshore, a practice that has already been refined in the practice of the Bank of Japan.

Third, regular and detailed on-site inspection is increasingly regarded as vital to the early detection and correction of problems in banks. This point, in turn, goes back to the increased emphasis on the need for quality in bank portfolios and the impossibility of assessing this on the basis merely of statistical returns from the banks and the off-site consideration of these. It is also linked in to the point stressed by Bank Indonesia about the importance of banks and supervisors working collaboratively to both identify and then find solutions for banking problems as they emerge.

Some small differences of opinion were evident in relation to the matter of the disclosure of the findings of the supervisors. The Chilean example, where status

reports on the banks are published regularly in the press, seems to be quite exceptional. Some participants felt strongly that such a high level of public disclosure was inimical to the preservation of the basis of confidence that must exist between banks and their regulators. It was generally agreed that effective regulation depends increasingly on a high level of information disclosure flowing from the banks to the supervisors if not always to the public at large.

Roe concluded by considering briefly whether the seminar had revealed any obvious differences, as between Asian and Latin American practices and experiences in the area of financial sector reform. On this occasion it seemed reasonable to assert that the similarities in country experiences across the two continents had stood out more clearly than the differences. Thus, for example, there were very considerable similarities in the arrangements, the successes, and the problems experienced by Chile and Mexico on the one continent, as compared to Indonesia and Malaysia on the other. Some of the differences within continents, however, were large. For example, the problems that India still encounters with bank distress and restrictions on capital flows stand in marked contrast to the more mature reforms in Thailand, Indonesia, and Malaysia.

At the end of the Santiago seminar it had been suggested that the generally higher savings rates and stronger anti-inflation traditions of the Far Eastern economies gave them somewhat better starting conditions for improved resource allocation based on more liberal financial systems and, more important, provided them with a somewhat better cushion for accommodating shocks and policy errors. This proposition had again been suggested in this seminar, especially from the example of the very limited damage that the massive collapse of Japanese assets prices seems to have inflicted on the stability of that country's financial sector. More generally, the high saving economies of the Far East still seemed able to combine broad-based reforms with continuing high levels of discretionary interventions in various aspects of financial sector behavior and to do so without doing obvious damage to the high quality of overall economic performance. This remained a puzzle that neither of the two seminars had been able to resolve.

3

FINANCIAL REFORMS, OPENING UP, AND STABILITY: POLICY ISSUES AND SEQUENCING CONSIDERATIONS

Carlos Massad

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There is ample literature on opening up policies and stability in Latin American countries. The literature covers a discussion of the nature and origin of both domestic and external shocks, real and monetary, and of the propagation of their effects in the economy. It also includes a critical evaluation of policy instruments and opening up sequence: effects of alternative policies on the rate of growth of output and employment, balance of payments, and investment.[1] The literature is based on a variety of experiences, ranging from the first-trade-then-capital strategy of Chile to the first-capital-then-trade strategy of Argentina and Uruguay.

However, there is still no agreement among economists on the nature of an "optimal" opening up strategy and policy or even on whether there is such an optimal approach. The differences of opinion are based not only on who "pays the bill," that is, how the short-term costs and medium-and long-term benefits of opening up are distributed. They are also based on differences implicit or explicit, regarding the analytical models used, the values assumed for relevant parameters, and the initial conditions before the opening up program is implemented.

This paper examines some of the unresolved issues. The first section on oversized capital movements explores the adjustment mechanism to oversized capital inflows under fixed and non-fixed exchange rate regimes, and the efficiency of monetary and fiscal policy in minimizing negative effects. This section concludes that

1. See Bustelo (1987), Bouzas (1993), Corbo (1988), Dornbusch and Fisher (1993); Edwards (1988), Massad and Zahler (1986), Meller (1993), Rosales (1990), Solimano (1987), Velasco (1987).

under a wide set of conditions monetary policy is substantially powerless, while fiscal policy is not flexible enough to substitute for it.

The second section examines interest rates and saving in the context of an open economy and the role of monetary and fiscal policy to handle interest rate disturbances in the opening up process. A distinction between tradable and nontradable securities is drawn, and the consequence of such distinction on the behavior of interest rates in an opening economy are studied. The finding is that the strength of the domestic financial system is more important than the sequence of the reforms in trade and in the capital market to explain interest rates movements. The conclusion is that monetary policy is not efficient in a number of circumstances, while fiscal policy is not equipped for the task.

The third section takes up the question of the limitations of fiscal policy at present, and suggests a particular form of fiscal policy that could contribute better to short-and medium-term stability.

Oversized Capital Inflows: How to Cope?

In the first opening up experience in recent Chilean economic history, 1975–1981, net capital inflows reached peaks of over 10 percent of GDP. During the second experience, 1986 to the present, the peak reached almost 5 percent (table 3.1). A similar case of oversized capital inflows has registered in Argentina (Fanelli and Machinea 1993) and Mexico.[2] As pointed out by Dooley, the nature of these movements has been different. During the first period, the inflow was essentially in the form of lending by foreign private banks to both governments and the domestic private sector; during the second period, capital inflow has taken more the form of direct investment and acquisition of domestic currency securities.

From the point of view of the macroeconomic impact of an eventual reversal of the flows, this difference is extremely important. In the case of foreign bank creditors lending to governments or to domestic banks, they could assume, rightly or wrongly, that there were explicit or implicit government guarantees on their loans. When the assumption proved to be wrong, as in the case of Chile in 1982, creditor banks had power enough to convince the authorities to extend an ex-post guarantee on Chilean private banks borrowings, despite the fact that the Chilean authorities had insisted starting as early as the late 1970s, that no such guarantee existed and that it would not be granted. Mexico, in fact, extended such an ex-post guarantee through the nationalization of the banking system in September, 1982. In both cases, the pending danger of a complete collapse of the financial system prompted the authorities to provide the guarantees demanded.

2. See Michael Dooley, "Globalization, Speculative Bubbles, and Central Banking," paper 5 in this volume.

Post-debt crisis financial reforms and the character of capital inflows after 1985 would make it very difficult for such guarantees to be demanded and even more difficult for them to be granted. There do not seem to be practical policies that could put expost guarantees into effect in the case of direct investment. It takes time to sell real assets, and there is no way for governments to guarantee their prices short of nationalization, an approach completely out of fashion. Furthermore, there does not seem to be an incentive for governments to do so. The selling of assets, including securities and shares of stock by foreign investors, would depress asset prices without endangering the stability of the financial or other markets. The reduction of asset prices would impose capital losses on the investor and limit subsequent demands for foreign exchange, and the increase in the rate of return on assets as their price is pushed down would attract other, perhaps domestic, investors.

Furthermore, under conditions of exchange rate flexibility, there would be a weakening of the domestic currency, thus increasing the capital losses faced by the withdrawing investor. In fact, the spread-over effects of an eventual withdrawal of foreign investments would cushion the impact on any one of the several markets such as securities, real assets, and foreign exchange markets. Naturally, the withdrawal of foreign investors could create other problems related to expectations and confidence, but such problems would be in the economy as before the withdrawal, as the latter would most likely be a consequence of the lack of confidence to start with.

My conclusion is that the macroeconomic problems caused by an eventual paralysation and reversal of the type of foreign investment prevailing today would be far less damaging than those registered in the decade of the 1980s.[3] However, the short term "digestion" problems caused by the inflow of capital in large amounts relative to GDP, investment, and exports, do not seem to depend closely on the nature of the inflows but rather on their relative size to the economy.

Capital Inflows under Fixed Exchange Rates

The process through which autonomous capital inflows are absorbed in an open economy crucially depend on the foreign exchange regime. Under fixed nominal exchange rates, a nonsterilized inflow will produce an increase in the money supply, asset prices, perceived wealth and expenditures, generating excess demand in the markets for tradables and nontradables. Effects on assets prices and perceived wealth

3. This conclusion is to be qualified on the basis of the rapidly growing placement of bonds by official institutions in international markets and the strong demand for securities expressed in domestic currency by foreign investors like the Mexican *cetes*. However, both cases are specific to a very small number of countries, all of which have managed to strengthen their external sector and their fiscal accounts.

will be larger, the larger the proportion of the capital inflows devoted to buying shares of stock and existing firms.

Since prices of tradables are basically determined by the nominal exchange rate and foreign prices, they will not show substantial changes, and the excess demand will be reflected in an excess of imports over exports. In the market for nontradables, prices will increase, thus strengthening the domestic currency's exchange rate in real terms, which may lead to a deficit in the trade account. As long as there is no sterilization, this process will continue until the surplus in the capital account is matched by an identical deficit in the current account. At that point, foreign exchange reserves and the money supply will stop growing. The economy is adjusted to the increased capital inflow, until new changes in the flows start the process again.

While adjustment is going on, prices of nontradables are increasing, which is reflected in domestic price indices. The economy is overheated. One readily available evidence that this process might be in operation is the fact that wholesale price indices with heavier content of tradables move up at a slower rate than consumer price indices, where nontradables have higher weight (table 3.1). If there is widespread indexation, increases in prices of nontradables are rapidly transmitted to the rest of the economy, accelerating the loss of competitiveness and generating some "overshooting" in the real revaluation of the domestic currency.

If exports are essentially commodities with little or no demand in the domestic market and with relatively low short-run elasticities of supply, the burden of the changes in the current accounts will be born mostly by imports. This, in turn, means that changes in income rather than in relative prices will bear the brunt of the adjustment. Income growth will be associated with currency appreciation in real terms during the period of inflows, and fall in income will be associated with a real depreciation of the currency when the inflow comes to an end.

The analysis above implies that, under these circumstances, revaluation or devaluation are not "caused" by changes in income, or vice versa, rather by autonomous capital movements reflecting structural changes in the financial and goods and services markets. Attempts to sterilize the capital inflow under the assumed conditions of fixed nominal exchange rates and open capital movements will be unsuccessful. Under such conditions, the supply of money is determined by its demand, and the authorities will not be able to affect domestic interest rates significantly to induce some effect on expenditure levels once the opening up process is fully established and credible. Interest rate differentials between the two markets may remain for a long time, as the experience of many countries show. However, the differential will eventually tend toward a level that could be explained mostly by higher operating costs and higher risk.

As the oversized capital inflow comes to an end, so does the increased level of expenditures, and the deficit in the current account recedes accordingly. The process is reversed.

Capital Inflows under Floating Exchange Rates

Floating rates introduce changes in the process described above. Assuming sterilization of exchange rate affects the government budget, capital inflows would be reflected in a real revaluation mainly through a drop in the nominal exchange rate and a consequent drop in the nominal price of tradable goods rather than in an increase in the nominal price of nontradables. The initial inflationary effects would then be smaller, or nonexistent, and the overheating will be due to the increasing disequilibrium in the current account. Of course, there will be an excess demand for nontradables but the change in their relative price would come about mainly through the drop in nominal prices of tradables. Inflationary effects are minimized.

If the government accounts have a current surplus in foreign exchange, as in Chile or Venezuela, the effects of changes in the exchange rate on the economy will differ from those in countries with a deficit, like Argentina and Uruguay. The effects will depend on how governments face the new situation. These differential effects probably contribute to explain why Chile failed in its effort to fix the nominal exchange rate in the early 1980s, while Argentina succeeded in the early 1990s. Chile and Venezuela have continued applying some form of flexibility in their foreign exchange markets.

In both fixed and floating rate cases, the capital inflow is absorbed in the economy through changes in income and relative prices. If capital inflows were somewhat erratic, or if they were large relative to the size of the economy, transitory changes in relative prices of tradables and nontradables may introduce undesired noise in the market. This is particularly so as the capital inflows are positively associated with opening up, at a time when most countries are vitally interested in the expansion of exports. Suppressing capital inflows would convey information contrary to the long-run objectives of the authorities and, under conditions of full opening of the current account, even limiting such inflows may prove impossible. Furthermore, direct investment, which is an important form of capital inflows in the present phase of the world economy, will increase the investment/GDP ratio, which is desirable from a long-term point of view.

Policy Tools: Monetary and Fiscal Policies

The question arises whether there are other policy tools that could facilitate absorption of foreign investment minimizing short-term negative effects. In my view, the real question is whether it is possible to affect domestic spending in the desired direction during the process of absorbing additional investment from abroad. Of course, the need to regulate expenditures arises mainly in cases where the economy is close to full employment. If it is working substantially below full employment,

increases in expenditure would be welcome, and foreign investment would become an undoubted blessing.

The traditional policy tools to affect spending are money and interest rate policies. However, under conditions of fixed nominal exchange rate and open capital and trade accounts, these tools are substantially powerless since interest rates are determined abroad and the supply of money is determined by demand, a well-known conclusion of the monetary approach to the balance of payments. Under floating rates, monetary and interest rate policy become meaningful, but changes in the exchange rates needed to maintain a stable level of foreign exchange reserves seem to be too large to swallow. Countries, in general, are willing to accept changes in reserve levels to avoid big changes in the exchange rate. The finding by Dooley, that effects of capital inflows in recent years have been about equally spread over reserve changes and trade account changes, can be interpreted as an evidence of "dirtiness" in floating or of limited flexibility of exchange rates.

As a consequence, monetary tools can play only a limited role in accommodating foreign capital flows. And they would do so by affecting mainly private sector spending, as governments increasingly avoid recourse to the banking system. A growing number of Latin American central banks are independent from government and forbidden from lending to the government. It is mostly private spending that is likely to be affected by changes in asset prices and perceived wealth brought about by capital inflows.

Fiscal policy is the remaining macroeconomic tool to control spending. As it is well-known, acting on both the income and the expenditure side of the budget may take a long time. Income tax changes, apart from changes in the prices of goods or services provided by state enterprises that are not important in modern states, usually require prior action from the legislature. Expenditure changes take time to be implemented, as governments commit their budgets well ahead of the time of disbursement. I shall come back to this later.

Interest Rates and Saving in Open Economies

We have learned from economic theory that saving is related to interest rates. Equilibrium between present and future consumption at the microeconomic level is reached when the subjective rate of time preference equals the rate at which present and future resources can be exchanged in the market. An increase in the market rate of interest would induce consumers to expand future consumption at the cost of present consumption, and consumers' saving will increase for any given level of income and wealth.

Also, if consumers are faced with an increase in their income, saving will increase unless wealth increases enough for the difference between desired and existing

wealth to go down sufficiently. Under several circumstances, interest rate changes will affect wealth and income, introducing some uncertainty in the final effect on saving.

Business Saving

But consumers are not the only savers in the economy. Firms and governments are, by far, much more important as savers or dissavers in most developing economies. This is clearly so in Latin American countries. The relationship between interest rates and saving at the firm and at the government levels is by no means clear.

At the firm's level, net saving equals undistributed profits. Current theory states that, in an ideal world, the firm's dividend policy is completely independent from investment policy, as investment can be financed with funds external to the firm (Modigliani and Miller 1958, 1963). As personal income taxes are introduced, the above conclusion is revised. It is also revised when capital gains taxes are taken into account. But interest rates do not seem to play a central role since they are supposed to affect equally all forms of financing. The capital structure of the firm is undetermined (Modigliani and Miller 1958, 1963).

This general theoretical conclusion is modified as the assumption of an ideal world is relaxed, but the result seems to be that taxes, risk and the cost of bankruptcy, and not interest rates, have an influence in the determination of a firm's capital structure. As a consequence, interest rates do not seem to affect the firm's policy regarding dividends.

This conclusion, however, may not hold in recently liberalized markets. As a matter of fact, undistributed profits have played a large role in financing new projects undertaken by firms in Latin America. Longer-term financing in the domestic market is limited due to inflation. Foreign financing, except for a brief period between the late 1970s and the early 1980s, has been limited to funds provided to governments, or with government guarantees, by the World Bank and the Inter-American Development Bank. Commercial bank lending has reappeared on the scene only recently. On the other hand, equity funding has not been an easily available option. Stock transactions are still small relative to any scale variable, share prices are quite volatile, and firms are not commonly organized in the form of open corporations.[4] (table 3.2.)

At the firm's level, the behavior regarding undistributed profits is probably influenced very heavily by growth opportunities. As profitable investment opportunities arise, the firm is stimulated to save in order to finance new projects. Thus, saving becomes directly related to the availability of new investment options. If

4. However, direct buying of shares of stock in domestic exchanges by foreigners is growing rapidly as information improves.

this is so, then saving at the firm's level is negatively related with interest rates in the financial market. If rates go up, financial costs go up and the present value of the expected future income stream of available new projects declines. A consequence of this is a diminished incentive to retain profits within the firm, and saving at the firm's level will drop.

However, firms are owned by consumers. It is reasonable to expect that, under perfect information conditions, a change in business savings will be matched by a change in household savings in the opposite direction, as both should be perfect substitutes. If information is not costless to the household, substitution will not be perfect, and changes in interest rates will have, if any, an effect on household plus business saving running counter to the usual theoretical expectation. On balance, the effect of a change in interest rates on the sum of business and consumer savings is difficult to predict.

Government Saving

As regard governments' saving behavior relative to changes in interest rates, the exploration can follow many leads. One, which has been explored mostly in Mexico and Argentina, is the effect of interest rates on government expenditures. As rates grow, debt-related expenditures of the government go up and, other things being equal, government saving is negatively affected. Another lead is of a more macroeconomic character. As domestic spending increases, the monetary authorities intervene by tightening monetary policy, and domestic interest rates go up. The public sector's stabilizing reaction ought to be in the direction of reducing its own spending, with a consequential increase in saving, in order to provide support to the monetary policy stance with minimum effect on output. This implies that there is an indirect relationship between interest rates and government saving in the "right" direction, that is, increases in interest rates lead to increases in government saving. But, these two cases lead to opposite conclusions regarding the direction of the effect of interest rates on government saving.

Therefore, the effects of changes in interest rates on private savings as a whole and on government saving are difficult to predict. Available evidence supports the view that there appears to be no discernible positive relationship between interest rate and saving. More than that, if there is any evidence, it shows a negative, rather than a positive, influence of interest rates on savings (Giovanni 1983).

My interpretation of the evidence up to this point, at least for firms, relies on the assumption of imperfect and relatively closed financial markets. However, this assumption is not strictly necessary. Even with open capital and financial markets, it is useful to distinguish between tradable and nontradable securities following the same type of distinction as in the markets for goods and services.

Interest Rates in the Opening Process: Tradable and Nontradable Securities

Tradable and nontradable securities differ on the basis of information costs, transaction costs, and risks. They are all partly related to the cost of obtaining information on the issuing firms, which in turn is related to the size and institutional form of the firm (information on open corporations is usually easily available). It is, of course, also related to the cost of information on the issuing country.

Opening capital and financial markets will influence and stabilize interest rates in the market for tradable securities, but may have little influence on the market for nontradable securities, at least during the first stages of the opening process. Large-size firm's securities will probably become tradable soon after opening, while those of medium- and small-size firms, and of households (consumer borrowing), may remain nontradable, perhaps for a long period of time. Domestic and foreign rates of interest may differ by more than the expected rate of change of the exchange rate plus "country risks."

In principle, even if there is a segment of the financial market where nontradable securities are transacted involving lending mainly to consumers and medium-and small-size firms, increases in rates in this market should drive financial intermediaries to find additional financing abroad in a sort of induced capital inflow, thereby defeating the purposes of the authorities. Even with relatively close connections between the tradable and nontradable sections of the domestic financial market, experience in Latin America shows that differences between domestic and foreign rates may remain for long periods of time (table 3.3).

The above discussion is relevant in the context of the opening up process. A reduction in trade barriers will change domestic relative prices, generating new investment opportunities as well as economic obsolescence. Both will push up demand for credit. Furthermore, the change in policy and in relative prices will increase systematic risk. As a consequence, domestic interest rates will shoot up. If the capital account has been open, the rate will go up more in the nontradable sector of the market. If it is still closed, it will go up in the market as a whole. But rates will increase in both cases, without generating an increased flow of saving domestically while attracting foreign financing to the tradable financial sector.

This discussion leads to the conclusion that it does not seem to be too important to decide on whether the capital market or the goods and services market are to be opened first. In both cases, interest rates relevant to a wide sector of the economy will tend to go up. And domestic saving will not respond positively, even when facing huge increases in real interest rates (table 3.4).

Under the conditions generated by strong changes in relative prices, it is most likely that real interest rates go up very sharply. Firms, borrowing in distress or in search of new opportunities, will face a low short-run elasticity supply of credit to the nontradable sector of the financial market. The flow of saving does not respond, and

domestic interest rates become "outlyers," accelerating the process of bankruptcies. Negative effects on employment prevail over employment expansion generated by new investment opportunities. Unemployment grows, and the stability of the financial system is endangered.

Policy Options

Only three categories of major policy options are briefly discussed here, though the policy menu within each category deserves a more comprehensive treatment and is covered by other papers in this volume.

The Speed of Reforms

The first and most obvious policy option is to slow down the rate of change of relative prices by introducing reforms gradually. However, this option may reduce the chances of the policies being fully implemented, as it gives the opportunity for opposing interests to react. The speed at which reforms are introduced is to be determined not only by economic effects but also by considerations of political sustainability of the reform package. The proper balancing of these two considerations is a question of political judgment on the basis of the relative strength of forces pro and against reform. The stronger the pro-reform forces, the lower the speed at which reform measures can be introduced and the lower the economic and social cost to be paid.

The Strengthening of the Domestic Financial Market

In any case, in countries where both the trade and capital accounts have been relatively closed, I agree with those that believe that a first step to reform should be the strengthening of the domestic financial system. The main elements for strengthening are capital and solvency requirements, and the quality of prudential regulation by the authorities. Interest rate regulations will need revision to allow for increase in rates that take them to positive levels in real terms, but it seems unnecessary and inconvenient to allow rates to reach absurd levels. If the interest rate necessary to clear the credit market grossly exceeds something like 10 to 15 percent in real terms, it will destabilize other markets, leading eventually to capital transfers that are difficult to sustain.

At very high levels, interest rates become simply a mechanism for eventual capital transfers between firms and sectors rather than an indication of rates of return in the economy. Initially, higher interest payments are simply financed, exacerbating

demand for credit. As a firm reaches the point of illiquidity, the financial system stops lending to it and capital transfers are expected to materialize, leading to traumatic legal and economic processes. Meanwhile, domestic interest rates do not play an efficient role in allocating resources or in increasing the flow of domestic saving. They do contribute to attract foreign capital, but they do so at the cost of an overkill.

Legislation about bankruptcy procedures also need modernization, mostly in the direction of finding ways to allow the firm in distress to continue operations as a unit and of speeding up the process of liquidation. There are many cases where the recognition of a lower capital value of a firm leading to a reduction in liabilities is enough to facilitate its continued profitable operations, avoiding unnecessary additions to unemployment. In cases such as these, there is little creditors can do to protect their claims.

Monetary and Fiscal Policies

Monetary and fiscal policies should not press the financial markets further. Expansive monetary policy would risk inflation, as the whole adjustment process is dominated by changes in relative prices that monetary policy by itself cannot change. An expansive policy stance of the monetary authority could lead to inflation without contributing much to unemployment reduction. On the other hand, a restrictive policy stance would only aggravate pressures on the financial markets.

Fiscal policy could be of great significance. By eliminating negative public saving it could positively contribute to the flow of saving in the economy, directly alleviating the pressure on financial markets. But it will probably need to do so by increasing government income rather than by reducing expenditures. Expenditure reduction may come at a later stage, when the economy is well on its way to recovery and positive stimulus from the expanding sectors begin to take hold.

A second option is available to countries that have kept open capital markets for a long time. In such cases, it is likely that the nontradable sector of the financial market has been shrunk to be negligible from a macroeconomic point of view. If this is the case, trade reform can proceed at a faster pace as its effects on domestic interest rates will be minimized by capital inflows. Resources will be pulled out from negatively affected firms and/or sectors rather than pushed out of them by falling relative prices and unbearable interest payments. Unemployment effects will thus be minimized.

The case of Argentina illustrates this option. Argentina has maintained open capital markets, either by design or de facto, for a long period of time. However, trade opening occurred only recently. Under these conditions, Argentina's open trade policy did not cause the disruptions in employment and growth of the type experienced, for example in Chile in the mid 1970s, or in Peru in the early 1990s. Similarly, real

interest rates in Argentina during the trade opening period did not reach levels even half as high as those in Chile or Peru. Again, these results are not a consequence of opening up the capital market before opening up trade; it is rather a question of the relative importance of nontradable securities in the economy and of the speed at which they become tradable (table 3.5).

The Exchange Rate Regime

The exchange rate system of the country is quite relevant to this discussion. A credible fixed nominal exchange rate in relation to the intervention currency will help stabilize the price level, by providing a significant anchor for prices of tradable goods and services. If opening up occurs in an inflationary environment, a fixed nominal exchange rate will produce a separation between real interest rates in domestic currency and real rates measured in foreign currency, and the difference between the two may become substantial. For example, at a rate of inflation of, say, 15 percent per year, an interest rate of 20 percent in the domestic market will imply an internal real rate of roughly 5 percent, while the corresponding rate measured in dollars would be 20 percent, as the price of the dollar is not expected to change (table 3.5).

The difference between these two real rates is a strong incentive for capital inflows. Fixed nominal exchange rates in an inflationary environment imply a "subsidy" to capital inflows. The magnitude of the subsidy is equal to the difference between the domestic and the foreign rates of inflation. However, this peculiar subsidy is paid only when the inflow of capital is reversed. It particularly stimulates short-term inflows, ready to leave when the domestic currency is in danger of a devaluation. If devaluation expectations flare up, the authorities could do little to prevent a devaluation of the domestic currency.

More flexible exchange rates provide a cushion to short-term capital movements, but at the cost of affecting domestic price levels and introducing additional uncertainty costs to tradables. Hence, flexibility is usually limited, either discretionally as in dirty floats or by some rule such as a band, a crawling-peg, or a *tablita*. These are intermediate cases that help distribute the impact of shocks among different markets.

Fiscal policy is the single most important domestic tool to affect the probability of a devaluation, as monetary policy is powerless in an open economy with fixed exchange rates, and of limited effect in intermediate cases. Once again, fiscal policy appears in the forefront.

Conclusion: Need for a New Fiscal Policy?

Fiscal policy directly affects expenditures, public or private, either by changing government income or spending, although changes in either are rather slow to implement. Given the limited short-run predictive capacity regarding the timing and magnitude of shocks, such slowness in implementation prevents the use of fiscal policy in many cases. In other cases, it generates undesired effects of aggravating rather than reducing the impact of shocks in the economy.

This type of consideration is relevant when the government budget is not the source itself of major disequilibria in the economy. The general recommendation to governments that the budget ought to be near balance at all times is perhaps one of the most important rules learned during the 1980s.

But this is not enough. The more open the economy of a relatively small country, and the narrower the limits within which the nominal exchange rate is allowed to move, the lower the efficiency of monetary policy. Or, put in other words, the more open the economy, the lower the capacity of the monetary authorities to control the supply of money and domestic interest rates, and their powers to control private spending in case of need. As the economy is more open, the policy burden falls increasingly upon fiscal policy. Yet, tax changes in most countries can only be introduced by law, and the legislative process usually takes months. Tax changes, therefore, are ruled out as short-term policy tools. On the other hand, government expenditures do not respond easily to decisions to change them.

Furthermore, a theoretical argument has been put forward to point out that under some conditions, changes in taxes or in government spending may not influence private or even total spending. According to the Ricardian equivalence principle, the private sector takes into account future tax changes that are expected to occur as a consequence of present changes and its own spending stream is not affected. However, this theoretical argument assumes no liquidity constraints, and households are assumed to take into account taxes on future generations when deciding about their own spending. Empirical evidence does not seem to be in accord with the theoretical argument (Bernheim 1987).

The practical considerations mentioned above must be taken seriously in the design of policy. On the expenditure side, while governments may manage to increase their flexibility to alter spending, there are practical limits to it. Flexibility in spending requires not only an efficient decisionmaking process, which is a relatively scarce commodity the world over, but also demands efficient implementation and a generalized system of short-term contracts or provisions for change on short notice within prevailing contracts. Such provisions would certainly entail additional costs both in economic and political terms. Hence, they are generally ruled out.

On balance, it seems that short-term changes in government expenditures can not be used efficiently as a policy tool. Such changes, due to delays in implementation

and predictive errors, may destabilize the economy. After the desired relative size of the state has been achieved, the best one can hope for on the expenditure side, is to aim to a roughly constant rate of growth of government spending. This rate should be similar to or slightly smaller than the long-term growth rate of the economy. In this way, the relative size of the state achieved would be preserved and the risk of errors on the side of an excessive increase of its size would be minimized.

This argument is logically similar to that of Milton Friedman in his recommendation of a constant rate of change in the money supply through time implying rules and not discretion in the conduct of monetary policy (Friedman 1961). Obviously, it is impossible to apply Friedman's recommendation in a small, open economy that regulates its exchange rates. In that case, the supply of money would be determined by demand. But it is not impossible to apply the same logic to government spending.

The story on the income side of the public budget can be quite different. Government income moves with the economy, as tax collections are sensitive to the level of economic activity. That sensitivity could be increased through appropriate changes in the tax structure that could be introduced once and for all. Furthermore, the authorities could be empowered by law to make transitory changes in some tax rates to support the built-in stabilizing characteristics of the government budget.

The tax rates, which are first line candidates for transitory adjustment, are pay-as-you-go type taxes of general application. Perhaps the most widely applied tax of that type is the value added tax, and since VAT is collected on each sale, the effects of changes in the tax rate will be visible as soon as the change is introduced. Variable tax rates could also apply to short-term capital inflows. This is already done in some countries through the introduction of obligatory noninterest bearing deposits of variable maturities and in different proportions of the inflow.

With government expenditures growing at a constant rate while government income moves with the cycle, the fiscal budget could become a very important policy tool, to take up more and more of the burden that monetary policy is increasingly unable to bear. This is the road that Chile has just begun to follow. Congress has approved legislation allowing the executive power to introduce limited, transitory changes in the rate of the VAT, while government spending is expected to grow in consonance with the potential rate of growth of the economy.

Table 3.1. *Chile and Mexico: Annual Average Percentage Change in Consumer and Wholesale Price Indices and Net Capital Inflow as a percentage of GDP, 1975–91*

	Chile			*Mexico*		
Year	*CPI*	*WPI*	*NCI*	*CPI*	*WPI*	*NCI*
1975	374.70	481.90	(1.03)	15.20	10.70	2 .85
1976	211.80	221.10	(1.27)	15.80	22.30	0.80
1977	91.90	86.10	2.78	29.00	41.20	0.06
1978	40.10	43.00	8.86	17.50	15.80	0.79
1979	33.40	49.40	7.65	18.20	18.30	1.42
1980	35.10	39.60	8.75	26.40	24.50	2.68
1981	19.70	9.10	10.66	27.90	24.50	3.01
1982	9.90	7.20	(3.65)	58.90	56.10	(5.77)
1983	27.30	45.50	(5.65)	101.80	107.40	(8.84)
1984	19.90	24.30	1.25	65.50	70.30	(7.07)
1985	30.70	43.40	(4.46)	57.70	53.60	(6.86)
1986	19.50	19.80	(5.39)	86.20	88.40	(4.73)
1987	19.90	19.20	(3.67)	131.80	135.60	(3.80)
1988	14.70	5.90	(3.67)	114.20	107.80	(6.60)
1989	17.00	15.10	(1.70)	20.00	16.10	(1.80)
1990	26.00	21.80	4.55	26.70	23.30	1.15
1991	21.80	21.70	(1.29)	22.70	20.50	5.02

CPI Consumer price index
WPI Wholesale price index.
NCI Net Capital inflow.
Source: ECLAC.

Table 3.2. *Argentina, Chile, and Mexico: Nominal Value of Shares Sold in Stock Exchanges as a Percentage of GDP, 1988 and 1922*

Year	*Argentina*	*Chile*	*Mexico*
1988	0.70	5.10	3.30
1992	8.30	4.80	13.30

Source: Santiago Stock Exchange.

Table 3.3. *Argentina, Chile, and Mexico: Domestic Interest Rates (U.S.dollars) 1979–93*

Year	*Argentina (a)*	*Chile (a)*	*Mexico (b)*
1979	-	37.78	15.02
1980	-	40.52	21.40
1981	-	52.02	22.76
1982	-	25.54	(36.69)
1983	-	(7.78)	(25.30)
1984	518.39	10.55	6.87
1985	454.11	(13.44)	6.60
1986	(49.04)	5.38	-
1987	6,992.23	16.76	(9.85)
1988	40.56	16.95	47.43
1989	1,087.53	12.83	25.78
1990	16,436.85	31.56	20.43
1991	6.58	15.80	14.28
1992	18.58	22.23	14.03
1993	(4.30)	12.40	6.80

a. Lending rate.
b. Based on treasury bills.
Source: International Monetary Fund, IFS 1993.

Table 3.4. *Argentina, Chile, and Mexico: Domestic Real Interest Rates (DRI), and Saving as a Percentage of GDP, 1975–92*

	Argentina		*Chile*		*Mexico*	
Year	*DRI (a)*	*S (b)*	*DRI (a)*	*S (b)*	*DRI (a)*	*S (b)*
1975	-	-	20.8	11.1	-	-
1976		-	34.9	17.1	-	-
1977	-	-	37.1	12.4	-	-
1978	-	-	32.9	14.5	(5.9)	23.0
1979	-	-	21.5	15.0	(2.7	24.7
1980	-	-	8.9	16.9	(3.1)	24.9
1981	-	-	27.0	12.4	2.2	24.9
1982	-	-	49.1	9.4	(8.3)	27.9
1983	-	-	12.2	12.5	(21.2)	30.3
1984	33.3	45.1	15.[illegible]	12.5	(9.8)	27.7
1985	63.2	39.8	8.1	16.5	3.5	26.3
1986	9.4	36.6	5.7	18.4	-	22.4
1987	48.3	34.5	10.8	21.0	(12.4)	25.4
1988	8.8	41.7	7.6	24.2	11.1	22.0
1989	2,784.1	36.8	11.9	24.0	21.1	21.2
1990	9,432.4	19.7	17.1	23.1	3.8	20.7
1991	13.9	16.2	8.4	23.7	0.6	19.3
1992	8.0	15.2	10.1	23.4	3.5	17.7

DRI Domestic real interest rates.
S Savings as a percentage of GDP.
a. For Argentina and Chile, the DRI is based on lending rates. For Mexico, DRI is based on treasury bills.
b. Calculated as the difference between GDP and total consumption, divided by GDP (nominal).
Source: International Monetary Fund, IFS 1993.

Table 3.5. *Argentina, Chile, Mexico, and Peru: Domestic Real Interest Rates, Selected Years*

	Chile (a)	
Year	*Pesos*	*US$*
1976	34.90	58.24
1977	37.13	59.56
1978	32.86	26.59
1979	21.52	37.78
1980	8.91	40.52
1981	27.00	52.02

	Argentina (a)		Mexico (b)		Peru (a)	
Year	*Pesos*	*US$*	*Pesos*	*US$*	*Pesos*	*US$*
1988	8.80	40.56	11.05	47.43	-	-
1989	2,784.10	1,087.53	21.10	25.78	(125.00)	131.55
1990	9,432.38	16,436.85	3.80	20.43	(13.05)	29.50
1991	13.90	6.58	0.63	14.28	248.20	504.90
1992	7.98	18.58	3.50	14.03	55.83	67.93
1993 (c)	(4.30)	4.70	6.80	16.25	40.30	47.93

a. Lending rates in 1993.
b. Data based on the average of the first and second quarters of 1993.
c. The interest rate is based on treasury bills.

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4

FINANCIAL DEREGULATION AND BANK SUPERVISION: THE CASE OF INDONESIA

Binhadi, Managing Director, Bank Indonesia

Indonesia initiated financial deregulation beginning in the late 1960s. At that time, deregulation covered the foreign exchange market, investment and banking institutions. The implementation of the deregulation policy, however, was affected by unfavorable economic conditions in the early 1960s, and was delayed by the oil booms in 1970 and the early 1980s. To accommodate such conditions, deregulation in monetary policies was not implemented until 1983, while deregulation of banking institutions was terminated in the early 1970s, only to be reimplemented again beginning in 1988. Meanwhile, deregulation in foreign exchange and investment continued.

In 1982 the Indonesian economy was affected by the world recession of the early 1980s. The situation worsened when declining oil prices led to significant decreases in net oil exports. In addition, the growth rate of deposit mobilization by the banking sector continued to decline since liquidity credits were backed up by the oil boom in the 1970s. To cope with these problems, the government responded with a broad range of actions including deregulation of the financial sector. Since then, the Indonesian government changed its economic policy to implement a sweeping deregulation, including deregulation of the real sector.

Indonesia introduced bank supervision in the 1950s implemented by Bank Indonesia. In implementing bank supervision, Bank Indonesia's techniques and approaches changed from time to time based on economic policies and developments within the financial and banking systems.

Financial System Deregulation

Deregulation of the financial system in Indonesia was done in a sequence and was followed by other deregulation and reductions in bureaucracy that covered a wide range of activities that affected the development of the economy. In the late 1960s the government conducted economic stabilization and rehabilitation programs designed to reduce inflation, provide adequate supply of basic needs, rehabilitate the economic infrastructure, and increase exports. In this context the government deregulated

foreign exchange control, encouraged domestic as well as foreign investments, and eased the establishment of new private and foreign banks.

Because of very high inflation rates and undeveloped banking and money markets in the late 1960s, the monetary policy was implemented through a direct instrument: interest rate determination by the central bank. In the 1970s and early 1980s the oil boom greatly affected the Indonesian economy. This condition discouraged the implementation of the deregulation policy. On the other hand, the evidence of a banking crisis in the early 1970s urged the government to issue a merger policy and to regulate the banking sector. Meanwhile, deregulation of foreign exchange and capital account continued.

To overcome the economic deterioration caused by the world recession and the decline in oil prices in the early 1980s, the government further deregulated the foreign exchange market. This was followed by deregulation of the financial, monetary, and banking system and deregulation of the capital market. As part of the deregulation launched in 1990, Bank Indonesia further reduced its liquidity credit and improved the national credit system.

Following the monetary and banking deregulations the government deregulated the real sector in several stages. In 1991 Bank Indonesia improved its bank supervision system by introducing banking prudential principles. To improve the legal framework, the new Banking Act, the Insurance Act, and the Pension Fund Act were enacted in March 1992.

Deregulation of the Foreign Exchange Market

The process of deregulating the foreign exchange market changed three key aspects, namely, the foreign exchange trading mechanism, foreign exchange market participants, and foreign exchange rates. The adjustment measures were selectively applied, covering either all three aspects simultaneously or only one aspect at a time. During 1967–70, several changes occurred concerning the foreign exchange trading mechanism and foreign exchange market participants, and some movements away from a multiple exchange rate system toward a single foreign exchange rate.

A major change in the foreign exchange market mechanism occurred in 1967 when the government established the Foreign Exchange Bourse, and abolished the regulation that required official permission to use foreign exchange. For the first time since the existence of exchange controls, it was now possible to legally trade foreign currencies against the rupiah. Starting in 1970 the holding, selling, and purchasing of foreign exchange were no longer subject to restrictions. The requirement for exporters to surrender the export proceeds to a foreign exchange bank, however, was retained, although nothing prevented them from buying an even larger amount of foreign exchange at the same time. Foreign exchange banks, in turn, had to sell to Bank Indonesia the amount of foreign exchange they acquired. Importers and those who

needed foreign exchange for whatever purpose had to buy foreign exchange from a foreign exchange bank. Thus, a foreign exchange bank could buy and sell foreign exchange to their customers. Foreign exchange transactions between banks and Bank Indonesia were conducted through the Foreign Exchange Bourse.

During 1978–82, major changes occurred in the exchange rate system. The rupiah was devalued by 33.6 percent primarily to improve non-oil export and was pegged to a basket of the currencies of Indonesia's major trading partner in place of the U.S. dollar.

The new system was expected to improve the competitiveness of Indonesian exports in the international markets, increase foreign exchange earnings, and stimulate foreign capital investments. Beginning in 1982 exporters no longer had to surrender foreign exchange proceeds to Bank Indonesia. They were allowed to hold export proceeds for their needs, and they could sell part or all foreign exchange proceeds to Bank Indonesia through a foreign exchange bank. The same applied to importers who wanted to buy part or all foreign exchange for their imports from Bank Indonesia. To encourage the development of the foreign exchange market, the government allowed the establishment of brokerage firms.

In 1989 the government abolished the Foreign Exchange Bourse and decided that transactions between Bank Indonesia and a foreign exchange bank must be done through dealing rooms. The government also removed the ceilings on a bank's foreign borrowings and applied the Net Foreign Exchange Open Position regulation as a way to minimize a bank's risks. Furthermore, the procedures of liquidity and investment swaps between foreign exchange banks and Bank Indonesia were revised. These revisions of the foreign exchange mechanism allowed the government to develop the central bank intervention pattern through the buying and selling of foreign exchange in the foreign exchange market.

With the monetary and banking deregulation in 1988, the government reopened the opportunity to set up a foreign bank in the form of a joint-venture that could also be a foreign exchange bank. For private national banks the government had given some flexibility to operate as a foreign exchange bank provided the banks were sound.

From 1989 onward, the exchange rate determined by the central bank was not the daily compulsory rate to be applied but rather only an indicative rate, which meant that the rate in the foreign exchange market could fluctuate on the basis of developments in the domestic and international markets. The central bank could exercise intervention in order to adjust this rate. With the Net Foreign Exchange Open Position regulation, which provided a squaring system for banks in the afternoon, the central bank determined the rate for squaring by simply examining the development of rates in domestic and international markets. In determining the indicative rate the central bank, however, still maintains the managed floating exchange rate system based on a basket of currencies.

The Monetary, Financial, and Banking Deregulation

In 1983 the government instituted a far-reaching deregulation in the financial system. It removed the interest rate controls on state banks and lifted the system of controlling bank credits through administrated ceilings in favor of a more market oriented approach that relied on the development of indirect monetary instruments, namely, reserve requirements, open market operations, and discount facilities. To reduce the injection of money supply through liquidity credits, a significant part to those credits outstanding as of March 1983, were not renewed, and new liquidity credits were provided only for high priority sectors.

For the implementation of open market operations, Bank Indonesia developed money market instruments, namely, Bank Indonesia Certificates (SBIs), and money market securities (SBPUs). SBIs were introduced in 1984 for three main reasons: first, as a monetary policy instrument, especially for monetary contraction; second, as a money market instrument; and third, as an alternative opportunity for the banking system to invest temporary excess reserves. Money market securities were introduced in 1985 primarily for monetary expansion purposes. In addition to the SBIs and SBPUs, Bank Indonesia introduced discount facilities and improved the operations of the interbank market.

The 1983 reforms had positive effects and enabled the economy to generate alternative sources of funds and significant increases in non-oil exports. The reforms played a crucial role in mobilizing funds, for investments, promoting non-oil exports, determining the market interest rates, affecting movement of exchange rates, influencing capital flow, contributing to the control of inflation, and improving the distribution of income. By and large, the banking system contributed to the considerable development of the private sector, enhanced the monetization and financial deepening throughout the country. Expansions in banking also increased competition among the banks, encouraging them to provide professional banking services and increase their efficiency.

To further increase the role of the banking system, the government introduced a deregulation package in 1988, called PAKTO 27. The package was designed to mobilize funds, increase efficiency in the operation of banks and other financial institutions, effectively implement monetary policy, and develop the capital market and boost non-oil exports. In effect, these measures served as an integral part of the government's efforts on deregulation and debureaucratization.

Policies on fund mobilization involved (a) opening opportunities for expanding the offices of banks and nonbank financial intermediaries (NBFIs) and establishing new banks including rural banks; (b) giving freedom to banks to further develop savings schemes and to issue certificates of deposits; and (c) giving opportunities to NBFIs to act as deposit takers through the issuance of certificate of deposits.

The promotion of non-oil exports requires expanded and improved banking services. For this purpose, deregulations involved (a) opening opportunities for

expanding foreign exchange banks, establishing of joint banks, opening foreign bank sub-branch offices, and expanding of money changes to promote tourism; (b) improving foreign exchange swap and reswap arrangements; (c) abolishing foreign borrowing limits for banks and NBFIs and introducing the foreign exchange net open position; and (d) requiring joint banks and foreign banks to provide 50 percent of total credits for export purposes.

To increase the efficiency of banks and NBFIs, a climate to induce sound competition was to be created. The expansion of banks and branch offices and the freedom to create new products for fund mobilization and credit expansion were the most important aspects for the inducement of sound competition. In this context, the government allowed the state companies to deposit their funds in private banks, with a maximum of 50 percent of the funds invested. Such deposits in a single private bank must be a maximum of 20 percent of the deposit by state companies.

To further increase the effectiveness of the monetary policy, the deregulations also incorporated unification and standardization of the reserve requirement for banks and NBFIs, and the continuation of the conduct of open market operations with the use of SBIs and SBPUs. For banks, the reserve requirement was reduced to 2 percent of deposits, and NBFIs were required to maintain the same percentage of reserve requirements.

To accelerate developments of the capital market, deregulations included a plan to equalize taxes on income from deposits with that of income from securities, and permission for banks and NBFIs to raise capital by issuing new shares through the capital market in addition to increase in the equity participation of shareholders. For equal tax treatment, the principal measure was to charge a 15 percent final tax rate on interest income earned from time deposits, savings deposits, and certificate of deposits, with the possibility of tax restitution for small savers. However, since January 1992, the 15 percent final tax is only for deposits owned by individuals, whereas interest income on corporate deposits is treated as regular income.

The Deregulation of Capital Market

The capital market in Indonesia was reestablished in 1976 and grew very slowly until 1988. Since the deregulation in December 1988, however, the capital market has grown rapidly. The existence of the capital market is complementary to the banking sector to provide alternative source of funds for investment. Nevertheless, in the past, participation in the capital market did not increase as expected. Among the conditions needed to develop a strong capital market are an adequate number of companies, who are willing to sell their shares in the market, and supportive institutions and active trading in the secondary market.

To overcome the lack of participation, the government initially introduced a policy package in 1987 that significantly modified and relaxed the requirements for the issuance of securities at the stock exchange. A parallel stock exchange was also established for companies who wished to issue their shares but could not fulfill the requirement of the stock exchange. In addition, foreign investors were also allowed to participate in the parallel market in accordance with foreign investment regulations.

As a follow-up, in December 1988, the government introduced another policy package for the capital market resulting in significant improvement in the activity of the capital market. The measures in this package included the establishment of a private stock exchange, the opening of the stock exchange outside Jakarta, the expansion of marketable securities trade at the Jakarta Stock Exchange, and the development of finance companies. The package provided various opportunities for new financing activities to encourage the development of finance institutions that could support the capital market. To conduct their activities, foreign investors were allowed to participate in the ownership of a joint venture securities company and finance company.

The National Credit Policy

Satisfactory developments in the banking sector with respect to funds mobilization, improvement in efficiency and services to the public, interest rate movements, a favorable inflation rate, and exchange rate movement signified that the foundation of the financial sector had become stronger, efficient, and more supportive to development efforts. In the meantime, even though efforts were made to reduce the liquidity credits provided by Bank Indonesia, its yearly development showed an increasing amount. This was not favorable for the development of an efficient and strong financial sector.

In 1990, the government took measures to improve the national credit system. Its objective was to gradually reduce the liquidity credits for various programs and activities, and at the same time to increase the role of the banking sector and general credit expansion. Furthermore, only a limited amount of liquidity credits from Bank Indonesia could be provided to support the efforts for food self-sufficiency, the development of cooperatives, and the enhancement of investments. Credits extended by banks and other financial institutions, except for the above mentioned credit programs, would be based on their deposit mobilization. National banks were to allocate a minimum of 20 percent of their total credits for a guaranteed availability of funds for small-scale industry and productive activities of cooperatives. In addition, foreign banks and joint banks were to provide at least 50 percent of their total credit for export purposes.

The New Banking Act, the Insurance Act, and the Pension Fund Act of 1992

Three new laws were enacted in 1992 to provide legal foundation to deregulation policies and to enhance the role of the banks. These were: the new Banking Act, the Insurance Act, and the Pension Fund Act. The new Banking Act concerns the ownership of banks and stipulates that foreigners may purchase commercial bank shares through the stock exchange but are not allowed to become majority shareholders, while the state-owned commercial banks may issue shares through the stock exchange provided the majority of shares is still owned by the government. However, the scope of a bank's operations is principally universal banking. Banks in Indonesia are permitted to conduct all financial activities, although some activities must be done through subsidiaries.

The ownership and establishment of insurance companies is treated in a similar manner as the banks. In the case of pension funds, two types of funds are available, namely employer pension funds and general pension funds. Banks are allowed to manage both types of pension funds. These new laws provide insurance and pension funds a legal foundation for conducting operations in a deregulated manner. The development of these institutions will enable mobilization of long-term funds to support investments and capital market development.

The Impact of Financial Deregulation

Financial deregulation affects both macroeconomic variables and financial institution development. In this section, the discussion first focuses on the impact on the banking sector, and then reviews the ways deregulation has affected macroeconomic variables.

The Banking Sector

There have been major changes in operational banking patterns and banking product development since the deregulation in 1988. The Indonesian banking industry experienced an impressive growth in the number of offices, the diversity of services, and the volume of business. In 1989 the number of commercial banks increased by thirty-five banks, in 1990 by twenty-five banks, in 1991 by twenty-one banks, and in 1992 by sixteen banks. At the end of 1992, the total number of new banks was 221 of which 7 are state-owned banks, 27 are regional development banks, 114 are private national banks, 10 are foreign bank branches , 20 are joint banks, and 13 are NBFIs.

The total number of branches and sub-branches also increased substantially. During 1989–92, 3,681 new branches were established bringing the total number of

branches to 5,626 by the end of 1992. In addition, there are 3,195 BRI village units and 8,520 rural banks, of which 814 are newly established. This means that with a population of around 180 million, one office unit serves about 10,000 people.

The mobilization of funds also expanded rapidly during 1989 and 1990. Deposits increased by 44 percent in 1989 and by 51 percent in 1990. Credits increased by 37 percent in 1989 and by 51 percent in 1990. Because of the tight monetary policy that began in the middle of 1990, the growth of deposits in 1991 and 1992 slowed down to 17 percent, and credit expansion also slowed down to 17 percent in 1991 and 10 percent in 1992.

The deregulation policy also encouraged the development of banking products and services. To mobilize funds, each bank tried to develop its own specialties to attract as many customers as possible. As a consequence, the number of savings schemes, for example, increased to about 140. The money market and the foreign exchange market have also developed in terms of both volume and product diversification. The interbank money market in rupiah increased from a daily average of Rp 180 billion in 1988 to Rp 435 billion in 1992. Short-term securities trading increased from a daily average of Rp 102 billion in 1988 to Rp 294 billion in 1992. The foreign exchange market grew substantially, from a daily average of US$2 billion in 1992. The products of the foreign exchange markets also expanded; in addition to spot transactions, they now include products, such as swap, forward, option, futures, and margin trading.

The increase of banks and bank offices and the increased volume of assets, liabilities, and banking products and services affected the number of employees needed. Even though the banks' human resource development began much before the banking institutional deregulation, the sudden increase caused a shortage of skilled bank staff. This situation created keen competition and hijacking of personnel.

The Impact on Macroeconomic Variables

Since the early 1980s, the deregulation policies, as well as macroeconomic policies, such as the fiscal policy and the rephasing of huge government projects, have helped to improve the Indonesian economy. GDP growth, which had declined to 2.3 percent in 1982, increased to 4.2 percent in 1983. In the following five years the average growth of GDP reached 5.2 percent per year. On the other hand, the rate of inflation, which was 11.5 percent in 1983, declined to an average of 7.2 percent per year in the following five years.

In 1988, as a result of further deregulation of banking and relaxation of monetary controls, the GDP growth was around 7.4 percent during 1989 and 1990. The ensuing enormous increase in demand both in consumption and in investment caused an overheated economy. This led to a sharp increase in imports, a deterioration in the growth of non-oil exports, and an increase in inflation. This situation eventually

forced the government to implement a tight monetary policy. To avoid an increase in foreign commercial borrowings, the government issued a prudential foreign commercial borrowing policy.

Rapid credit expansion after financial deregulation in 1988 caused a rapid increase in money supply (M1 and M2) in 1989 and 1990. In 1989 both M1 and M2 increased by 40 percent. In 1990, growth in M1 declined to 18 percent, but M2 continued to show a rapid increase of 44 percent. This development, on the one hand, supported the GDP growth, but on the other hand, increased the inflation rate from 5.9 percent in 1989 to about 9.5 percent during 1990 and 1991. The growth of M1 and M2 then began to decline due to the implementation of a tight monetary policy in the middle of 1990. In 1991, both M1 and M2 increased by 10 percent, but in 1992, M1 growth was 9.3 percent and M2 growth 20 percent. Because of the new monetary policy, the interest rate that had increased to 25 percent in early 1991 started to decline at the end of 1991 and was 15 percent in 1992.

With regard to exports, since the removal of the obligation for exporters to surrender their export proceeds and the deregulation policies in other sectors, non-oil exports began a sustained increase in 1983 and surpassed the value of oil exports by 1987. In 1989, non-oil exports were higher than imports, and given a slight increase in oil exports as well, current account deficit declined. There were some slack in non-oil export growth in 1990, but during 1991 and 1992 the growth resumed to about 21 percent.

With the above development, Indonesian's share in international trade continued to increase. The ratio of exports to GDP was 18.2 percent in 1986 and increased to 22.7 percent in 1987, 24.5 percent in 1989, and 25.4 percent in 1991. The imports to GDP ratio was 15 percent in 1986 and increased to 16.5 percent in 1987, 17.3 percent in 1989, and 21.3 percent in 1991.

Furthermore, the deregulation of foreign exchange market since 1982 and other macroeconomic policies stimulated domestic and foreign investment. Domestic and foreign capital investment approved by the government amounted to an average of Rp 2 trillion and US$933.8 million during 1982–87, increased to an average of Rp 5 trillion and US$1,311.0 million during 1982–87, and further increased to an annual average of Rp 31 trillion and US$7.1 million during 1987–92.

Bank Supervision in the Deregulation Era

Bank Indonesia as the central bank has been entrusted the reponsibility of bank supervision since the 1950s. Bank supervision techniques and approaches were adjusted from time to time based on economic policies and the development of the financial and banking systems. Several issues of bank supervision in the deregulation era can be further explored.

The Philosophy and Objectives of Bank Supervision

The philosophy and objectives of bank supervision have remained basically unchanged since the regulation era. Traditionally, the philosophy has been to protect the interest of depositors and maintain the public confidence in banking. As an institution of intermediary and deposit money banking, bank activities significantly affect, either positively or negatively, economic activity and monetary stability. Hence, further development in bank supervision must support this function. There are two types of depositor protection: indirect and direct. Indirect protection maintains the soundness of banks and banking systems. Direct protection can be done through deposit insurance or deposit fund. Indonesia's bank supervision policy is related to indirect protection.

Given these, the objectives of bank supervision are to achieve a sound and efficient banking system by maintaining public interest, allowing the banking industry to grow properly, and supporting the implementation of economic development and monetary policy.

Scope and Strategy

The deregulation era has produced basic changes in the type and complexity of operational banking patterns and banking product development. The number of banks and office networks to be supervised has also expanded. In addition, the banking industry is closely related to other financial institutions and is affected by macroeconomic conditions. Therefore, the scope of banking supervision has widened, creating a need to develop a new strategy and technique in bank supervision.

In February 1991, Bank Indonesia undertook a new strategy in supervising banks and NBFIs based on the following principles.

- Banking supervision is to be carried out to achieve a sound and efficient banking system.
- Bank soundness should become the concern of all related parties, namely, bank owners, bank management, bank customers, and Bank Indonesia as the banks' supervisor.
- Two major aspects should be taken into account: changes in the way of thinking of all related parties concerning the soundness of the bank, and adjustments of the bank supervision system in accordance with globalization and deregulation of the financial system.

- The supervision system involves six areas: prudential regulation, creation of a supervisory monitoring system, bank examination, effective discussion, cease and desist orders, and the development of a supporting mechanism.

- In the case of a problem bank the central bank will no longer rescue by providing financial assistance but will indirectly support the bank by providing technical assistance, including possible merger with other banks or inviting new shareholders.

The implementation of bank supervision strategy is further elaborated in the following paragraphs.

Prudential Regulation as a Guideline for Bank Operation. Operational rules and prudential regulations are needed to guide banks in conducting their activities and maintaining soundness. The soundness of banks should be maintained as soon as the bank is established. Therefore, prudential regulations should cover licensing provisions as well as operational guidelines and bank rating criteria.

Improvement of licensing provisions include, among others things, requirements and guidelines for bank ownership and management, requirements for opening new branches and sub-branches domestically as well as abroad, and guidelines for mergers and consolidation.

Improvement of operational guidelines includes: capital adequacy requirements; asset quality evaluation; provision for bad debt; some aspects of credit operations, including legal lending limits and collateral; and foreign exchange operation that includes net open position, swap and reswap, margin trading, and bank guarantees in foreign exchange.

The rating system is based on the principle that in addition to quantitative evaluation of capital, asset quality, management, earnings, and liquidity (CAMEL), other aspects that may influence the soundness of a bank are also to be evaluated. For this purpose, the bank reporting system has to improve, including its computerization.

Creation of an Early Warning System. An early warning system is an important aspect of bank supervision through off-site surveillance. The information needed for an early warning system includes returns from the bank concerned, peer group analysis, economic developments, and other external aspects such as the condition of the bank's group. The early warning system is also used to reassess the fairness of the bank rating evaluation. To make the early warning system work, computerization and telecommunication systems are essential.

Bank Examination Methods. A proper examination is very important for bank supervision to objectively evaluate a bank's financial condition and management

capability. In this regard, the following aspects should be covered: (a) the asset evaluation system based on a quantitative method and judgment about soundness using qualitative analysis; (b) an examination method that is flexible enough to anticipate new banking products; and (c) the quality of the examination and timely reporting of results for which the number and quality of the examiners is very important. For this purpose, the use of public accountants is possible.

Effective Discussion to Improve the Soundness of a Bank. To achieve good results, discussion with a bank should be based on open communications and effective problem solving. The discussion should be held periodically by using the early warning and bank examination results. Periodic discussions with a bank can also be used as a means of emphasizing to the bank owner and bank management the importance of protecting the interest of depositors and other aspects of sound banking.

Enforcement of Sanctions Including Cease and Desist Orders. Sanctions imposed on banks can be formal in the form of a fine or a cease and desist order. For the cease and desist order, the bank may be required to restrict the establishment of new offices limit the expansion of business activities and loans, and to replace its management. If the cease and desist order is considered necessary, a bank supervisor may ask a bank to merge with another bank or to transfer all or part of the bank shares to new investors.

Supporting the Efficiency of the Banking Business. Besides supervision, supporting facilities are needed to increase the efficiency and soundness of the banking system in general. Supporting facilities can include a clearing house, a credit information system, the money market, foreign exchange market, and a code of conduct among bankers. The establishment of the Indonesian Bankers Institute is needed for these purposes.

Legal Framework

A strong legal framework is necessary for long-term development of a sound banking system and effective banking supervision. Therefore, a new strategy and framework of the bank supervision system has been developed in the deregulation era, but needs to have a strong legal foundation in the articles of the new Banking Act of 1992. This is the only act governing banking in Indonesia. Currently, the types of banks are simplified into commercial and rural banks. The scope of operation of rural banks is universal in nature, focusing on the development of rural areas without actively participating in the *giro* payment schemes. Both commercial and rural banks are allowed to conduct banking business based on profit sharing principles under a special license.

In the new act, the licensing aspect is stipulated by a provision that covers the organization, structure, a minimum capital requirement, banking expertise, and a feasibility study. The Minister of Finance grants licenses to new banks after taking into consideration the recommendation of Bank Indonesia.

Since Bank Indonesia is responsible for bank supervision, it stipulates provisions covering the soundness of a bank, capital adequacy, quality of management, profitability, liquidity, solvency, and other aspects related to banking operations in accordance with the prudential principles. As part of prudential principles, a legal lending limit is imposed. Besides stipulations on the type of business activities, some restrictions are also included in the Banking Act. With regard to bank surveillance, a bank must submit to Bank Indonesia all information and clarification concerning its operations. A bank's annual balance sheet and profit and loss statements should be audited by a public accountant.

Bank Indonesia conducts examinations of banks, both periodically and at any time deemed necessary. Upon request by Bank Indonesia, a bank must fully cooperate in the audit of its books and files in its possession, and provide any necessary assistance in verifying any information, documents, and clarification submitted by the bank. The information is not to be made public and is confidential.

Another aspect of bank supervision in the new Banking Act is the authority of Bank Indonesia to take action in the case of a problem bank. According to the act, Bank Indonesia is authorized to require shareholders to increase the capital or replace the board of management, to ask the bank to write-off bad debts and offset the gain of capitals, and to merge with other banks or sell the bank to other parties that are willing to take over all liabilities. Other actions can also be taken by Bank Indonesia in accordance with the prevailing laws and regulations.

Bank Indonesia is allowed to impose administrative sanctions or fines on the bank or related parties. When the condition of a bank endangers the banking system and all actions taken prove to be insufficient to overcome the problems, Bank Indonesia may propose to the Minister of Finance to revoke the license of the bank. Based on the recommendation of Bank Indonesia, the Minister of Finance shall revoke the license and order the board of directors to liquidate the bank.

Improvement of Supervision Quality

Because of the wide network of banks and banking offices throughout the country, supervision needs to be decentralized. At the same time, there has to be an increase in the quality and the number of bank examiners and bank supervisors in line with the number of bank offices to be covered and the expansion of the banking business. In this respect, a good recruitment system for bank supervisors and bank examiners should be set up. The services of outside experts, consultants, and other

professionals, such as accountants, are also needed for improvement of the supervision system. In this context, it was agreed with the World Bank to provide five types of expertise, namely, for credit, foreign exchange, computerization, bank examination, and early warning system.

Another aspect of increasing the quality of bank supervision is international cooperation among bank supervisors, either through exchange of information, training in supervisory techniques, or the problem solving of similar matters. Such cooperation includes membership in South East Asian Central Banks (SEACEN), South East Asia, New Zealand, Australia (SEANZA), and the International Conference for Banking Supervision.

Bank Supervision and Macroeconomic Policy

To achieve a sound banking system and to increase the role of the banking institution in economic development, bank supervision policy and approach should closely relate to the macroeconomic policy. The implementation of macroeconomic policy, especially the monetary policy, directly affects the condition of banks and should be the concern of bank supervisors. On the other hand, a prudential approach to bank supervision could affect the development of banking, which, in turn, is related to the performance of the economy.

The Indonesian experience from 1989 to 1992 proved that the deregulation policy supported rapid growth of banking institutions, which has facilitated the high growth of the economy but also caused an overheated economy. Too rapid a growth of the banking business has affected the quality of bank operations, which in turn affected the quality of banking assets. Efforts of the monetary authority to cool down the economy has affected also the banking business and has forced some banks to consolidate.

Prudential banking regulations, to some extent, limit the ability of banks to a grow. Whereas during period of slow economic growth, when an increase in banking credit is needed, banks may then exceed prudential regulations to extend credit. In such situations, bank supervisors face the dilemma of balancing between strict and relaxed regulation.

Closing Remarks

Financial deregulation in Indonesia was implemented in sequence. It started in 1967, but general deregulation only began in 1983, when the government changed the economic policy approach, including deregulation of the real sectors.

As deregulation proceeded during the 1980s, the Indonesian banking industry experienced an impressive growth in terms of number of banks and bank offices, and

diversity of financial services and volume of business. This development had a strong impact on macroeconomic variables. An enormous increase in demand, both in consumption and investment, caused an overheated economy. This was reflected in a sharp increase in imports, a deterioration in the percentage of non-oil export growth, and an increase in inflation.

To cool down the overheated economy, the government imposed a tight monetary policy. This policy induced lowering the inflation rate, accompanied reduced growth of non-oil exports, increased interest rates, and lowered GDP lowered growth. On the other hand, the quality of credit granted in the overheated period worsened and forced banks to consolidate their operations. This enhanced the burden of bank supervision.

The philosophy and objectives of bank supervision in both the regulation and the deregulation eras was basically unchanged. Traditionally, the philosophy was to protect the interest of depositors. In line with this philosophy, the implementation of bank supervision also strived to maintain the public's confidence in banking and to strengthen the role of banking in economic activities and monetary stability.

Bank Indonesia developed a new strategy and approach to banking supervision in the deregulation era. The new strategy included a basic approach and changes to the way of thinking that the bank's soundness is a concern to all related parties. This approach should be followed by adjustment of the bank supervision system in six areas: operational guidelines, creation of an early warning system, examination method, effective discussion with a bank, cease and desist orders, and the development of support to banks. Decentralization of supervision is also part of the new strategy.

Changes in strategies and techniques in the implementation of bank supervision requires high quality bank supervisors in adequate number. A strong legal framework is necessary for long-term development of a sound banking system and effective banking supervision. Therefore, the new strategy and framework of the bank supervision system as developed in the deregulation era needed a strong legal foundation as stipulated in the 1992 Banking Act.

In a deregulated environment, macroeconomic policy and bank supervision policy are closely related. The adjustment in the macroeconomic policy directly, and perhaps adversely, affects the development of the banking sector and thus becomes a concern of the bank supervisors. On the other hand, a bank supervision policy should consider its possible effects on macroeconomic policy objectives.

To avoid negative impact, deregulation in the financial sector should be directly followed by prudential regulation and improvement of banking supervision. To maintain stability and to support the development of the banking system, financial deregulation should also be supported by strong monetary instruments.

Table 4.1. *Number of Commercial Banks, 1982–92*

Year	*State banks*	*Private national banks*	*Foreign & joint venture*	*Regional development banks*	*Total commercial banks*
1982	7	86	11	27	131
1985	7	80	11	27	129
1987	7	80	11	27	125
1988	7	77	11	27	122
1989	7	103	21	27	158
1990	7	122	28	27	184
1991	7	142	29	27	205
1992	7	157	29	27	221

Table 4.2. *Number of Bank Offices, 1982–92*

Year	*State banks*	*Private national banks*	*Foreign & joint venture*	*Regional development banks*	*Total commercial banks*	*Rural banks*	*BRI-village units*
1982	854	339	86	196	1,475	5,808	3,569
1985	909	442	92	222	1,665	5,835	3,628
1987	992	552	91	235	1,870	5,783	2,358
1988	1,030	658	87	270	2,045	7,706	2,585
1989	1,137	1,512	92	335	3,076	7,770	2,843
1990	1,269	2,591	118	459	4,437	8,006	3,040
1991	1,333	3,282	123	580	5,318	8,296	3,210
1992	1,430	3,451	133	612	5,626	8,520	3,195

Table 4.3. *Deposits, 1982-92*
(billions of Rp)

*Year**	*State banks*	*Private national banks*	*Foreign joint & venture banks*	*Regional development banks*	*Rural banks*	*Total*
1982	6,165	1,186	908	411	41	8,711
1985	12,905	4,538	1,764	825	213	20,245
1987	22,165	10,924	2,534	1,234	-	36,857
1988	22,511	11,132	2,515	1,300	401	37,859
1989	29,618	19,468	3,274	1,674	395	54,429
1990	40,535	33,078	5,423	2,550	521	82,107
1991	41,812	43,142	6,935	3,228	606	95,723
1992	51,428	48,289	7,584	3,700	686	111,687

* End of the year.

Table 4.4. *Loans, 1982–92*

*Year**	*State banks*	*Private national banks*	*Foreign & join venture banks*	*Regional development banks*	*Rural banks*	*Total*
1982	9,322	1,177	666	357	61	11,583
1985	19,125	4,106	1,073	640	234	25,178
1987	28,308	10,538	1,743	1,147	-	41,736
1988	35,984	10,809	1,913	1,196	501	50,403
1989	45,106	18,758	3,115	1,625	455	69,059
1990	59,811	35,217	6,177	2,302	656	104,163
1991	67,845	43,797	9,407	3,032	960	133,914
1992	76,718	43,797	9,407	3,032	960	133,914

* End of the year.

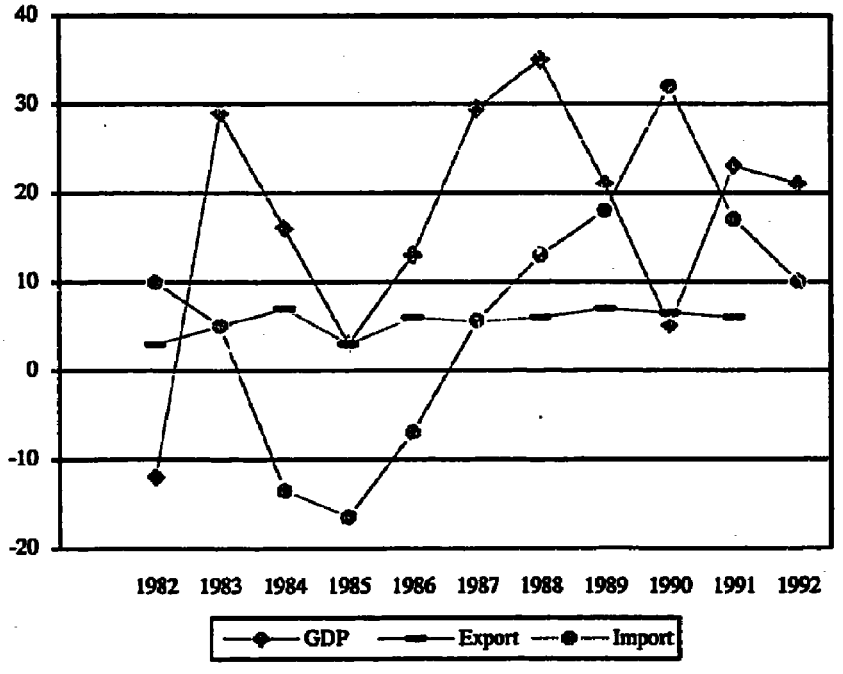
Table 4.5. *GDP, Export and Import, 1982–92*
(millions of $)

		Export				Import			
Year	*GDP growth*	*Oil & gas*	*Non-Oil & gas*	*Percentage change*	*Total*	*Oil & gas*	*Non-Oil & gas*	*Percentage change*	*Total*
1982	2.2	15.869	3.878	-12.48	19.747	-4.433	-13.421	10.12	-17.854
1983	4.2	13.696	4.993	28.75	18.689	-3.832	-13.896	3.54	-17.728
1984	7.0	14.979	5.775	15.66	20.754	-2.937	-12.110	-12.85	-15.047
1985	2.5	12.549	5.978	3.52	18.527	-2.553	-10.152	-16.17	-12.705
1986	5.9	7.740	6.656	11.34	14.396	-2.181	-9.757	-3.89	-11.938
1987	4.9	8.571	8.635	29.73	17.206	-2.227	-10.305	5.62	-12.532
1988	5.8	7.832	11.677	35.23	19.509	-2.103	-11.728	13.81	-13.831
1989	7.5	8.914	14.060	20.41	22.974	-2.406	-13.904	18.55	-16.310
1990	7.1	11.931	14.876	5.80	26.807	-3.222	-18.233	31.13	-21.455
1991	6.6	11.455	18.180	22.21	29.635	-3.370	-21.464	17.72	-24.834
1992	-	10.492	22.010	21.07	32.502	-2.900	-23.581	9.86	-26.481

Table 4.6. *Money Supply and Inflation Rate, 1982–92*
(trillions of Rp.)

Year	*M1*	*Percentage growth*	*M2*	*Percentage growth*	*Rate of Inflation*
1982	7.2	10.9	11.9	22.2	9.69
1983	7.6	5.6	14.7	23.5	11.46
1984	8.6	13.4	17.9	22.3	8.76
1985	10.1	17.7	23.2	29.1	4.32
1986	11.7	15.6	27.7	19.5	8.83
1987	12.7	6.6	33.9	22.5	8.90
1988	14.4	13.5	42.0	23.9	5.47
1989	20.1	39.8	58.7	39.8	5.97
1990	23.1	18.4	84.6	44.1	9.53
1991	27.3	10.6	99.1	17.1	9.52
1992	28.8	9.3	119.1	20.2	4.94

Figure 4.1. *GDP, Non-oil Export and Non-oil Import Growth, 1982–92*



Money Supply Growth and Inflation Rate, 1982–92

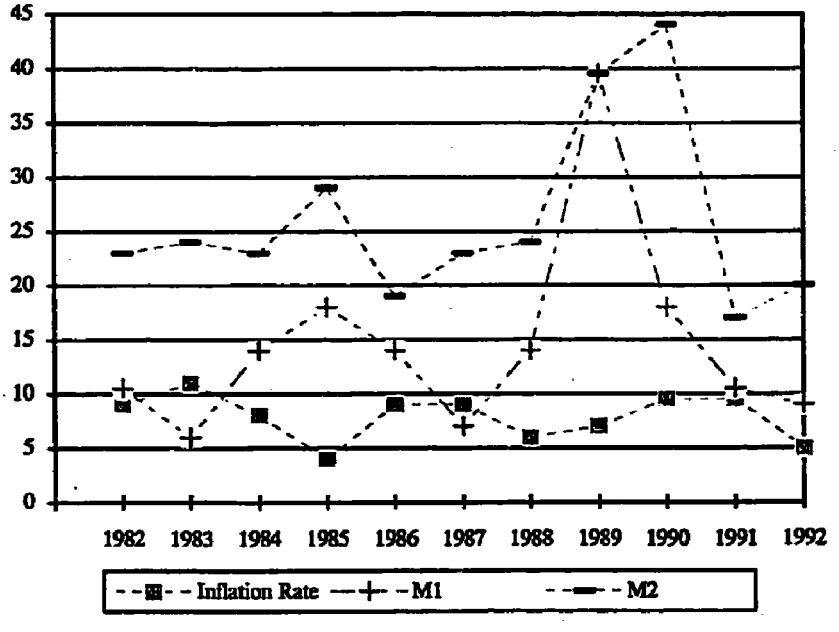
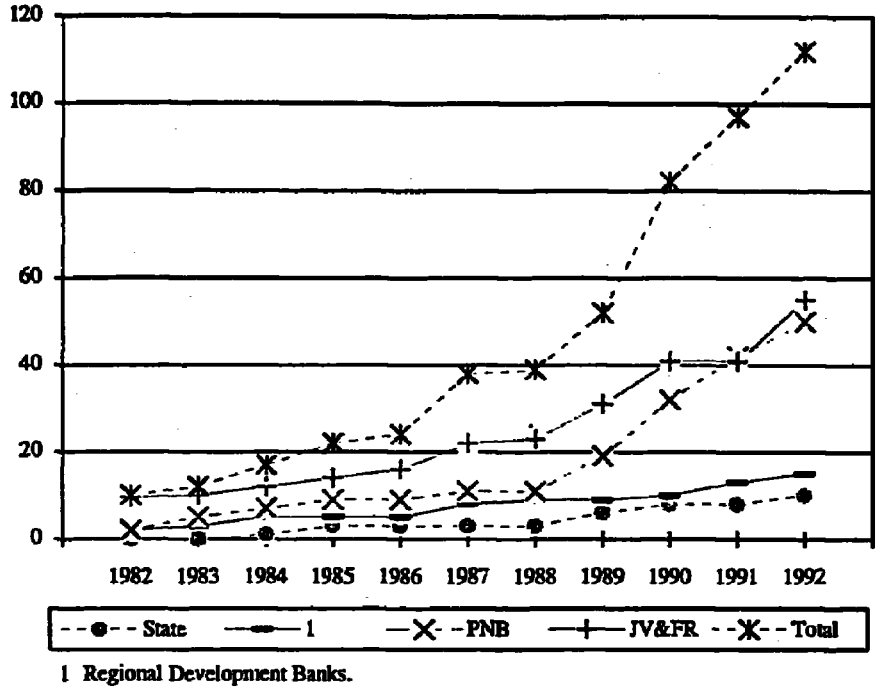


Figure 4.2. *Deposit and Loans, 1982–92*

Deposits



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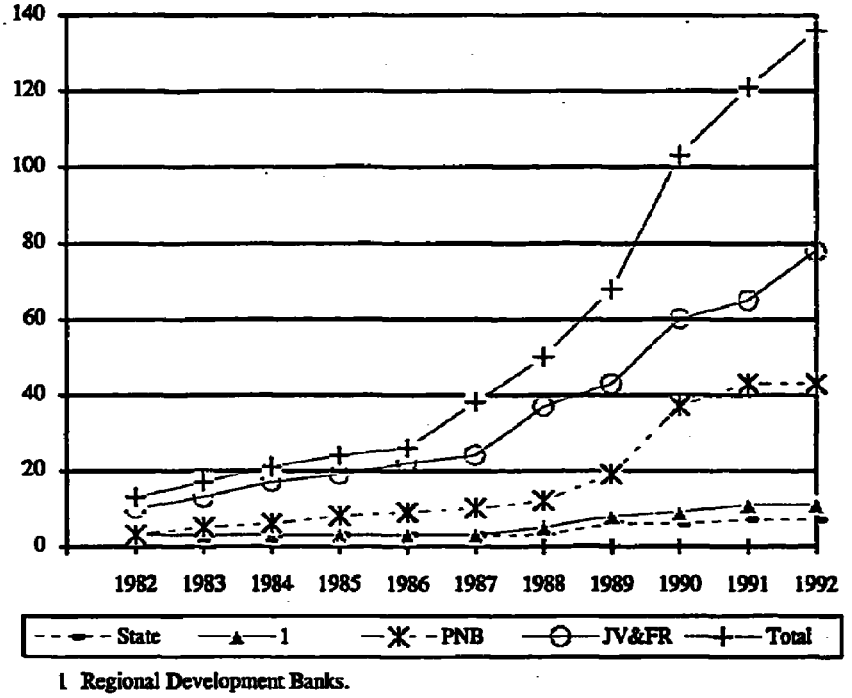
Loans



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GLOBALIZATION, SPECULATIVE BUBBLES, AND CENTRAL BANKING

Michael Dooley

Private capital inflows have recently been a widespread and suprising problem for developing countries. Although capital inflows are something that governments would be willing to learn to live with, there is the concern that what flows in for reasons we do not fully understand could flow out for those same unknown reasons. If capital inflows are speculative bubbles, they could burst with dire consequences. It could be argued, moreover, that return in flight capital could prove to be very sensitive to economic developments, both in developing countries and in industrial countries. For example, if inflows have been generated by depressed yields available in developing countries, they might evaporate as yields return to more normal levels in the course of an economic recovery.

On a more optimistic note, private capital inflows might fundamentally reflect improved prospects for recipient countries. Inflation declined in many developing countries in 1992, and lasting progress in fiscal adjustment is evident in many cases. This would suggest that capital inflows are consistent with a fundamental improvement in the expected return on investment in these countries. Since unusual inflows seem to cut across regional lines, a discussion of policy options for dealing with inflows provides a focus for a more general discussion of economic policy in an increasingly integrated world capital market.

Recent Private Capital Inflows into Developing Countries

In the darkest days of the debt crisis, many believed that developing countries would not reenter international capital markets for a generation. The useful life of this prediction was even shorter than the average for economic prediction, because very large inflows to Latin America and Asia, along with spectacular booms in equity markets, were widespread after 1989.

Table 5.1 shows the dollar value of private capital flows into developing countries in Asia and the Western Hemisphere. In some respects the experience of the two regions has been remarkably similar.

Table 5.1. *Private Capital Flows and the Balance of Payments for Developing Countries in Asia and the Western Hemisphere*
(billions of U.S. dollars)

Region	*1984–88*	*1989*	*1990*	*1991*	*1992*
Asia					
Private capital inflows	18	10	28	43	42
Increase in reserves	19	8	23	36	28
Goods and services deficit	-1	2	5	7	14
Western Hemisphere					
Private capital inflows	10	10	24	39	43
Increase in reserves	1	2	15	17	15
Goods and services deficit	9	8	9	22	28

Source: IMF. World Economic Outlook, semi-annual issues, 1984–92.

For the Western Hemisphere private capital inflows reduced dramatically following the 1982 debt crisis; inflows averaged less than US$10 billion from 1984 to 1989. However, inflows doubled in 1990 and doubled again in 1991 before leveling off last year. For Asian developing countries private inflows were less affected by the debt crisis and averaged about US$18 billion after 1984. But here too, inflows increased sharply in 1991 and 1992, reaching levels roughly double the historical average.

The counterpart of these private inflows can be divided into official capital outflows, conventionally measured by increases in international reserves and current account deficits. This is an interesting division because the offsetting capital flows are associated with sterilized intervention while trade deficits are measures of the contribution of foreign savings to real domestic consumption and capital formation.

For the Western Hemisphere the small private inflows before 1989 financed current account deficits. In contrast, in the past three years the much larger private inflows have been about equally divided between reserve accumulation and deficits.

For Asia almost all the private inflow was matched by reserve accumulations through 1989. The much larger private inflows since then have increasingly supported larger current account deficits, although for three years the reserve buildup still accounts for two-thirds of the private inflow. These data suggest that policy decisions to offset, or sterilize, the domestic effects of private capital inflows have been an important force in shaping the balance of payments flows in developing countries in recent years.

Considerable caution should be exercised in commenting on structural relationships among variables that are jointly determined and that are tied together afterward in an accounting identity. But some interesting empirical regularities seem to emerge from these data. First, a widespread response to capital inflows has been official intervention in foreign exchange markets and increases in international reserve assets. This response suggests that differences in formal exchange rate arrangements might be less important than governments' attitudes toward the effects of inflows on exchange rates, interest rates, and the monetary base. Second, renewed access to international capital markets has allowed many countries to increase investment or consumption relative to GDP. Finally, a sudden reversal of private capital inflows would constitute a significant shock to a majority of the countries in the sample.

A rough idea of the economic size of capital inflows is presented in table 5.2, where capital flows are expressed as a percentage of GDP of the recipient country. Not surprisingly, the regional data conceal important differences across countries. For the Western Hemisphere, capital inflows to Mexico in 1991 were 8 percent of GDP, a larger annual inflow than recorded before the debt crisis. With the exception of Brazil and Ecuador, inflows to other countries are impressive, although generally much smaller than levels seen before 1982. For the Asian sample, inflows to Indonesia, Nepal, and Thailand were large by historical standards, while Singapore showed the opposite trend.

Implications for Economic Management

One of the challenges in adapting the practical work of central banking to a world in which resident's access to international credit markets is growing is to modify the balance sheets that capture the economic interactions between the official sector and the private sector. A failure to keep pace with the new financial positions available to residents can result in very unpleasant surprises for monetary authorities. A recurring problem is that which speculative behavior and accompanying market movements at first may appear to be irrational this assessment is often the result of looking at only one part of a new pattern of international transactions.

The recent capital inflows experienced by developing countries may be an example of this phenomenon. While we cannot rule out the possibility that such inflows are motivated by follow-the-leader behavior or speculative bubbles, I argue below that arbitrage opportunities created by the monetary authorities explain the size and widespread nature of such capital inflows.

The key to the argument is the careful evaluation of contingent liabilities taken on by governments. These implicit liabilities create powerful incentives for private financial transactions, some of which show up in the balance of payments. International capital markets magnify the effects of these incentives.

Table 5.2. *Capital Account Balance as a Percentage of GDP, Western Hemisphere. 1970–91*

Year	*Argentina*	*Bolivia*	*Brazil*	*Philippines*	*Colombia*	*Ecuador*	*Mexico*	*Indonesia*	*Uruguay*	*Venezuela*
1970	1.0	-0.4	2.4	1.7	4.2	7.0	2.8	2.8	0.3	0.8
1971	-0.2	0.1	3.3	1.3	5.5	8.8	2.2	3.2	1.0	2.2
1972	0.4	0.3	5.5	2.0	4.0	7.2	2.2	6.0	-2.8	1.3
1973	0.2	-1.2	4.8	2.2	2.1	3.2	2.6	4.7	-2.3	-1.1
1974	-0.0	-0.6	5.6	5.2	2.0	1.8	3.7	0.3	1.4	-4.9
1975	0.5	3.1	4.7	5.6	1.4	5.0	4.4	-2.9	2.0	1.7
1976	0.5	1.3	5.4	5.8	2.7	5.5	2.7	3.7	4.2	-1.1
1977	1.1	2.0	3.3	3.7	1.1	11.4	2.9	2.1	6.8	6.7
1978	-0.1	1.0	5.6	8.2	1.2	9.6	3.3	2.6	5.8	11.3
1979	4.3	4.7	3.6	6.3	4.3	6.9	4.1	0.4	10.1	8.4
1980	1.6	-9.8	4.0	3.7	4.4	7.3	4.5	-1.1	18.0	1.5
1981	1.4	1.0	4.7	2.2	6.1	5.0	6.1	0.8	8.6	-2.1
1982	-3.8	-3.3	3.3	3.5	7.4	3.7	-0.3	3.5	-6.6	-6.8
1983	-3.5	-4.1	-0.9	1.4	3.8	-15.0	0.1	7.5	-5.8	-7.8
1984	0.2	0.3	1.2	-1.1	2.2	-7.8	-0.8	3.5	-0.5	-8.6
1985	-0.7	0.0	-4.2	-6.1	5.9	-7.2	-2.5	1.7	-2.8	-4.3
1986	0.4	1.2	-3.2	-4.7	2.4	-7.9	0.1	1.4	-1.9	-5.2
1987	-4.8	-0.7	-3.7	-5.0	-0.4	-4.2	1.7	3.0	-2.6	1.6
1988	0.3	3.8	-2.8	-2.2	1.6	-7.6	-2.5	1.6	-4.7	2.2
1989	-5.0	-1.1	-1.3	0.6	0.6	-3.0	1.7	2.1	-2.6	-4.1
1990	-1.7	3.5	-1.2	2.1	0.5	-5.4	2.7	5.8	-0.2	-9.3
1991	1.7	3.8	-1.0	3.4	1.4	-4.7	8.2	6.0	0.8	2.4

Year	*Peru*	*Republic of Korea*	*Malaysia*	*Myanmar*	*Nepal*	*Chile*	*Singapore*	*Sri Lanka*	*Taiwan, China*	*Thailand*
1970	-2.1	5.7	0.1	-0.2	1.3	0.9	42.0	1.9	0.6	2.6
1971	-0.2	6.2	3.8	-0.3	1.5	-0.5	50.5	1.2	0.7	2.4
1972	0.3	3.7	4.9	0.5	1.4	-0.1	31.9	1.5	0.6	3.3
1973	3.3	4.2	1.5	1.7	1.3	-0.1	23.5	1.3	-5.0	2.8
1974	8.4	8.9	7.2	1.4	1.1	-3.1	25.3	2.7	8.0	4.5
1975	5.8	9.7	5.1	0.6	1.2	0.1	17.3	1.8	3.9	4.0
1976	2.0	5.3	1.8	0.3	0.7	1.2	14.8	1.6	0.6	3.2
1977	3.8	3.6	-0.9	3.8	1.2	5.1	9.2	1.7	-5.3	5.8
1978	-0.0	1.9	1.1	4.2	0.0	12.0	14.2	2.6	-5.9	4.8
1979	-0.8	6.9	-0.6	4.3	1.6	10.8	13.3	8.1	-0.6	7.4
1980	1.1	7.5	3.1	2.7	0.8	11.8	19.0	9.0	4.5	5.8
1981	3.7	5.4	8.1	3.1	2.7	14.9	17.1	9.1	9.3	7.5
1982	5.8	3.6	12.5	4.0	3.4	3.9	16.2	11.5	-1.7	2.2
1983	-1.4	1.2	11.6	2.7	3.1	-3.1	9.6	9.1	-2.1	6.4
1984	-6.9	1.6	6.4	2.0	2.4	5.8	10.2	5.9	-5.1	6.4
1985	-7.1	1.3	5.8	2.1	2.0	-7.5	7.6	5.1	-4.3	4.4
1986	-4.7	-3.8	4.6	2.2	6.2	4.4	1.3	5.5	9.3	0.8
1987	-4.7	-6.4	-3.7	2.5	5.1	-3.7	4.4	3.9	10.0	2.8
1988	-5.4	-2.8	-8.3	1.5	10.9	-6.0	1.7	4.4	-9.5	6.5
1989	-3.3	-1.0	3.8	2.3	8.2	-3.0	0.7	4.6	-8.3	9.1
1990	-2.2	0.7	8.8	1.4	12.6	5.9	9.3	4.7	-9.3	13.4
1991	0.8	2.7	5.8	1.7	8.4	2.3	1.9	5.1	-1.4	12.7

Source: International Financial Statistics (IFS).

In a tightly controlled financial system such incentives are difficult to exploit, but as capital markets become more integrated and direct controls on financial transactions break down investors will find new and better ways to take advantage of explicit or implicit government guarantees. The volume of such capital flows may have little to do with the economic fundamentals we usually associate with private capital flows. Instead, the scale of transactions is determined by the resources expected to be available to support the government guarantee.

The important difference between this and a bubble is that when a bubble bursts some private speculators lose to others. When an implicit guarantee is called the government loses.

Experience in Industrial Countries

This problem is by no means unique to developing countries. In fact, there are valuable analogies in the experience of industrial countries. Over the past twenty years the monetary policy regimes in industrial countries have evolved in response to increasingly open financial systems. One result of this has been growing reliance on open market operations rather than direct controls over financial markets. This process has generally occurred slowly as the monetary authorities have adapted their policy tools to a situation in which direct control of financial intermediaries has become less effective because of increased domestic and international competition for intermediary services. A strong market view of this process, popular in the United States in recent years, is that residual moral suasion or regulatory policies available to the monetary authority are of historical interest but have little consequence for the behavior of the economy. A by-product of this process of deregulation has been the ability of private investors to exploit arbitrage opportunities in ways not possible in a more rigid regulatory environment.

At the opposite end of the spectrum, there are very few countries where the central bank directly controls the balance sheets of all financial intermediaries so that market incentives are of little consequence. For example, if an increase in the monetary base is offset by an increase in required reserves and the potential market implications are blocked by controlled interest rates and effective quantitative controls over credit creation, it makes sense to focus on the balance sheet of the financial system rather than the relatively small and uninteresting balance sheet of the central bank.

Historically, this is the reason international organizations have focused on domestic credit as a summary measure of monetary policy. Given a wide array of market and control structures, domestic credit or a similar broad measure of financial intermediation is thought to be the best source of timely information about the success the central bank was having in translating intentions into reality. In this setting,

incentives to exploit government guarantees are blunted by quantitative controls on financial positions.

Experience in Developing Countries

A useful way to think about the globalization of credit markets is that direct control of private sector balance sheets becomes more difficult. Thus, the focus of the central bank's analysis has to shift from direct monitoring of the credit or liability side of a set of private financial intermediaries to the central bank's own balance sheet and the incentives that drive the system via market forces.

This is not an easy transition to deal with and it seems clear that authorities in emerging markets today face a particularly difficult problem. In contrast to the experience in industrial countries, international banking centers and other forms of international financial intermediation are in place, well understood, and alert for new sources of business. Thus, the authorities do not have the luxury of learning along with the private sector as new forms of financial intermediation are developed.

As residents gain access to foreign markets, controlled domestic intermediaries are usually at a competitive disadvantage. When the formerly protected domestic institutions lose their market share, the information content of their balance sheets is also eroded. The typical experience of industrial countries is that domestic intermediaries have lobbied for removal of the restrictions on their ability to compete. This generally has meant a rapid dismantling of interest rate ceilings, reserve requirements, and other quantitative controls over their activities. The rapid erosion of the effectiveness of direct controls is likely to expose arbitrage opportunities based on government contingent liabilities. This freedom to exploit these opportunities can create capital flows that are limited only by the ability of the government to live up to its contingent liabilities.

Bubbles or Arbitrage?

A popular explanation of short-term capital flows that seem to be unrelated to the fundamentals is simply that free markets are inherently unstable. A plausible story is that market participants in transition economies have little experience or track records to go on in forming expectations in the newly liberalized environment. It is a fact of life that financial markets are dominated by expectations of future events and that the possibility that bubbles dominate price movements cannot be ruled out.

From the point of view of economic theory, the issue is that the level of price of an asset depends in part on the expected change in the price. In modern exchange rate models, for example, there is usually an equilibrium path for exchange rates that is characterized by an increasing rate of appreciation. From a more practical perspective

it is somewhat unsettling that the closer one gets to such markets the stronger the belief among market participants that price movements are often self-reinforcing. Governments have often cited the ill effects of speculative bubbles as the reason for exchange market intervention. In industrial countries, officials were once very straightforward about this, although since the mid 1970s it has been more fashionable to talk about maintaining orderly markets. Thus, bubbles and the central bank intervention to explode them has long been an important motive behind intervention in foreign exchange markets.

It has been argued, for example, that market participants get caught up in the excitement of a speculative move in prices or capital flows and carry the value of an asset well beyond that consistent with the fundamentals. An appealing story is that market participants recognize that an asset is becoming overvalued, but because they made money by holding it yesterday they go along for the ride. The relevant condition after all is not that the speculator is correct in valuing the asset but only that someone is willing to pay a higher price tomorrow. I should admit that my own research dating back to 1975 suggests that it is very difficult to reject such a model of behavior in foreign exchange markets.

A common feature of such bubbles is that market participants believe that the underlying value of the asset is not important, but expect that the game will last long enough for them to get out before the bubble bursts. It is in this area where the central bank can play a strong role in promoting bubble behavior. This is clearly the case when the government is the someone else expected to provide a backstop, so private investor's losses are limited even if private expectations should change.

One can find dramatic examples of this process in both developed and developing countries. The combination of deposit insurance and a relaxation of controls over portfolio selection in the United States led to explosive growth in inflows into savings and loans, and an eventual collapse of the bubble. The problem, clear in retrospect, was that the contingent liability of the U.S. government provided the private investor with a virtual guarantee that high yields offered by savings and loan deposits would not be matched by depositors' losses. Depositors did not question the ability of some savings and loans to offer deposit rates 200 basis points over the market. As long as deposits were probably guaranteed there was little downside risk.

The important lesson is that the size of the capital inflow to the savings and loans did not depend on the fundamental quality of the assets they were acquiring. Depositors were protected by the very considerable ability of the government to bail them out. Moreover, the interest rate offered by the institutions did not accurately reflect the expected rate of return on the assets. For these reasons it was a mistake to interpret the capital inflow as reflecting an irrational evaluation of the prospects for these financial intermediaries.

In developing countries a similar process helped generate the debt crisis of 1982. In this case the government of debtor countries offered guarantees of the dollar

value of residents' liabilities. The rapid buildup of private external debt in the 1970s was matched by a buildup of contingent liabilities of the government. This contingent liability became an important, but little noticed part of the government's overall financial position. To some extent the offer of the guarantee caused the private capital inflow. Perhaps more important the usual market checks to private inflows were short-circuited by the government guarantee.

We would normally expect large capital inflows to depress the rate of return as the most profitable investment opportunities are exhausted. We now know that in many countries this natural limitation was avoided as residents recycled the inflows into private capital outflows, what afterward was labeled capital flight. Thus, calculations from Dooley (1982) suggest that about one-third of the buildup in external debt in the 1980s was matched by unrecorded private capital outflows from the debtor countries.

This is a clear example of an unintended and little noticed pattern of financial transactions made possible by the globalization of international capital markets. Capital flows of this type can appear to be bubbles because they lead to very large flows that seem to defy the usual market rules that flows are self-limiting. In most cases I believe that what appear to be speculative bubbles in international capital flows are better understood as a part of an arbitrage game being played against a government. This was certainly the way large inflows to U.S. savings and loans avoided self-limiting forces, and explains a major part of the capital inflow into developing countries in the 1970s.

Recent Capital Flows

Is it possible that such a process is again at work in international capital markets? It is interesting to note that the bubble or overlending hypothesis for the buildup of external debt of developing countries was often explained by the story that a bubble can occur once in every generation of bankers. Thus, as the story goes, memory of the widespread defaults by developing countries in the 1930s died off with the bankers of that time and set the stage for irrational, follow-the-leader lending to the same countries in the 1970s. A repeat of the same argument to explain recent widespread inflows to developing countries implies a dramatic reduction in the half-life of bankers, or at least their memories. In this business one learns not to rule out an explanation simply because it assumes a high level of incompetence. But in the current circumstances I believe there is a much better and more important lesson to be learned.

The alternative explanation is that a combination of fundamentals and arbitrage transactions are again at work. First, the fundamentals clearly favor a repatriation of funds to many debtor countries. Fiscal reform has been impressive in many countries, debt restructuring has been put in place, and privatization, as well as intentions, has been remarkably successful. At the same time, yields available in industrial countries are at their lowest levels in many years. All these factors make capital inflow to

developing countries unsurprising. But are these factors sufficient to explain the large private capital inflows in the past eighteen months? I have serious doubts.

It seems likely that once again private capital inflows are being sustained not only by the more favorable investment climate but also by arbitrage opportunities generated by the governments of developing countries. The form of the incentive is different when compared to the external debt-capital flight pattern that led to the 1982 debt crisis. But in one important respect the recent private capital inflows are similar because they are sustained by a contingent claim on the government.

In a recent case private capital inflows took the form of foreign purchases of domestic currency instruments. This is certainly different from the dollar-denominated, government-guaranteed, syndicated credits that comprised the buildup in debt before 1982. Thus, it is clear that if a mistake is being made it is not the bankers that are making the same mistake.

In the current pattern of capital flows it is not obvious therefore that the government of the borrowing country has provided a guarantee. However, an implicit guarantee might be implied by the increasingly popular use of the nominal exchange rate as an anchor for inflationary expectations. In basing its credibility on the maintenance of a fixed or managed exchange rate, the government, in effect, provides an exchange rate guarantee for the investor in domestic currency denominated instruments. Moreover, the credit risk is also implicitly or explicitly guaranteed by the government. When inflow is to government securities, the guarantee is explicit. Bank liabilities are implicitly guaranteed especially if the deposit is denominated in domestic currency.

The current pattern of private capital inflows and official outflows also blunts limiting price adjustments. Recall above that in the 1970s capital flight in the form of private capital outflows recycled funds to the international market and prevented a limiting fall in yields on debtor country liabilities that would normally limit the inflow. In the recent round of inflows, funds are recycled to international markets in a form that is easy to measure because it is typically an increase in the international reserves of the central bank. For Latin America about half of the recent private capital inflow has been matched by increases in official reserves and, for Asia, about two-thirds of inflows have been recycled. The engine that keeps all this going is the willingness of the central bank to intervene in the foreign exchange market to prevent appreciation of the domestic currency and to intervene in the domestic money market to prevent declines in interest rates. In effect, the private sector relies on the political difficulty that the government will have in allowing a depreciation of the exchange rate should things turn around.

What limits this process? As long as the developing country central bank offers a higher expected yield on its domestic currency liabilities than it earns on its reserve assets there is in principle no limit to the round-trip capital flows generated. Of course, in reality the central bank's resources are limited, but the scale of private

capital inflows and official capital outflows necessary to exhaust the central bank's expected net worth can be very large indeed. One way to quantify the constraint is to calculate the quasi-fiscal deficit that the government can support through borrowing and taxation.

This is not a bubble in the usual sense, because the private capital inflow is consistent with the expectation that the process will crash at some point. The crash does not lead to private losses because the government will bail out the private investor. The bailout in this case involves the rapid exhaustion of the central bank's international reserves and assistance to the banking system to meet deposit outflows. This is a dangerous policy stance for the government of developing countries.

Solutions?

The key to the problem in my view is the commitment to the exchange rate as an anchor for anti-inflation expectations. Although the exchange rate is a powerful way for the government to signal its intentions to the private sector, exchange rates can encourage international arbitrage transactions that can eventually break the bank. The nominal exchange rate target does not contribute to credibility in an environment where private expectations for the real equilibrium exchange rates are changing rapidly. Surely, economies undergoing transitions are those for which we have little previous information about the equilibrium real exchange rate. It seems important, therefore, to break this pattern by introducing greater uncertainty for the international investor. This can be accomplished either by allowing the capital inflow to depress domestic interest rates, that is, by not sterilizing the capital inflow, or by allowing the exchange rate to adjust to market forces.

Neither policy will greatly affect the net private capital inflow that is fully justified by the economic reform packages that have been put in place in many developing countries. It will stop round trip capital flows that have dominated all fixed exchange rate systems since the globalization of international capital markets. If I can once again cite the experience of the industrial countries in dealing with increased capital market integration, most have opted for a flexible exchange rate regime with limited intervention. The anchor for inflation expectations has been a monetary aggregate, or more simply, a target for inflation. Many very open developing countries will find it better to fix the exchange rate and relinquish control over domestic interest rates. Like all good lessons, this is a very old one simply dressed up in a new structure of international capital flows.

6

THE FINANCIAL SYSTEM AND MACROECONOMIC STABILITY: THE CHILEAN EXPERIENCE

Guillermo Le-Fort, Central Bank of Chile

Over the last fifteen years, the history of the Chilean economy and its financial system has been characterized by deep structural changes and accelerated development, and also by instability and crisis. Overall the experience has been successful, and the Chilean economy has not only recovered from the crisis but is now much more developed and solid than when the reform process began in the 1970s. However, some consequences of the crisis remain, the main one being the large domestic debt of the central bank, on the order of one-third of GDP, that generates the central bank's annual quasi-fiscal losses, 15 percent of GDP. The valid policy lessons that can be drawn from this history of failure and success are discussed below.

The paper has two major sections. The first section provides an overview of the developments in the Chilean financial system over the last fifteen years, beginning with the start of the reform process in 1974, after which the first symptoms of financial instability became apparent (see macroeconomic indicators presented in table 6.1). This section continues with a description of the financial crisis of the early 1980s, the strategy developed to confront it, and the post-crisis financial reforms directed at increasing financial stability. The section ends with a discussion on recent financial system developments and current issues.

The second part of the paper discusses the relationship between macroeconomic equilibrium and financial stability. As is clear from the Chilean experience, macroeconomic and financial stability are closely tied, but their causal relationship is complex and bidirectional. To some extent, macroeconomic instability seems to have played a very important role in generating the financial system crisis, however, it is also clear that microeconomic problems within the financial system were in itself a source of overall macroeconomic instability.

The paper summarizes some policy lessons drawn from the Chilean experience of the last fifteen years, looking particularly at ways the financial system can develop consistently with macroeconomic stability. The most important premise is that a freely operating financial system with strong international links is conducive to economic development. The financial system, however, needs to be regulated to avoid problems that weaken financial stability, such as moral hazard originating from subsidized

deposit insurance and the limited liability and small equity levels characteristic of financial institutions. In any case, a stable and efficient financial system is a necessary but not a sufficient condition for macroeconomic stability, which also requires well-designed and coherent macroeconomic policies.

Overview of the Chilean Financial System

By 1973, the Chilean financial system had become highly repressed. Most banks were under government control, real interest rates were negative, and quantitative credit was restricted. The liberalization of the financial system began in 1974 with reprivatization of commercial banks, elimination of restrictions interest rates and banking activities, and authorization for the operation of new financial institutions. International capital flows, however, continued to be strictly limited until mid-1979 when some restrictions to medium- and long-term international capital movements were lifted. The final steps in this first deregulation process were taken in April 1980 when quantitative limits on monthly capital inflows were lifted.

The financial reform was characterized by an important development of the financial system that was interrupted by the financial crisis of the early 1980s. Total bank credit increased from the equivalent of 5.6 percent of GDP in 1975 to more than 77 percent in 1982, and M2 grew from 6 percent to 26 percent of GDP over the same period. The process of financial deepening was interrupted by the emergence of a financial crisis in 1982, and total bank credit fell to 60 percent and to 17 percent of GDP by 1985. The financial deepening process has resumed since, and by 1992 M2 has the equivalent of 25 percent of GDP. In addition, total financial savings increased from 26 percent of GDP in 1980 to the equivalent of almost two-thirds of GDP by 1992 (table 6.1).

Liberalization and Financial Distress

The liberalization of the financial system was part of an overall government strategy to establish a market-oriented economic system open to foreign trade and international capital flows. The liberalization of the financial system was based on the idea that market-determined interest rates would stimulate economic growth, positive real interest rates would increase savings, and market-based allocation would improve the quality of investment. While the economic system was being reformed and the economy rapidly recovered from the 1975 recession, the financial system accumulated a number of imbalances that increased its vulnerability to external and domestic shocks. In 1982, external shocks and the nonsustainable external current-account position led to a large expenditure adjustment that triggered Chile's worst financial and economic crisis since the Great Depression.

Table 6.1. *Financial System Aggregates*

	As percentage of GDP			*As percent of total loans*
Year	*Financial system loans*	*M2*	*M3*	*Non-performing loans*
1975	5.6	5.6	-	-
1976	7.1	5.9	-	-
1977	11.0	8.3	-	-
1978	16.1	11.2	-	-
1979	23.1	13.5	-	1.6
1980	36.8	13.4	26.4	1.2
1981	53.7	21.2	28.3	2.3
1982	76.9	26.2	36.6	4.1
1983	68.0	18.9	34.3	8.4
1984	66.1	17.8	34.8	8.9
1985	59.6	17.1	35.2	3.5
1986	59.9	18.1	41.4	3.5
1987	55.4	19.3	44.6	2.7
1988	52.6	20.0	46.4	2.0
1989	54.2	21.2	50.5	1.8
1990	54.6	22.5	57.4	2.1
1991	50.6	22.9	61.5	1.8

The financial liberalization process was followed by two periods of financial distress. The first outburst of distress (1975–78) began with the failure of the whole savings and loan systems, followed by the failure of several unregulated financial companies and Banco Osorno, a medium-sized commercial bank. Next, several large financial cooperatives failed in 1977 and 1978. The second period of financial distress, and the most severe in Chilean history, began in November 1981 when financial institutions representing 8 percent of private banks deposits had to be taken over by the public sector. This period reached its peak in January 1983, when almost all the remaining private commercial banks became insolvent and were taken over by the public sector. Non-performing bank assets plus loans at risk increased to several times the capital of the financial system as a whole. Non-performing loans increased from 1.2 percent of total loans in 1980 to almost 9 percent in 1984 (table 6.1).

With a financial system repressed by quantitative credit control and interest-rate ceilings over many years, the Superintendency of Banks had lost the ability to exercise prudential regulation in an environment almost free of restrictions. In addition, in what proved to be a gross misunderstanding of the true meaning of financial liberalization, some officials and analysts argued against the enforcement of all forms of financial

regulation. The lack of rules and the loose enforcement allowed the buyers of privatized banks to operate with little or no capital and to concentrate their lending on firms owned by shareholders. In addition, financial companies were unregulated, and some of them lent substantial sums to their owners, who used them to buy shares of the eleven commercial banks that were privatized by late 1975.

In January 1977, however, the difficulties of the recently privatized Banco Osorno forced government intervention to avoid the bank's failure. As a result of that action, depositors had every reason to believe that they were insured by the government. All the responsibility for policing bank solvency was passed on to the regulators, with no help from private depositors. This event reinforced the conditions for the classical moral hazard problem of subsidized insurance, and is seen as a key to the behavior that led to the financial crisis of the early 1980s.

The first outburst of financial distress resulted in the accumulation of non-performing assets in the banking system, but the situation, while bad, was still manageable until the crisis erupted. On November 2, 1981, the Superintendency of Banks decided to take over eight minor banks and financial companies where regular bank examination had exposed insolvency or fraud. The deep recession initiated in late 1981 undermined the solvency of the remaining private banks and a full-blown financial crisis ensued. The crisis originated from domestic macroeconomic policies and an extremely vulnerable financial system. The vulnerability resulted from the backlog of bad loans brought about by the risky behavior of domestic banks that loaned funds to clients overexposed to currency and interest rate risks. A deterioration in the terms of trade and the reversal in foreign credit flows ignited the crisis. The current account deficit of 14 percent of GDP in 1981, however, had reached nonsustainable levels and the adjustment was unavoidable. The adjustment of such a large disequilibrium was not a controlled process and resulted in a severe contraction in economic activity that contributed to the financial system crisis, which in turn amplified the recession.

The Crisis, 1982–85

During 1982 the banking sector solvency deteriorated rapidly. It was evident that, for a great portion of debtors, the level of liabilities exceeded the value of assets.[1] How did the banks as well as their depositors and debtors allow this to happen? For many debtors the change in relative prices brought about by the reforms of the 1970s had reduced the value of assets to the point of almost eliminating their net worth. From then on the debtors' optimal behavior was to continue borrowing regardless of the interest rate, hoping for a reversal of the economic situation (even though the

1. For a description and different interpretations of the crisis see Barandiaran (1983), Ramírez and Rosende (1989), Reinstein and Vergara (1993).

probability of this event was very low). The banks that had become agents of economic conglomerates willingly financed risky loans provided they were in the interest of the conglomerate. Banks had extremely low equity levels that created incentives to finance risky projects because they could reap all possible profits while losses, above a certain level (the value of the bank equity), were not a bank problem. Depositors accepted this bank behavior because they were concerned with getting the highest possible interest rate and felt protected from bank failure by the implicit deposit insurance. Finally, regulators were very much behind events, and bank supervision was extremely limited.

During 1982 banking sector solvency deteriorated rapidly. In January 1982 loans in arrears net of loan loss provisions accounted for 10.8 percent of the banking system capital and reserves. This percentage jumped to 19.9 percent in March, to 27.4 percent in June, and to 57.5 percent in September 1982. In March 1983 it rose to 89.5 percent, in June to 104 percent, and in September to 181.2 percent. The rapid increase in non-performing loans resulted from the extremely high real lending interest, which ranged from 40 percent to 60 percent annually in 1981 and 1982.

The extremely high interest rates were the result of several factors, including the very limited access to foreign credit and the higher external interest rates, the restrictive monetary policy in operation, the exchange risk and the expectation of currency depreciation, the moral hazard that induced banks to increase the interest rates paid on deposits, and the expectation of a discriminatory bailout of bank debtors. After two discrete steps toward currency depreciation in June and August of 1982, the exchange risk was reduced, and real interest rates began to fall. Chile's two largest economic conglomerates and many smaller independent investors, which operated on high leverage, went bankrupt as a result of their large foreign currency exposure in early 1983. On January 13, 1983, the government took control of five banks, including the two largest private ones owned by the most important economic conglomerates. Three were closed down, and two were subject to direct supervision. These entities represented a combined 64 percent of capital and reserves of the private financial sector.

Several problems of the financial system created the conditions for the financial crisis, including the following:

- The implicit deposit insurance that dissociated yield and risk of bank liabilities. On the one hand, and due to the existence of an implicit government insurance on bank liabilities, bank creditors were not concerned about portfolio risk.[2] On

2. The view that bank liabilities were insured by the government was confirmed in 1976 in the Banco Osorno episode. Foreign creditors may have also perceived that their assets were insured by the government, as was the case in the Banco Osorno episode, and later during the 1982 financial crisis when private foreign debt received an expost public guarantee.

the other hand, the government did not regulate and supervise banking activity because the economic authorities assumed that the financial market, like any other market, should be free of regulations and thus left risk evaluation to market participants.

- The excessive optimism in the economy's growth possibilities overstated wealth and deflated consumers' perceptions of the real level of their indebtedness. The emerging financial difficulties were deemed temporary, and refinancing was easily extended. After awhile, banks' capital fell drastically because of increases in their past due loans. The banks continued to refinance their debtors, attracting resources at high rates and expecting unlikely favorable conditions. In any case, banks were no longer risking their own capital but only that of their insurers and creditors in general.

- The most important banks were part of large economic conglomerates. The bank's own capital was marginal within the conglomerate, so preference was given to rescue the firms by granting them loans under conditions that were unfavorable for the bank.

Cleanup and Reform

By 1981 the Chilean economy was confronting serious macroeconomic imbalances. Excessive aggregate expenditure had increased the current account deficit to 14.3 percent of GDP in 1981, which led to a high level of foreign indebtedness that peaked in 1985 as the foreign debt to GDP ratio reached 143.3 percent. The domestic side of the foreign debt problem was that local debtors were unable to pay their obligations to commercial banks, which in turn could not discharge their obligations. Facing such a critical situation the authorities had few options. The first one, which could be called the liberal option, was to allow banks to fail. Thus creditors would have to take over bank assets, sell them, and face the losses generated by the difference between the market value of bank assets and the bank's liabilities. A second alternative was "to melt the debt" by reducing the real value of obligations via inflation. Nevertheless, in the Chilean case the generalized indication of bank assets and liabilities would have had to be eliminated for this solution to work, or, alternatively, very high rates of inflation would have been required. A third alternative was a monetary reform to reduce the nominal value of bank liabilities, that is, depositors would have to face a substantial portion of the financial system losses. Finally, the last alternative was to socialize losses and defer them over time through a debt restructuring process financed by the central bank.

The Rescue Strategy

The Chilean authorities chose the last option. This brought about public guarantees to private sector foreign debt, government intervention in the main local banks, and the implementation of a massive program to support banks and their debtors. An additional component of this solution was the special guarantee given by the state to private foreign debt. The expectation of receiving this guarantee may help to explain the behavior of foreign banks about private overindebtedness. This solution, however, meant that the central bank had to extend subsidized credits to local debtors while backing domestic and foreign bank liabilities, generating the conditions for its present quasi-fiscal deficit.[3]

The central bank bought the non-performing bank loans at par value in exchange for central bank promissory notes thus notably improving the quality of the asset portfolio of banks. The transaction also included a provision to eventually buy back the bad loans from the central bank with a fraction of future bank profits. In that sense the deal meant the deferment of banks losses. The relative size of the assets to be bought back and the bank profits, however, imply that part of these loans will never be bought back. To avoid the monetary consequences of the purchases of bad loans, the central bank carried out most of the operations with debt instruments, which in most cases could be sold in the secondary market. This is precisely the origin of the current domestic debt of the central bank. Loans sold to the central bank by the two largest private banks are presented in table 6.2.

Table 6.2. *Loans Sold to the Central Bank*
(as percent of total loans)

Years	*Banco Chile*	*Banco Santiago*	*Total*
1985	7.0	5.2	16.3
1986	1.9	2.0	5.7
1987	0.4	0.2	0.6

The solution adopted some advantages: it prevented the undershooting of asset prices caused by their simultaneous forced sale; it prevented the closing of activities damaged by very high interest rates, but with reasonable yields and positive capital at the interest rates of central bank refinancing; and it avoided a run on deposits in the financial system. This alternative also involved several difficulties. First, the

3. Quasi-fiscal operations include financial transactions of central banks that entail some form of explicit subsidy or cash transfer.

refinancing terms allowed debtors to postpone payment of their obligations and await better negotiating conditions. Second, given the difficulty of establishing a correct criterion regarding an accurate evaluation of the degree of insolvency, the conditions set in the refinancing were relatively mild, thus creating expectations of debt forgiveness. Third, these conditions implied an important transfer of resources from the taxpayers to the debtors, and resources that belonged to everyone were used to help a few debtors and banks indifferently. Finally, the refinancing conditions allowed for the continued existence of firms with negative capital, and implied the diversion of resources from the generation of new assets.

The rescue strategy also incorporated other important medium-term elements: a policy of macroeconomic adjustment consistent with external conditions, sustained real currency depreciation that more than doubled the relative price of tradable goods between 1982 and 1988, centralized negotiation with foreign creditors, and a new banking legislation (1986) that overcame shortcomings in the area of financial regulation. The major programs designed to help domestic debtors and banks are analyzed in the next section and their effects on the quasi-fiscal deficit.

Quasi-Fiscal Implications

The support programs for the financial system began in December 1981 when the central bank and the state bank granted emergency loans to four banks and four financial companies. These credits were completely written off by the central bank and will never be repaid. Between 1982 and 1985 the central bank extended emergency loans to commercial banks that were not under government control and purchased their non-performing portfolio. The credit assistance enabled commercial banks to continue operating, because the value of their non-performing loans significantly exceeded that of their capital and reserves. The central bank acquired 60 percent of the non-performing loan 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 central bank at a real interest rate of only 5 percent per annum, redeemable with bank profits over an indefinite term. The original arrangement implied a predetermined and finite time to repurchase the debt portfolio sold to the central bank. However, in 1989 the authorities decided to change the conditions so that banks use every year up to a given percentage of their earnings to repurchase the portfolio sold to the central bank independently of the time they need to redeem all the debt. It is estimated that some banks will never be able to do so. All the loans sold melted together, and the total package is what is now called the subordinated debt, because its payment is subordinated to the earnings of the debtor banks (table 6.3).

Table 6.3. *Subordinated Debt*

Year	*US$ millions*	*Percentage of GDP*
1984	1,705	8.8
1985	2,738	16.1
1986	3,319	19.7
1987	3,713	19.6
1988	3,513	15.9
1989	3,586	14.1
1990	3,925	14.1
1991	3,920	12.5

Thus, the portfolio purchase program had two implicit subsidies. The first one 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 was the discount rate of more than 5 percent, applicable to bank profits with which the portfolio was to be repurchased. The central bank had to absorb the losses of banks under government control through allowances to the accounts for risky credits and, in addition, had to purchase the overdue debt portfolio and subsidize new stockholders in order to privatize the banks. The portfolio purchase for these banks was similar to that of the other banks, the sole difference being that these banks must use only up to 70 percent of their profits to repurchase the loans.

The process of real currency depreciation began in 1982, which substantially increased the real value of the foreign debt. The government decided to assist foreign currency debtors through an exchange subsidy that ended up being one of the main sources of quasi-fiscal loss. The subsidy consisted in the sale of foreign exchange at a fraction of the official rate. The loss generated by the differential between the official and subsidized rates was met by the central bank. At the early stages the central bank sold the subsidized U.S. dollars directly. Later, the subsidy operated through promissory notes that were given to each debtor according to the value of the exchange subsidy entitlements. The notes were denominated in the indexation unit and were tradable in the secondary market.

In addition to the assistance to foreign currency debtors, the central bank refinanced domestic currency debts. The program took place mainly between 1984 and 1985, and its beneficiaries were debtor firms, mortgage debtors, and consumption loan debtors. This essentially enabled debtors to transfer short-term liabilities at market rates to long-term liabilities at subsidized rates. This program also benefited banks because it raised the quality of their loan portfolios.

Other transactions, even though they did not represent financial assistance to debtors or banks, had important quasi-fiscal implications. The exchange rate insurance mechanism (swaps) allowed economic agents to sell U.S. dollars to the central bank at the prevailing exchange rate, with the option of repurchasing them at the same rate corrected by the domestic to foreign inflation rate differential. Given the process of real currency depreciation, the aforementioned mechanism involved large losses for the central bank and profits for the private agents that sold foreign exchange through this mechanism.

The cumulative cost of these programs is estimated to be between US$7,000 and US$7.0 to US$9.0 billion, the equivalent of up to one-third of annual GDP.[4] One way to estimate this cost is to add up the increase in the central bank net indebtedness US$5.7 billion in the period 1981–90 and the inflation tax collection, estimated at US$1,800 over the same period. Inflation tax collections are estimated at an annual average of 0.5 percent of GDP, or around US$180 million in 1992 (Eyzaguirre 1992).

One of the consequences of the financial crisis is the central bank quasi-fiscal deficit, equivalent to approximately 1.5 percent of GDP in annual cash flow losses.[5] This deficit is financed mainly with the issuance of additional domestic debt and with inflation tax collections. The continuation of the sustained reduction in the inflation rate that began in 1990 is projected to reduce the inflation tax so that the financing of the deficit will rest mostly on domestic debt. Indeed, given that the domestic debt represents nearly 40 percent of GDP, a 4 percent annual GDP growth allows the complete financing of the quasi-fiscal deficit while keeping the debt-output ratio constant. Since the long-term growth rate is projected at 5 to 6 percent (in the last nine years it has averaged around 6 percent), the financing of a quasi-fiscal deficit equivalent to 1.5 percent of GDP is consistent with a gradual reduction in the domestic debt to GDP ratio.

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4. Detailed estimations of the cost of the crisis can be found in Eyzaguirre and Larranaga (1990). They also analyze the macro consequences of the quasi-fiscal deficit.

5. This figure includes promissory notes for US$7,000 million that the nonfinancial public sector transferred to the central bank in order to balance part of the losses. These public-debt promissory notes cannot be sold in the secondary market, yield Libor plus 0.5 percent, but annual payments through 1995 are limited to 2 percent of the outstanding debt. The balance is capitalized and will be amortized in twenty annual installments beginning in December 1995.

Reform: The Banking Law of 1986

The lack of appropriate regulations is among the leading factors that created the conditions for the financial crisis.[6] As already mentioned, the pre-crisis banking legislation did not contemplate explicit deposit insurance. Nevertheless, in practice, different signals given by the authorities had created a generalized perception of an implicit deposit insurance, which allowed banks to finance risky loan portfolios with deposits. In addition, regulation and supervision of the system were inadequate and inconsistent with this implicit insurance. There were no regulations to ensure continued supervision of portfolio risk, loan concentration, and the level of bank equity. Generalized problems of high loan concentration, massive loan rollovers, and increases in deposit interest rates to confront liquidity shortages show the absence of prudential regulations. Moreover, there was no supervision that allowed the early detection of financial problems, and financial legislation was not specific cn the actions to follow when financial institutions were in trouble. In practice, the government had to take control of financial institutions only when failure was imminent, and the law provided no mechanism to order the recapitalization of a failed institution.

The 1986 banking legislation attempted to establish a framework to confront the problems associated with the generation of the financial crisis. This legislation gives great importance to bank supervision. Under this law, the Superintendency of Banks and Financial Institutions (SBIF) must make available detailed information on the financial conditions of each bank. Moreover, the SBIF must publish in the press, at least three times a year, its opinion on the status of each banking institution. Private sector agencies are also allowed to participate in bank supervision. To evaluate and classify the quality and risk of bank assets currently each bank must have at least two private appraisers. The new legislation also places great emphasis on the regulation of activities. Bank activities mainly involve intermediate deposits into loans or central bank documents, contingent operations (letters of credit, futures, and others), exchange operations, and other services (collections, discounts, and so on). These activities are subject to a number of regulations, including limits on loans by debtors, limits on position in different foreign currencies, limits to mortgage financing, and others. It was also ruled that loans to individuals or corporations that were directly or indirectly related to the owners or managers of the bank could not be granted more favorable terms than those approved to third parties in similar transactions.

In addition, the 1986 law allows banks to perform new activities in the areas of securities intermediation and financial services through bank subsidiaries. The first area includes securities agencies, stock trading agencies, mutual funds, and investment

6. See Ramírez and Rosende (1989), and Reinstein and Vergara (1993) for a more detailed description of the 1986 Banking Law.

funds. The second area includes leasing, credit card management, and financial consulting. The authorization to expand banking activities, however, strictly separates traditional banking and subsidiary business. The law establishes different kinds of rules. First, the creation of a subsidiary must be done with segregated bank capital. That is, if a bank wishes to invest part of its own capital in a subsidiary, the contribution is deducted from the bank capital for the calculation of different ratios (debt to capital, and so forth.) Second, the law establishes the separation between the bank and its subsidiaries in terms of personnel and equipment. Third, bank loans to its subsidiaries are subject to limits.

One of the main innovations in the 1986 legislation is related to the provisions the banks have to make for their loans. The provisioning rules require banks to write off non-performing loans that are estimated to have higher than normal risks and would force an effective increase in bank capital to compensate for the loss. The rule focuses capital requirements on the economic rather than the book value of bank equity, which is clearly the relevant one in order to implement effective prudential regulations. The new legislation establishes a maximum debt to equity ratio of twenty. Should a bank exceed this limit, it is assumed that the bank has been involved in activities that might endanger its financial situation, and procedures provided by law are then initiated to normalize the situation.

To protect the payments system, an explicit and full insurance is applied to demand deposits. In the case of a run on a bank, the central bank must provides at the earliest possible time, the resources to fully guarantee demand deposits. If a bank fails the central bank would have preference over other creditors up to the value of the emergency loans. In addition, and to limit the moral hazard problem of deposit insurance, the new legislation includes an explicit partial insurance on time and savings deposits. The deposit guarantee covers up to 90 percent of each individual time or savings deposit, and up to 120 index units, equivalent to about US$2,500 per depositor, per year (articles 141 and 142 of the General Banking Law). The latter limit applies to deposits in the overall banking system and cannot be bypassed by distributing deposits in different banks.

Further Developments and Current Problems of the Financial System

The emergence of new forms of financial intermediation during the post-reform period has meant a reduction in the bank's market share, a process of disintermediation. These new forms of intermediation have a competitive edge for banks, because banks are subject to lower capital standards and looser regulations, but at the same time they cannot benefit from explicit deposit insurance. With the emergence of new financial intermediaries, the banks have been progressively authorized to establish subsidiaries to perform financial activities, such as leasing,

brokerage, investment banking, mutual funds management, financial consulting, and other activities.

Technological and financial development, as well as the increasing role of institutional investors, have 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 they maintain restrictive legislation that hinders bank activities.

The Post-Reform Banking System

A particular source, of concern is the unorganized emergence of different financial intermediaries. The problem is not that there are many and different intermediaries. On the contrary, it is probably positive, because, it allows more competition and increasing alternatives to savers and investors. The point is that these events happen with so much dynamism bypassing the regulatory mechanism. Thus, for example, it is common to find that regulations and supervision for the same operation, but performed by two different intermediaries, are not the same. The challenge then is to achieve consistency regarding the norms that rule different financial intermediaries.

This is especially relevant for countries like Chile, where financial reforms and banking legislation are quite advanced, and where new bank financial intermediaries, most importantly pension funds, have acquired an extraordinary dynamism and play a key role in the capital market. The processes of disintermediation raise new challenges that have not taken place in other countries. It requires to gradually adapt financial legislation and supervision according to changes as they occur 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 updating the legislation designed to prevent financial instability without hindering the development of financial markets.

A second post-reform trend has been the globalization of financial markets. In spite of the pressures, the authorities have taken a gradual approach to globalization. The sudden and unplanned opening of the economy to international capital flows has been known to lead to an undesired appreciation of the real exchange rate, a rapid increase in foreign indebtedness, and financial instability. The opening of the capital account should be approached gradually to avoid generating macroeconomic imbalances. In Chile during the last three years very important actions have been taken in the direction of opening the capital account eliminating restrictions to capital outflows. Persons and firms are allowed to invest abroad using the informal exchange market and informing the central bank of the operation. An explicit authorization of

the Central Bank is needed to use the formal exchange market for these operations.[7] The situation is more restrictive for banks and other institutional investors. Banks can invest only up to 25 percent of their U.S. dollar deposits in highly rated foreign securities. A relaxation of these standards, however, is currently being studied. Domestic banks can only finance nonresidents in international trade operations involving one Chilean party or in operations within the Latin American Integration Association (ALADI). Of the other institutional investors only pension funds managing entities can invest up to 3 percent of their portfolios abroad in low risk, highly rated securities.

The Capital Market and the Pension Funds

One of the major developments in Chile's financial market in the last decade has been the emergence of private pension fund agencies (AFPs). Chile switched from a public pay as you go system to a privately funded capitalization system in the early 1980s.[8] Since then social security contributions are deposited in AFPs, which in turn invest these funds in various instruments, including bank deposits, privately issued securities, central bank bonds, and stocks. The AFPs have accumulated significant resources that currently represent about 30 percent of GDP and that have been very important in the deepening of the Chilean financial markets. The AFP and the life insurance companies (whose significant development is also a direct consequence of the new pension system) are the main holders of long-term financial instruments. In Chile, unlike other Latin American countries, there is a deep long-term capital market. Currently, bonds and deposits issued by the financial system with an original maturity of at least one year represent around 20 percent of GDP (table 6.4).

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7. The relatively small exchange rate differential between the formal and informal markets of the last two years is an indicator of the degree of openness of the capital account.

8. The social security reform consists of the privatization of the pension system and the replacement of the pay as you go system with one of individual capitalization. The government sets regulations but does not administer funds. A transitional fiscal problem arose because of the payments of retirement pensions under the old system that generate public expenditure, while social security contributions are no longer part of public revenue.

Table 6.4. *Pension Fund Assets per Financial Instruments*
(as of December of each year)

Years	*Securities*	*Time deposits financial instruments*	*Credit notes financial instruments*	*Firm shares and debentures*
1981	28.1	61.9	9.4	0.6
1982	26.0	26.6	46.8	0.6
1983	44.5	2.7	50.7	2.1
1984	42.3	12.8	43.1	1.8
1985	42.6	20.9	35.4	1.1
1986	46.7	26.9	25.5	0.8
1987	43.1	32.0	22.2	2.7
1988	35.5	37.5	20.6	6.4
1989	41.6	21.5	17.7	19.2
1990	44.1	17.3	16.1	22.4
1991	38.3	13.3	13.4	34.9

Financial and Macroeconomic Stability: Links and Causality

The links between financial and macroeconomic stability are multiple, complex, and difficult to disentangle. In this part of the paper, we attempt to identify some of the links and analyze the extent to which the disruptions to macroeconomic stability can be originated in microeconomic problems of the financial system, or, alternatively, if macroeconomic and financial stability appear to be closely related. Despite these limitations it appears that the microeconomic problems of the financial system played a significant role in creating the conditions for the macroeconomic crisis of the 1980s.

Macroeconomic Origins of the Financial Crisis

Macroeconomic stability in the Chilean experience appears to be directly related to the value of two key prices that are indicators of the level of aggregate spending and of the sustainability of macroeconomic policies. The real exchange rate, the relative price of tradable and nontradable goods, and the real interest rate were grossly out of line in the period before the crisis. (Corbo 1985; Corbo, de Melo, and Tybout 1986). From 1978 to 1981 the real exchange rate appreciated by 22 percent, while the real borrowing interest rate averaged 27 percent in annual terms. The two key prices reflected a serious macroeconomic imbalance. Over the same period aggregate

expenditure increased at an annual average rate of 10.3 percent while GDP increased only 7.4 percent. Consequently, the external current-account deficit increased from 7.1 percent of GDP in 1978 to 14.5 percent of GDP in 1981.

The Importance of Key Prices

The macroeconomic imbalances were a source of financial fragility. The adjustment process that followed resulted in a severe deterioration of the loan portfolio. Since the level of aggregate expenditure and the relative prices of tradable and nontradable goods were grossly out of line, the income of borrowers and the profitability of investment projects financed by bank loans were severely reduced by the adjustment. Many bank borrowers were unable to discharge their contractual obligations.

The inadequacy of the Chilean macroeconomic policy of the early 1980s has been linked to the fixed exchange rate policy in effect since June 1979. A possible interpretation of this inadequacy was that demand management policies were not appropriate, resulting in an expansion of aggregate expenditure far beyond what could be reasonably considered consistent with the fixed exchange rate. Despite the small fiscal surplus averaging 1.4 percent of GDP in 1978–81, fiscal policy afterward may have been too expansive, partly explaining the rapid expansion of aggregate expenditure that took place in that period. It could be argued that the accumulation of contingent fiscal liabilities, although excluded from the definition of public debt, were considered by private agents to estimate their expected wealth and to decide their spending plans. Among the contingent fiscal liabilities could be included the implicit deposit insurance, the exchange rate insurance, and other contingent support given to banking system borrowers. If these contingent liabilities were taken into account, public sector liabilities would have been growing at a fast rate in the period before the financial crisis of the early 1980s.

Monetary policy at the same time proved to be extremely ineffective, especially considering the ambitious inflation objective reflected in the fixed exchange rate. The monetary policy along with the exchange rate policy that basically followed the monetary approach to the balance of payments was inconsistent with the overall macroeconomic situation. To the extent that monetary policy can be represented by the level of interest rate, monetary policy was contractionary because real interest rates were extraordinarily high. These high rates, however, were ineffective in moderating the expansion of real expenditure. The elimination of capital account restrictions under these conditions generated a massive inflow of foreign capital that accommodated an even larger increase in aggregate demand, while interest rates remained at high levels. The prevalence of high real interest rates and a rapid increase in expenditure can be reconciled considering that borrowers' expectations included an indefinite refinancing of interest payments or some other form of debt bailout.

An important lesson from this experience is that aggregate demand policy should be directed toward obtaining stable macroeconomic conditions for which the sustainability of the key relative prices is a necessary condition. The level of the real exchange rate and that of the real interest rate should be of central importance for policymakers. To attain this goal, demand management, and particularly fiscal policy, should control aggregate spending over the medium term and not solely concentrate on intermediate targets such as the fiscal deficit. As the Chilean experience indicates, excessive expenditure, whether private or public, ends up being a source of serious macroeconomic disruption, and the main tool to limit the expansion of aggregate expenditure is fiscal policy.[9]

Moreover, a possible interpretation of this experience is that to a large extent the macroeconomic imbalances had their origins in the microeconomic problems of the financial system. These problems could have resulted in expansive macroeconomic policies due to the accumulation of contingent fiscal liabilities and the ineffectiveness of monetary policy. The debtors' expectations of a bailout and the implicit deposit and exchange rate insurance could not be excluded as factors behind the nonsustainable level of real expenditure. The failure of the macroeconomic policy at that time was that authorities failed to recognize that expenditure expansion was excessive and thus did not attempt to restrain it. The alternatives for policy action included reducing aggregate expenditure using a restrictive fiscal policy or, acting on the source of the problem, attempting a financial reform by limiting deposit and exchange insurance and expectations of a debtor's bailout. If neither option was feasible, it was necessary to accept a less ambitious inflation target and adjust the rate of currency depreciation accordingly, to avoid the overappreciation of the real exchange rate and the severe deterioration of foreign accounts. This last alternative would have limited the expansion of domestic expenditure with an inflation tax and may have created some room for contractionary monetary policy.

The Chilean experience of the 1980s reinforced the importance of concentrating efforts to keep key macroeconomic prices at sustainable levels and carefully monitoring the level of aggregate expenditure. Perhaps one result of this macroeconomic policy stance could be a lower rate of GDP growth in one particular year, but under this stance the average growth rate would be higher, and the growth process would be much more stable.

9. The effectiveness of monetary policy is seriously limited by the targeting of the real exchange rate.

Capital Account Opening

The extremely high level of the domestic real interest rate did not eliminate excessive domestic expenditure, but it did attract massive external capital inflows. To a large extent capital inflows were intermediated by the financial system and by private analysts and bankers lobbying for a rapid elimination of the remaining capital account restrictions. Quantitative restrictions on foreign borrowing by banks were seen as the cause for the high domestic interest rate. The rapid removal of quantitative restrictions created more problems than it solved. Interest rates fell but continued at high levels, and the massive capital inflow financed an even larger increase in domestic spending. Eliminating restrictions to international capital flows when domestic interest rates exceed international rates, after performing the appropriate exchange rate and risk corrections, amounted to an expenditure shock that created pressures on domestic prices and expenditures.

Although today in Chile there are no quantitative restrictions on foreign borrowing, some restrictions to capital flows still apply. A 30 percent reserve requirement is imposed on all foreign capital inflows, with the sole exception of equity financing. This reserve requirement is not remunerated and must be kept in the central bank for a year, thus increasing the cost of foreign financing, particularly for short-run operations. The removal of these restrictions should be step-by-step in order to avoid a sudden increase in expenditure and to allow for a careful monitoring of bank lending. The removal of restrictions affecting capital movements and exchange transactions is in itself desirable, but they should be part of a well-planned strategy. The excellent macroeconomic performance of the last three years should not be endangered by an impulsive opening of the capital account.

Openness to Trade and Vulnerability to External Shock

One of the most notable characteristics of the international economy during the 1980s was the rapid growth of international trade. Between 1983 and 1989 the volume of international trade increased at an average annual rate of 6 percent compared to an annual growth rate of the world's GDP of only 4 percent. Overall, during the 1980s world trade volume increased by 50 percent; and an important share of this growth has taken place with goods of a high technological content, and with a greater number of countries taking part in technologically advanced trade. Technological progress in management, communications, and information processing has globalized the marketplace because numerous institutional obstacles and political frontiers have been removed. The dynamics of this process should be sustained because it has increased the welfare of citizens of many countries. The emergence of international trading blocks may segment international markets, endangering the gains derived from trade and specialization in a global marketplace.

Chile has favored multilateral openness as the best way to promote specialization, efficiency, and growth. Chile began to unilaterally open to international trade almost two decades ago. Over this period the relative size of Chilean exports have doubled as compared with domestic activity with world trade. Exports of goods and services that represented 15 percent of GDP in 1970 reached 35 percent of GDP in 1992. In 1970, for each million U.S. dollars of world exports, Chile exported US$940 of non-copper goods, whereas in 1991 for each million U.S. dollar of world exports Chile exported US$1,540, almost doubling its share in world trade. However, if copper exports are also included in this calculation, the share of Chilean exports in world exports would have fallen from US$3,800 per million dollars of world exports in 1970 to US$2,600 per million of world exports in 1991. This reflects the importance of copper exports in Chilean trade and the significant reduction of the real price of copper over the last thirty years.

Over the last two decades Chilean trade restrictions have been drastically reduced. In fact, in the early 1970s trade tariffs averaged more than 100 percent, had a wide variance, and were complemented by quantitative trade restrictions. Today, quantitative restrictions have been eliminated, and a single uniform 11 percent tariff rate is applied.

Under this strategy of openness to international trade the country is vulnerable to international shocks, particularly to the extent that exports are not widely diversified. Despite some diversification in recent years, copper and a few other export products still represent more than 70 percent of Chilean exports and more than 20 percent of Chilean GDP. This risk could be reduced by additional trade diversification, but some of the benefits from trade, which come precisely from specialization, would then be lost. To allow for a reduction in risk faced by domestic residents and to still fully benefit from trade induced specialization, contingent claims should be traded in international capital markets. Openness to international capital flows, including direct foreign investment, allows for an efficient diversification of risks, thus reducing national exposure to external shocks.

Along the same lines, the regulation and supervision of the domestic financial system is oriented to reduce risk to the financial system. However, to the extent that the domestic production system becomes more specialized, possibilities for effectively diversifying loan risks become more restricted. Consequently, overall risk can be reduced if domestic financial institutions seek investment opportunities abroad. Of course, the relaxation of restrictions on bank investments abroad creates the need to improve regulations on international lending transactions so as to limit and monitor commercial and currency risks of international lending by domestic banks.

Financial Origins of Macroeconomic Disequilibrium

While macroeconomic instability can negatively affect the financial system, the inverse is that financial instability can damage the economy. A financial system that is not functioning well can affect the economy because it introduces inefficiencies at the micro level in the intermediation of savings. In addition, such a financial system can be a contributing factor in the beginning of a macroeconomic crisis or, more commonly, a factor that helps deepen a crisis. The following paragraphs analyze the externalities imposed by a financial system that does not work properly, followed by a review of the intrinsic fragility of the financial system. In both cases the importance of good regulation and supervision of the financial system becomes clear. Finally, macroeconomic costs of the Chilean financial system in the early 1980s are briefly discussed.

Financial System Externalities

Financial problems can negatively affect the real economy, first, because the financial system, through performing the role of intermediation of savings, can affect the efficiency of investment and the growth possibilities of the economy. Given the limitations on financial intermediation, (for example, information and transaction costs, the need for project screening and for monitoring loans, among others), specialized institutions are required to efficiently carry out intermediation. Moreover, a well-organized financial system allows for more efficient risk management, risk sharing, and reduction through transactions in contingent claims. In discharging this function, the financial system can make a significant contribution to development, but when it fails, severe macroeconomic disruptions follow.

The financial system also has a very important role in providing the economy with an efficient payments system. Demand deposits are the most important means of conducting transactions. Consequently, the failure of a financial institution can create serious disruption in the payments system. Not surprisingly, one of the main concerns of economic policy when confronting the failure of a financial institution is to provide for the continuing operation of the payments system, and to avoid the problem of an individual bank escalating into a general crisis.

The disintermediation of savings, the difficulties for carrying out risk-sharing operations, and the limitations for carrying out current transactions through a failed payments system can generate significant economic costs. It is clear that the financial industry is the only one where localized problems can develop into a bank run and an economywide crisis. The externality that affects the financial system implies the need for a protective net for depositors that limits the risk of a bank run. Endogenous financial problems have been the object of study in economic literature (Charles Kindleberger (1978) describes a process of financial manias, panics, and crashes).

Structural weaknesses of the financial system increase the likelihood of this self-destructive process.

Structural Weaknesses of the Financial System

With deposit insurance, depositors have no incentive for discriminating between financial institutions according to the risk of their portfolios; they are only concerned with the return offered.[10] Financial institutions tend to increase the risk of their portfolios to increase returns and attract a larger share of deposits. This risky behavior tends to be aggravated by the low level of bank capitalization.

In theory, the solution to this moral hazard problem requires bank supervision and regulation. Regulations should attempt to impose minimum capital requirements directly related to the risk of the loan portfolio. Higher levels of risk demand stricter loan provisioning and higher bank capitalization. Deposit insurance should be explicit and limited, and if possible, the cost should relate to the risk of failure faced by the banking institution. Finally, bank supervision is needed to enforce regulations and to publicize the information on the financial conditions of the banking institution using well-known accounting criteria.

Quasi-Fiscal Losses

The origin of the Chilean financial crisis has been related to implicit deposit insurance and contingent liabilities and transfer given out by the central bank to depositors and debtors. The effect of the implicit insurance and the contingent transfers on macroeconomic stability has already been discussed, but the effect of these quasi-fiscal operations continued both during and after the crisis. At the outburst of the crisis the central bank provided the contingent liabilities, and the equity of the central bank was seriously impaired. The central bank debt issued to finance the transfers will represent a burden on fiscal resources for several years to come.

The solution of the Chilean financial crisis was built upon financial assistance and transfers given by the central bank to depositors and debtors. The financial assistance and transfers resulted in important losses that continue to generate cash losses for the central bank. These losses, or quasi-fiscal deficits, are equivalent to other types of public expenditure that have a detrimental effect on national savings and should be taken into account when designing fiscal policy. If fiscal policy does not compensate for the lower savings ratio generated by the quasi-fiscal losses, the central

10. For a formal modeling of these issues see Le-Fort (1991).

bank may be forced to increase the real interest rate in order to avoid pressures on prices and external accounts. Moreover, in an extreme case of fiscal irresponsibility, monetary policy may lose its effectiveness, owing to a large international interest rate differential and the inconvenience of further real appreciation. The monetary authorities may then be forced to use the inflation tax to finance the quasi-fiscal deficit.

Concluding Remarks

Financial system reform in Chile has finally been successful. This success was obtained at an important transitional cost in the form of a crisis that ended with almost all the banking system under government control and the worst recession since the Great Depression. The lifting of financial repression, inspired by the work of McKinnon and Shaw in the 1970s (McKinnon 1973; Shaw 1973), was poorly implemented. The crisis generated a significant fiscal cost that, over and above the lower output of the recession, is estimated to have reached up to one-third of the annual GDP. Moreover, this cost will continue to contribute to the central bank's quasi-fiscal deficit, which is equivalent to around 1.5 percent of GDP for many years.

The Chilean crisis of the early 1980s may have been triggered by inadequate macroeconomic policies and external shocks, but the structural weaknesses of the financial system created the conditions for a crisis that sooner or later was going to burst. Problems of moral hazard in the financial system had resulted in particularly risky behavior by financial market participants that weakened banks' solvency and increased the likelihood of a crisis. To a large extent the macroeconomic conditions of excessive aggregate expenditure that existed before the outbreak of the financial crisis were the result of inadequate operations within the financial system. It can be argued that economic agents believed that the government was insuring the deposits and foreign currency exposure of both banks and bank debtors. The perceived contingent wealth transfers that were implicit in the insurance mechanisms helped foster excessive spending and weaken the effect of high interest rates on aggregate expenditure.

Given the importance of externalities generated by the proper operation of the banking system, it seems inadequate to eliminate all forms of deposit insurance. With deposit insurance there is the need for adequate bank supervision and regulation to avoid the moral hazard problem associated with subsidized insurance.

The development of the domestic financial system and the integration of the international financial system had a positive effect on macroeconomic performance and stability. The experience of the 1980s indicates that the structural change involving the financial system must be done gradually in order to minimize the transitional costs that can be created. Finally, financial liberalization should consist of reforming regulations affecting financial transactions, but not in the complete elimination of these regulations. Regulations should be directed at avoiding the excessive risk taking fostered by inappropriate incentives present in an unregulated financial system.

Finally, in a dynamic world it is important to have flexible legislation that can adapt to new changes. In this sense the processes of globalization and disintermediation impose a new challenge to the regulatory authorities. The challenge is not to discourage the normal development of a modern financial system but to avoid processes within financial development that may bring about a perverse structure of incentives that finally ends up in a financial and macroeconomic crisis.

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7

SECURITIES MARKET REGULATIONS AND REFORMS IN THAILAND

Ekamol Kiriwat, Deputy Governor, Bank of Thailand

As with many fast developing countries, Thailand has struggled to develop an infrastructure to keep pace with the economic development. The government raised massive financial resources to pour into sectors that are regarded as essential for the rapid growth of the economy. However, not only were the end users of these financial resources trying to keep up with the changing pace, but so was the whole system in which money could effectively be raised to accommodate those needs and demands. The capital market in Thailand, though attracting huge interest among investors and fund-raisers in recent years, was too ill-equipped to support financial innovation so necessary to propel Thailand into the international securities market. The Thai capital market was governed by outdated laws that restricted direct financing by companies. Moreover, jurisdiction over the capital market was split among various entities ranging from the Ministry of Finance, the Ministry of Commerce, the Bank of Thailand, and the Stock Exchange of Thailand. As a result, there was no coherent policy direction for market participants to follow. Thus, the market was left to develop through a maze of laws and regulations that were sometimes irreconcilable.

This paper illustrates in more detail the problems facing the Thai capital market and how those problems were tackled by the reforms brought about through the promulgation of the Securities and Exchange Act. Essentially, the act created a new environment for the capital market and paved the way for financial innovations.

Weaknesses of the Old Legal Framework and Financial Innovation

A major weakness in the old legal system, which hindered financial innovation, was that there were many laws that securities market participants had to observe, namely, the Stock Exchange of Thailand Act, B.E. 2517, governing the activities of the Stock Exchange of Thailand (SET); the Act on the Undertaking of Finance Business, Securities Business, and Credit Foncier Business, B.E. 2522, governing the business of securities companies; the Public Company Act, B.E. 2522, governing the public offering of shares and debentures; and the Civil and Commercial Code providing

general provisions regarding the civil and commercial practices in Thailand, such as the setting up of limited companies. The greater the number of laws, the greater the chance of inconsistency among them which certainly created a burden on market participants.

After the enactment of the Public Company Act and the amendments to the Civil and Commercial Codes in 1978, limited companies were not allowed to make any initial public offering (IPO) of their shares, nor were they allowed to offer debentures to the public. New shares had to be initially offered only to existing shareholders. These provisions significantly obstructed the mobilization of funds in the primary market, thus having an adverse effect on the secondary market.

According to the provisions of the Public Company Act, only public companies could make an IPO of their shares and debentures. However, after over ten years since the Public Company Act had been enacted, only thirty-three companies had become public companies because of the strict provisions and some other weaknesses of the act. The problems with the act included the severe criminal and civil liabilities on companies' directors, and the requirement that any company having more than thirty-three shareholders had to convert itself to a public company regardless of its intention whether to raise funds from the public or not.

In 1984 the Stock Exchange of Thailand Act was used to overrule some of the provisions in the Public Company Act and the Amendments to the Civil and Commercial Codes. The Stock Exchange of Thailand Act allowed listed and authorized companies in the Stock Exchange of Thailand (SET). Companies that were tentatively approved to be listed and authorized in the SET and were waiting for final approval from the Finance Minister could offer their shares and debentures to the public. The Stock Exchange of Thailand Act, however, was primarily a regulation on the trading of securities in the secondary market, and was not intended to be a regulation on the primary market. Thus, most of the listed companies in the SET were limited companies according to the Civil and Commercial Codes, and hence were not regulated by the Public Company Act. Consequently, there was no effective legal framework to supervise the primary market, that is, nobody cared about the development of the primary market.

Weaknesses in Supervision and Enforcement

Apart from the number of laws that needed to be observed, there were also various supervisory agencies in charge of the securities businesses, namely, the Minister of Finance, the SET, the Bank of Thailand, and the Ministry of Commerce. Thus no single supervisory agency had an overview of the securities businesses. For example, the Bank of Thailand supervised securities companies but did not supervise the activities in the SET, and the SET supervised member brokers but did not have the authority to regulate nonmember brokers. These inconsistencies and the large number

of supervisory agencies involved created inefficiency in the enforcement of securities regulations.

The Need to Develop Financial Instruments

Apart from the obstacles and weaknesses in the legal framework that had to be eliminated, it was also necessary to enhance the development of financial instruments. The Thai financial market was becoming more deregulated; market forces were allowed to work more fully with less intervention. Therefore, the financial managers' or individuals' needs for financial instruments to assist them in managing cash flow and risk were expected to gain more importance than in the past. Several debt and equity instruments were useful in seeding direct financing. More varieties of financial instruments would promote the mobilization of savings, especially to support the long-term savings as a result of the availability of secondary markets of several financial instruments.

Consequently, the enactment of the Securities and Exchange Act was designed to achieve four 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 securities business and the Stock Exchange of Thailand.

The Securities and Exchange Act introduced several important changes to expand and improve the securities market in Thailand. The following paragraphs describe these changes.

Unification of Supervisory Agencies

The Securities and Exchange Commission was established to supervise all aspects of securities businesses. Currently, eleven commission members are appointed

from the various agencies that previously supervised securities businesses from financial, accounting, and legal companies and from professionals in the securities business to represent every party concerned. The SEC is supported by the Office of the Securities and Exchange Commission, which is headed by the secretary-general.

Issuance of Securities

The Securities and Exchange Act stipulated that the mobilization of funds from the public by using stocks or equity instruments is limited to public companies, while debt can be issued by both public companies and limited companies. These companies, however, must obtain approval from the Office of the Securities and Exchange Commission to mobilize funds from the public.

Public Offering of Securities

As mentioned earlier, the public offering of securities by public companies was formerly regulated by the Public Company Act, while the public offering by listed companies was partially regulated by the Stock 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 SET. Companies thus could circumvent the laws by selling new securities to existing shareholders who later sold 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 issuers must disclose as much information and be as reliable as possible to the investors to enable them to make informed investment decisions.

Debt Instruments, Investor Representatives and Trustees

Under the Securities and Exchange Act, the definition of debenture includes all kinds of debt instruments, both short and long term, except "bill" as defined in the Civil and Commercial Code. This is intended to prevent companies from circumventing the law by calling basic debt instruments by other names.

The act also introduced the concept of investor representatives and trustees under the section on secured bond and fund management. This provision gives investors protection and prepares the groundwork for the supervision of securitization of assets.

Securities Business

The Securities and Exchange Act clearly defined rules, procedures, and supervision of each type of securities business, and added private fund management as a new type of securities business. Thus, securities companies can now manage the surplus fund of persons and foundations.

For a mutual fund company, 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 provision on the supervision of securities business emphasizes the importance of capital adequacy and increases 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 Stock Exchange of Thailand (SET)

The Securities and Exchange Act restructured the authority and responsibility of the SET by transferring the enforcement work from the SET to the SEC. The SET is responsible for overseeing the operational work of the Securities and Exchange Commission. The act also permitted smaller, over-the-counter markets to be set up with no cross-listing with the SET and laid the groundwork for the establishment of various securities related organizations, such as the Securities Depository Center, the Securities Registrar Office, and the Securities Clearing House. These organizations will be privately run.

Investors' Protection

The Securities and Exchange Act specified a number of requirements to improve investors' protection, namely, such as the requirement of SEC approval before a company can issue securities to the public, and the requirement for disclosure of information before a company can make a public offering. The act also made the penalty for insider trading more severe.

Impacts of the Securities and Exchange Act on Financial Reform

The promulgation of the Securities and Exchange Act is expected to change the financial system. Direct financing for businesses seeking financial sources without having to go through commercial banks or finance companies will help boost the source of funds for businesses while offering the public additional investment tools. It has set

up a framework for supervision and development of both primary and secondary securities markets. In addition, the act encourages financial innovation, which should lead to new types of businesses.

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

8

PAKISTAN'S LIBERALIZATION OF THE EXTERNAL SECTOR

Mohammad Ashraf Janjua, Deputy Governor, State Bank of Pakistan

Though the genesis of the exchange and payments reforms can be traced back to 1972 when the Pakistan's rupee was massively devalued and import payments were liberalized, more conscious and consistent efforts were made since 1980 when a three-year Extended Fund Facility (EFF) arrangement was agreed upon with the International Monetary Fund (IMF). A central feature of the EFF program was a reform of the import system and a phased implementation of import liberalization. During 1980-81 a number of restrictions affecting imports were eased, including removal of the licensing ceiling on virtually all nonconsumer goods and the liberalization of virtually all raw material imports. A basic change was made in the format of the import system by replacing the old system of publishing positive lists of permissible import items with negative and restricted lists systems. The free list consisted of 435 items in 1979–80. It was gradually enlarged to 575 during 1983–84, while the tied list, which comprised 23 items in 1979–80, was reduced to 20 in 1983–84. As a further measure of support to these efforts a flexible exchange rate policy was introduced in January 1982 under which the value of the rupee is determined with reference to a basket of currencies of Pakistan's major trading partners.

As a major element of the macroeconomic adjustment and structural reform effort, a comprehensive medium-term program of trade liberalization and tariff reduction and rationalization was initiated in 1988. As part of the replacement program of most of the nontariff barriers into tariffs and in order to improve the transparency in the lists of banned and restricted goods, the government reclassified all categories of importable items that were subject to restrictions (the restricted list) and all categories of banned imports (the negative list). With respect to imports subject to restrictions, a number of additional categories were removed from the restricted list, thereby reducing the list to sixty-two categories. The 1991–92 Import Policy Order stipulated removal of further categories from the restricted list, with a plan to eventually eliminate the restricted list completely.

The government also introduced a comprehensive reform and rationalization of the tariff system in 1988. The maximum ad valorem custom duty rate on all categories of imports was reduced from 225 percent in 1987–88 to 125 percent during 1988–89, except for alcoholic beverages and spirits and luxury vehicles.

Reforms since February 1991

As part of the recent efforts to liberalize, deregulate, and privatize the economy, the external sector was opened up and a number of controls and restrictions were dismantled. In addition, beginning February 1991, the government introduced important reforms concerning foreign investment, the exchange and payments systems and foreign trade. They are as follows:

- Allowing foreigners to invest freely in all industries, except certain specified industries, without prior approval of the government;

- Permitting foreign ownership of up to 100 percent of the equity of a business in Pakistan;

- Allowing remittances overseas of dividends on shares, held by nonresidents, without prior permission from the State Bank of Pakistan (SBP);

- Removing the requirement of government approval before shares held by foreigners can be transferred or foreign holdings of domestic capital can be remitted;

- Allowing foreign nationals to invest in shares in existing companies through the stock exchange. Establishing a special convertible rupee account with an authorized dealer in Pakistan that can be opened by nonresidents to purchase shares quoted on the stock exchange with the balance in this account transferable outside Pakistan without prior approval of the state bank;

- Liberalizing the rule for foreign controlled manufacturing companies (FMC) for working capital from domestic credit institutions without any limit and without prior approval of the state bank;

- Obtaining foreign loans through industrial undertakings for setting up new industries or for expansion without any restrictions on interest rate and with no involvement in the front-end fees provided by the government repayment guarantee;

- Abolishing the ceiling on payment of royalty technical assistance fees;

- Issuing National Investment Trust (NIT) units to Pakistan nationals residing outside Pakistan and foreign nationals residing in or out of Pakistan, on the basis of repatriation of capital and profits.

To supplement Foreign Exchange Bearer Certificate (FEBC) scheme, dollar bearer certificates (DBCs) with a one-year maturity were introduced in April 1991. These can be purchased by residents and nonresidents using foreign exchange. In addition, permission was granted for the opening of foreign currency accounts (FCAs) by residents of Pakistan on the same basis as nonresidents. Thus, balances held in FCAs will be freely transferable abroad, and there will be no limits on amounts of withdrawal.

Other changes specific to foreign exchange are as follows:

- Limits for financing certain invisible transactions were enhanced;

- The requirement of declaration of notes, coins, and foreign exchange to customers' authorities in respect of outgoing and incoming passengers was dispensed with;

- Permission was granted to Pakistan nationals and resident companies and firms to work as money changers;

- To protect domestic borrowers against the appreciation of foreign currencies, exchange risk cover was provided by the State Bank of Pakistan so that their repayment liability is fixed in advance, irrespective of exchange rate fluctuations;

- The limit of foreign exchange that resident Pakistanis could hold abroad was raised from US$500 (or the equivalent hereof in other currencies) to US$1,000;

- The raising of foreign currency funds from abroad, by investment banks through the issue of certificates of investment having maturity of at least three months has been allowed;

- Five-year foreign currency bearer certificates denominated in U.S. dollars, deutsche marks, pound sterling, and Japanese yen have been issued, and these certificates, which can be cashed after a minimum holding period of two years, will bear fixed rates of profit payable half-yearly;

- Licensing requirements for items on the free list and other specified items were abolished;
- The maximum import duty was reduced from 125 percent to 90 percent in 1991–92 and further to 80 percent in 1992–93;
- And about forty-four items have been removed from the negative list in the import policies since 1990.

At the end of 1990 there were 118 items or groups of items that were on the negative import list. Finally, foreign companies have been allowed to undertake export trade, and the public sector monopoly for the export of rice and cotton has been abolished.

The Impact of the Reforms

Although it is premature to assess the impact of these extensive exchange and payments reforms, it can be safely said that these reforms have started paying dividends. The following paragraphs summarize the impact of these reforms on the capital account.

Foreign Investment

The reforms introduced to attract foreign investment have shown positive results. Foreign investment was US$216 million during 1989–90 and increased to US$246 million during 1990–91, reaching US$335 million during 1991–92. During the first six months of 1992–93 direct investment stood at US$77.7 million compared to US$90.6 million during the same period of 1991–92.

Portfolio Investment

The permission to overseas Pakistanis and foreign nationals to open convertible rupee accounts and to make repatriable investments in shares of existing listed companies with stock exchanges has attracted US$219 million during 1991–92. During July to December 1992, inflows from portfolio investments amounted to US$75.8 million as compared to US$97.9 million in the comparable period of 1991–92.

Foreign Private Loans

The permission to industrial undertakings to raise foreign loans without any restrictions on interest rates, front-end fees, and repayment periods has resulted in a considerable increase in the flow of foreign private loans. The disbursements were US$150 million during 1989–90, increased to US$158 million in 1990–91, and further to US$559 million in 1991–92. Thus, the 1991 to 1992 disbursements showed an increase of 253.8 percent. The rising trend is continuing. During the first six months of 1992–93 disbursements amounted to US$420.2 million as compared to US$373.3 million during the same period of 1991–92.

Government Securities

The government's scheme regarding the issuance of one-year dollar bearer certificates and five-year foreign currency bearer certificates, introduced in 1991–1992, has attracted sums of US$53.1 million and US$62.7 million, respectively, as of December 1992.

Foreign Exchange Bearer Certificates (FEBC)

FEBCs, denominated in Pak rupee with three-year maturity, were first issued in August 1985. The outstanding amount of FEBCs, which at the end of June 1989 stood at US$280 million, rose to US$381 million at the end of June 1991. After declining to US$338.4 million on June 30, 1992, they rose to US$400 million by the end of 1992.

Foreign Currency Account (FCAs)

The foreign currency accounts scheme, which was introduced in January 1973, was initially meant for Pakistani nationals residing abroad. The scope of the scheme was gradually widened. Permission to Pakistani residents to open and maintain these accounts and general permission for credit to these accounts with the proceeds of FEBCs, dollar bearer certificates, travelers checks, and currency notes was granted as part of the overall package of foreign exchange reforms announced in February 1991. As a result, the deposits under the scheme have gone up sharply: deposits averaged US$1,871.4 million during 1987–90, and started rising rather sharply since March 1991. From US$2,346 million at the end of March 1991, these deposits rose to US$3,867.5 million by the end of December 1992. The breakdown of these deposits in terms of residents and nonresidents indicated that residents deposits showed a steady

steep rise from US$32.8 million at the end of March 1991 to US$1,618.7 million by the end of December 1992, and nonresident deposits peaked at US$2,446.1 million at the end of October 1991 but started declining and stood at US$2,248.8 million at the end of December 1992. These deposits can be further classified as deposits to banks and financial institutions and deposits to companies (non-financial institutions). The deposits to companies steadily increased from US$1,332 million in February 1991 to US$3,058 million in December 1992, an increase of 127 percent, while deposits to financial institutions declined from US$961 million in February 1991 to US$804 million in January 1993. The decline in these deposits mainly reflected the impact of the abolition of credit ceilings.

The net increase in foreign currency account (FCA) deposits during the past four years has been steady, but the rise has been particularly sharp in 1991–92 when these deposits recorded an increase of $1,104.1 million compared to US$476.2 million in 1990–91 and US$266.3 million in 1989–90. The sharp increases in 1990–91 and 1991–92 mainly reflected increases in residents' deposits after the government granted permission to resident Pakistanis to open and maintain FCAs on the same basis as nonresidents. The breakdown of the overall increases in terms of residents and nonresidents indicated that while the deposits of the former went up sharply by US$157.6 million during April-June 1991 and US$1,164.7 million during 1991–92, those of the latter increased only by US$88.6 million in April-June 1991 but fell by US$60.6 million during 1991–92. While the deposits of the residents continued rising during July-December, 1992 and stood at US$1,618.7 million and $263.6 million at the end of December 1992, nonresident deposits recorded a further fall of US$92.4 million over the same period. The sharp increase in resident deposits could be attributed to diversion of part of the home remittances, sales, and encashment of FEBCs; under or overinvoicing of exports and imports; and a division of the differential between the maximum permissible and actual commission paid to importers by Pakistani exporters. Table 8.1 shows how each of the above factors is estimated to have accounted for the sharp increases in resident deposits.

Table 8.1. *Factors Affecting the Rise in Resident Deposits*
(US $,million)

Factor	*1990–91*	*1991–92*	*July-Dec. 1992*
Home remittances	94.1	474.9	166.0
FEBCs	151.0	485.1	-
Commissions	-	109.0	42.0
Total	245.1	1,069.0	208.0

For the purpose of balance of payments, the way part of the FCA deposits pertaining to residents have been evaluated has been recently changed. Formerly, these deposits constituted liability to nonresidents and formed a component of the capital account. Now these deposits are treated as a part of unrequited transfers in the current account.

This experience of capital account liberalization is a recent one for Pakistan. The deliberations of this seminar on the experiences of other countries in Asia and Latin America will be helpful in formulating policies and management of external balances in the forthcoming years.

9

FINANCIAL LIBERALIZATION IN AN AGRARIAN ECONOMY: THE CASE OF PARAGUAY

Reinaldo Penner, Central Bank of Paraguay

The banking sector in Paraguay developed with the establishment of international bank branches mainly during the 1960s and 1970s (table 9.1). During 1980–92, the sector experienced high growth when several local banks were established, even though some branches closed. An open system of free entry and exit was the basis of the expansion of modern banking. Local banks started with an acceptable performance in this competitive environment. Their entrance into the market usually began through a process called "spin-off," when local managers of foreign branches initiated their own management of a local bank. In addition, these local managers would buy closed branches and, in some cases, develop a joint venture with the former owners of the closing branches. As a result, the total assets and liabilities of the banking system were more or less equally distributed among local banks and foreign branches.

By this time the economy changed from a small-peasant economy into an agro-export economy and income per capita doubled. But external conditions, in the form of price swings and climatological change, increased. Along with the stimulation of a primary export-oriented economy based on cotton, soybeans, and meat, the government followed an expansionary policy through external as well as internal indebtedness on behalf of an investment program on public enterprises. The program, however, was highly inefficient and generated serious monetary instability. This policy produced recurrent recessions during 1982–83 and again in 1986. The situation led to the resignation of the government in 1989, and the current administration took power.

The Limited Growth of the Financial Sector from 1980 to 1988

Except for temporary slowdowns in profitability and a rise in the level of nonperforming loans, the economic recessions of 1982–83 and 1986 apparently had no lasting effect on the financial system. For instance, in 1982–83 the nonperforming loans of the banks grew from 6.1 percent to 14.9 percent (table 9.2).

The recession increased the risk of default and led to many reschedulings of agricultural credit. Interventions by the supervisory authorities of the Central Bank of Paraguay, however, were limited to two banks, each with limited losses during 1980–88.

One important feature was the unfavorable anticipation of the local currency devaluation by the banks in 1982–83. After more than two decades of fixed exchange rates (figure 9.1), the real exchange rate dropped by 140 percent in the first half of the 1980s, causing high losses to the banks. Since 1986, however, the rate has been quite stable, and by the end of the decade banks again assumed external liabilities.

Since 1973, banks had been allowed to accept dollar deposits from the public and the deposit rates were freely negotiated between banks and clients, though these rates were usually lower than the international rates, and the banks channeled the funds abroad to earn higher interest rates. The branches were allowed to use resources from parent banks abroad to grant dollar denominated loans to well-established local exporting firms. These policies on capital account liberalization helped Paraguay avoid a financial crisis similar to the Chilean crisis in 1983, when Chile's banks were unable to afford their exchange rates and credit risks on dollar liabiiities.

The substantial expansion of the financial sector during the 1980s was not quite consistent with the level of financial intermediation and savings. For instance, from 1980 to 1988 eight banks were incorporated in to the system, an increase of almost 60 percent, while total banking liabilities and assets decreased in real terms (table 9.3). Indeed, the lower growth rate of deposits and loans increased the overhead expenses of the system because of the larger number of banks. Consequently, this pushed the spread to higher levels, although the official interest ceilings prevented this to a certain degree. The average number of bank employees in 1991 was 151, whereas the average stock of available domestic resources per bank was US$29 million. This was hardly enough to generate a turnover to pay salaries and bills.

The financial intermediation ratios, which already were extremely low by international standards, decreased sharply during the second half of the 1980s. This resulted in a drop of all monetary aggregates. As a ratio of GNP, M1 decreased from 8.2 percent in 1985 to 7.9 percent in 1988; M2 from 15.4 percent to 12.7 percent; and M3 from 18.9 percent to 14.5 percent. The quasi-monetary saving dropped particularly sharply from 7.2 percent to 4.8 percent for local currency and from 3.4 percent to 1.8 percent for foreign currency (table 9.4). The disintermediation process clearly indicated the growing importance of the informal financial sector. Increasingly banks operated through related nonbanking institutions where reserve requirements were lower and unregistered transactions were easier to perform because of relaxed supervision. The state controlled National Development Bank (BNF) decreased its participation during the 1980s as did commercial banks, while savings and loan associations (SAPV) and finance companies grew. BNF loans fell from 22.6 percent of total domestic resource mobilization in 1981 to 20.9 percent in 1988. BNF's domestic resource mobilization, however, increased from 7.8 percent to 10.2 percent in the same

period (table 9.5). Commercial bank credits were reduced from 70.3 percent to 60.4 percent of the total domestic resource mobilization, although domestic resource mobilization for domestic banks grew from 68.7 to 71.8 percent. Both the BNF and the commercial banks experienced a reduction in credits and resources during 1980–88 compared to credit and resource level in 1975. Conversely, SAPV loans grew from 8.1 percent to 10.9 percent of the total domestic resource mobilization, although the level of resource mobilization decreased. The finance companies also expanded their credit from 0.5 percent to 5.9 percent during 1980–88.

Many local banks and some branches are related to the expanding segments of nonbank financial intermediaries (NBFIs), such as finance companies, SAPVs, credit cooperatives, warehouses, insurance companies, and investment banks. Between 1979 and 1988, nineteen finance companies came into existence, each operating with an average of ten employees (table 9.6). The main reason for the increase in intermediation by the NBFIs was the high legal reserve requirements for banks, set at 42 percent for sight deposits, 30 percent for time deposits, and 15 percent for dollar denominated deposits. Meanwhile the SAPVs had a reserve requirement of only 5 percent and the financial companies only 10 percent.

In addition to the reserve requirements, a stamp tax on financial transactions increased the disintermediation process. The tax pushed retail banking and personal loans out of the formal sector. The additional requirements of a minimum asset of 50 percent invested in agriculture, industry, or export financing, and the ceiling imposed on interest rates, played at the same time an important role in this process. A third element was the expansionary rediscount policy of the central bank at subsidized rates.

The local banks are not only financially connected to the NBFIs, but they are also tied to large corporations in the commodity or service sectors constituting a broad economic group. Such an interlocking economic unit is partially self-funding but is also funded by banks and the NBFIs. During the economic recessions, banks had to take over many bankrupt firms that were then merged with the groups. A special case of financially related firms exists in agriculture. The agro-exporting firms and trading firms buying up and transporting crops to silos and warehouses need large amounts of credit to pre-finance their farmers. In many cases the corporations operate as near-banks when they select their clients, although unlike banks they do not assume the total risk. The risk is partially passed on to the NBFIs, commercial banks, or the state controlled banks who, in turn, transfer part of the risks to the central bank through the rediscount facility.

The state controlled BNF, the National Workers Banks (BNT), and some eligible commercial banks offered loans for agricultural activities by rediscounting these at the central bank with subsidized interest rates (figure 9.3). Until the beginning of the 1980s, the BNF had access to abundant external loans from multilateral organizations. But after the international financial crisis of 1982 the central bank provided funds equivalent to almost 80 percent of the loans channeled by the BNF for

commercial crops (cotton, soybeans, wheat, and sugarcane). While the BNF financed planting, the commercial bank took a more active role in the financing of the harvest and pre-export loans. Overall, the commercial banks (including the state controlled BNT) financed approximately 75 percent of commercial agriculture and the BNF financed the remaining 25 percent.

Commercial banks also increased their share of rediscount operations, from 11.5 percent in 1980 to 51.5 percent in 1988. Under these circumstances the banks did not need to augment their intermediation, but they increasingly relied on the rediscount facilities offered by the central bank and channeled them to agro-exporting firms. The mobilization of domestic resources were transferred to the NBFIs, which offer, in many instances, higher and positive real interest rates.

Monetary policy was inadequate to manage the distortions created within this type of financial system. The control of the monetary expansion of all the financial institutions was difficult, not only because of the rediscount facility of the central bank, but also the central bank financed an ambitious public sector investments program that raised the public debt over US$400 million during the second half of the 1980s. To cope with the monetary expansion, the central bank increased the reserve requirements to 42 percent in some cases. This, however, stimulated disintermediation and growth of unregulated and informal institutions, in some cases run by formal financial intermediaries.

Based on a study performed in the 1980s the system as a whole seemed financially sound on the surface because the bulk of the commercial banks appeared profitable and adequately capitalized. Behind this apparent success, however, the limits of financial expansion appeared to be clear. Several factors caused such limits: diminishing financial intermediaton, a concentrated market, inflexible regulations, inefficient supervision, high and differentiated reserve requirements, and indirect taxes on financial transactions. The result was overspecialized institutions for the size of the market and fragmentation in most categories, while a good number of unregulated informed institutions were actually run by financial institutions in the formal sector.

The Policy of Financial Reform, 1989–92

The unstable macroeconomic situation caused by mismanagement and inappropriate policies during the 1980s ended in an internal collapse at the end of 1989, leaving the central bank without international reserves. In February 1989, the new government initiated an unprecedented general economic liberalization accompanied by financial liberalization, supported by the International Monetary Fund and the World Bank. The reform process has been synthesized in four areas: (a) external liberalization involving foreign exchange, current and capital account; (b) internal liberalization concerning interest rate and credit allocation; (c) monetary management; and (d) financial supervision.

External Liberalization

The first measure of financial reform was to abolish the multiple exchange rates and establish a free-floating exchange rate. Since then all operations of the private sector have been channeled directly to the foreign currency market where banks and exchange houses can operate freely. But as long as the public sector's transactions in foreign currencies, including those of the nine public enterprises, were still performed by the foreign exchange desk of the central bank, although at the prevailing market rate, the liberalization did not fully release official control on capital account transactions. The active intervention by the foreign exchange desk of the central bank on both the demand and supply sides resulted in a very powerful instrument of monetary and exchange rate regulation.

Other related measures on current and capital account liberalization soon followed. In July 1989 the external tariffs were fixed at a weighted average of 8 percent.[1] The reserve requirements on dollar deposits were lowered and unified at 15 percent, but it was increased in two steps until it reached 30 percent by June 1992. This was done to unify the requirements between local and foreign currency deposits and to reduce the huge capital inflows during the period. In October 1990 all banks, not just the branch banks, were allowed to mobilize external funds and provide foreign currency loans to exporting firms. By the end of 1992, Congress authorized banks to grant such loans for import-substitution activities by investing their domestically funded foreign currency liabilities.

Internal Liberalization

The second part of the reform process consisted of a series of measures during July 1989 and October 1990 to improve financial intermediation. First, all interest rates on deposits, except the rediscount operation of the central bank, were liberalized. Second, all ceilings on credit interest rates and the minimum portfolio requirements, except for the newly created Certificates of Deposit (CDs), were also discontinued. In July 1989 the central bank authorized the banks to issue CDs at market rates. The CDs were tax exempt and subject to a reserve requirement of only 10 percent. The funds, however, were channeled to the agro-exporting sector. Since January 1990, the financial companies were also authorized to operate in the agro-exporting market. The CDs had to have a maturity of 180 and 360 days, like the rediscount operations of the central bank, which they were supposed to replace.

In October 1990, the central bank relaxed the limitation on investing CDs funds in agriculture, but the rediscount rate was raised to 30 percent, which was the

1 . In July 1992 tariffs were considerably simplified.

prevailing average interest rate for CDs. This rate was lowered in 1991 when inflation rate decreased to the current level of about 18 percent.

Monetary Management

The third part of financial reform concerned the monetary policy on which the central bank from the very beginning received assistance from the International Monetary Fund. Basically, the assistance consisted of the development of financial programming and management of the money and foreign exchange departments. In addition, other important organizational and administrative areas of the central bank also received such assistance.

Since October 1990 the central bank followed a policy to achieve a weekly target of the monetary base through open market interventions and reserve requirements, and to better control the rediscount operation. A policy of budget control and a tax reform in 1992 reduced public sector loans to a minimum resulting in a fiscal surplus in 1990, 1991, and 1992.

In November 1990 the bank introduced issued Letras de Regulacion Monetaria (LRM) to perform open market interventions. The LRMs are exempt from all taxes, have a flexible maturity (average thirty days), and are sold at weekly auctions at an average yearly yield of 18 percent. In January 1992, the money and the foreign exchange desks were unified to form the Open Market Interventions Department to better coordinate the activities of both.

The objective was to equalize the reserve requirements on foreign currency deposits with requirements on domestic currency deposits, by, first, slowly reducing the reserve requirements on domestic deposits to acceptable levels and gradually replacing them with LRMs. In October 1990 the reserve requirements on domestic currency deposits were reduced from 42 percent to 37 percent. Concomitantly, the requirements on CDs were raised from 10 percent to 15 percent, and on the finance company deposits from 5 percent to 10 percent. In July 1991 the requirement of 37 percent was reduced to 30 percent, equaling the requirements on foreign currency deposits in June 1992. Since July 1992, the central bank began to remunerate 50 percent of the reserves at a 10 percent interest rate. In June 1992 the investment and mutual funds were also subject to reserve requirements of 30 percent, to be complied with gradually.

The policy on rediscount operations was to reduce the operations to a minimum level and replace them with bank mobilization of funds through CDs. Further elements of the policy on rediscount operations were to equalize its interest rate to those of CDs and to equalize it with the average yield of the LRMs.

Financial Supervision

The fourth part of the reforms concerned the improvement of the supervision system of the financial system. For this purpose the central bank first increased the minimum capital requirements for banks and finance companies to five times the initial level during October 1989 and April 1991.

In January 1991 the government signed an agreement with the World Bank for a technical assistance program with the following objectives: (a) modernizing and strengthening the supervisory capacity of the central bank; (b) replacing the Central Banking Law and the Banking Law, dated 1941 and 1952, respectively (this was also a main objective of the assistance program approved by the IMF); and (c) developing the capital market, setting up a stock exchange, and increasing the banking capacity to be able to grant long-term loans to the real sector.

The supervisory program consisted of two steps: (a) developing a centralized database for preventive control and risk evaluation; and (b) developing regulations on asset classification based on the international standards on risk evaluation and capital provision. This was designed to improve the solvency and transparency of banks and finance companies. For the first time banks had to evaluate their asset risks at the closing balance sheet of 1992 and afterward. This was subject to capital provision by June 1993.

But the Central Banking Law and the Banking Law were prepared and revised many times, and no version has reached Congress. The critical elements of these laws are the autonomy and the supervisory power of the central banks. But concern has repeatedly caused postponement of the approval of these laws. The Capital Market Law had less opposition and was approved in 1991, creating the National Stock Exchange Commission, which is engaged in developing stock exchange promotion.

The Results of Liberalization

The economic reform and liberalization policy undertaken after 1989 has stabilized inflation, which declined from 44.1 percent in 1990 to 17.8 percent in 1992. The fiscal surplus was 3.4 percent in 1990, 1.5 percent in 1991, and 0.2 percent in 1992, which supported a modest increase in domestic savings and helped in the achievement of monetary targets. Notwithstanding these positive results, the economy entered into a recession in 1991 resulting in lower economic growth rate of 2.5 percent in 1991 and 1.7 percent in 1992 together with an increasing rate of unemployment.

Issues of Stability

The fragility of the monoculture economy took its toll on stability. This is similar to what happened in the 1980s. The policy of stabilization and adjustment that followed after 1989 did not overcome the negative economic effects of the agricultural crisis, caused by a fall of yield per acre because of climatic conditions. There was a 45 percent price drop in soybeans and a 50 percent price drop in cotton during the 1989–92 period (figure 9.2). The unstable prices and the unfavorable climatic conditions led to a credit rationing in the agricultural sector, which, in turn, hampered its diversification. Consequently, financial reform seemed to become a paradoxical choice: on the one hand the financial system needed to be liberalized and modernized to increase domestic saving and to mobilize international finance, but on the other hand the experience so far showed that liberalization would not automatically ensure better levels of financial intermediation and financial deepening in an economic climate characterized by stagnation. On the contrary, the central bank had to expand its old style rediscount during 1992 to prevent a total collapse in cotton and soybean production. Thus, an unstable agrarian economy is not the best climate to liberalize because it demands a policy of diversification to dismantle the structure of monoculture, which, in turn, demands financial assistance.

Many analysts questioned whether the policy of financial liberalization should have gone faster to cope with some of the bottlenecks, or slower to ensure the necessary adjustments in other areas, such as economic diversification. This remains a controversial matter.

Domestic Savings and Intermediation

Gross domestic savings increased from 20 percent of GNP to 25 percent in the 1988–92 period. The change in the national accounting methods since 1991, however, makes these data somewhat unreliable. Notwithstanding, a modest increase in saving may be plausible. Banking intermediation, especially in foreign currency, increased as well, although some illusory effects exist in the ratio of money to GNP to the extent that a rise may reflect less of a rise in deposit and more of GNP stagnation. The rise in banking intermediation has occurred at the same time as a shift of deposits from NBFIs to banking institutions. This shift is explained by two elements: the reduction of the reserve requirements on bank deposits and the increase of those on NBFI deposits; and the virtual elimination of the transaction tax, which makes retail banking attractive again for banks.

Because of a lack of data on broad monetary aggregates, which should include both bank and nonbank deposits, the analysis of financial intermediation centers on three monetary aggregates, M1, M2, and M3, as shown in table 9.4. M1, which includes the current account, increased from 7.9 percent in 1988 to 8.7 in 1992; M2,

which includes all banking savings deposits in local currency, increased from 12 percent in 1988 to 14.4 percent in 1992. In both cases the ratios matched the levels in 1985, which show slow progress in intermediation, that is already low compared to similar economies, especially concerning savings in local currency. M3, which also includes banking savings in foreign currency, increased from 14.5 percent to 22 percent between 1988 and 1992 because of the increase in foreign currency deposits from 1.8 percent to 7.6 percent (table 9.4).

The slight increase of banking intermediation during 1989–92 is the result of a shift in financial intermediation away from the BNF, the SAPV, and the finance companies to the banking system. The commercial banks increased their share of total domestic resource mobilization from 71.8 percent in 1988 to 84.7 percent in 1992, whereas the BNF share decreased from 10.2 percent to 5.1 percent, the SAPV share from 14.4 percent to 8.0 percent, and the finance companies' share from 3.6 percent to 2.0 percent over the same period.

The Credit Expansion

Following the increase in the level of financial intermediation, the banks increased loans to the private sector. from 11 percent of GNP in 1988 to 17.2 percent in 1992. This is above the level reached in 1985 (table 9.4). This reflects not only the increased banking intermediation but also the adjustment on public sector expenses, which reversed the crowding-out effect experienced by the Paraguayan economy during most of the 1980s. As a result the banking system expanded steadily, incorporating six new banks (one branch and five local banks) between 1989 and 1992 (table 9.1). The financial companies expanded as well with some twenty new institutions during 1989–92. Many of these finance companies were operating illegally and requested official authorization to conduct their business.

The striking result of the growth due to liberalization is the change in credit flows away from development loans for primary and manufacturing activities to consumer loans, such as personal loans, retailing activities, and housing. The share of development loans decreased from 32 percent of total loans in 1988 to 22 percent in 1992, whereas the share of consumer loans increased from 49 percent of total flow of loans in 1988 to 63 percent in 1992 (table 9.7). The declining trend in the flow of funds to the real sector during 1989–92 was especially strong in the core activities of the economy, namely soybean and cotton cultivation.

An important reason for the increase of loans channeled to retailing activities and housing could be the overvaluation of local currency due to an inflow of short-term capital to the economy. This capital inflow reduced relative prices of nontradables (construction, services, and imported goods) against those of tradables (exports and import substitution goods).

The decrease of loans to the core activities during 1991–92 is similar to what happened during the economic recessions in 1982–83 and 1987. Thus, the situation will probably settle when the agriculture recovers. A review of the evolution of interest rates, however, shows that the reduction in real terms is somehow contradictory to the reduction of credits channeled to core activities.

The increase of loans for exports was either because of the agrarian crisis, or because international banks refused to finance Paraguayan exports while the accumulation arrears in the external debt was so great. (The external debt was not serviced until the end of 1992.) Another reason for the strong rise in export financing was primarily because of the policy of external liberalization.

Nominal and Real Interest Rates

Nominal interest rates sharply increased in 1990, the year all ceilings on rates were dismantled. This mainly reflected the rise of inflation rates from 28 percent in 1989 to 44 percent in 1990 (table 9.8). After the fall of the inflation rate to 12 percent in 1991, the interest rates decreased as well, but for the first time stabilized at positive real levels. The difference between commercial, housing, and development interest rates is still notable, reflecting the segmentation of the market. Real interest rates of the commercial banks were around 15 percent in 1991, and those of the finance companies were about 28 percent. Development rates were slightly lower, because of the rediscount facilities of the central bank. Deposit rates in 1991 were also positive for the first time, especially for CDs, which yielded 5 percent in real terms. During 1992 the nominal commercial rates increased from 27 percent to 30 percent. Because the inflation rate increased from 12 percent in 1991 to 18 percent in 1992, the real commercial rates decreased by about 3 points. The nominal CDs rates increased from 18 percent to 20.6 percent, and their real interest rates also remained at positive levels.

Although most nominal rates were reduced in 1991, and real rates were reduced in 1992, the level of real rates is still above 10 percent. This is high when compared to international standards. Notwithstanding the measures regarding external liberalization and free market entry, the internal rates did not show a clear tendency toward equalization with international interest rates until now. The expectation is that the regularization of the arrears of external debt will reduce the country risk, and internal and external real interest rates will begin to equalize.

The Limits of the Reform

The reduction of the flow of funds to core activities has reduced the political support for continuing policies of financial reform, designed to allow banks to mobilize funds through CDs and to channel these to core activities, such as cultivating and

harvesting soybeans and cotton. This, in turn, should have allowed the central bank to withdraw gradually from its involvement in development financing by adjusting its rediscount rate to positive real levels.

The policy of steadily augmenting the rediscount rate, however, prevented banks from making use of the rediscount facility. Thus, total commercial banking loans subject to rediscount (soybean, cotton, wheat, sugarcane) fell from 40.5 percent in 1989 to only 4 percent in 1992 (table 9.9). As a result, rediscount loans from the central bank to agricultural activities have declined steadily as a percentage of total rediscountable funds from 48 percent in 1989 to 21 percent in 1990. The banks, instead of mobilizing local currency funds through CDs, had more success in attracting foreign currency deposits and channeling them offshore or toward consumptive activities. The real flow of funds from commercial banks to the plantations declined from 1989 onward, because the banks invested their assets in less risky activities, such as export financing, which in 1992 received twice the funds it received in 1989 (table 9.9)

Under these circumstances the central bank has maintained its involvement in rediscount operations. The real flow of funds from the state controlled BNF to the core activities remained stable during these years and were financed mostly with rediscount loans from the central bank as in the 1980s. Rediscount operations resumed in 1992 when the government decided to expand these operations because of the bank's unwillingness to take over the credit market for commercial farming activities. Apparently the central bank was not prepared to assume the risks. Or another explanation could be credit aversion by the banks when clients reach a certain upper level of risk.

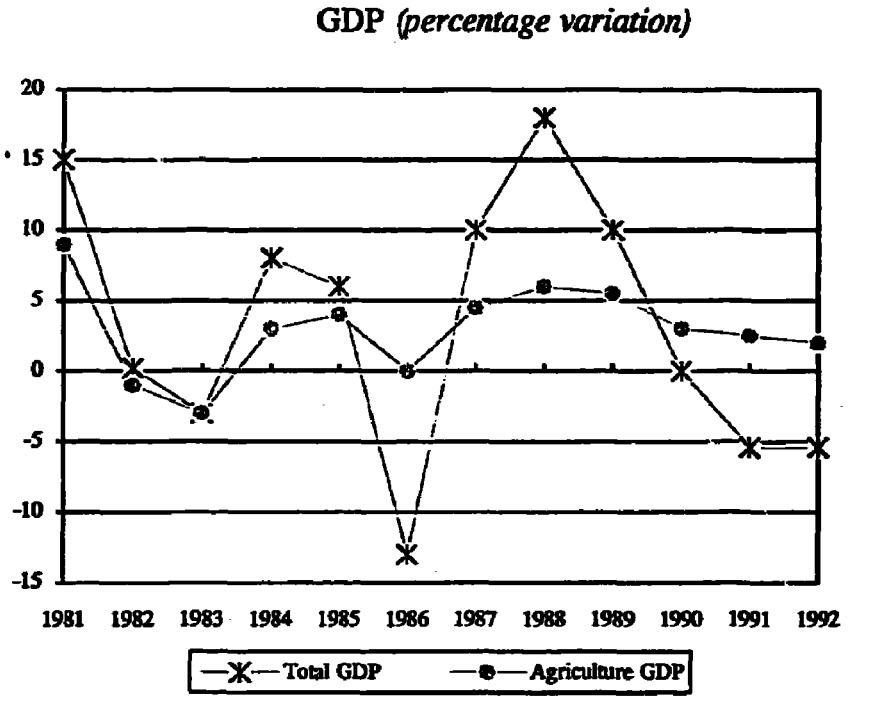
External liberalization allowed banks to increase their foreign currency loans to local firms, which increased their participation in total commercial bank loans to the private sector from 6.0 percent in 1989 to 18.6 percent in 1992 (table 9.10). Foreign currency flows augmented the total flow of funds from commercial banks to the core activities from 30 to 35 percent for cotton and 40 to 50 percent for soybeans in 1988–90, and to 50 percent for cotton and 60 percent for soybeans in 1991–92. These funds, however, are limited to the segments that earn foreign exchanges; thus, they do not really reach the farmers. This means that foreign currency loans are used mainly for the harvest season and less for the cultivation season.

To conclude, the rediscount operations are still of fundamental importance but do not support objectives of financial reform to develop a competitive financial market that would be able to intermediate between domestic savings and investment, especially in core activities. The major resources generated by liberalization through increased domestic saving, however, did not flow to core activities of the economy, especially to farming activities. Rather, the flow was directed toward consumer financing. Therefore, the financial system still relies on central bank rediscount operations that are channeled basically to the BNF at negative real interest rates. The BNF in turn

channels them to farmers or agro-exporting firms at slightly positive real rates of 4 percent. The agro-exporting firms pass the funds further down to the farmers or to commodity intermediaries (firms buying up and transporting crops) at real interest rates of about 17 percent. Finally, many farmers get the loans from the intermediaries at real rates that reach as high as 57 percent (figure 9.3). This system has large overhead costs for the financial intermediaries, is quite expensive for the farmers, and lacks the necessary transparency to be competitive.

The need to reform this system is not only important for the intermediation process but also has significant importance for the central bank, which is engaged in monetary targeting. Instead of being the first lender of the economy, it should assume the role of the lender of the last resort, but as long as domestic savings do not flow to the needy sectors, the current system must remain operational. The limits of the reform financial system have not yet resulted in a slowdown of credit expansion, nor are there open financial tensions at present that could lead to crisis. The reform process, however, has stagnated, and a decision on central issues is needed to redesign a system that is appropriate for an unstable agrarian economy at an immature stage of economic diversification. Decisions have not yet been made to begin such a process. To a certain extent it may be concluded that financing economic diversification is a precondition for stabilizing the economy and developing a system based on a liberalized financial system.

Figure 9.1. *GDP, Inflation, 1981–92*



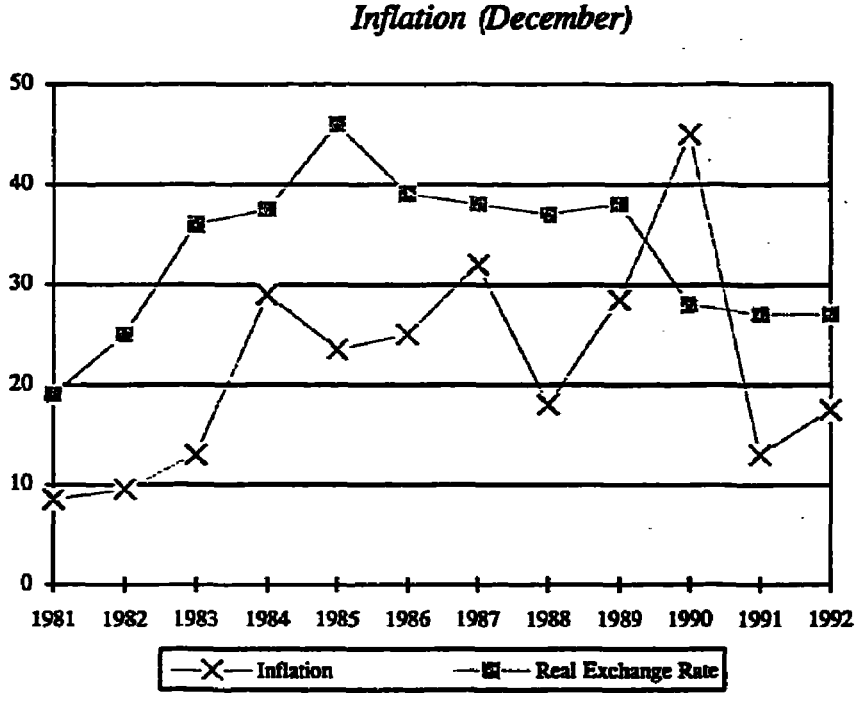


Figure 9.2. *Cotton Prices and Yields, 1981–92*

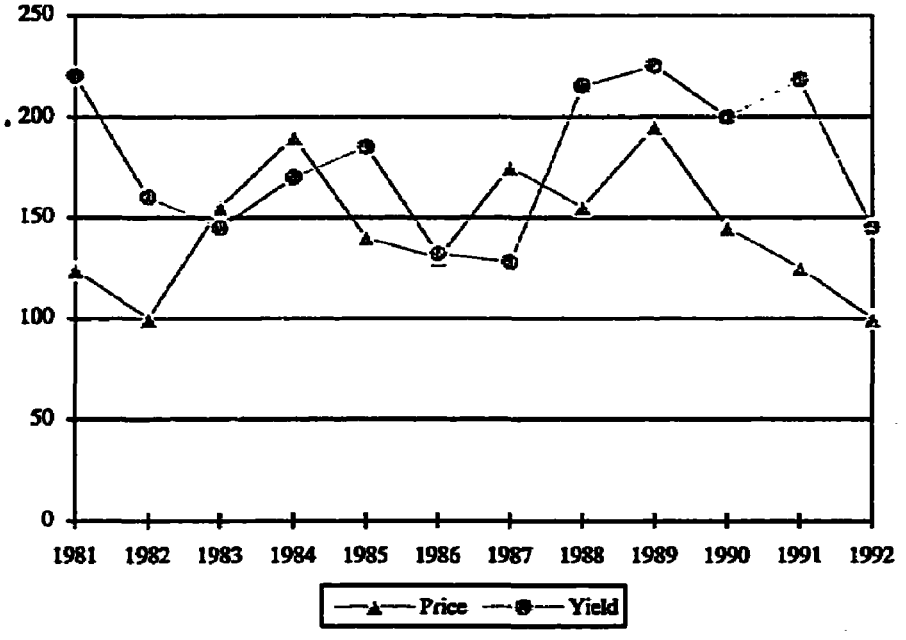


Figure 9.2. *(continued) Soy Bean Prices and Yields, 1981–92*

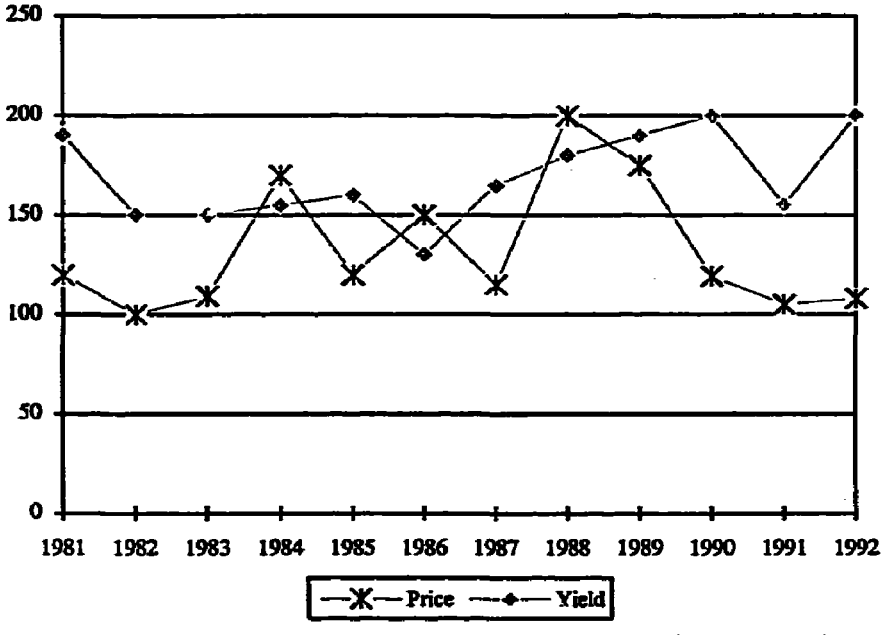


Figure 9.3. *The Process of Financial Intermediation in Agriculture*

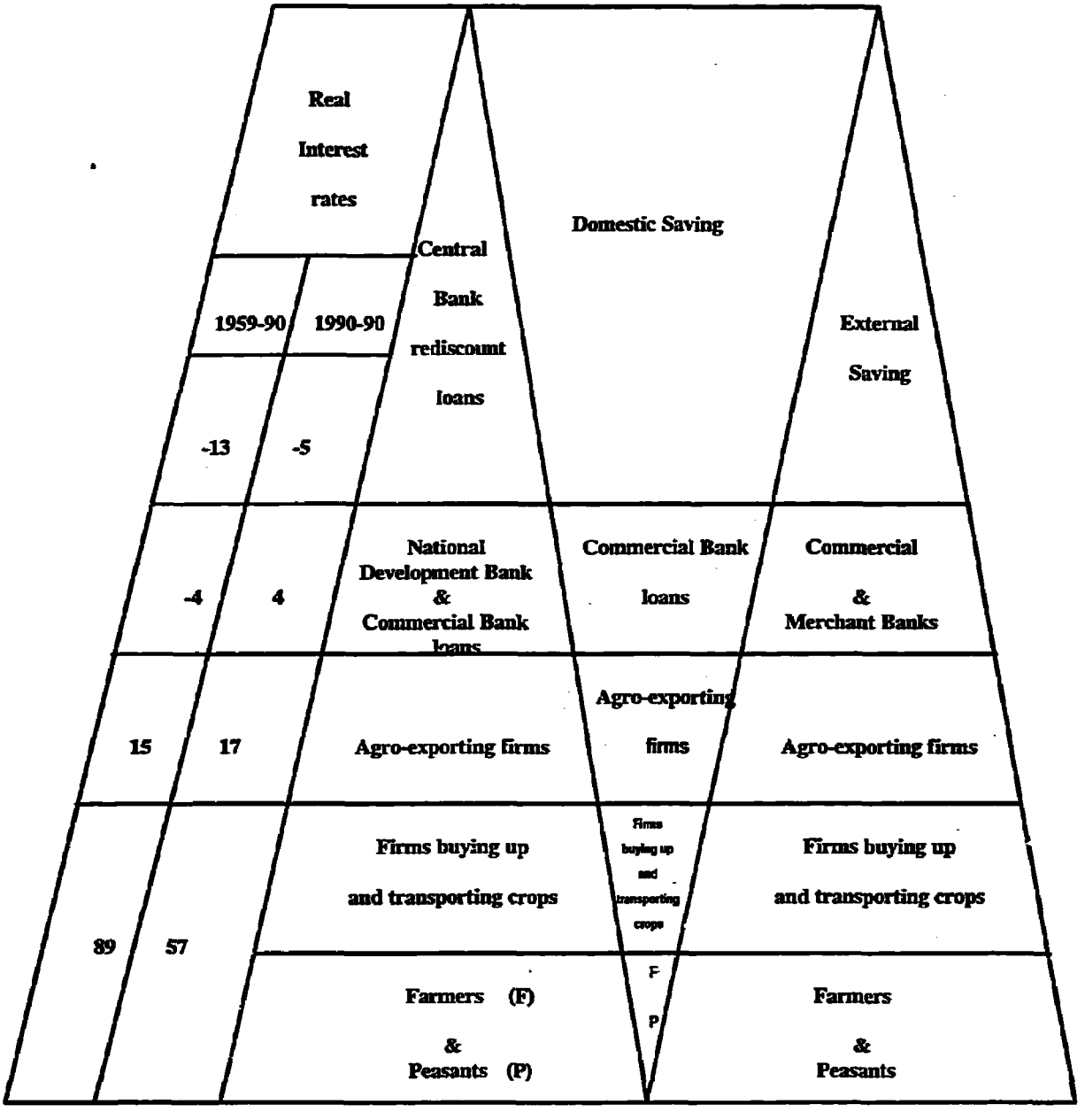


Table 9.1. *The Paraguayan Banking System, 1992*

Branches	*Parent banks*	*Country of origin*	*Year founded*	*Branches*	*Employees*
		Foreign banks			
Citibank N.A.	Citicorp	E.E.U.U.	1958	7	110
Asunción S.A.	Bco. Central S.A.	Spain	1964	13	164
LLoyds Bank PLC	LLoyds Bank	U. Kingdom	1920	8	128
Interbanco S.A.	Bco. Nacional S.A.	Brazil	1978	3	87
Holandés Unido	Algemene B. Neder L.	Netherlands	1965	3	98
Do Brasil S.A.	Bco. do Brasil	Brazil	1941	1	92
Real del Par. S.A.	Bco. Real	Brazil	1974	2	72
Sudameris S.A.	Banque Sudameris	France	1961	5	113
Nación Argentina	Bco. Nac. Argentina	Argentina	1942	3	93
Exterior S.A.	Bco. Exter. de España	Spain	1961	2	66
1Paraná S.A.	Bco. do Est. de Paraná	Brazil	1980	5	158
BANESPA S.A.	Bco. do Est. de S. Paulo	Brazil	1977	1	52
I.N.G. Bank	I.N.G. Bank	Netherlands	1992	1	22
Subtotal				54	1,255
		Local private banks			
Unión S.A.		Paraguay	1978	21	270
General S.A.		Paraguay	1987	11	157
Continental S.A.		Paraguay	1980	10	119
Corporation S.A.		Paraguay	1987	3	101
Inversiones S.A.		Paraguay	1984	11	242
Desarrollo S.A.		Paraguay	1971	2	75
Finamérica S.A.		Paraguay	1988	7	98
Alemán Paraguayo S.A.		Paraguay	1989	2	67
Bancopar S.A.		Paraguay	1981	12	157
Paraguayo Oriental S.A.		Paraguay	1988	3	104
Unión S.A. de Inv. y Fom.		Paraguay	1990	5	160
Regional S.A. de Inv. y Fom.		Paraguay	1991	4	45
Bancosur S.A. de Inv. y Fom.		Paraguay	1992	1	39
Subtotal				92	1,634
		Public banks			
National Development Bank		Paraguay	1961	47	935
National Workers Bank		Paraguay	1975	12	180
Subtotal				59	1,115

Source: Central Bank of Paraguay, Superintendency of Banks.

Table 9.2. *Nonperforming Portfolio of Commercial Banks, 1981–92*

Category	*1981*	*1983*	*1985*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*
				Billions of guaranies					
Nonperforming loans	6.6	19.2	18.2	12.9	11.4	17.3	13.6	24.0	41.3
Total portfolio	107.5	129.0	165.4	254.7	325.5	608.8	525.5	853.2	1,198.4
Loan loss provision	1.0	2.3	2.8	3.0	2.5	4.3	5.0	8.2	11.8
				Percentages					
Nonperforming/total	6.1	14.9	11.0	5.1	3.5	2.8	2.6	2.8	3.5
Loss prov/nonperform.	15.2	12.2	15.6	23.2	21.6	25.1	36.5	34.1	28.7

Source: Central Bank of Paraguay and World Bank estimates.

Table 9.3. *Consolidated Balance Sheet of the Banking System, 1981–89*
(billions of guaranies, 1980 constant prices)

Assets and Liabilities	*1981*	*1985*	*1987*	*1988*	*1989*	*1990*	*1991*
ASSETS							
Liquid assets	13.3	10.2	8.3	11.4	40.1	35.2	30.6
Reserv. W/central bank	45.4	38.1	50.4	45.4	44.7	37.7	38.1
Net loans	96.6	79.0	82.1	83.8	94.2	94.1	94.5
a) Loans	98.9	81.7	84.4	85.3	96.0	95.7	95.4
(i) In operation	89.2	69.5	78.3	81.3	90.9	90.4	92.7
(ii) Nonperforming	9.6	12.2	6.0	4.0	5.0	5.2	2.7
b) Minus: loan loss provision	(2.2)	(2.7)	(2.2)	(1.4)	(1.7)	(1.5)	(0.9)
Building and equipment	2.6	1.7	936	2.9	2.7	3.6	5.2
Other assets	11.7	15.2	10.0	7.3	9.1	11.6	9.2
TOTAL ASSETS	169.7	144.3	151.9	151.0	191.0	182.5	177.7
LIABILITIES							
Deposits	101.8	84.2	94.0	89.1	121.5	118.7	135.4
Borrowed funds	25.3	29.8	27.8	31.3	32.5	27.4	12.6
Other liabilities	13.2	11.2	10.4	9.4	11.6	9.8	6.2
Total liabilities	140.4	125.3	132.3	129.9	165.6	156.1	154.3
Capital and reserves	24.3	20.1	19.0	18.5	23.1	24.2	20.2
Profit and loss	2.6	77.9	1.5	2.1	1.3	2.5	2.6
Net worth	29.3	19.0	19.5	21.0	25.3	26.4	23.4
TOTAL LIABILITIES	169.7	144.3	151.9	151.0	191.0	182.5	177.7

Source: Central Bank of Paraguay, Superintendency of Banks.

Table 9.4. *Indicators of Financial Intermediation Banking System Liabilities and Assets*
(percent of GDP)

Monetary aggregates	*1985*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992**
M 1	8.2	8.5	7.9	8.1	7.6	7.5	8.7
M 2	15.4	14.0	12.7	12.9	12.1	12.8	14.4
M 3	18.9	16.8	14.5	17.2	17.5	18.5	22.0
Financial saving	10.6	8.3	6.6	9.0	9.9	10.9	13.7
Local	7.2	5.5	4.8	4.7	4.5	5.2	6.1
Foreign	3.4	2.8	1.8	4.3	5.4	5.7	7.6
Bank credit to the private sector	13.2	12.0	11.0	10.8	12.1	15.3	17.2

* Preliminary.
Source: Central Bank of Paraguay.

Table 9.5. *Size of Financial Intermediaries, Selected Years*
(Percentage of total domestic resource mobilization)

Financial intermediaries	*1975*	*1981*	*1985*	*1988*	*1989*	*1990*	*1991*	*1992**
National development bank								
Liquid assets	8.7	5.4	5.4	10.2	5.6	5.5	3.9	4.8
Credit	52.9	22.6	22.7	20.9	21.8	22.1	14.6	11.5
Domestic resource mobilization	14.8	7.8	7.6	10.2	6.3	7.4	4.2	5.1
Other net	46.8	20.2	20.5	20.9	21.1	20.3	14.3	11.2
Commercial banks								
Liquid assets	43.2	35.4	45.6	36.5	36.8	30.7	42.9	46.1
Credit	70.3	72.3	57.6	60.4	68.0	79.2	60.5	62.3
Domestic resource mobilization	73.8	68.7	71.9	71.8	75.6	76.7	85.3	84.7
Other net	39.6	39.0	31.2	25.1	29.2	33.3	18.1	23.7
Savings and loan association								
Liquid assets	3.3	4.6	2.4	2.2	2.2	1.9	2.9	2.0
Credit	8.1	16.1	11.3	10.9	11.0	11.1	5.9	5.5
Domestic resource mobilization	10.8	21.1	16.9	14.4	14.0	13.8	9.2	8.0
Other net	0.6	-0.4	-3.2	-1.2	0.8	-0.8	-0.6	-0.6
Private development banks								
Liquid assets	0.2	0.0	0.4	0.7	0.6	0.8	0.6	0.0
Credit	3.6	0.8	0.8	1.1	1.1	1.8	1.0	1.1
Domestic resource mobilization	0.3	0.0	0.0	0.1	0.3	0.6	0.0	0.0
Other net	3.6	0.8	1.2	1.7	1.4	2.1	1.3	1.4
Finance companies								
Liquid assets	0.0	0.4	0.4	0.5	0.6	1.1	1.0	0.0
Credit	0.5	7.6	6.8	5.9	5.6	6.2	4.7	5.4
Domestic resource mobilization	0.3	2.4	3.6	3.6	3.8	1.6	1.0	2.0
Other net	0.2	5.6	3.6	2.8	2.4	6.3	4.6	3.8
Total								
Liquid assets	55.4	45.7	54.1	50.0	45.7	40.1	51.1	53.8
Credit	133.4	119.5	99.1	99.3	107.4	121.1	86.6	85.8
Domestic resource mobilization	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Other net	90.8	65.2	53.2	49.3	53.2	61.2	37.7	39.6

*Preliminary.
Source: Central Bank of Paraguay.

Table 9.6. *Summary Information on Finance Companies, 1992*

Finance companies	*Operation beginning*	*Total branches*	*Total employees*	*External audit*	*Loan portfolio examination*
La Paraguaya	1975	0	17	No	No
Corporación	1976	1	29	No	No
F. Paraguaya	1976	0	9	No	No
Rural	1965	0	12	No	No
Urundey	1976	0	11	Yes	No
Cifra	1976	0	12	No	No
El Comercio	1976	0	28	Yes	Yes
Ercole	1976	0	13	Yes	No
Finamérica	1977	0	5	No	No
Finansud	1979	5	33	No	No
Financentro	1979	0	11	No	No
General	1979	0	12	No	No
Chaco	1979	0	7	No	No
Intersifa	1979	3	31	No	No
Paratodo	1979	0	15	No	No
Unión	1979	2	17	No	No
Exterior	1979	0	4	Yes	Yes
Parati	1980	0	18	No	No
Corpus	1980	0	8	No	No
Citifinanciera	1980	0	4	No	No
Asunción	1980	0	13	No	No
Finanzas & Inversiones	1981	1	15	Yes	Yes
Sauce	1981	0	6	No	No
Sudamérica	1981	0	9	Yes	Yes
Financopar	1984	1	21	Yes	Yes
Vencedora	1987	0	12	No	No
Sta. Ana	1987	0	8	No	No
Metropolitana	1989	1	19	No	No
Vanguardia	1989	0	7	No	No
Finexpar	1990	0	8	No	No
Roble	1990	0	6	No	No
Finanban	1990	1	14	No	No
Técnica	1990	0	8	No	No
Empresarial	1990	1	19	No	No
Mercantil	1990	0	11	No	No
Encarnación	1990	0	3	No	No
Cristal	1990	0	5	No	No
Agrofinanciera	1991	0	7	No	No
Estrella	1991	0	11	No	No
Finantrebol	1991	0	8	No	No
Alfa	1992	0	14	No	No
Efisa	1992	0	8	No	No
Agro Amambay	1992	0	4	No	No
Capital	1992	0	11	No	No
Familiar	1992	0	6	Yes	Yes
Industrial	1992	0	5	No	No
Itagua	1992	0	5	No	No
El Productor	1992	0	5	Yes	Yes
Total		16	564		

Source: Central Bank of Paraguay, Superintendency of Banks.

Table 9.7. *Bank Credit Extended to Private Sector by Composition, December 31, 1985–92*

Category	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*
				Billions of guaranies				
National development bank	36.1	57.8	77.0	84.5	133.6	157.5	231.0	285.1
Agriculture	29.9	46.5	61.3	58.1	99.1	129.3	176.0	227.3
Live stock	0.6	0.9	1.6	1.9	3.1	3.5	4.3	6.3
Industry	2.9	6.0	7.9	17.1	23.8	17.7	13.2	31.5
Commerce	2.2	4.0	5.5	7.1	7.3	5.3	18.1	13.2
Export	0.3	0.3	0.5	-	-	-	16.2	6.1
Other	-	-	-	0.2	-	1.5	3.0	0.5
Commercial banks	266.2	334.1	462.2	669.1	1,054.2	1,660.5	2,726.7	3,904.4
Agriculture	15.0	81.6	86.0	134.4	227.7	318.5	338.7	317.6
Live stock	9.4	6.4	13.8	22.8	28.4	34.5	63.6	90.6
Industry	50.6	48.9	73.6	83.3	127.5	155.7	267.3	252.3
Commerce	132.2	131.5	208.3	324.1	419.4	722.6	1,024.3	2,044.8
Export	42.0	46.4	57.2	63.0	149.6	329.6	469.2	597.4
Constructions and others	16.7	19.1	23.0	41.3	101.3	99.5	383.4	601.5
TOTAL	302.4	391.9	539.2	753.7	1,187.8	1,818.0	2,957.8	4,189.6
				Percentage share				
National development bank	12.0	14.8	14.3	11.2	11.2	8.7	7.8	6.8
Agriculture	9.9	11.9	11.4	7.7	8.3	7.1	6.0	5.4
Live stock	0.2	0.2	0.3	0.3	0.3	0.3	0.1	0.8
Industry	1.0	1.5	1.5	2.3	2.0	1.0	0.4	0.8
Commerce	0.7	1.0	1.0	0.9	0.6	0.3	0.6	0.3
Export	0.1	0.1	0.1	0.0	0.0	0.0	0.5	0.1
Other	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.0
Commercial banks	88.8	85.2	85.7	88.8	88.8	91.3	92.2	93.2
Agriculture	5.0	20.8	15.9	17.8	19.2	17.5	11.5	7.6
Life stock	3.1	1.7	2.6	3.0	2.4	1.9	2.2	7.6
Industry	16.8	12.5	13.7	11.1	10.7	8.6	9.0	6.0
Commerce	43.7	33.6	38.6	43.0	35.3	39.7	40.7	48.8
Export	13.9	11.9	10.6	8.4	12.6	18.1	15.9	14.3
Constructions and others	5.5	4.9	4.3	5.5	8.5	5.5	13.0	14.4
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Central Bank of Paraguay.

Table 9.8. *Interest Rate Structure, 1989–92*
(financial system rates in annual percentage)

	December			
Rates	*1989*	*1990*	*1991*	*1992*
Deposit rates				
Commercial banks				
Saving deposit (at sight)	11.0	12.0	12.0	10.5
Term deposits				
60 to 90 days	14-18	16.0	13.0	16.6
91 to 180 days	14-18	17.0	12.9	14.0
More than 180 days	14-18	24.0	14.0	13.8
Saving deposit certificates	-	27.0	18.0	20.6
Housing, saving and loan associations				
Saving deposit (at sight)	8-11	8-20	11.5	9.7
Term deposits				
60 to 90 days	14-18	22.0	17.5	16.0
91 to 180 days	14-18	26.0	24.0	22.6
More than 180 days	14-18	30.0	26.0	27.7
Financial institutions				
Promissory notes issued against deposits	13-20	30.0	24.6	25.8
Saving deposit certificates	-	29.0	25.8	28.0
Development banks				
Securities	-	-	16.3	16.3
Loan rates				
Commercial rates				
Commercial banks	28.0	40.0	27.1	30.1
National development bank	28.0	40.0	27.5	32.6
Financial institutions	35.0	42.0	40.2	44.2
Housing rates				
Housing, saving and loan associations	22-30	28-36	29.0	29.0
Development rates				
Commercial banks	28.0	40.0	25.8	28.8
National development bank	22-28	36.0	24.2	25.0
Development banks	28.0	40.0	25.8	28.8

Source: Central Bank of Paraguay.

Table 9.9. *Central Bank Rediscount of Banking System Loans to Export and Agriculture Sector, 1980–92*
(million of guaranies and percentages)

Loans by national development banks (BNF)

	Agriculture		Exports				
Years	Loans	Redis-counted	Loans	Redis-counted	Total loans	Redis-counted by CB	Percent[2]
1980	7,584	6,826	600	401	7,228	1,525	21.1
1981	10,902	9,811	643	431	10,243	2,238	21.8
1982	10,486	9,438	8	5	9,443	7,653	81.0
1983	10,178	9,124	108	7,272	9,197	7,428	80.7
1984	14,574	13,116	559	374	13,491	8,142	60.3
1985	14,414	12,972	161	108	13,081	8,846	67.6
1986	16,977	15,279	103	6,942	15,349	10,583	68.9
1987	18,399	16,559	153	103	16,662	14,012	84.1
1988	14,166	12,749	6	4	12,753	10,165	79.7
1989	19,167	17,250	1	1	17,251	13,121	76.0
1990	18,090	16,281	1	1	16,282	16,274	99.9
1991	19,822	17,839	1,829	1,225	19,065	12,464	65.3
1992[1]	19,386	17,447	570	382	17,830	14,354	80.5

Loans by workers Bank (BNT) and commercial banks

	Agriculture		Exports					Consolidated		
Years	Loans	Redis-counted	Loans	Redis-counted	Total loans	Redis-counted by CB	Percent	Total Loans	Redis-counted by CB	Percent[2]
1980	4,573	4,573	35,045	23,480	28,053	3,214	11.4	35,281	4,739	13.4
1981	5,043	5,043	31,055	20,807	25,850	3,583	13.8	36,093	5,821	16.1
1982	3,797	3,797	18,584	12,451	16,249	2,854	17.5	25,692	10,507	40.9
1983	4,281	4,281	15,618	10,464	14,745	3,977	26.9	23,942	11,405	47.6
1984	4,975	4,975	31,105	20,840	25,815	8,166	31.6	39,307	16,309	41.4
1985	7,256	7,256	20,216	13,545	20,801	17,010	81.7	33,882	25,856	7.3
1986	29,799	29,799	16,958	11,362	41,161	21,604	52.4	56,510	32,187	56.9
1987	25,773	25,773	17,161	11,498	37,271	15,644	41.9	53,933	29,657	54.9
1988	32,733	32,733	15,366	10,295	43,029	22,175	51.5	55,783	32,341	57.9
1989	44,035	44,035	28,930	19,383	63,418	25,657	40.4	80,670	38,779	48.0
1990	44,564	44,564	46,113	30,895	75,460	17,023	22.5	91,743	33,298	36.3
1991	38,139	38,139	52,830	35,396	73,535	6,288	8.5	92,601	18,753	20.2
1992[1]	26,511	26,511	52,205	34,977	61,488	2,476	4.0	79,319	16,830	21.2

1. June - Nov. 30, 1992.
2. Percent of the total agriculture and export portfolio subject to rediscount (products subject to rediscount: soybean, cotton, wheat, sugarcane).

Table 9.10. *Consolidated Loans to the Private Sector by the Banking System, 1988–92*

	December				
Category	*1988*	*1989*	*1990*	*1991*	*1992*
			Billions of guaranies		
Loans in local currency	343.0	466.7	684.9	993.9	1,381.9
Rediscount facilities	93.2	111.1	117.1	112.2	170.2
Deposits	249.8	355.6	477.4	723.0	1,023.3
Mutual funds resources	-	-	90.2	158.5	188.2
Loans in foreign currency (US$)	23.5	29.5	85.0	241.5	315.4
(From which mutual funds resources)	-	-	-	(3%)	(3%)
Total loans	366.6	496.2	769.9	1,235.5	1,697.4
			Percent		
Loans in local currency	93.58	94.04	88.96	80.45	81.42
Rediscount facilities	25.44	22.38	15.22	9.09	10.03
Deposits	68.14	71.65	62.01	58.52	60.29
Mutual funds resources			11.72	12.83	11.09
Loans in foreign currency (US$)	6.42	5.96	11.04	19.55	18.58
(From which mutual funds resources)					
Total loans	100.00	100.00	100.00	100.00	100.00

Source: Central Bank of Paraguay.

10

JAPANESE BANKS, SPECULATIVE BUBBLE, AND BANK SUPERVISION

Takashi Kanzaki, Bank of Japan

I will discuss two subjects based on the Japanese experience: the recent speculative bubble and the Japanese financial system; the framework of on-site examination by the Bank of Japan.

Japanese Banks and the Speculative Bubble

First, let me begin by reviewing the recent fluctuation of asset prices in Japan and the stability of the Japanese financial system. It is true that recent business circumstances surrounding Japanese financial institutions have become increasingly severe. The major reasons for this are: the emergence and collapse of the speculative bubble in asset prices, the slowdown in the Japanese economy, and ongoing financial liberalization in Japan, including liberalization of interest rates, which has raised funding costs and intensified competition among Japanese financial institutions. Of these three reasons, the first one is especially significant.

Emerging Risks

Against the background of the sharp rise in asset prices in the late 1980s, Japanese banks competed excessively with each other, giving first priority to expansion of their banking activities. Consequently, credit, market, and management risks have emerged.

Credit risk emerged as many Japanese banks, in expectation of a continuous rise in land and stock prices, excessively extended real estate loans and real estate secured loans in the late 1980s. In addition, Japanese banks used nonbank financial subsidiaries to expand these loans. Furthermore, in this process of credit expansion, Japanese banks began to pay inadequate attention to credit analysis, follow-up management of loans, and relied too much on collateral. As a result, as asset prices declined, credit risk emerged. Japanese banks' asset quality, especially that of real estate related loans and loans to nonbank financial institutions, has deteriorated since 1990, as can be seen in the increase in nonperforming loans.

Market risk emerged to cover the increase in funding costs due to interest rate liberalization. Many small and medium-size Japanese banks increased investments in high-risk, high-return securities such as stocks, stock investment trusts, and equity-linked structured bonds without adequate knowledge of these assets and a strong asset and liability management. Accordingly, these banks' asset portfolios deteriorated as stock prices declined.

Management risk emerged as the expansion oriented policy of Japanese banks penetrated into the branches, exerted pressures on the staff, and weakened internal controls, thus inducing financial irregularities.

To cope with the emergence of these risks, the Bank of Japan, through on-site examinations and other supervisory tools, has guided Japanese banks to take comprehensive and effective corrective action. In response to the Bank of Japan's supervisory guidance and the lessons from the recent deterioration of asset quality and financial irregularities, Japanese banks are implementing various corrective measures.

Corrective Measures

First, the banks are shifting business priorities from quantitative expansion to enhancement of qualitative elements such as returns on assets. This shift is also due to the requirement to meet the Bank for International Settlements (BIS) capital standard. The plunge in Japan's stock market prices reduced Japanese banks' unrealized capital gains on securities holdings included in Tier-2 capital, thereby exerting negative effects on the BIS capital ratios of Japanese banks. Under such circumstances, Japanese banks are restraining asset growth.

The second corrective measure is the reinforcement of credit analysis function, or a separation of credit analysis sections from business promotion sections. In the process credit underwriting, creditworthiness, and financial conditions of a borrower are to be fully examined by a credit analysis section. Japanese banks, based on the experience of the speculative bubble, have been strengthening credit analysis sections by giving them independent function and authority to reject inappropriate loan applications.

The third measure is the reinforcement of internal controls, including the strengthening of the internal audit system and the dual control system.

The fourth measure is the strengthening of controls over nonbank financial subsidiaries. This is especially important for Japanese banks, because in the late 1980s nonbank subsidiaries of Japanese banks' extended real estate loans at a rapid pace without adequate credit analysis and proper control by the parent banks.

In addition to the above mentioned corrective measures, in my view, Japanese banks should implement three additional measures.

First, Japanese banks should effectively deal with the increase in problem assets. Because of the recent inactive real estate market in Japan, repayment dues have

been increasing in real estate related loans made by Japanese banks and nonbank financial subsidiaries. Also, the liquidation of collateralized real estate has been lagging. In this situation, Japanese banks, based on the principle of self-responsibility, should effectively handle problem loans by employing all possible measures, such as establishing a task force or a special division to collect problem loans and appropriately charge off bad assets.

Second, Japanese banks should promote consolidation. By this I mean that Japanese banks should focus on strategically selected core banking businesses while reducing unprofitable sectors to improve overall profitability. Broadly, consolidation may include bank mergers and acquisitions to enhance efficiency. Through such consolidation, Japanese banks should enhance capital positions as a buffer to absorb potential losses.

Third, Japanese banks should promote the disclosure of banks' financial conditions. Financial conditions of Japanese banks are published through financial statements, including balance sheets and income statements. However, since the quality of assets, in particular the condition of nonperforming loans, is so far undisclosed, it should be gradually disclosed, which will contribute to the enhancement of the market discipline of banks.

The Bank of Japan will continue to closely watch the effectiveness of the corrective measures of Japanese banks and will provide supervisory guidance as needed.

Bank Supervision

Next, I will speak about lessons for bank supervisors. Based on our experience in dealing with the speculative bubble, I believe that bank supervisors should implement the following three methods of bank supervision.

First, bank supervisors need to conduct on-site examinations on a regular and full-fledged basis. The merit of on-site examinations is that supervisors can directly review the overall operations of a bank, in particular, they can thoroughly assess the asset quality. It is essential for bank supervisors to detect problems as early as possible and to take supervisory actions as promptly as possible by conducting regular and full-scope on-site examinations of banks. Moreover, such examinations can help prevent the emergence of systemic risk.

Second, on-site examinations should be conducted at the discretion and judgment of supervisors and specific features of individual banks should be fully taken into consideration. To appropriately supervise banks, the discretion and judgment of supervisory authorities is more important than the mechanical execution of rules and formulas as stipulated in laws and regulations. It is thus necessary for supervisors when conducting an on-site examination to make fair supervisory judgments flexibly,

taking into full consideration the macro-financial situation and the specific features of the bank. Bank supervisors need to take effective and concrete supervisory action based on the actual condition of a bank, after due consideration has been given to corrective measures essential for each bank.

Third, bank supervisors need to conduct examinations on a consolidated basis and closely monitor the financial conditions not only of parent banks but also of domestic and foreign subsidiaries. The bank supervisor should monitor the actual condition of the whole organization of a bank, including its subsidiaries, because the emergence of risk is unavoidable between a parent bank and its subsidiaries.

In response to the globalization of Japanese banks' business activities and the deterioration in the financial conditions of their domestic subsidiaries, the Bank of Japan has recently been promoting consolidated supervision. Putting this in more concrete terms, the Bank of Japan has been strengthening the on-site examinations of the overseas branches of Japanese banks. In the case of large banks, as part of regular on-site examination, the Bank of Japan sends examiners to major overseas branches to examine their asset quality and other financial conditions. In the case of medium-size banks, examination teams are sent abroad four times annually to conduct on-site examinations of the branches of several selected banks in each major financial market.

Furthermore, the Bank of Japan has been reinforcing the monitoring of domestic nonbank financial subsidiaries of Japanese banks. Although the Bank is not authorized to conduct on-site examination of bank subsidiaries directly, it obtains detailed information on the condition of such subsidiaries when it examines parent banks. In particular, since the domestic subsidiaries of Japanese banks have made substantial real estate loans and other loans through funding from their parent bank and also from other banks, the Bank of Japan analyzes the asset quality and other financial conditions of these subsidiaries by obtaining information from the parent banks.

Bearing in mind the emergence of risks and the response of the Bank of Japan and Japanese commercial banks, I will next outline the impact of the recent fluctuation of asset prices on the management of Japanese banks and the Japanese financial system.

The Fluctuation of Asset Prices on Bank Management

Because of the recent decline in interest rates, interest rate margins and, as a result, the operating profits of Japanese banks have been recovering. Thanks to this, most Japanese banks have been able to absorb losses from past due interest and loan charge-offs caused by the recent deterioration of assets. In addition, retained earnings of Japanese banks have greatly improved since the 1980s.

Therefore, the financial risks can be managed by major Japanese banks, and the recent fluctuation of asset prices has not strongly damaged the overall financial system in Japan. The Bank of Japan believes that the banking system will recover from the current situation if the banks effectively implement corrective measures.

I conclude my first subject by touching on the background of the recent speculative bubble from a macroeconomic perspective. The question is why the speculative bubble developed simultaneously in the latter half of the 1980s in major countries, including the United States, the United Kingdom, France, and Japan. In my view, it was partly related to expansionary monetary policies implemented by most industrial countries in the 1980s. However, I think that the most important factor was inflationary expectations for asset prices such as real estate and stocks that provoked speculative transactions of these assets. Borrowers, lenders, and investors expected a continuous rise in asset prices and went to excesses. Such speculative and excessive risk-taking prevailed on a global basis as a result of the globalization of financial and real estate transactions. The most important lesson financial institutions can learn from the recent collapse of the bubble is to find ways to prevent the recurrence of excessive and speculative risk-taking.

On-Site Examination

Next, I will move on to the second subject, namely the framework of on-site examination by the Bank of Japan. In supervising individual banks, the Bank of Japan conducts regular on-site examinations once every two to three years as well as off-site monitoring through day-to-day contact. The basic objective of an on-site examination is to thoroughly review the business condition of the bank being examined and determine whether it is financially sound and to take prompt corrective action if the examination identifies problems so as to protect depositors and ensure the stability of the financial system.

This early detection of problems and prompt corrective measures based on on-site examinations have become increasingly important. This is because the progress of deregulation, globalization, and increase in off-balance sheet transactions have created risks that are increasingly diversified, complicated, and globalized. This is also because credit risk, market risk, and management risk are emerging because of the collapse of the speculative bubble.

In terms of the scope and focus, the Bank of Japan's on-site examination covers all areas of bank activity. Given the limited time for on-site examination, which ranges from two to four weeks, the most important components of on-site examination are: (a) to thoroughly examine asset quality while also considering capital adequacy; (b) to evaluate risk management capabilities; and (c) to evaluate profitability. I will discuss each of these in turn.

Asset Quality

A deterioration in asset quality is the most crucial element in the worsening condition of a bank. In this connection, a survey by the Office of the Comptroller of the Currency of the United States points out that the most decisive factor accounting for U.S. bank failures was the deterioration of asset quality. Evaluation of asset quality is thus the most important part of on-site examination.

More concretely, evaluation of asset quality begins with identifying problem assets, including on- and off-balance sheet items. The Bank of Japan, like the Federal Reserve Board of the United States, classifies problem assets into three categories: loss, doubtful, and substandard. Then the ratio of these classified assets to total assets is computed to evaluate the overall soundness of asset quality. Furthermore, by comparing the capital ratio and the weighted classified asset ratio, examiners evaluate the real financial strength of a bank, problem assets, and the need for additional capital.

In evaluating the severity of a bank's problem assets, it is thus important to assess the implication of the problem of asset quality for financial strength. For example, even when a bank has a high capital to asset ratio of 10 percent, if its weighted classified asset ratio is 10 percent, we judge that the bank's real financial position is significantly weak because the bank's capital position is estimated to be critically impaired by problem assets.

In evaluating asset quality, it is also important to review the concentration of credit extended to any given industry or corporate group. In many cases, such credit concentration leads to a substantial deterioration of asset quality.

Risk Management Capability

The second important component of on-site examination is to evaluate the capability of a bank to manage various risks. The Bank of Japan's supervisory philosophy of risk management is that, based on the principle of self-responsibility, banks themselves should effectively manage risks. During on-site examinations, the adequacy of the risk management framework of a bank is closely evaluated.

In evaluating risk management capability, a wide range of items should be checked against the background of financial liberalization and globalization. Because of this, in 1987 the Bank of Japan distributed a checklist for risk management to all banking institutions, which describes the risks to be managed and the management items to be checked during on-site examination.

Risks studied during on-site examinations cover a wide range from traditional banking risks, such as credit risk and daily operations risk, to market risks, such as interest rate risk, price-fluctuation risk, and foreign exchange risk, and to administrative and other management risks. In summary, risk management capability is evaluated to determine whether a bank effectively controls risks by establishing an

organizational risk management framework, including internal controls, rules, guidelines, position limits, and so on.

Profitability

The third important component of on-site examinations is the evaluation of profitability. This involves measuring the real earnings of a bank after adjusting for windfall gains or losses, and other extraordinary elements; investigating whether financial statements contain any end-of-year window dressing; and forecasting future profits and losses. In addition to these important targets of on-site examination, the Bank of Japan visits some branches to evaluate the accuracy and efficiency of day-to-day business operations and to investigate any financial irregularities By combining all the various evaluations, the Bank of Japan makes an overall evaluation of the examined bank in terms of safety and soundness. If the overall evaluation is unsatisfactory, the bank is classified as a problem bank and is subject to the Bank of Japan's strict supervisory guidance.

Conclusion

I have today discussed various issues concerning the Bank of Japan's supervision of individual banks. The dual mission of a central bank is undoubtedly to stabilize the value of the currency, or price stability, as well as to maintain the stability of the financial system. To accomplish this, it is imperative to appropriately supervise individual banks. But, against the background of increasingly difficult business circumstances surrounding financial institutions, bank supervision has taken on a high public profile in many countries. Therefore, it has become increasingly significant for central banks to secure the safety and soundness of individual banks by detecting problems early and taking corrective measures promptly so as to protect depositors and stabilize the financial system.

In this regard, safety nets, such as deposit insurance systems and the provision of emergency liquidity assistance by central banks, play an important role in securing confidence in the financial system. Safety nets, however, are not a panacea, and they also often encourage the moral hazard problem, as we learned from the experiences of the United States. Thus, such safety nets should work as the very last resort. Authorities should first make every effort to supervise and guide individual banks appropriately. From this viewpoint, central banks in each country should give priority to establish an effective on-site examination framework.

At the seventh International Conference of Bank Supervisors held in Cannes, France, in October 1992, Mr. Corrigan, Chairman of the Basle Committee of Banking

Supervision, said in his address to bank supervisors worldwide that all bank supervisors should hang together or hang separately. By that statement, I think he meant that bank supervisors in each country should unite and coordinate worldwide, otherwise we will be defeated one by one.

I conclude my presentation by saying that the Bank of Japan would like to hang together with all the participants at this seminar to enhance the effectiveness of bank supervision on a global basis.

Table 10.1. *List of Financial Institutions in Japan*[1]

Type		Financial institutions	Number	Examined institutions
Private financial institutions	Japanese banks[2]	City banks	11	11
		Regional banks[3]	64	64
		Regional banks II[4]	66	66
		Trust banks	7	7
		Long-term credit banks	3	3
	Foreign banks[5]		95	94
	Financial Institutions for small business	Shinkin banks[6]	439	354
		Shoko Chukin Bank	1	1
		Credit cooperatives[7]	396	1
		Labor credit associations[8]	48	1
	Financial institutions for agriculture, forestry and fisheries	Norinchukin Bank	1	1
		Agricultural cooperatives	3,432	0
		Fishery cooperatives[9]	1,711	0
	Other financial institutions	Insurance companies[10]	52	0
		Securities companies[9]	209	39
		Securities finance companies	3	3
Government financial institutions		Government banks	2	0
		Government corporations	9	0
		Postal savings	1	0
		Others	2	0
Total			6,558	651

1. As of June 1992.
2. Member Banks of the Federation of Bankers Association of Japan.
3. Member Banks of the Association of Regional Banks.
4. Member Banks of the second Association of Regional Banks.
5. Includes foreign trust banks.
6. Includes Zenshinren Bank.
7. Includes National Federation of Credit Cooperatives.
8. Includes National Federation of Labor Credit Association.
9. As of May 1992.
10. As of April 1992.

Table 10.2. *Process of Full Examination—(The Bank of Japan)*

(1) Case of Money Center Banks

(One month before)	Determination of the bank examined, notice to the bank examined, collecting information and data
(Two weeks before)	Pre-study
(The first week)	Start of on-site examination
Mon	
Tue	Interview with the president, executive directors, and department managers
Wed	
Thu	
Fri	
(The second week)	Appraisal of assets
Mon	
Tue	
Wed	
Thu	
Fri	
(The third week)	
Mon	Examination visit to branch offices
Tue	
Wed	
Thu	
Fri	General examination
(The fourth week)	
Mon	
Tue	
Wed	Review
End of on-site examination	
Rating, Reporting and Review	

(2) Case of Regional Banks

(One month before)	Determination of the bank examined, notice to the bank examined, collecting information and data
(Two weeks before)	Pre-study
(The first week)	Start of on-site examination
Mon	
Tue	Interview with the president, executive directors, and department managers
Wed	
Thu	Appraisal of assets
Fri	
(The second week)	
Mon	Examination visit to branch offices
Tue	
Wed	General examination
Thu	
Fri	Review
End on the site examination	
Rating, Reporting and Review	

Table 10.3. *Main Items of Check list for Risk Management*

I. Credit risk

1. On-balance-sheet asset, domestic

(1) Prior assessment
(2) Follow-up management
(3) Country risk analysis
(4) Lending discipline
(5) Computerized supporting system

2. On-balance-sheet, overseas

(1) Country risk analysis
(2) Management of loans made to debtor countries
(3) Assessment of commercial risk
(4) Management of commercial risk and credit security
(5) Global profit management

3. Off-balance-sheet transactions

(1) Disclosure requirements
(2) Restrictions on the borrower concerning the change of business, sales of assets and mergers
(3) Restrictions on collateral and financial ratios and the material adverse change clause
(4) Components constituting default
(5) Management of financial data and authorization

II. Interest rate risk

1. Mismatched Position

(1) Directors and department heads' awareness of the risk
(2) Functions of the ALM (Asset Liability Management) committee and the subcommittee for interest rates forecasting
(3) Installation of database and computerized supporting system for checking gaps
(4) Establishment of gap limits and its authorization
(5) Gap management

2. Dealing in public bonds

(1) Directors' and department heads' awareness of the risk
(2) Organization and system
(3) Establishment and management of position limits
(4) Profit management
(5) Computerized system support

3. Management of securities in the investment account

(1) Directors and department heads' awareness of the risk
(2) Authorization for setting position limits and for the purchase and sale of securities
(3) Management of investments in foreign-currency-denominated securities
(4) Management of investments in bonds
(5) Management of investments in stocks

table continues on following page

Table 10.3. *(continued)*

III. Liquidity risk

(1) Directors' and department heads' awareness of the risk
(2) Funding measures related to the increase in securities positions
(3) Fund management with regard to off-balance-sheet transactions
(4) Countermeasures for credit crunch

IV. Foreign exchange rate risk

(1) Directors' and department heads' awareness of the risk
(2) Organization and system
(3) Establishment and management of position limits
(4) Profit management
(5) Computerized support system

V. EDP risk

(1) Crime and disaster prevention measures and back-up system
(2) System development
(3) System operation
(4) Personnel management
(5) EDP inspection

VI. Systemic risk

(1) Directors' and department heads' awareness of the risk
(2) Management of risks involved in the collective direct credit system
(3) Risks involved in the on-line cash dispense system
(4) Verification of contract provisions related to the participation in large-scale payment system
(5) Organizations and systems involved in large-scale payment system
(6) Supporting system for funds transfer

VII. Daily operation risk

(1) Organization and system
(2) Cash and documents
(3) Management of exceptional transactions
(4) Handling of receivables/payables and special deposit
(5) Measures to prevent troubles with customers

VIII. Management risk

(1) Organization
(2) Internal audit
(3) Management of affiliated companies
(4) Capacity of the management
(5) Quality of employees and training programs

Table 10.4. *Checklist for Credit Risk Management*

	Checklist Items	
Prior Assessment	1. Analysis of management/credit-worthiness of firms and individuals	• Is the bank aware of the managerial performance of the borrower? • Financial analysis based on financial statements and trial balance • Executive administrative ability and health • The use of databases for analysis of a firm
	2. Assessment of business plans, usage of funds and repayment ability of the borrower	• Is the assessment based on the following detailed items, taking business outlook and usage of funds into account? • Investigation on profitability of the plan • Investigation on the usage of funds • Investigation on the borrower's financial resources for repayment • Clear rules for setting the maximum borrowing limit • The use of a fund's allocation table to judge repayment ability
	3. Use of firm ratings	• Is there a uniform standard for assessing business performance such as firm ratings? • Standardized criteria such as the scale, financial conditions, and profitability of the debtor company • Regular reviews of firm ratings
	4. Ability to check commercial bills	• Does the bank have the ability to check customers' requests to discount nonstandard types of commercial bills such as accommodation bills?
	5. Implementation of measures aiming at improving credit analysis ability	• Are organizational measures taken to improve the staff's credit analysis ability?
Follow-up	1. Follow-up system for borrowers of large amounts and borrowers with problems	• Is there a sufficient follow-up system concerning borrowers of large amounts and borrowers with certain problems after loan execution? • Risk management focusing especially on borrowers of large amounts • Paying special attention to the main bank's and other banks' behavior toward the borrower • Investigation of the usage of funds and monthly monitoring of the financial conditions of problem borrowers
	2. Monitoring business performance of borrowers	• Is financial analysis after the loan execution conducted, including that for borrowers with no particular problems? • Investigation on the usage of funds
	3. Investigation of the usage of funds among group companies, family members, and individuals	• Is the usage of funds among group companies, etc. duly recognized after the loan execution?
	4. Support by research section	• Does a research section (including related research companies) collect useful information for credit analysis of a firm?

Chart 10.4. *(continued)*

	Checklist Items	
Credit Security	1. Management and reevaluation	• Is credit duly secured agains bankruptcy of the borrower? • Standards properly set for collateral management real estate as collateral • Encouragement of field investigations • Regular reevaluation of values • Awareness of the collateral leeway securities as collateral • Flexible reevaluation in the case of a stock market crash • Monthly reevaluation of stock market values
	2. Investigation of a guarantor's credibility and the reconfirmation of his willingness to be a guarantor	• Same as above (1) • Reconfirmation of intention to be a guarantor and to give security to a third party by giving a commitment on paper • Assessment of asset condition and annual income of the guarantor
	3. Management of loans in arrears and debts which need careful assessment	• Is the treatment of bad debts appropriate? • Clear criteria for the designation of credit which requires careful assessment, and for transferring of matters to the head office • Distribution of a list of loans in arrears to branches • Clear policies established in respect of cases of dishonor and bankruptcy and prompt response to such events
	4. Collecting information on the management of personal loans	• Is information on individuals concerning credit systematically accumulated?

Credit analysis system/ lending discipline	1. Independence of credit analysis/risk management section	• Is independence of credit analysis/risk management section fully ensured? • Is loan promotions section appropriately checked?
	2. Branck manager's discretionary lending authority, maximum amount of loans able to be extended	• Is discretion as regards credit extension delegated appropriately? • Maximum loan amount reviewed every term • Maximum loan amount reviewed in response to the condition of individual borrowers
	3. Power of head office decisions	• Can the head office guide and control branches with clear authority based on its credit analysis ability? • Adequate number of loans to be assessed by each credit analysis manager • Ability and experience of credit analysis manager • Functional efficiency of boards of managing and assessment directors
	4. Follow-up of loan conditions	• Are loan conditions strictly observed • Follow-up conducted through loan condition records?
	5. Violation of lending discipline	• Is there any violation of lending discipline? • Check if any violations including the following have occurred: -request for approval after a credit extension -neglecting to collect written guarantee agreements -credit extended exceeding an officer's discretion -strict management of due dates, few payment delays

11

GOVERNMENT INSURANCE AND FINANCIAL INTERMEDIARIES: ISSUES OF REGULATION, EVALUATION, AND MONITORING

Ross Levine

This paper was prepared after the completion of seminar series and has been included in this publication as background reading. Editor

Establishing appropriate financial sector policies is of paramount importance to policymakers, because financial intermediaries provide services that are necessary for economic growth. If inherent characteristics of the market for financial intermediary services suggest that unregulated markets will inadequately supply these crucial services, then governments have a responsibility to consider interventions to improve the provision of financial services. These government interventions themselves, however, often deleteriously distort the behavior of participants in financial markets, so that a delicate balance must be achieved between interventions that ameliorate market failures and the negative effects of these government interventions. This balance will depend on legal, political, and historical conditions and especially on the abilities of the private and public sectors to monitor intermediaries.

After reviewing why financial intermediary services are essential for economic growth, the paper discusses characteristics of financial markets—often termed "market failures"—that imply that unregulated markets will not produce a socially optimal supply of financial intermediary services. Although unrestricted markets may create mechanisms to ameliorate the negative effects of these market failures, the inherent characteristics of financial interactions plus the institutional, legal, and political arrangements in many countries strongly suggest that these market failures remain important.

The paper evaluates controversial financial policies in terms of whether these policies mitigate the negative effects of these market failures. Specifically, the paper analyzes government insurance of financial intermediary liabilities and regulatory restrictions on the activities of banks in terms of how these financial policies affect intermediary monitoring of firms, private and public sector monitoring of financial intermediaries, financial stability, competition in financial markets, and the availability of financial services.

Each financial policy tends to have positive and negative effects. Moreover, economic analysis alone does not provide unequivocal answers to financial policies regarding government insurance of financial intermediary liabilities or the proper range of powers that should be granted to banks. Country-specific legal, historical, and political characteristics will and should shape financial policy choices. Therefore, selecting a proper mix of regulatory and supervisory strategies to maximize the provision of crucial financial services is not unambiguous. Nevertheless, evaluating financial policies in terms of the issues emphasized in this paper allows thorough analyses of financial policies in any country.

The paper offers some conclusions regarding government insurance of intermediary liabilities and the powers and latitude that should be granted to banks. These conclusions are conditioned on legal, political, and institutional considerations.

Intermediaries and Financial Services

Government supervision and regulation of financial intermediaries need to be reviewed in the context of services provided by financial intermediaries. The pivotal importance of these services in generating economic growth suggests that governments should focus on enacting financial policies, including potentially laissez-faire policies, that encourage financial intermediaries to supply a sufficient quantity of these services.

A basic service provided by financial intermediaries is that they facilitate transactions, so that businesses and individuals can engage in a broader set of mutually beneficial trades; put succinctly, financial intermediaries encourage commerce. Second, financial intermediaries ease the trading, sharing, and pooling of risk, which stimulates more efficient resource allocation and faster economic growth. Third, financial intermediaries mobilize resources from disparate savers. Some worthwhile investments require large capital inputs and some enjoy economies of scale. By agglomerating savings from many individuals, financial intermediaries enlarge the set of projects available to society and thereby enhance economic efficiency and development. Fourth, after researching firms, managers, sectors, and business trends, financial intermediaries invest societies savings. The better financial intermediaries are at obtaining and processing information, the better will be the allocation of capital and the faster will be the rate of economic growth. Finally, financial intermediaries evaluate and monitor firm managers and thereby compel managers to act more in the interests of stock and debt holders than would a disparate group of individual shareholders none of whom would find it worthwhile to undertake the large monitoring costs individually. By facilitating the ability of principal claim holders to monitor managers, that is by ameliorating the principal-agent problem, financial intermediaries encourage more efficient resource allocation. Also, by mitigating the principal-agent problem, financial intermediaries encourage greater diversification, since ownership will not have to be concentrated in the hands of a few owners that find it worthwhile to

monitor the managers. These five financial services are crucial for economic development. Therefore, if there exist fundamental economic reasons why a free market will not adequately and appropriately supply these services, the government should consider interventions in the financial sector to improve economic development.[1]

Reasons for Government Intervention

This section describes inherent characteristics of the activities of financial intermediaries that create a potentially positive role for government intervention in financial markets. Put differently, there exist good economic reasons for believing that free financial markets—financial markets that are unregulated and unrestricted by the government—will frequently not produce an optimal quantity of financial services, so that government supervision and regulation of financial market activities can sometimes improve social welfare. Financial regulations, and financial policies more generally, should be evaluated and compared in terms of whether they ameliorate or aggravate the negative effects of these five market failures. Specifically, financial policies can be evaluated in terms of how they affect the financial intermediaries regarding the degree of financial stability, the degree of competition among financial intermediaries, and the spectrum of available financial arrangements. It is also important to determine how financial intermediaries evaluate and monitor firms, the borrowers; and how the regulators evaluate financial institutions, the creditors.[2]

Financial policies typically involve tradeoffs among these issues. For example, as argued below, government organized deposit insurance schemes often reduce the probability of bank runs while also reducing incentives for depositors to evaluate and monitor banks. Constructing or reforming a financial regulatory regime, therefore, involves a complex process of choosing a mixture of policies that maximizes the provision of financial services. As will become clear, the appropriate mix of policies depends importantly on the efficiency of the country's legal system, as well as on the country's institutional, political, and historical character.

1. Conceptually, any study of the role of government in financial markets owes a great debt to Joseph Stiglitz. This paper relies heavily on Stiglitz (1993). On the empirical and theoretical links between financial services and growth, see Caprio (1994) and King and Levine (1993a,b).

2. The terms "evaluating" and "monitoring" should be interpreted broadly to include assessing the quality of management, the performance of the intermediary, the accuracy of disclosed information, the connections between management and firms or other intermediaries, the quality of the business plan, and changes in the character of the intermediary without the consent of creditors.

Externalities in Monitoring and Allocating Resources to Firms

Financial intermediaries are heavily involved in evaluating firms before they invest in firms. Furthermore, intermediaries monitor firm managers after funding the firm. These evaluation and monitoring activities are valuable and costly to undertake. These activities are also easily observed by other investors or intermediaries, who can use and benefit from these evaluation and monitoring activities without paying for them; expenditures by one financial intermediary on selecting firms and monitoring managers create external benefits for other investors and financial intermediaries. Thus, unless the financial intermediaries that actively evaluate and monitor can design mechanisms to internalize all of the benefits that accrue to these information gathering activities, the externality associated with monitoring firms implies that financial intermediaries will provide a socially suboptimal amount of evaluation and monitoring services since private returns are lower than the social returns.

Inadequate evaluation and monitoring will have negative economic implications for four reasons.

- First, suboptimal evaluation and monitoring by intermediaries of firms imply that resources will be allocated on the basis of a socially suboptimal amount of information about firms.

- Second, suboptimal evaluation and monitoring of firms provide management with excessive independence from firm creditors and hinder the efficient allocation of resources.

- Third, suboptimal evaluation and monitoring of firms may deter investment by potential creditors and thereby retard economic growth.

- Fourth, to the extent that the principal-agent problem is not mitigated by financial intermediaries, firm ownership may become more concentrated (to ease the principal-agent problem) than it would be in the presence of sufficient monitoring services. This could hurt economic efficiency by reducing diversification.

An unregulated market may create methods for internalizing some of the externalities associated with financial intermediary monitoring of firms. For example, a firm may pay higher fees and interest rates to financial intermediaries that carefully monitor the firm if the firm believes that this monitoring will be observed by financial market participants and thereby enhance the firm's access to capital markets and other

intermediaries.[3] Through this market mechanism, intermediaries that carefully evaluate and monitor firms will internalize more of the social benefits of this information gathering activity and thereby reduce the undersupply of financial intermediary monitoring of firms. Nonetheless, externalities associated with monitoring firms are unlikely to be eliminated, so that financial institutions will tend to undersupply evaluation and monitoring services. Even more important for the purposes of establishing a useful analytical framework, financial policies may affect the incentives and ability of financial intermediaries to evaluate and monitor firms. Thus, analyses of financial policies should consider the effects of financial policies on incentives to monitor firms even in the absence of preexisting externalities.

Given the economic importance of financial intermediary evaluation and monitoring of firms, the effects of financial policies and regulations on incentives for intermediaries to research and monitor firms should be part of the "checklist" of issues to be taken into consideration when evaluating the pros and cons of financial policies.

Two straightforward, though often unachieved, policy strategies for enhancing financial intermediary monitoring of firms are worth noting here. First, make it easier for the private sector to evaluate and monitor firms. Information disclosure laws, competent accounting standards, standardized and transparent financial reporting forms, and an efficient corporate legal system that make the ownership, control, and performance of firms more transparent will facilitate the ability of auditors, creditors, rating agencies, and financial intermediaries to evaluate firms. Second, government supervision and regulation can be carefully crafted to enhance incentives and minimize disincentives for sound financial intermediary monitoring of firms.

Externalities in Monitoring Financial Institutions

Monitoring financial institutions also has external effects. It is costly and time-consuming to research and evaluate the condition and prospects of complex financial intermediaries. Also important, expenditures by one entity on evaluating a financial institution often create benefits for other investors, who do not have to pay the research costs. Instead, the market can observe the behavior of investors and agencies that have carefully evaluated intermediaries.

The externalities associated with monitoring financial institutions suggest that, under many sets of institutional arrangements, the market will insufficiently monitor and evaluate financial institutions because the private returns from monitoring are

3. In the United States, borrowers experience abnormally positive stock returns when they announce that they have renewed loans with their banks. These abnormal returns do not materialize for nonbank debt James (1987) and Lummer and McConnell (1989). This illustrates the importance the market gives to bank monitoring of firms.

lower than the social returns.[4] This tendency for insufficient monitoring is exacerbated in the case of financial institutions for at least two reasons: one, financial intermediaries frequently have many small creditors (for example, depositors), so that the incentives for any individual creditor to undertake the expensive monitoring costs are small; and two, it is very costly to evaluate financial intermediaries, so that only very large, sophisticated claim holders would monitor financial institutions. Thus, free markets will likely produce a socially suboptimal amount of monitoring of financial institutions.

Unregulated markets may respond to this dearth of creditor monitoring. For example, in the case of banks, small depositors would be wary of putting their savings in banks in which they did not have confidence. Consequently, banks might respond by designing simple, innovative ways to communicate the safety of their portfolios to savers or create capital structures where financial intermediaries have a few large creditors or owners that are respected by the public and that are expected to monitor the intermediary objectively. While these mechanisms may enhance monitoring, they are unlikely to eliminate the undersupply of private sector monitoring of financial intermediaries. Uncertainty about the objectivity of large creditors and the information communicated by the bank would in most cases still imply socially suboptimal monitoring of financial institutions.

Insufficient monitoring of financial intermediaries can negatively effect economic activity for at least five reasons.

- First, insufficient monitoring will worsen the principal-agent problem of intermediaries, so that financial intermediary managers will not act in the best interests of creditors, and financial intermediary services, therefore, will not be appropriately supplied to the economy. As explained above, an undersupply of financial services will tend to slow the rate of economic growth.

- Second, insufficient monitoring of financial institutions tends to raise uncertainty about financial institutions. This uncertainty will tend to deter investors from entrusting their savings to financial institutions. Increased wariness of financial intermediaries will reduce intermediated savings and investment, and thereby lower the efficiency with which society allocates resources.

- Third, poor information about the management and performance of specific financial intermediaries will make it difficult for savers to evaluate and compare

4. Another way to see that free markets will tend to undermonitor financial intermediaries is to note, that to a significant degree, information about the management and solvency of financial institutions is a public good: many people can have this information at the same time, and it is difficult to exclude others from using the information.

financial institutions and funnel their resources to those financial intermediaries best able to allocate capital efficiently.

- Fourth, insufficient monitoring of financial intermediaries may prevent markets and institutions from arising or severely limit their activities. For example, the mutual fund industry in the United States would probably not have blossomed in the last fifteen years unless investors could easily compare funds and have confidence that there are minimal possibilities for fraud.

- Fifth, insufficient monitoring of financial intermediaries by the market may encourage concentrated ownership (or the emergence of a few large debt holders) of financial intermediaries, so that large owners and creditors find it worthwhile to monitor intermediaries. Concentrated ownership may produce suboptimal diversification and thereby alter the products offered by intermediaries and create incentives for financial institutions to behave generously toward large owners and creditors.

Thus, insufficient monitoring of financial institutions can reduce the provision of financial services and thereby lower investment, reduce the efficiency of resource allocation, and slow economic development.

Consequently, the effect of financial policies on the incentives for private investors and institutions to evaluate and monitor financial intermediaries must be carefully considered in evaluating and designing financial regulations and policies.

In general terms, governments should create incentives for—and be sensitive to financial policies that create disincentives for—self-regulatory agencies and private monitoring arrangements.[5] Legal systems that define and enforce property rights efficiently will help creditors, rating agencies, and other institutions monitor financial intermediaries while also facilitating the emergence and functioning of self-regulatory bodies. Similarly, sound accounting standards and information disclosure laws will facilitate the ability of the private sector to monitor financial intermediaries. If self-regulatory and private arrangements do not adequately monitor financial intermediary activities, the governments should: seek to improve private sector monitoring through legal, accounting, and other reforms; review and reform financial sector policies that are impeding or creating disincentives for private sector monitoring of intermediaries; and help monitor financial institutions directly. Governments often set capital adequacy requirements, monitor the asset quality of intermediaries, establish regulations regarding the liquidity of banks, set limits on large exposures, restrict intermediary financing of intermediary managers, owners, or related parties, monitor trading on insider information, and carefully regulate the entry of new participants. Conducting effective supervision and designing appropriate incentives for self-

5. Regarding incentives for self-regulation of securities markets, see T. Glaessner (1992).

regulation, however, are very difficult. Some of these details will be discussed below. The essential point in the present context is that one critical criterion for evaluating financial policies is how they affect the monitoring of financial institutions.

Externalities in Failure

Failure of an individual financial intermediary may produce negative effects that extend beyond the creditors of that individual institution. There may be contagion: given poor information about the solvency and performance of financial institutions, investors may interpret the financial weakness of one financial institution as a signal of the poor condition of other financial institutions and withdraw their funds from all intermediaries. The potential social costs of this "contagion" are not internalized by individual financial intermediaries when making decisions. Thus, with imperfect information about the financial condition of intermediaries on the part of savers, the social costs of a single financial institution failure will often be greater than the private costs since one failure could reduce saver confidence in other institutions; there will exist external costs to excessive risk taking any single intermediary because of contagion.

Because financial intermediaries stand at the focal point of economic activity, and because they mobilize savings and allocate resources to all sectors of the economy, and form the foundation of the payments system, excessive risk taking by them will have large negative costs:

- First, fears of contagion and financial instability reduce confidence in financial intermediaries and lower intermediated savings and the efficient provision of crucial financial services. This would tend to slow economic growth and impede improvements in welfare.

- Second, contagion disrupts economic activity. For example, bank runs cause banks to demand payment of existing loans and to stop the issuance of new loans, which reduces investment, induces bankruptcies, raises unemployment, and slows growth. In addition, contagion, by inducing a contraction in credit and the medium of exchange, can often disrupt a country's payments system and thereby impede all forms of commerce. Similarly, runs on mutual funds depress assets prices, while runs on insurance companies reduce risk sharing.

- Third, given the pivotal role of financial services, financial intermediary failure on a large scale can negatively influence long-run, overall economic performance by disrupting the flow of financial services. These disruptions are particularly acute in the case of financial institutions, because bankruptcy of financial institutions is different from bankruptcy of most other entities.

> Financial intermediaries are primarily involved in the production, assessment, and dissemination of information. This information capital is not easily transferred. Thus, bankruptcy of financial institutions will entail the loss of a very valuable resource—information—because it cannot be transferred in bankruptcy court. The loss of financial intermediary information on a large scale through bankruptcy will significantly diminish the ability of society to allocate resources efficiently for an extended period.[6]

Thus, if risk taking by individual financial entities has external negative costs because of contagion, governments should be concerned that financial intermediaries will undertake socially excessive levels of risk. Note, individual financial intermediary failures per se will have very positive effects if failure, or the fear of failure, encourages privately organized insurance and crisis management systems, self-regulation, and better monitoring by creditors. The external social costs of an individual financial intermediary failure stem from potential contagion: poor information may induce individual failures to spread to otherwise healthy intermediaries.

The importance of contagion and financial fragility to economic activity suggests that contagion and financial stability should be part of our select "checklist" of issues to consider when evaluating financial policies.

Potential policy (and market) responses to externalities associated with financial intermediary failure fall into four categories. First, governments may enact financial policies that encourage prudent risk taking by financial intermediaries. This may include restricting the activities and investments of financial institutions, establishing high, risk-based capital requirements, and even limiting competition. Second, governments should be wary of tax systems that create incentives for high debt-equity ratios which may enhance enterprise and financial fragility. Third, governments should avoid financial policies that augment the possibility of contagion.

For example, evidence from the United States suggests that financial policies can encourage the proliferation of an excessively large number of underdiversified banks that are more sensitive to economic shocks and less able to organize private insurance and self-regulatory mechanisms effectively and coordinate constructively

6. Evidence in the United States suggests that bank failure, or bank distress more generally, harms client firms because of the intrinsic, though nontradable, long-run relationships that develop between banks and their customers. Increases in the probability that the bank-borrower relationship will be negatively disrupted reduces the share price of the borrower, while the rescue of a bank expected to fail increases the stock price of client firms. See Slovin, Sushka, and Polonchek (1993).

when faced with problems.[7] Fourth, governments may insure investor assets in financial intermediaries to prevent contagion.

Imperfect Competition

There are large fixed costs associated with evaluating firms and monitoring activities. The costs associated with obtaining and maintaining accurate information on firms create incentives for financial intermediaries to establish long-run relationships with firms: intermediaries will be able to recoup the costs of spending resources to acquire and update information over long periods, and firms will be able to access cheaper and more secure financing. Indeed, because information is both imperfect and costly to obtain, a firm's current bank will probably have more information about the firm than other banks, so that if the firm seeks financing from a different bank, this search will probably be viewed as a negative signal about the quality of the firm. Thus, an inherent characteristic of many financial arrangements—the high fixed costs of acquiring and maintaining accurate information—implies that financial markets are likely to be imperfectly competitive.[8]

The optimal degree of competition among financial intermediaries is difficult to specify, so that the direct economic implications of imperfectly competitive financial markets produced by the high costs of acquiring information on firms are difficult to quantify. Insufficient competition and contestability will reduce innovation and efficiency. Similarly, to the extent that imperfect competition creates excessively symbiotic links between financial intermediaries and firms, the objectivity with which intermediaries evaluate firms will deteriorate. By contrast to the extent that an oligopolistic financial system reflects the buildup and maintenance of long-run relationships that encourage an efficient exchange of information and more complete monitoring, then apparently lax competition will reflect good monitoring of firms.

One mechanism for limiting competition is through "franchise" value as explained by Caprio and Summers (1994). By restricting entry, officials can create monopoly profits. These monopoly profits increase the value of having a license, the franchise value, and increases the costs of losing that license through bankruptcy.

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7. For example, Calomiris (1989) notes that in the 1800s many states in the United States prohibited branch banking. This led to the emergence in those states of many, underdiversified banks. The lack of diversification increased exposure to idiosyncratic shocks. The large number of banks made it difficult for banks: (a) to establish private deposit insurance funds with sound monitoring mechanismsand,(b) coordinate effectively when confronted with a drop in depositor confidence. In fact, states that restricted branching suffered more banking failures than states with fewer, better diversified banks.

8. In a free market, sellers are willing to sell to any buyer at a stated price. Because of informational asymmetries, this is not true in all financial markets. All firms cannot borrow from banks at a stated interest rate. Typically, a firm can only borrow from a single bank at a publicized interest rate. Trying to move to another bank involves a costly and risky process of establishing a relationship with new bank.

Consequently, financial policies that increase franchise value tend to decrease competition while simultaneously decreasing risk taking.

Thus, the effect of financial policies on the level of competition must be carefully considered and therefore forms one of our "checklist" items. Supervision and regulation need to balance the negative and positive aspects of competition in the financial sector so as to maximize the efficient processing of information while minimizing arrangements that thwart innovation and encourage excessive risk taking. While easy to say and hard to accomplish, it is a balance that should be kept in mind when evaluating financial policies.

Incomplete Markets

Financial institutions are in the business of obtaining and processing information, but there are informational asymmetries in their business. Information obtained by evaluators is imperfect relative to the information known by the entity being evaluated. Information asymmetries imply that some financial arrangements will be limited or nonexistent-even though these arrangements would exist in the absence of informational asymmetries. The following examples will help clarify this point.

- *Credit rationing*—If it is difficult for banks to obtain accurate information about the riskiness of firms, raising interest rates may cause firms with the safest projects to drop out of the loan market, so that the mix of firms demanding loans becomes more risky. Thus, raising interest rates may cause an adverse selection of firms in the loan market (without changing the management of projects). Banks may then keep interests rates lower than the rate that would clear the market to maintain a safer mix of firms in the pool of firms demanding credit. This low interest rate will produce an excess demand for loans by firms; the adverse selection problem reduces the issuance of loans below what it would be in the absence of asymmetric information.

  If it is impossible to monitor the behavior of firms perfectly, raising interest rates may induce project managers to change their behavior and undertake riskier projects. To mitigate this moral hazard problem, banks may keep interest rates lower than would clear the loan market. Consequently, there will be an excess demand for loans by firms.

- *Equity issuance*—If firm insiders have more information about the firm than outsiders, then the issuance of new shares by insiders will be perceived as a negative signal by outsiders: insiders willing to sell shares to outsiders must think the price is high. This informational asymmetry between insiders and outsiders will discourage the raising of capital through equity issuance and

therefore reduce the usefulness of the stock market as a vehicle for raising capital and diversifying risk.

- *Incomplete insurance*—Insurance creates incentives for the insured to do less to avoid the insured-against event. If information were fully available and monitoring were costless, the insurance agency could prespecify a comprehensive, complex list of actions and behaviors for the insured that would eliminate this moral hazard problem. But, all actions cannot be monitored. Thus, insurers will provide less than complete insurance to enhance the incentives for the insured to avoid the insured-against event. The result is incomplete insurance because of information asymmetries.

  Voluntary deposit insurance schemes will be difficult to organize because of informational problems inherent in evaluating and pricing the riskiness of banks. Good banks may not want to join deposit insurance schemes because they are unsure about the asset quality of other banks; good banks do not want to subsidize bad banks and it may be too difficult and costly to evaluate other banks and set risk-based deposit insurance premiums. This adverse selection problem induces a deterioration of voluntary deposit insurance schemes.

The above examples illustrate cases of incomplete or missing markets that involve a reduction in financial intermediary services from the level of services that would exist in the absence of information asymmetries. Thus, investment and resource allocation may be suboptimal because of credit rationing and built-in incentives against the raising of capital through stock offerings. Similarly, moral problems created by insurance may imply incomplete insurance markets that yield less risk reduction opportunities. Finally, because of adverse selection problems, certain types of private insurance, like voluntary deposit insurance and other self-regulatory insurance schemes may be provided at a suboptimal level.

For these reasons, policymakers should consider the effects of financial policies and regulations on the types of financial contracts and services offered by financial markets to the public.[9]

There are market mechanisms that rely on the legal infrastructure to help reduce these asymmetries and their negative economic effects. Intermediaries and firms build long-run relationships that facilitate information exchange. The ability to use collateral in loan contracts helps extract information from borrowers that reduces informational asymmetries and expands the availability of financial services. Also, efficient legal systems and registries permit creative financial contracting to service the needs of

9. Caprio (1992) analyzes the interactions of financial reform and asymmetric information. He concludes that the long-run relationships that form between financial intermediaries and firms to mitigate informational asymmetries must be carefully considered in designing financial reforms, so that the negative economic implications of asymmetric information are not unnecessarily aggravated by reform.

clients, and sound bankruptcy courts enable intermediaries to seize and dispose of assets of delinquent borrowers quickly and confidently, which further promotes the provision of financial services. Finally, financial systems that allow a single financial intermediary to engage in different financial contracts, like issuing loans and buying equity, may be able to establish relationships with firms that maximize information exchange, thereby reducing the negative effects of asymmetric information. Nonetheless, these informational problems frequently cannot be eliminated.

Market Failures—A Summary

By studying important characteristics of financial markets, two general points emerge. First, from a policy perspective, the existence and economic importance of market failures suggest that governments should consider selective interventions in financial markets. This conclusion is based on the following argument: the market failures analyzed above suggest that free markets will not produce a socially optimal amount of financial services; and these market failures have negative economic implications. Although the market may respond to these market failures by yielding contractual and financial arrangements that mitigate the negative consequences of the five market failures, the inherent characteristics of financial markets imply that some of these market failures are important in all countries.

Second, regardless of the hypothetical importance or unimportance of these market failures in an unregulated environment, countries typically have a complex network of financial policies and regulations. Thus, changes in any particular policy or regulation must be carefully studied. The checklist outlined in this section will help organize analyses of financial policy reforms by providing analysts with a vehicle for comprehensively considering the effects of policy changes on the provision of crucial financial services. Analysts should evaluate whether policy changes on balance aggravate or ameliorate the negative effects of market failures. Specifically, financial reforms should be evaluated in terms of how they affect (a) financial intermediary monitoring of firms, (b) private and public sector monitoring of financial intermediaries, (c) the possibility of contagion and financial stability, (d) the degree of competition, and (e) the spectrum of available financial arrangements.

Insurance and Financial Intermediaries

A basic economic rationale underlying government organized insurance of financial intermediary liabilities stems from externalities associated with financial

intermediary failure (for example bank runs).[10] Government insurance, however, then creates an entirely new economic rationale for further government involvement in the financial sector: government insurance of investor assets in financial intermediaries reduces the incentives for investors in financial intermediaries to monitor the health of those intermediaries and for intermediaries to self-regulate one another to prevent failure and contagion. This tends to increase the incentives for and the ability of financial intermediaries to undertake more risky activities. This is the moral hazard problem.

Frequently, this moral hazard problem cannot be avoided because the public believes that the government would insure their savings in the case of a financial crisis. This expectation alone, even in the absence of explicit government insurance, creates the moral hazard problem, because expectations of government insurance reduce incentives for investors to monitor financial intermediaries. The extent of this moral hazard problem in each country, therefore, depends on public expectations on the role of the government. Since financial sector policy choices depend on the extent of the moral hazard problem, financial sector policies should contain country-specific elements that reflect these differing expectations.

Government Insurance

There are many different ways to organize government insurance. Governments may insure all assets, a percentage of assets, or only relatively small asset holders. The design of insurance schemes may also differ. For example, governments may attempt to charge a market price for the insurance they provide based on the riskiness of particular financial institutions. Or, governments may charge a simple fee that is not market or risk based. Furthermore, governments may require financial institutions to insure themselves with private insurers that are authorized and monitored by the government. The exact nature of the insurance scheme will have important implications for the behavior of financial intermediaries.

For simplicity, first consider complete government insurance in the absence of risk-based premiums or risk-based capital requirements to get the blunt, first-order effects of government insurance on the five market failures defined above, and then broaden the discussion to more sophisticated schemes. This paper, however, does not comprehensively review the design of insurance schemes. It identifies a few features associated with insuring saver assets, noting a key political economy issue associated with insurance, and extracting some important strategic considerations concerning the linkages between insuring saver assets and the expansion of banking powers.

10. Talley and Mas (1993) provide an excellent analysis of deposit insurance. The discussion here draws liberally from their insights.

Contagion and Financial Stability

Insurance of assets in financial intermediaries will tend to reduce the probability that the failure of one institution will spread to other institutions; credible government insurance lowers the probability of contagion. Nonetheless, insurance of intermediary liabilities increases financial fragility by generating incentives and capabilities for excessive risk taking on the part of intermediaries. This is discussed below while considering the effects of insurance on the monitoring of intermediaries.

Evaluation and Monitoring of Intermediaries

The most important consequence of insuring investor assets is that it increases the incentives for risk taking by financial intermediaries, a socially suboptimal monitoring system. If investor assets are credibly insured, they will have fewer incentives to monitor the intermediary, and will provoke risk taking by financial institutions. For example, the capital strength of banks is a way of signaling depositors about the security of the bank. Deposit insurance lowers the benefit of maintaining high capital standards to reassure depositors. Thus, banks with deposit insurance have incentives to reduce capital/asset ratios. Furthermore, banks with deposit insurance have greater incentives to lend to riskier clients than banks with no deposit insurance. Bank owners keep most of the benefits from lending to clients with very risky but potentially high return projects, but if the risks do not pay off and the bank fails, some of the losses will be passed to the government insurance fund. This incentive to gamble with insured deposits is intensified as the capital position worsens. Thus, the combination of greater incentives for financial intermediaries to assume risk and lower incentives for private creditors to monitor financial intermediary behavior implies that government insurance dramatically augments the need for mechanisms to intensify monitoring of intermediaries.[11]

As an aside, it is worth noting that governments can promote better monitoring of financial intermediaries through a combination of mechanisms. Governments can monitor financial intermediaries directly. The government can restrict the activities and investments of financial intermediaries to promote prudent behavior; require intermediaries to hold well-diversified portfolios to reduce exposure to idiosyncratic shocks; review the owners, management, and organization of intermediaries to enhance the soundness of financial institutions; and use risk-based capital requirements and risk-based insurance premiums to create appropriate incentives for intermediaries. Also, governments may insure only small investors, which would maintain incentives for

11. See Dowd (1993).

large investors to monitor intermediaries.[12] Besides direct government supervision and regulation, governments may require and use audits from internationally reputable accounting firms and assessments by rating agencies to engage a diverse network of financial experts to evaluate financial institutions. Furthermore, by increasing the franchise value of insured intermediaries through reduced competition, governments reduce incentives for risk taking and thereby counterbalance enhanced incentives and opportunities for risk taking created by government insurance. Finally, the government can also encourage or even require greater private sector participation in monitoring financial institutions to bolster oversight of financial institution activities. Some aspects of private insurance will be discussed below. The literature on deposit insurance is enormous and advances a myriad of schemes. This paper only mentions a few approaches and focuses instead on the first-order effects of government insurance on financial market behavior. Most important, government insurance tends to reduce private creditor monitoring of intermediaries.

Evaluation and Monitoring of Firms

Government insurance tends to reduce the intensity with which insured financial intermediaries monitor firms.[13] One way in which intermediaries compete for funds is by having a reputation of carefully monitoring the firms in which they invest. Careful monitoring by the intermediary lowers the probability that the intermediary will experience losses. Thus, in the absence of insurance, safe intermediaries should be able to raise funds less expensively than intermediaries who do not monitor firms intensively. Investors with assets in insured intermediaries, however, are less concerned about losing their savings than if these savings were not insured. Therefore, in the presence of insurance, intermediaries have less of an incentive to monitor firms carefully, invest in a diversified portfolio of relatively safe firms, and communicate this information credibly to savers.

Competition Among Financial Intermediaries

Insurance will also influence the level and form of competition. For example, with deposit insurance, depositors view banks as closer substitutes than without deposit

12. Incomplete insurance, however, will not eliminate contagion under all conditions. For example, the best informed and biggest investors may still view imperfect signals of financial weakness in any particular institution as sufficient information to withdrawal funds from other financial institutions.

13. This assumes that insurance premiums and capital requirements are not risk based and that regulations and supervision of intermediaries do not fully compensate for the incentives created by insurance.

insurance. Banks will compete in terms of services and interest rates, but banks will have fewer incentives to transmit information to depositors about the quality of their loans. In the absence of insurance, however, intermediaries would need to convey information about the quality of their assets to attract investors. Insurance may also change the overall level of competition. For example, in an oligopolistic banking system with a few large, well established banks that are able to self-regulate each other and self-organize a deposit insurance system that excludes other banks, the introduction of government deposit insurance for all banks may increase the level of competition for deposits in the system. Thus, it is difficult to draw clear conclusions about the effect of government insurance on the level and form of competition.

Incomplete Markets and Available Financial Services

Mandatory government insurance may be a mechanism for overcoming a market failure. As discussed above, missing insurance markets often exist because of adverse selection: if the costs of acquiring information and monitoring other intermediaries and designing risk-based insurance fees are very high, safe financial intermediaries may opt out of privately organized, voluntary insurance schemes because they do not want to subsidize more risky intermediaries. The existence of a large number of banks, for example, will tend to aggravate the adverse selection problem by making monitoring of banks and coordinating a voluntary, private insurance system more difficult. Thus, voluntary insurance systems will tend to deteriorate when adverse selection is particularly acute, which would not occur with mandatory government insurance.

Political Economy and the Fallacy of Choice

While reducing the potential for contagion, insurance of intermediary liabilities tends to aggravate the suboptimal evaluation and monitoring of insured financial intermediaries. This negative consequence has led some analysts to argue that the costs of insuring investor assets in intermediaries are greater than the benefits, and many recommend abolishing or avoiding government organized insurance. This is typically not an option.

Given the huge macroeconomic implications of financial failure, governments will typically act to prevent individual financial intermediary failures from spreading and becoming systemic failures. Many governments have insured assets when faced with financial failures even in the absence of preexisting commitments and even after stating beforehand that the government would not insure assets in the case of financial failure. Thus, most governments cannot credibly commit to not interfere in the presence of financial failure. The belief by the public that the government insures their

investments creates the moral hazard problem: there is a reduced incentive to monitor financial institutions on the part of the public because people expect the government will insure their assets in the case of failure. Thus, the policy choice between government insurance and no government insurance is generally irrelevant. The more useful concerns are explicit and implicit insurance and the level and design of the coverage.

Different societies expect different levels of government insurance. Some societies expect governments to protect the assets of small savers in banks, others expect deeper coverage (for example, insuring large bank accounts), while some societies expect the government to insure a broader set of institutions such as insurance policies, private pension accounts, and even the returns on investment company assets. The extent of the moral hazard problem produced by insurance is a by product of these expectations and therefore also depends on political and historical ingredients that vary from country to country.

Public expectations about the coverage of government insurance may also change systematically with financial development and even respond to changes in financial policy. Two examples will help illustrate these points. As a country's financial system develops, households may shift their assets out of insured demand deposits into uninsured, relatively unregulated money market accounts. As this shift occurs, public expectations concerning government responsibility toward money market accounts may change. Specifically, expectations may expand to include money market accounts under the umbrella of government insurance. Thus, the understanding between the public and government is critical in designing financial policies, because this understanding, or social contract, between the public and the government concerning what saver assets are insured by the government determines the depth and scope of the moral hazard problem.

Using financial regulation to limit the scope of government insurance is a complex task. For example, some analysts propose the creation of "narrow" banks.[14] These narrow banks would enjoy 100 percent deposit insurance and would be the only institutions tied to the nation's payments system. These narrow banks would also be very restricted and tightly regulated. They could only make loans that were almost risk free; they would not be permitted to assume interest rate risk; and they would face high capital requirements. Thus, households would have a safe place to save with correspondingly low returns. If savers seek higher returns, they could invest in uninsured financial institutions. This would limit the moral hazard problem created by insurance, because the intermediaries receiving government insurance would be tightly restricted and supervised. One problem with this scheme is that it may not be compatible with public expectations. While in some contexts the population may adjust its expectations of the scope of government insurance to this new regulatory structure, this may not occur in all countries. For example, savers may believe the government

14. See the discussion and citations in Talley (1993b).

would also insure intermediaries that are not narrow banks if faced with a financial crisis. This expectation would lower incentives of private creditors to monitor non-narrow bank financial intermediaries carefully. Thus, the narrow bank scheme may not control the moral hazard problem.

One generic conclusion that emerges from this analysis is that in countries where relatively broad and deep coverage of financial assets under the umbrella of government insurance is expected, there will be correspondingly greater undersupply of monitoring of financial intermediaries by investors. Therefore, the greater are public expectations of a government safety net, the greater is the need for financial policies that strengthen incentives for monitoring of insured intermediaries.

Government Insurance: Implicit or Explicit?

Authorities could forgo a formal government operated insurance system. Instead, the government could intervene following a financial failure. This "implicit" insurance has been used in many countries. It must be emphasized, however, that implicit insurance does not avoid the moral hazard problem created by public expectations of government insurance; using implicit instead of explicit insurance does not circumvent the reduction in monitoring of intermediaries by creditors created by public expectations of government insurance. Implicit insurance provides flexibility in terms of the amount and form of protection since preexisting rules and procedures restrict decisionmaking. Nonetheless, on balance, explicit insurance generally has advantages over implicit insurance.

Implicit insurance will often not offer the same stability as explicit insurance. Implicit insurance implies ad hoc, unsystematic procedures for coping with failures, does not foster the buildup of an insurance fund that could withstand potential financial crises, and therefore will not significantly enhance public confidence in the safety of their assets. Thus, implicit insurance will not mitigate the probability of contagion to the same degree as explicit insurance.[15]

Explicit insurance seems to offer greater opportunities and encouragement for government to enact forward-looking financial policies that bolster private and public sector oversight of financial intermediaries than implicit insurance. Although proponents of implicit insurance argue that greater uncertainty concerning government insurance enhances incentives for (a) private creditors to monitor intermediaries and (b) intermediaries to form private insurance and self-regulatory bodies, this argument relies on the assumption that uncertainty surrounding the extent and form of government insurance creates positive incentives for private sector monitoring of intermediaries that

15. It should also be noted thhe public expenditure effects from financial failure can be very large (as the savings and loan experience in the United States demonstrates). Therefore, building an insurance fund prior to a failure may mitigate the macroeconomic implications of a systemic financial failure.

are greater than the negative incentives for private creditor monitoring of intermediaries generated by expectations of government insurance.

More important, under the premise that the public expects the government to insure assets in the presence of a financial crisis, governments will be able to counteract the moral hazard problem better with explicit insurance than with implicit insurance. By explicitly recognizing a social responsibility to insure some class of saver assets, governments will be able to design and enact forward-looking financial regulations that augment the monitoring of financial intermediaries and enhance financial stability better than could be achieved with an implicit insurance system. For example, governments could use risk-based insurance premiums with explicit insurance, while this would send confusing signals with implicit insurance. Moreover, credible, explicit insurance system may be able to limit public expectations regarding the size and set of financial instruments insured by the government. For example, with explicit insurance and universal banks, it may be possible to limit the government safety net to small checking accounts. It may be impossible to draw this line ex post with implicit insurance.

As mentioned above, insurance tends to reduce the intensity and the incentives with which intermediaries monitor firms. Although choosing explicit or implicit insurance does not appear to affect firm monitoring incentives differentially, explicit government insurance encourages better regulatory strategies. Specifically, in the absence of explicit government insurance, governments may believe there is not a moral hazard problem. Therefore, officials may not design financial policies appropriately, because they will ignore, or insufficiently weight, the distortions created by expectations of government insurance. Explicit recognition of public expectations, and therefore government responsibilities, will permit and spur more prescient policies. Thus, explicit insurance would have a higher probability of generating regulations to impel intermediaries to effectively monitor firms than implicit insurance.

For similar reasons, explicit insurance may prompt government to consider raising the franchise value of insured intermediaries. This would reduce risk taking and further work to counterbalance the moral hazard created by government insurance. This would be recommended only if there was sufficient competition to spur innovation and efficient provision of financial services.

Finally, in terms of the effects on the availability of financial arrangements, there does not appear much difference between explicit and implicit insurance. But using this paper's criteria for assessing the advantages and disadvantages of explicit and implicit insurance, there seem to be substantial advantages to explicit insurance. Most important, explicit insurance entails prior recognition of the problems created by public expectations of insurance. Therefore, explicit insurance encourages forward-looking financial policies to mitigate these problems.

Vignettes on Private Insurance

An alternative or complement to government organized insurance is private insurance. For example, a group of banks could create a deposit insurance fund. If credible, private insurance will limit the probability of contagion, stimulate self-regulation, and encourage financial stability. Private insurance also has advantages with respect to government insurance. Edward J. Kane has noted that, in the United States, government officials are slow to recognize the existence of a problem and also slow to take action to cope with the problem once it is recognized. Kane argues that the interests of government officials often differ from those of taxpayers. Taxpayers want to cope with bank problems in the least expensive way, while government officials want to project a favorable image of their capacity. Government officials, therefore, focus on minimizing the number of failures recorded on their watch and assigning the blame for failures to others rather than focusing their energies on expeditiously minimizing the aggregate expense to the insurance fund. Private insurance may reduce some of these problems by establishing better incentives for the owners and managers of private insurance funds.

Private insurance funds that eliminate fears of contagion will be difficult to organize, however, for a number of reasons. First, losses in a crisis could be larger than the reserves of the private insurance fund, in which case members would face two difficult options: to inject more capital, which could weaken otherwise healthy institutions and contribute to the contagion; or not inject more capital, which could reduce public confidence in the private insurance scheme and precipitate a spread of the crisis. Thus, in many cases, private insurance may not be sufficiently credible to lower the probability of contagion substantially. Second, if the public still believes that the government ultimately stands behind these private insurers, the public will not carefully evaluate whether the private insurance system has adequate funding and staff. Under these conditions, private insurance will not substitute for government insurance in the case of a sufficiently large financial failure. Governments will still have to choose between implicit and explicit government insurance and the precise form of the insurance system if they choose explicit insurance. Third, as mentioned above, adverse selection problems in participating in voluntary private insurance schemes will hinder the functioning of these voluntary schemes. For example, safe banks may not want to subsidize risky banks, and it may be very difficult, complex, and costly to set risk-based insurance premiums. Thus, safe banks may opt out of private insurance schemes, which they cannot do with government insurance. Finally, an alternative to having banks (or other intermediaries) form their own private insurance system is to use insurance companies to insure bank deposits. But, in most countries the banking system is larger than the insurance industry, so that the insurance industry may not have the capacity to underwrite bank deposits. Also, if an insurance company canceled

the insurance of an individual bank, this would tend to precipitate a run on that bank. Governments may not wish to give private insurers such powers.

Private insurance, therefore, may only work in special cases. Where a few banks have very good historical reputations and have established sound mechanisms for self-regulation, the public may have confidence in their ability to self-regulate, insure deposits, and screen other intermediaries.

Using examples from different states in the United States in the 1800s, Calomiris (1989) shows that in states where a few banks created self-insurance organizations with strong self-regulatory powers, and where each bank's liability to the insurance fund was unlimited, there was much tighter monitoring of banks and many fewer bank failures than in other states. (see footnote 16 on the next page.)[16]

Instead of viewing private and public insurance as substitutes, Kane (1993) views the two methods of insuring saver assets as complements. He proposes that banks with insured deposits should be required to have insurance with a private company. These private insurance companies would have to be authorized, monitored, and reinsured by the government. While not solving all problems, Kane argues that this type of institutional arrangement would make evaluation and monitoring of banks more responsive to market conditions, because private insurers with their financial capital on the line would have incentives more aligned with those of taxpayers than government supervisors who do not have their financial capital exposed. It is important to note, however, that even in Kane's proposal, the government ultimately stands behind the liabilities of financial institutions.

Bank Powers

This section evaluates the costs and benefits of allowing banks to engage in activities that go beyond traditional banking activities, such as taking deposits and making loans.[17] These broader activities include underwriting and dealing in securities, holding equity in companies, operating investment and trust companies, and participating in the insurance industry. The focus will be on securities market activities and holding equity in nonfinancial firms.

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16. Another example is West Germany. In 1966, a purely private consortia of banks formed a mutual-type, deposit insurance fund. The Federal Association of German Commercial Banks organized cross-monitoring of banks to ensure stability of the banking system. In 1976, this purely private insurance fund came under public sector regulation, but administration and monitoring are still organized and conducted by the private Federal Association of German Commercial Banks.

17. Conversely, this section could be viewed as evaluating the costs and benefits of restricting the activities of financial conglomerates to only those activities associated with traditional banking and forcing other activities to take place in distinct legal entitles.

Monitoring of Firms

Broadening banking powers should have generally positive effects on how the financial system evaluates and monitors firms, though there are reasons for caution. Expanding the array of services provided by a single entity may broaden and deepen the relationship between the intermediary and firm and facilitate the flow of information. Also, banks that hold equity in firms and sit on the boards of directors will tend to exert better corporate governance. On the other hand, intermediaries with broader powers may have a greater tendency than more narrowly defined institutions to become overexposed to a few firms and thereby lose their ability to objectively monitor corporations.

Monitoring Financial Intermediaries

The monitoring of banks will become more difficult as the activities of banks become more complicated. More important, complex financial entities that are engaged in a wide range of activities may be more difficult to monitor than separate entities providing these same services. The complexity of measuring exposure to specific firms, industries, and geographical locations, and of evaluating the riskiness of the intermediary in general may grow more than proportionally as the permitted activities of the intermediary grow.

Similarly, broadening financial intermediary powers may encourage the development of larger, more powerful intermediaries. The political influence that will likely accompany this power may also hinder the ability of officials to force full disclosure of information and supervise intermediaries effectively and objectively.

The potential for conflicts of interest and insider manipulations will grow. Monitoring transactions between the financial intermediary and significant shareholders, directors, officers, and their important and relevant business concerns will be more difficult, because the intermediary will be involved in more transactions and more complex transactions. Similarly, there will be greater opportunities for conflicts of interest. For example, banks with problem loans to a client may try to extricate themselves by underwriting and selling shares to an investment company or trust account run by the bank itself. Or, banks may issue a bridge loan to support a new equity sale being underwritten by the investment banking arm of the bank and thereby use insured deposits to support lucrative but risky investment banking activities.[18]

18. See Edwards and Edwards (1991) for examples of the activities of financial and industrial groups in Chile.

Given the inherent additional difficulties associated with monitoring financial intermediaries that are engaged in a broad spectrum of activities, establishing an adequate capital base becomes more important. There must be adequate capital to balance the social costs of intermediaries undertaking risky investments. This will also help maximize the incentives for owners to price risk appropriately and for owners to monitor intermediary managers carefully. Furthermore, this capital must be secure, so that in the event of financial problems owners cannot remove capital surreptitiously. The identity of owners also needs to be clear so that observers can monitor insider trading and investments. Thus, even if industries are permitted to own financial intermediaries, there should be clear documentation of the physical people who ultimately exert control over the financial intermediary.

Thus, policymakers weighing the expansion of banking powers should consider the ability of auditors, boards of directors, and government supervisors to monitor the activities of financial conglomerates. Where (a) external auditors are well-qualified and independent of financial intermediary management, (b) the boards of directors of financial intermediaries exert sound corporate governance over management, and (c) the ownership and capital base of financial intermediaries are clearly defined and secure, broadening the permitted powers of financial intermediaries will have less of a chance of excessively burdening government supervisors.

Financial Stability and Contagion

Broadening banking powers may increase or decrease the riskiness of financial intermediaries. The ability to engage in a broader set of financial activities may permit greater mechanisms for diversification. On the other hand, securities trading and investment banking activities tend to be more risky. If these additional risks are not diversified away, intermediaries may undertake more risk as their permitted powers expand.[19]

The emergence of large financial conglomerates through the broadening of bank powers also implies that the failure of any single intermediary may create severe economic disruptions. Thus, stability of each intermediary becomes more important for the stability of the financial system as a whole as financial power becomes concentrated in fewer institutions.

Furthermore, broadening the powers of financial intermediaries may expand the set of financial instruments presumed to be insured by the government and thereby augment financial fragility. In particular, with a compartmentalized financial institution (banks taking deposits and issuing loans, investment companies purchasing equity shares and bonds, investment banks underwriting security issuance, insurance

19. Note, however, that empirical evidence suggests that security affiliates' operations of banks did not deleteriously affect the soundness of banks in the United States prior to the Glass-Steagall Act of 1933 that legally separated commercial banking from securities operations (White 1986).

companies writing and selling insurance policies, and so on.), governments may be able to define the set of financial instruments insured by the government more narrowly than with financial conglomerates with broad powers. For example, governments may be able to credibly insure bank deposits up to US$100,000 but not returns to investments in mutual funds. When all of these financial services are provided by a single financial institution, the government may find it difficult to isolate and insure only specific assets. Thus, complex financial conglomerates will attempt to extend the social safety net to as broad a set of financial instruments as possible in order to attract investors. This may place more and more risky assets under the government's insurance umbrella. Extending the social safety net and expanding the moral hazard problem may generate avenues for excessive risk taking without a concomitant increases in the ability of governments to monitor intermediaries.

Competition and Markets

Broadening the permitted activities of financial intermediaries should increase competition in the short run but may decrease competition in the longer run. By allowing banks to compete against investment banks, securities companies, and insurance companies, broadening the scope of permitted activities would initially increase competition. On the other hand, if economies of scale and scope are important, decompartmentalizing financial powers may eventually encourage the consolidation of financial power in the hands of a few large financial conglomerates. This consolidation of power could work to reduce competition and contestability. Furthermore, such consolidation would concentrate considerable economic and, therefore, political power in the hands of the few individuals that control these financial conglomerates.

With broader powers, a financial intermediary will have more financial instruments available to serve clients and may, therefore, be able to obtain more information about clients; economies of scope from bundling several services will reduce information acquisition costs. Thus, financial intermediaries that enjoy greater flexibility in servicing clients and with more information about clients should be able to overcome—to a greater degree than compartmentalized financial intermediaries—the informational asymmetries that cause incomplete or missing markets. With more financial instruments and more information, financial intermediaries should be able to provide better financial services, all else being equal.

Conclusions

This paper studied five characteristics of financial markets that imply that free markets will produce an undersupply of financial services. Government interventions to improve the provision of financial services, however, often distort financial markets and hinder financial development. Thus, each country must find an appropriate mix of financial policies that optimally balances the beneficial and harmful effects of government interventions.

The paper proposes a checklist of five issues to consider when evaluating financial policies. Specifically, how will financial policies affect (1) financial intermediary evaluation and monitoring of firms by financial intermediaries, (2) private and public sector evaluation and monitoring of financial intermediaries, (3) financial stability and the possibility of contagion, (4) the degree of competition among financial institutions, and (5) the spectrum of financial arrangements available to firms and individuals. Using this checklist, the paper evaluates two financial policies: insurance of saver assets in financial intermediaries and the powers and activities in which particular financial intermediaries should be allowed to engage. Although country specific legal, historical, political, and institutional traits should contribute to the determination of financial policies, the following broad conclusions emerge from the analysis.

Governments generally must insure some of the public's savings. Historically, governments have insured assets when faced with financial failures even in the absence of preexisting commitments and even after stating before the failure that the government would not insure assets in the case of a failure. The public understands this social contract and therefore has fewer incentives to monitor financial institutions that it believes are insured by the government. These expectations of government responsibility for insuring saver assets are country specific and depend on political, sociological, and historical developments. Thus, instead of debating whether to have or not to have insurance, the more relevant policy questions involve the extent of coverage and whether this insurance should be provided implicitly or explicitly.

Explicit insurance is typically better than implicit insurance. Explicit insurance entails prior recognition that the government will insure some set of saver assets in the case of financial intermediary failure. Thus, explicit insurance encourages forward-looking financial policies to mitigate the undersupply of monitoring of financial intermediaries exacerbated by government insurance of saver assets. The forward-looking policies that may accompany explicit insurance include the buildup of an adequate insurance fund, risk-based capital requirements, risk-based insurance premiums, restrictions on insured intermediary investments and activities, the coordinated use of self-regulatory bodies, private insurance, trustworthy rating agencies, and reputable accounting firms to help monitor insured intermediaries, and

more intensive government supervision of insured institutions. The mix of mechanisms for monitoring insured intermediaries and bolstering their safety depends on the existence and usefulness of self-regulatory bodies, rating agencies, and accounting firms and on the institutional capacity of the government to organize, implement, and enforce particular supervisory strategies.

Explicit insurance can often reduce the set of assets insured by the government. Since public insurance of public assets in financial institutions tends to reduce private sector screening of intermediaries, governments should attempt to limit the extent of this moral hazard by limiting the spectrum of assets insured by the government. Although there is an implicit social contract that some set of saver assets are insured by the government, and although this contract may vary from country to country based on public expectations of the role of government, governments may be able to limit the extent of the coverage by designing and publicizing a credible, simple, and explicit insurance scheme. This cannot be done with implicit insurance.

It is dangerous to combine implicit government insurance plus broad banking powers. If policymakers want to expand banking powers beyond deposit taking and loan making to underwriting and trading securities, buying equity, and managing investment companies and trusts, they should make explicit, and socially credible, commitments about which assets are insured by the government. Broadening the range of financial instruments offered by banks or putting banks into holding companies that offer a wide range of instruments may expand the set of financial instruments that the public believes are insured by the government. Financial conglomerates will have great incentives to exploit and extend the perceived social safety net to attract savers. An expansion in expectations concerning the spectrum of financial assets insured by the government will tend to reduce public monitoring of intermediaries. At the same time, authorities may not feel sufficiently compelled to expand supervisory capabilities because there is no explicit insurance! Thus, unless supervision and regulation of financial conglomerates are particularly comprehensive and effective, broad financial powers combined with an unclear delineation between insured and uninsured instruments will tend to produce incentives that yield great financial instability and suboptimal provision of financial services.

Do not expand banking powers if private and public entities are not capable of rigorously monitoring the new financial conglomerates. Broadening the powers of financial intermediaries makes monitoring intermediaries both more important and more difficult. Monitoring becomes more important because intermediaries will tend to be larger, so that failure of any single institution has bigger macroeconomic implications. Monitoring also becomes more important because complex financial conglomerates will tend to blur the difference between insured and uninsured assets.

This implies that financial intermediary creditors will have fewer incentives to monitor the intermediaries. Monitoring becomes more difficult because the institutions become much more complex. Thus, unless a solid base of private auditors, rating agencies, self-regulatory groups along with government supervision and regulation can adequately monitor financial intermediaries, broadening the legal powers of financial institutions may produce negative results.

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12

CAPITAL ACCOUNT LIBERALIZATION: THE PHILIPPINES EXPERIENCE

Edgardo P. Zialcita, Deputy Governor, Central Bank of Philippines

During 1991–92 the Philippines implemented a series of historic changes toward the full liberalization of the exchange regime. These changes have resulted in virtually full convertibility of the current account. At the same time the government took major steps to liberalize the capital account. Together, the measures ended over four decades of pervasive exchange controls. Liberalization of the exchange regime constitutes a key element of a broader package of structural reforms aimed at enhancing Philippine competitiveness in the global marketplace. The stabilization of the economy has made it possible to implement these reforms.

This paper describes the foreign exchange reforms, focusing specifically on the capital account. It describes the evolution of exchange controls in the Philippines leading up to the present reforms, and it offers some preliminary assessments of the impact of the changes and considers the policy challenges that now face the authorities.

The Evolution of Exchange Controls in the Philippines

The government first imposed comprehensive import and exchange controls in 1949 in order to conserve available foreign exchange for the reconstruction and rehabilitation of its war-damaged economy. Capital controls were mostly in the form of outright quantitative restrictions implemented through a stringent prior approval system administered by the central bank.

Major liberalization began in the 1960s when the government lifted the requirement for prior central bank approval of foreign exchange transactions, including capital transactions. Thus, authorized agent banks were allowed to service foreign exchange requirements at the prevailing market rate without central bank clearance. The only notable restriction during this period of decontrol was the mandatory surrender requirement, albeit at the prevailing market rate, for all foreign exchange receipts.

Initially, the liberalization measures of the 1960s had a strongly positive effect on the balance of payments. Rapid increases in import volumes and deteriorating terms of trade, however, eventually led to an unsustainable balance of payments. Before the decade was out, the central bank was forced to reimpose controls on certain foreign

exchange transactions. Such controls were a central theme of the 1970s and the 1980s with only slight modifications during that time.

In the capital account, with the issuance of central bank (CB) Circular No. 289 (February 21, 1970) and subsequent amendments, all foreign borrowings were subjected to prior central bank approval. In general, the circular and its amendments established criteria to channel foreign borrowings to identified priority undertakings. Guidelines also established acceptable borrowing terms. To ensure enforcement of these controls and to ensure inward remittance of borrowing proceeds, the government enacted a system of debt registration. Without registration, foreign borrowings could not be serviced.

The authorities adopted a similar restrictive approach for foreign investments. All investments made after March 15, 1973 required registration with the central bank. Priority investments received preferential treatment with respect to the timetable for allowing repatriation of profits, dividends, and capital, while policies were tightly controlled and generally discouraged outward foreign investments. An important restriction on the foreign exchange activity of local banks was also placed in the form of a requirement for a balanced foreign exchange position..

Not all initiatives in this period were restrictive in nature; however, in July 1970 the authorities introduced the Philippine Foreign Currency Deposit System (CD). Nevertheless, permissible deposits by residents were initially quite restricted. In particular, deposits in foreign currency notes and travelers checks were not allowed. (This was eased later in 1987.) Furthermore, loans that could be extended to residents were restricted.

An offshore banking system was established in 1976. This allowed foreign banks to have a small window of operations in the Philippines at a time when entry of foreign banks remained blocked. The permissible activities were, however, initially very restricted, being confined to foreign currency transactions that over time could margin.

Despite the generally restrictive exchange control system, the economy still succumbed to a serious balance of payments crisis that culminated in the declaration of a debt moratorium in October 1983. Essentially, a series of adverse external developments brought about the crisis, including two major oil shocks and an interest rate shock compounded by inadequate policy adjustments, especially in the fiscal area and in the exchange rate.

During the ensuing crisis, exchange restrictions intensified to ensure the availability of foreign exchange for critical imports. Principal repayments on commercial and bilateral debt were suspended. In November 1983 the central bank also required all agent banks to surrender their foreign exchange receipts into a common pool. The central bank administered the pool and rationed payments in accordance with an administratively set priority imports including oil, cereals, and a few other critical items.

By October 1984 a measure of stability had been restored, and the central bank was able to once again liberalize the exchange regime using a an International Monetary Fund (IMF) supported standby arrangement through the lifting of emergency exchange controls. The reopening of the exchange market also ushered in the independent float of the peso. Thus, this system, which remains today, eliminated the central bank's role in determining the exchange rate, which it had done by announcing an interbank guiding rate and imposing a trading band. The banks could now freely quote their interbank buying and selling rates and establish a market clearing rate, albeit within relatively restricted trading rules. These rules primarily limited interbank trading to on-floor transactions that could last for only thirty minutes each trading day. The previous trading day's completed transactions formed the basis for the reference rate announced by the Bankers Association of the Philippines. These restrictive rules enable the central bank to intervene in the exchange market when necessary without requiring a huge war chest of reserves.

A series of reschedulings and financing subsequently regularized debt service arrears to official bilateral creditors and commercial banks. Moreover, trade liberalization resumed in 1986 when the Import Liberalization Program was continued in two phases. Phase I, undertaken from April 1986 to April 1988, liberalized a total of 1,229 import items. Meanwhile, another 533 items were deregulated under Phase II. Currently, about 94 percent of the total number of tariff lines have been liberalized. In addition, indirect tax reforms were introduced to eliminate most of the discriminatory aspects of the domestic tax structure against imports. Finally, the reforms significantly trimmed down the scope of exemptions, thus decreasing the variability of the tariff structure.

Despite the virtual completion of liberalization on the trade front and the regularization of the debt service, no significant measures were taken since 1984 to further liberalize the country's restrictive nontrade payments regime, nor were efforts made to remove the coercive elements of foreign exchange supply that tended to penalize foreign exchange earners. Moreover, trading rules that made official intervention in the market easier and more effective at the expense of thin trading continued to hamper interbank foreign exchange trading. All these features prevented the attainment of a truly market-clearing exchange rate. Addressing these lagging elements would form the basis for the major foreign exchange liberalization measures of 1991–92.

Foreign Exchange Liberalization: 1991–92

The Philippine economy was considerably set back by the debt crisis of 1983. Nevertheless, the long road to economic recovery commenced in 1987 under the Aquino government. But the recovery process was not smooth, and it lost momentum

in late 1989. This, in part, was attributed to adverse political developments and a series of natural disasters, but it was also clear that, notwithstanding some definite improvements, export growth potential had not been fully realized. Moreover, inadequate savings to support much-needed investments hampered sustainable economic growth .

These two critical lagging elements—exports and investments—were prime motivators for continuing the exchange liberalization process to eliminate remaining anti-export bias obstacles to foreign investment arising from regulatory constraints. The widely shared view that further liberalization was necessary facilitated the formation of a working political consensus in support of further decontrol against traditional resistance.

The improving economic conditions in 1991 also provided a good early opportunity for launching foreign exchange reforms. A new program with the IMF provided the framework for fiscal, monetary, and other financial policies that would enhance credibility in the market. The balance of payments had also strengthened considerably, with reserves building up to more comfortable levels. Debt negotiations progressed well. On the political front, a measure of normalcy had been restored, following the last coup attempt in 1989, with scheduled elections set in 1992. While some doubted that the new administration would be fully committed to exchange reform, all indications suggested that such reforms were broadly supported by potential candidates Nevertheless, to address initial fears that a too drastic implementation of liberalization measures would quickly trigger a foreign exchange crisis, the reforms were staggered throughout 1991-92.

Liberalization Measures

Table 12.1 summarizes the series of liberalization measures in both current and capital accounts. These measures can also be grouped according to the following desired effects.

First, exporters of goods and services were given full freedom to dispose of their foreign exchange receipts as they saw fit, hence avoiding being a captive foreign exchange supply source. This reform is an acid test of the market clearing property of any given exchange rate and would work to ensure the best exchange rate to exporters, all other things being equal.

Second, restrictions on payment modes other then through letters of credit were liberalized for export and import transactions. In addition, all central bank prior approval requirements on export transactions were lifted. Finally, reporting requirements were simplified. These various measures were all expected to reduce transaction costs on foreign trade.

Third, quantitative restrictions on the amount of foreign exchange that may be purchased from banks for service payments were lifted. This was expected to further

reduce impediments to business operations and encourage the general public to voluntarily convert their foreign exchange.

Fourth, free trade of gold was allowed. This would encourage domestic production of gold, which is a major natural resource endowment.

Fifth, exporters of goods and services, as well as domestic producers, resident and foreign currency deposit units (FCDU) depositors, and banks were allowed access to short-term foreign currency loans for interbank transactions from domestic FCDU without need of central bank prior approval. Short-term trade facility credits could also be granted to private companies without prior central bank approval. This would be especially helpful in lowering working capital financing costs of exporters given the much lower interest rates on foreign currency loans. Exchange risk would be minimal, as foreign currency earners would be naturally hedged.

Sixth, full and immediate repatriation of foreign investments, including profit remittances, was allowed to further encourage inward investments. In addition, all types of inward investments could be made without need for prior central bank approval. Moreover, only investments whose future foreign exchange requirements for capital repatriation and profit remittance were intended to be sourced from the banking systems (other than FCDU) needed to comply with central bank registration and mandatory surrender requirements. This latter reform legitimized informal investments and broadened further available project financing options.

Seventh, outward foreign investments could now be made without prior central bank approval if sourced from foreign currency deposits or nonbanks. Outward investments could also be sourced from the banking system for up to US$1 million per investor per year. This easing was expected to enhance export capability by facilitating the establishment overseas of appropriate marketing links and alliances, facilitating portfolio diversification, and strengthening technology transfer potential.

Eighth, commercial banks' long and short foreign exchange positions were now subject only to limits imposed for prudential reasons. Continuous interbank foreign exchange trading was also permitted and was actually provided through the launching of the Philippine Dealing System, an on-line electronic trading system. The previous regulation only allowed on-floor trading and for only thirty minutes each day. These changes were expected to lead to an exchange rate that efficiently reflected the views of major participants acting on all available information.

In some respects the current liberalization effort has been similar to previous efforts insofar as certain measures have worked to lift quantitative restrictions on foreign exchange demand. This has clearly been the case with the liberalization of service payments and foreign investment remittances. However, the main body of reforms—and this is really the distinctive innovation of the present liberalization episode—involved exchange liberalization acting chiefly through enhancement of the foreign exchange supply side. This has been achieved for foreign exchange earners either through lowering transaction costs, lowering financing costs, ensuring efficient

foreign exchange pricing, broadening financing options, or increasing flexibility of capital expenditure decisions. Thus, the current liberalization effort is much bolder and more encompassing than past efforts, although restrictions still remain.

Remaining Restrictions

In current account transactions, invisible payments have now been completely liberalized: all quantitative restrictions have been lifted and central bank prior approval requirements have been removed. This is also virtually the case for import payments. However, in the case of service payments, it is still not possible to walk up to a bank and ask to buy foreign exchange with no questions asked. One would have to show to the agent bank proof of the legitimacy of the transaction.

Some restrictions still apply on key capital accounts. Proceeds of foreign investments and loans still have to be surrendered to the banking system, albeit at the prevailing market rate, in the context of registration with the central bank of a loan or investment. Without registration, neither future debt servicing, capital repatriation, nor profit remittance can be sourced from the banking system. However, and this is the major change at this time, they can still be legitimately sourced from FCDU accounts and nonbank sources. Furthermore, the liberalized treatment of outward foreign investment is still subject to a quantitative limit of US$1 million per investor per year if funds are to be sourced from the banking system, although no limits are applicable if funds are to be sourced from outside the banking system.

These remaining restrictions need to be reviewed further and can be liberalized depending on the situation. In particular, there may be a case for fully liberalizing outward investments to help offset the large inflows of foreign exchange remittances into the formal economy. These inflows, now taking place, are proving difficult to absorb into the domestic economy in the short run. Moreover, it may be necessary to reconsider the need to require surrender of investment and loan proceeds for these to be later eligible for servicing. These transactions could be permitted if transaction costs were further reduced.

The authorities are also seriously considering liberalizing the entry of foreign financial institutions to further enhance the efficiency gains arising from the liberalization of capital accounts. Such a measure can deepen the domestic capital market by mobilizing more foreign capital efficiently and by speeding up innovation in financial technology.

The Early Results of Liberalization

The exchange reforms are quite recent, with many important reforms only completed in the second half of 1992. Thus, it may be too early to firmly determine

the efficacy of recent measures. But a variety of economic indicators suggest that the changes are making a difference compared to pre-reform trends.

The most visible impact is on service transactions. Major invisible receipts, notably travel receipts, combined worker remittances, personal transfers, FCDU withdrawals in pesos, and the residual other invisible receipts, have surged since late 1991. This can be clearly seen in figure 12.1. The comprehensive exchange reforms have created incentives in the form of market clearing exchange rates and better assurance that foreign exchange will be readily accessible in the future if it is needed for residents to bring foreign exchange into the formal economy.

The enhanced confidence in the economy, as suggested by trends in service flow transactions, seems to be supported by analysis of the developments on the balance sheets of the nonbanking sector. Figure 12.2 shows the overseas deposits of residents, as reported in International Financial Statistics (IFS), as a ratio of the total resident deposits (in pesos and peso equivalent of foreign currency deposits). The overseas deposit ratio shows a sharp drop in relation to total deposits from 1992. This trend may suggest a fundamental portfolio shift by the nonbank private sector in favor of resident financial assets. This point, however, cannot be too strongly made because there are too few observations and because the relative reduction in overseas deposits could also have been temporarily influenced by nominal and real interest rate differentials favoring peso assets (figure 12.3). Nonetheless, such substantial differentials existed in pre-liberalization periods without making any apparent strong impact on the asset portfolio distribution of nonbank residents. There is clearly a need to carefully monitor this development, especially because it may significantly affect monetary policy settings.

By looking at the balance sheet of the foreign currency deposit unit, one might see the beginnings of a significant increase in FCDU resources driven largely by a marked upward shift in resident foreign currency deposits in 1992 (figure 12.4). Two factors could account for this change. First, developments may reflect the reflow of flight capital, albeit not all the way into the economy, because such capital is still parked in foreign currency in FCDU rather than being inwardly remitted for pesos. Second, the relaxation of the export surrender requirement has led to the diversion of part of the export proceeds to foreign currency deposit (FCD) accounts, thus reflecting exporters' portfolio preferences. By closely matching the expansion in FCD resources, FCDU loans to residents are also accelerating. This is reflected mainly by the increased access of exporters as a result of recent liberalization measures. The combined trends of more demand for resident loans and increased deposit-based funding from residents would have significant implications for monetary and credit policies as the FCDU system expands and plays a bigger role in financial intermediation.

More generally, the foreign asset holding behavior of local banks appears to have shifted significantly in 1992 as a result of market liberalization. Specifically, the

relaxation of rules on net open foreign exchange may have led to a decline in liquid foreign asset holdings by commercial banks by about US$0.6 to US$0.7 billion, compared with the average for the period 1988–91. This behavioral change may well have been a shock factor in strengthening the peso in 1992. On the other hand, the balance on foreign currency transactions in relation to the volume of foreign currency transactions, as determined by the value of private imports of goods and services, appear to have remained stable, notwithstanding market liberalization.

There are still other interesting developments that probably reflect the impact of reforms. The volume of interbank foreign exchange trading has escalated sharply, beginning in 1991 (figure 12.5). In such a free environment the central bank has been participating heavily as gauged by large shares accounted for by the central bank in total interbank transactions (figure 12.6). This, in turn, has led to the rapid accumulation of central bank reserves, as shown in figure 12.7. This high degree of activity has been largely motivated by the desire to slow down the tendency of the exchange rate to appreciate so sharply the reforms began.

The concern about a potential upsurge in foreign exchange expenditures that could lead to a foreign exchange crisis as a result of lifting the controls has largely proven to be unfounded. To a large extent total import demand has been controlled through tight financial policies. However, it may also be observed that import propensity had not jumped up because of liberalization. Figure 12.7 shows trend developments in service payments, excluding interest, consumer imports, and non-consumer imports, respectively, as scaled by the GNP. There appear to be no major disruptions from past trends.

For investments, a definite recovery has taken place in 1991–92 from the low in 1990 (figure 12.8). The return of portfolio-type investments, including net bank interbranch investments, has been the main factor underpinning such recovery, because net foreign direct investments, including net bank interbranch investments, have remained stable since 1989. Direct investments have consistently served as a solid core of foreign investment activity even during periods of adversity. Nevertheless, the magnitude of direct investments has not yet shown clear signs of more rapid growth, which has been disappointing.

Part of the expansion in net inward investments of all types in 1992 have been somewhat offset by significantly higher outward investments. This is a rational consequence of the relaxation of outward investment rules and could represent a one-time adjustment. This trend, however, will have to be carefully monitored in the future to ensure that developments do not assume abnormal proportions.

Export developments continue to be a source of concern. For the moment exports have not sustained a clear growth acceleration. Recent developments are turning out to be rather disappointing, with the exception of a slight improvement in export market shares (figure 12.9). Recent real appreciation of the exchange rate and weak international market demand, however, has likely dampened stronger export

response. More time will be needed to make a firm judgment on how liberalization efforts have affected export developments.

Some Policy Issues

A key policy dilemma facing Philippine authorities is the observed sharp appreciation of the exchange rate in both nominal and real terms. This may have implications on the continuation of exchange liberalization.

A major factor in the recent nominal appreciation is the sharp improvement over previous trends in invisible receipts as compared side-by-side with sluggish economic growth. Substantial inflation in the Philippines, however, has been the prime cause of real appreciation, at least relative to major trading partners and competitors, despite marked progress in 1992.

Not surprisingly, pressures from the export sector have been mounting. The central bank has not been indifferent to such pressures and simply taken refuge in the equilibrating mechanism of the exchange rate. As a result, part of the total potential appreciation has been resisted through direct intervention in the marketplace. Such intervention, however, has had to be sterilized in light of the requirements of the current monetary program agreement with the IMF. Sterilized intervention has, in turn, created upward pressure on domestic interest rates, which has likely drawn in volatile short-term placements from abroad. Moreover, given the large stock of domestic debt to begin with and sharp increments due to sterilization, market intervention is going to have significant negative fiscal consequences.

Thus far, the central bank has resisted administrative measures that would restrain, for example, the problematic inflow of volatile short-term capital. As a practical matter the volume of such inflows does not yet appear to have reached troublesome proportions. Moreover, on policy grounds, the current thinking is that this approach not only departs from recent liberalization trends and sends the wrong signals to the market, but it may also become distortionary as private agents attempt to circumvent new restrictions. Moreover, a liberalized current account regime is bound to limit the effectiveness of capital controls.

Another approach would be to strengthen further the fiscal stance. The near term prospects of this, however, are not very encouraging in light of competing demands, notably the need to develop infrastructure and power investments and to consider the current weakness of domestic demand.

Perhaps the way forward is some measure of flexibility in monetary policy that could well be justified by increased demand for money as a result of lower inflationary expectations and increased confidence brought about by institutional reform. Inflation has declined sharply in the Philippines during 1991–92; the latest inflation in December 1992 was at 8.2 percent compared with a peak of over 20 percent in mid-1991.

Inflation, however, remains substantial relative to major trading partners and competitors. At this stage, while the need is there to further tighten inflation differentials, it is not obvious that the remedy lies mainly in further tightening monetary policy, especially in the presence of capital inflows. If anything, the lifting of exchange controls forces the authorities to look deeper at the causes of inflation, especially the role of structural factors.

Recent developments also lay exposed the lack of depth of domestic capital and financial markets and showed their inability to absorb increased inflow of private savings, denominated in foreign exchange, and to recycle that efficiently into the economy. As a result, some of these resources are leaking out of the economy in the form of capital outflows. Over the medium to long term, however, a stronger, more versatile capital market is urgently needed to provide the financial services and products to recycle these savings. Toward this objective, instead of offering special fiscal incentives, the government's most useful contribution would be to ensure macroeconomic stability and to reduce regulatory constraints that hamper or distort incentives.

Table 12.1. *Philippines: Foreign Exchange Liberalization Measures, 1991–92*

Ruling	*Trade and trade related transactions*	*Nontrade and services related transactions*	*International financial transactions*
1991			
July 2, 1991 CB Circular No. 1291	Allowed commodity exporters to retail 2 percent of their fore earnings in Special Foreign Currency Deposit Accounts (SFCDA) to be used for certain specified purposes.		
October 15, 1991 CB Circular No. 1317	Extended repatriation period for export proceeds from 60 to 90 days.		
December 11, 1991 CB Circular No. 1317			Allowed exporters to use foreign currency deposit units (FCDU) loans for up to 70 percent of the value of export letter of credit, purchase order or suppliers credit.
1992			
January 3, 1992 CB Circular No. 1318	Allowed domestic purchases and sales of gold without prior Central Bank approval.	Lifted mandatory surrender requirement of fore except for 15 types of nontrade fore earners.	Allowed full and immediate repatriation and remittance for all types of foreign investments.
		Increased limits on the amount of fore that Authorized Agent Banks (AABs) may sell to residents without prior CB approval.	Allowed outward investments, provided funds are withdrawn for FCDU or are not among those required to be sold to AABs.
CB Circular No. 1319	Increased retention rate for export proceeds to 40 percent.		
January 30, 1992 CB Circular No. 1327			Bank's long and short forex positions permitted but may not exceed 25 percent and 15 percent, respectively, of their unimpaired capital.

table continues on following page

Table 12.1. *(continued)*

Ruling	*Trade and trade related transactions*	*Nontrade and services related transactions*	*International financial transactions*
April 1, 1992 CB Circular No. 1334	Allowed funds retained in SFCDAs to be used freely for any purpose.		
April 28, 1992 CB Circular No. 1338			Lifted restrictions on off-floor forex trading among foreign banks with the launching of the Philippine Dealing System (PDS). Allowed service exporters to use FCDU loans for up to 70 percent of their expected forex receipts.
July 28, 1992 CB Circular No. 1338	Allowed use of all codes of export payments (except intercompany overseas accounts OA, which still requires prior CB approval) and import payments and to domestic producer, with prior CB approval. Lengthened period for inward remittance of export proceeds from 90 to 180 days. Lifted prior CB approval requirement on certain transactions (e.g., on-dollar exports, and self-funded and consigned imports). Simplified reportorial and procedural requirements.		

table continues on following page

Table 12.1. *(continued)*

Ruling	*Trade and trade related transactions*	*Nontrade and services related transactions*	*International financial transactions*
August 3, 1992			Allowed all forex trading to be conducted through the PDS because all banks had their systems on line.
August 21, 1992 CB Circular No. 1351			Allowed FCDUs to grant foreign currency loans without prior CB approval to exporters, domestic producers/manufacturers, and FCDU depositors.
August 24, 1992 CB Circular No. 1353	Allowed free domestic and international trade of gold.	Lifted all quantitative restrictions on amount of forex that can be purchased from banks.	Allowed inward foreign investments not to be registered and proceeds not to be surrendered except if bank funds are to be used subsequently for capital repatriation and dividend remittance.
	Allowed exporters to retain 100 percent of their export earnings.	Lifted mandatory surrender requirement for all forex receipts.	Allowed outward investments without prior CB approval in accounts less than US$1 million per investor per year.
	Liberalized further allowable export payments.		Allowed exporters, domestic manufacturers, and FCDU depositors to receive shor-term foreign currency loans without prior CB approval. However, medium-and long-term loans as well as short-term loans to the public sector still require prior approval of the CB. With or without prior approval, foreign currency loans may not be registered and proceeds thereof may not be surrendered to the banking system unless bank funds are to be used subsequently for debt servicing.
	Lifted prior CB approval on all export transactions.		

Figure 12.1. *Selected Invisible Receipts, 1988–92*

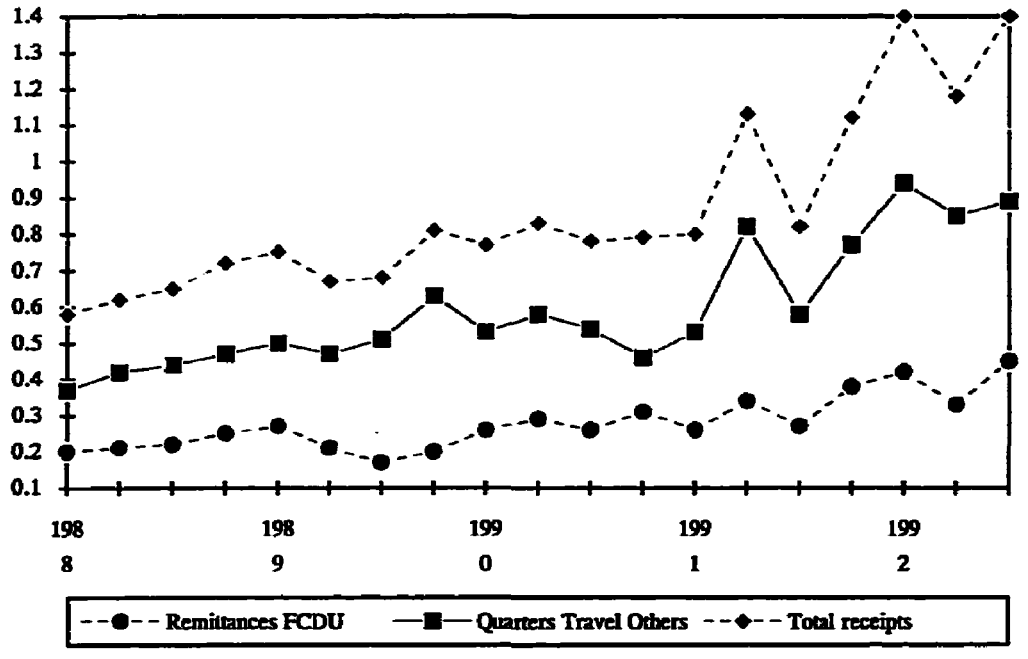


Figure 12.2. *Total Foreign Exchanges: Overseas and Foreign Currency Deposit, 1988–92*
(as percent of non-gold reserves NGR)

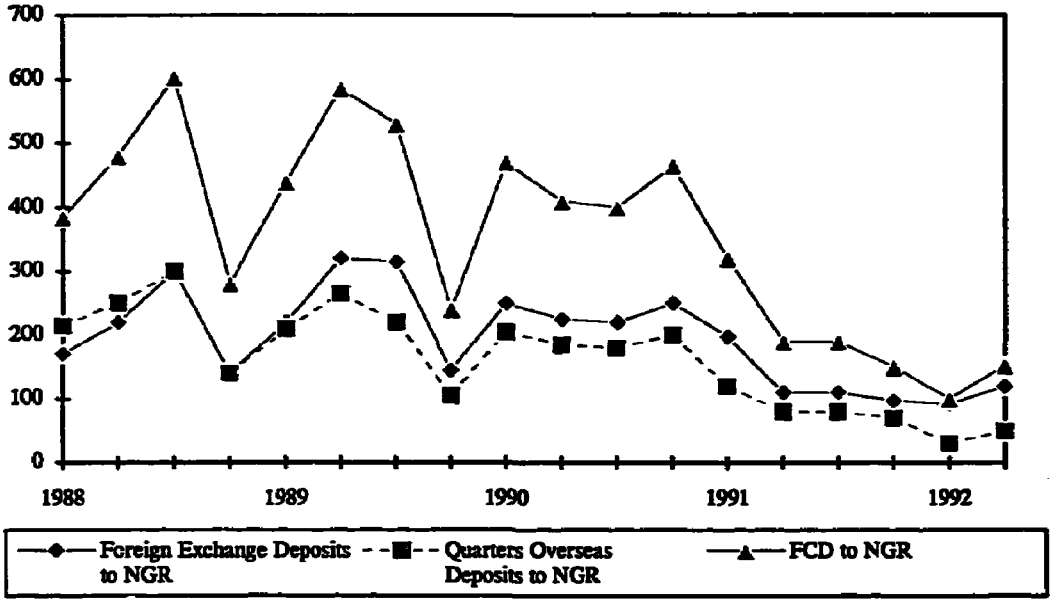


Figure 12.3. *Foreign Exchange Deposits: Overseas and Foreign Currency Deposit, 1988–92*
(as percent of total deposits)

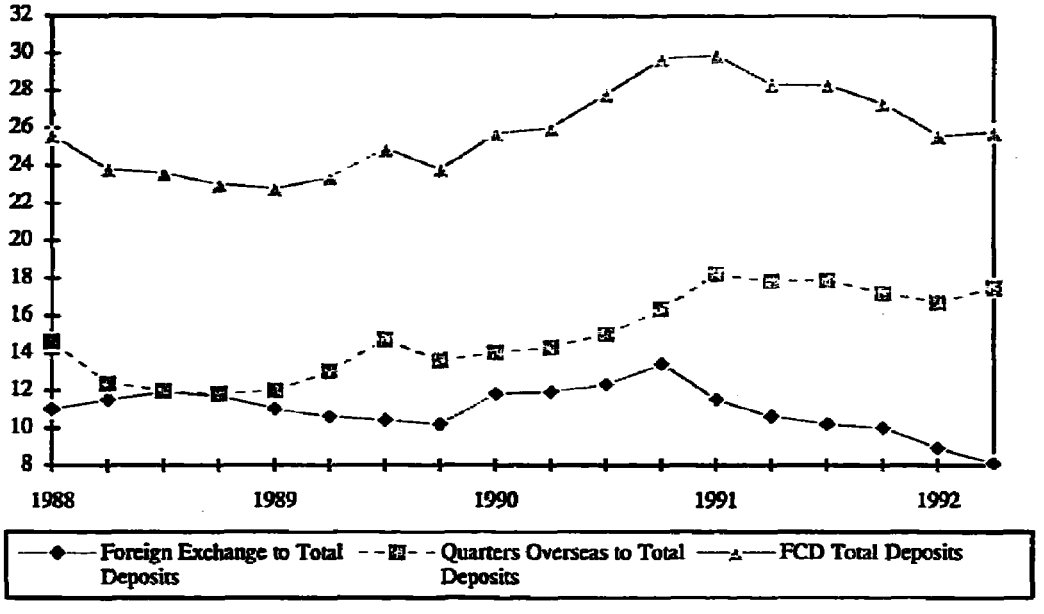


Figure 12.4. *Interest Differentials, 1988–92*
(peso vs dollar TBill rates)

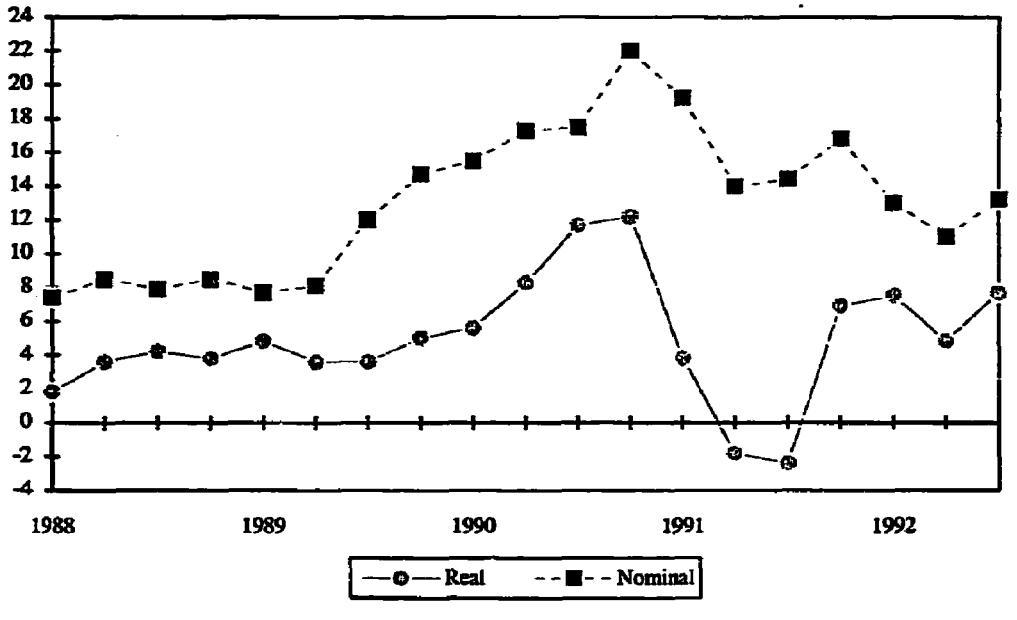


Figure 12.5. *Assets and Deposit Liabilities, 1988–92*

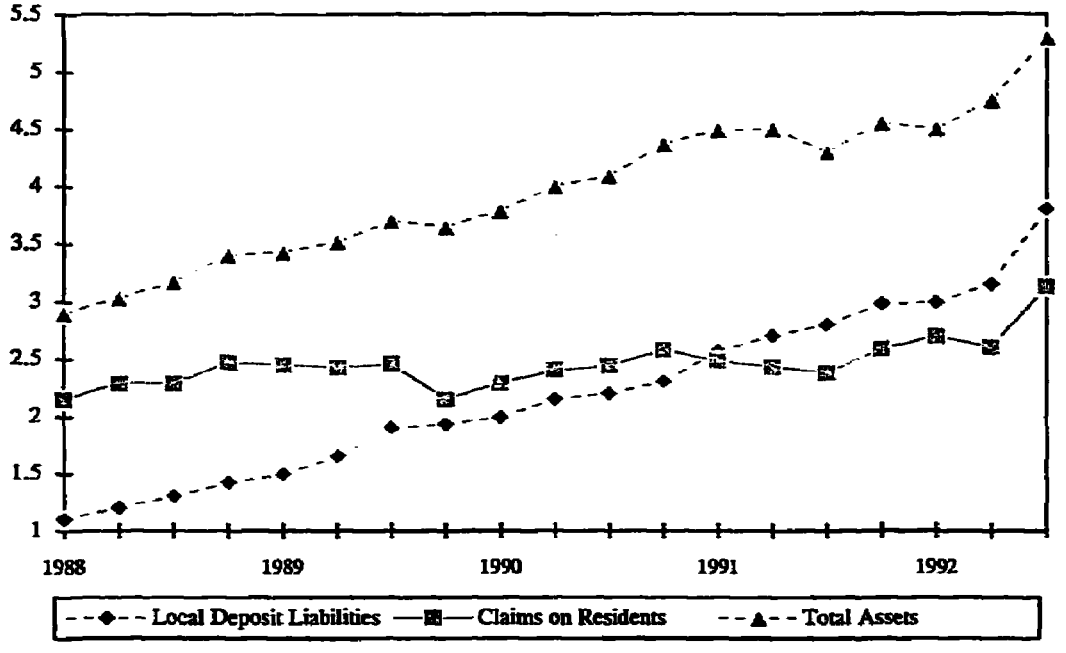


Figure 12.6. *Total Interbank Foreign Exchange Trading Volume, 1988–92*

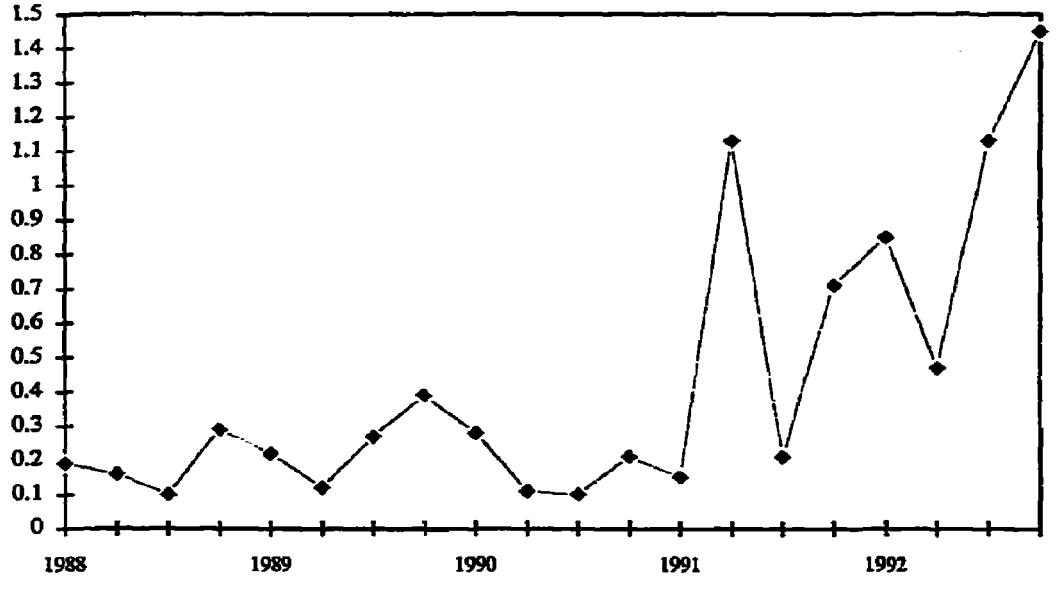


Figure 12.7. *Central Bank Foreign Exchange Volume, 1988–92*
(ratio to total volume)

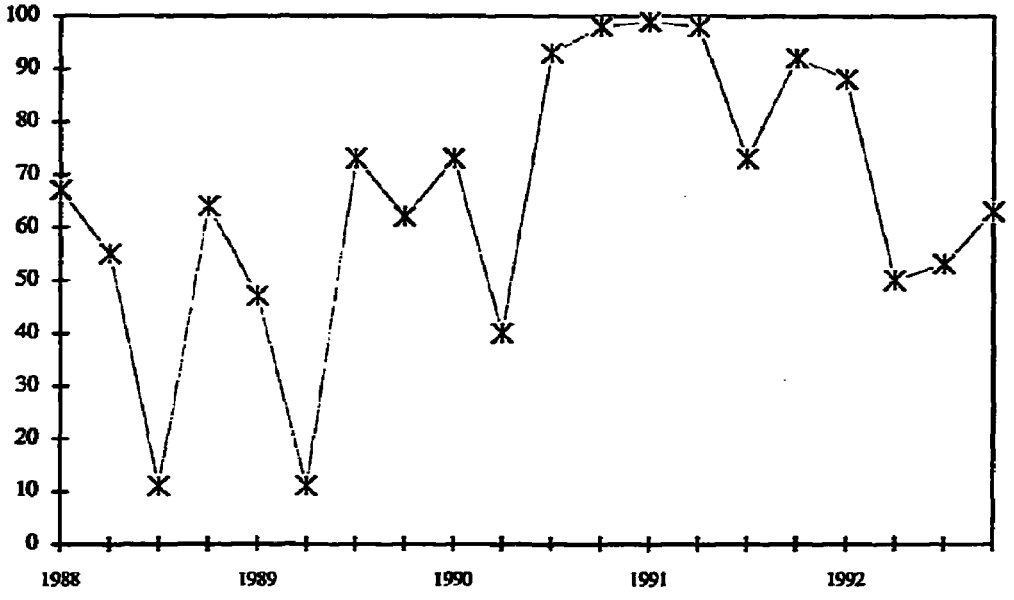


Figure 12.8. *International Reserves of the Banking System, 1988–92*

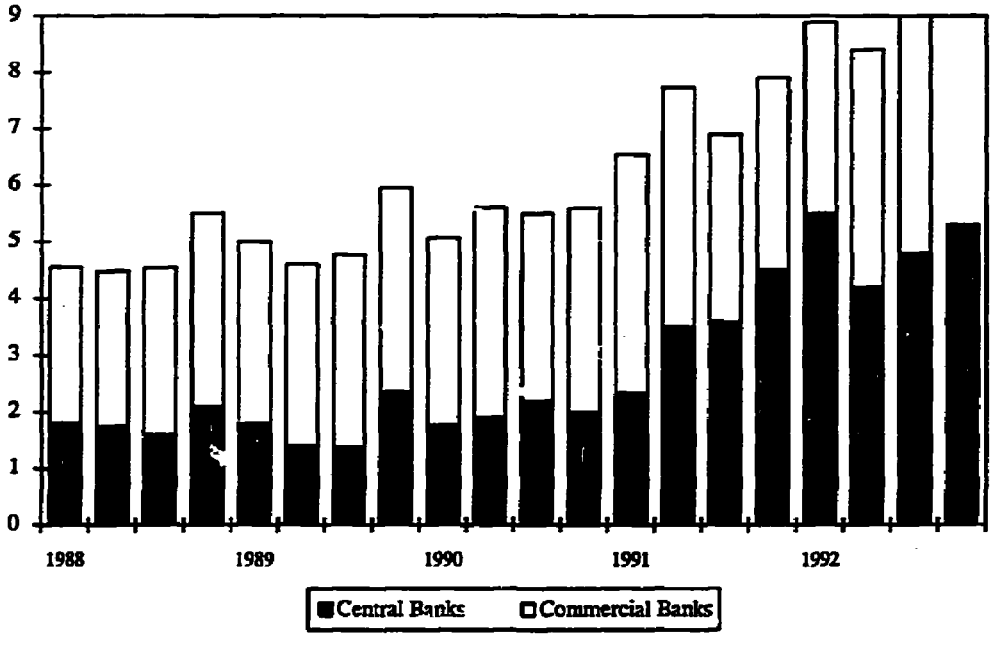
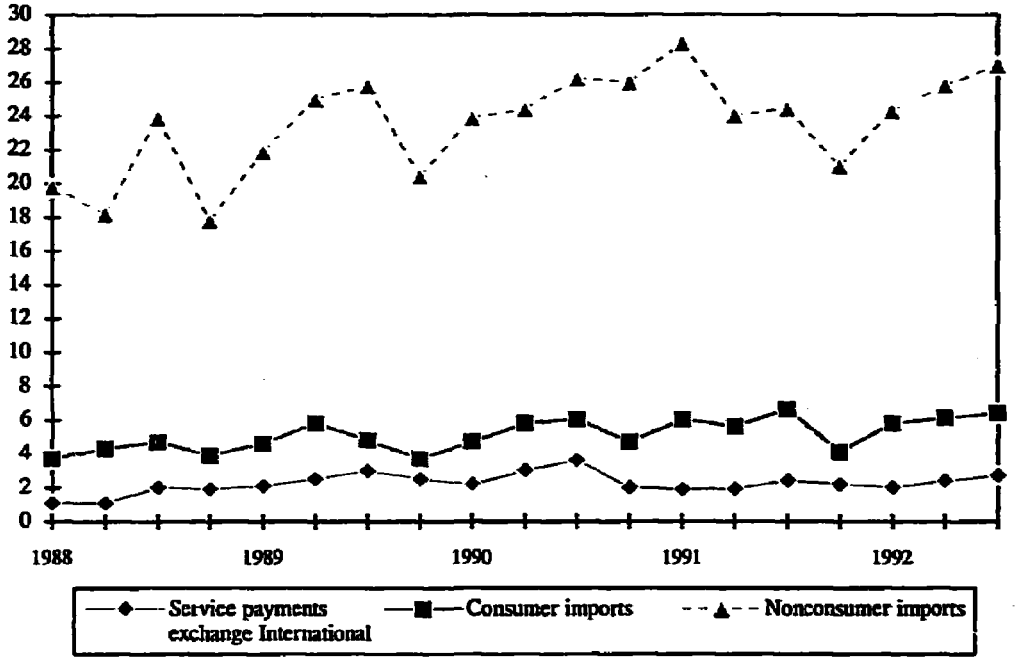


Figure 12.9. *Trends in Selected Major Foreign Exchange Outflows, 1988–92 (in percentage of GNP)*



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INDIA: COMMERCIAL BANK REFORM

Suman K. Bery

Suman K. Bery is special consultant to the Reserve Bank of India on leave from the World Bank. The views and opinions expressed in this paper are entirely the responsibility of the author and should not be attributed to either of the organizations with which he is associated. Editor

India is currently engaged in a wide-ranging program of reform and deregulation. Although initial efforts began in the early 1980s, the pace and intensity of reforms has increased markedly since July 1991. In mid-1991 India was in the throes of both political and economic crisis. A mid-term Parliamentary election had produced no clear majority and ex-Prime Minister Rajiv Gandhi had been assassinated in the course of the campaign. Concurrently, the country was racked by a severe balance of payments crisis. The proximate causes of this crisis were the Gulf war with its impact on oil prices and workers' remittances, as well as the turmoil in the former Soviet Union, a major trading partner for India and a source of low-cost oil. The combination of political and economic uncertainty in turn provoked unease on the part of foreign commercial lenders and rating agencies, causing a drying up of commercial credit, prompting recourse to official balance of payments support from the international agencies.

While these external elements served to provoke it, the crisis was also a sign that the inefficiencies generated by the existing policy framework were no longer affordable. Accordingly, the adjustment program, developed under the leadership of Prime Minister Narasimha Rao and Finance Minister Manmohan Singh, has consisted of both stabilization and structural elements.

The stabilization effort focused on fiscal consolidation, almost entirely at the central government level, largely consisting of expenditure cuts.[1] The structural measures were oriented largely to deregulation of private industry, foreign exchange

1. India has a federal financial system. In financial year 1991–92 (April to March) the consolidated deficit of the entire public sector has been estimated at 10 percent of GDP, of which the deficit of the central (or Union) government was 6.5 percent. The target fiscal deficit for 1994–95 is 6 percent of GDP. Since March 1993 the exchange rate of the Indian rupee has been unified and market-determined, with the Reserve Bank intervening to smooth out temporary imbalances. The rate has remained steady at around Rs 31.37 per US dollar.

and trade, including liberalization of domestic and foreign entry into previously licensed sectors, the replacement of a large number of quantitative restrictions (QRs) on imports by import tariffs, and the replacement of complex administrative allocation of foreign exchange by a unified market-determined exchange rate, and virtually full current account convertibility. The package was designed to stimulate export growth, and more broadly to improve the efficiency of a highly protected industrial sector.

Reform of the domestic financial sector did not form part of the initial set of reforms, but events quickly moved it to the forefront. The incoming government commissioned a high-level committee to review future directions for the financial system. This committee, referred to as the Narasimham Committee, Government of India, issued its report in November 1991, and was highly critical of the weak financial position of Indian depository institutions that are mostly owned by the government. Second, with the diffusion of Bank for International Settlements (BIS) capital standards and norms, foreign regulators required Indian banks operating abroad to meet international standards of accounting and capital adequacy. Third, in April 1992 irregularities were uncovered in the portfolio management and treasury activities of a number of commercial banks, both domestic and foreign. These irregularities revealed a large-scale breakdown in the internal controls of banks, as well as systematic violation of Reserve Bank regulations. The financial system, and the commercial banks at its heart, were seen to be operating a rogue existence, notwithstanding an elaborate panoply of regulations, internal and external audits, and central bank supervision.

For these reasons financial sector restructuring, liberalization and deregulation have become more prominent on the reform agenda, and have spawned a vigorous internal debate on the evolution of the system (Bery 1994; Government of India 1993a; Narasimham 1993; Rangarajan 1993). In this paper I will briefly sketch past policies toward the Indian financial system, concentrating particularly on those policies that affect the commercial banks, which comprise around two-thirds of the formal financial system. I will then describe the agenda of change which began first to be articulated in the mid-1980s and implemented at that time, but which has received further impetus from the forces described above. Finally I will describe recent measures taken by the authorities, and present some of the issues open for debate at this time.

Key indicators of the Indian economy and financial system indicate that, notwithstanding the denouement in 1991, the 1980s was a relatively successful decade for India, with average GDP growth of 5.3 percent and average inflation rates of around 8 percent. The table also indicates the steady increase in the depth and institutionalization of the financial system, as reflected in a rising M3/GDP ratio, increase in the number of bank branches (particularly in rural areas), and a reduction in the currency ratio. The draw on foreign savings (reflected in the difference between the savings and investment rates) was around 1.5 percent of GDP, resulting in a steady rise in the external debt ratio.

The Historical Context

Indian banking and finance were well developed even in the colonial period, sufficiently so to attract the attention of many academic analysts, including Keynes. There was a significant presence of both foreign and domestic banks, and a well-developed stock market. The financial system, then as now, was centered in Bombay, and the formal financial system was surrounded by and well integrated with traditional or informal financial markets of considerable reach and efficiency. The Reserve Bank of India (RBI), the Indian central bank, was established in 1935 along the pattern of the Bank of England. Prior to independence, commercial banking was largely oriented toward financing of both internal and external trade.

The first two decades after independence (1947) were spent in creating the legislative framework appropriate for banking in a newly independent nation, one that had committed itself to planned development. The colonial banking system was seen as inadequate in crucial respects: its focus was entirely short-term, providing working capital and trade finance, and its penetration into the rural areas was pitiful. The landmark Banking Regulation Act was passed in 1949, and provided the legal foundation for considerable control by the Reserve Bank of India over the pattern of credit flows by banks. Efforts were made to encourage the largest bank, the Imperial Bank, to extend its branch network into the rural areas, but it did not find this remunerative, leading ultimately to its nationalization in 1955 and rechristening as the State Bank of India. Term financing institutions for agriculture and industry were established in the public sector, supported by rediscount facilities and capital from the RBI. Life insurance business was nationalized in 1956.

The privately owned domestic banks did not cover themselves with glory in the post-independence period. In addition to several bank failures, there was growing criticism of the concentration of economic power in the hands of industrial houses which dominated the major banks. There were increasing efforts in the 1960s to curb 'excessive' credit preemption by favored industrial customers. This period saw the introduction of the Credit Authorization Scheme, which initiated the review of large credit accounts by the Reserve Bank itself (Reserve Bank of India, 1985). This was followed by an attempt at defining a National Credit Plan: what came to be known as 'social banking'. The agenda underlying social banking was the extension of banking to rural areas and reorientation of credit flows away from big business toward the neglected sectors such as artisans and self-employed.

State control of the commercial banking system greatly intensified in 1969, with the nationalization of the 14 largest domestic private banks.[2] A programming and monitoring system was put in place to realize the goals set before the banks to reorient credit flows, expand the branch network of banks, particularly to the rural and semi-urban areas, and to increase the mobilization of financial savings through the banking system (Rangarajan and Jadhav, 1992). Banks were set quantitative targets in all these areas, and their attention (and that of the regulators) was devoted to performance on these criteria, rather than financial soundness. Target allocation to designated priority sectors was initially 33 percent, and rose over time to 40 percent. Such directed credit targets also applied to privately owned domestic commercial banks, and in modified form to foreign banks.

These trends were paralleled by a rise in the preemption of credit by the central government to finance its fiscal deficit. The main device used was the statutory liquidity ratio (SLR), as an obligatory investment requirement in government bonds related to the size of a commercial bank's liabilities. Such portfolio requirements were also imposed on insurance companies and provident funds. The existence of this large pool of captive investors, mainly under public ownership, permitted government to place debt at below-market rates. This led to the decline of voluntary holding of government paper by the public at large, and prevented the development of a liquid secondary market in such paper.

In time, the scale of government funding requirements exceeded the capacity of this captive market, and the government resorted to increased direct borrowing from the RBI (i.e. monetisation of the deficit). In order to neutralise the impact of this expansion in high powered money, the RBI was compelled to raise reserve requirements, referred to as the cash reserve requirement (CRR), which represented a further control on bank asset portfolio composition. The proportion of incremental demand and time liabilities of scheduled commercial banks preempted by the CRR and the SLR rose from 40 percent in 1980–81 to 63.5 percent in 1990–91 (Government of India 1993a).

These asset restrictions were additional to the 40 percent of loans and advances that had to be assigned to priority sector borrowers, usually at susidized interest rates. Furthermore, lending to large industrial borrowers (in both the public and private sectors) took place through officially sanctioned consortia of banks with rigid rules of entry and exit to such consortia. By the beginning of the 1990s therefore, the margin to manoeuvre available to Indian commercial banks had become extremely small. The structure of the industry was however protected by a de facto ban on entry of private

2. In addition, six banks were nationalized in 1980. This group of 20 banks, wholly owned by the Government of India, are referred to as the nationalized banks. With the merger of two nationalized banks in 1993, their number now stands at 19. The State Bank group includes the State Bank of India and seven associate banks. The 19 nationalized banks and the eight banks in the State Bank group are collectively referred to as the public sector commercial banks.

domestic banks, and only limited entry of new foreign banks, or expansion of existing foreign banks.

The Narasimham Critique

As noted earlier, the most recent wave of liberalization has been guided by the Narasimham Report. The Report made the strategic judgement that the problems of Indian banking were not fundamentally attributable to public ownership, but rather to the managerial and policy environment within which banks had operated. It was forthright in drawing attention to the high cost, poor service, low profitability, poor loan recovery and weak capital position of virtually all publicly owned banks. The main explanations provided for this state of affairs were excessive centralization and political interference, which had served to undermine the sense of institutional autonomy, pride and accountability in the banks.

To correct this situation the Report recommended a series of measures to tighten accounting rules, raise capital requirements, reduce asset restrictions of various kinds particularly CRR, SLR, and priority sector credit, to strengthen the legal basis for enforcing foreclosure, and to liberalize the entry of both domestic and foreign banks. The Report was somewhat circumspect in recommending full liberalization of interest rates, arguing instead for administered maximum deposit rates at real levels and minimum lending rates, with only gradual decontrol. On the managerial side, the report made a strong plea for full autonomy for the management of the commercial banks. In particular it argued that supervision and control of the commercial banks be entrusted entirely to the Reserve Bank of India, rather than being shared between the Central Bank and the Ministry of Finance (the owner), as is currently the case. Overall it argued that "issues of competitive efficiency and profitability are.ownership neutral. It is how the institutions function or are allowed to function that is more important" (Government of India, 1991).

As would be clear from the above synopsis, the Narasimham proposals represented a clear departure from the prior pattern of Indian banking. While an overall vision of the future Indian banking system was sketched, issues of appropriate sequencing were not highlighted; thus the restructuring agenda and the liberalization agenda were presented as occurring concurrently. A number of policy actions have been taken since the report was submitted, while as noted a debate has been stimulated on others. Issues of strategy and sequencing are now more sharply defined, although final positions on certain key issues (e.g. the treatment of contaminated assets, and the treatment of excess staff) remain unresolved. Accordingly, we next turn to actions already taken, and issues still to be addressed.

Asset Classification, Provisioning and Capital Adequacy Norms

The first step, appropriately enough, was to establish the true condition of commercial bank balance sheets, especially of the public sector banks. To this end more objective and stringent standards of income recognition and asset classification were announced in April 1992, to be incorporated in the accounts of commercial banks for the financial year 1992–93 which ended in March 1993. Based on these standards, explicit prudential provisioning norms were laid down.

In regard to income recognition, the Reserve Bank instructed banks to treat a credit facility (loan or cash credit account) as 'past due' when interest has not been paid 30 days from the due date. A 'nonperforming asset' was defined as a credit facility in respect of which interest remained unpaid for a period of four quarters (one year) from the date it had become 'past due' during the year ending March 31, 1993. This definition will become progressively tighter: to three quarters in the financial year ending March 1994 and two quarters in the year ending March 1995. Banks are not allowed to book interest income on nonperforming assets.

With regard to asset classification, banks will now be required to classify assets into just four categories: standard assets, sub-standard, doubtful, and loss. This system replaced an earlier system of eight health codes, which was heavily reliant on subjective judgments of bank officials. Under the new classification scheme, a 'sub-standard asset' is one which has been classified as nonperforming for a period not exceeding two years. Banks are required to make nonspecific provisions of 10 percent against assets classified as sub-standard. After an asset has been classified as sub-standard for two years, its classification changes to 'doubtful'. Doubtful assets attract 100 percent provisioning for the unsecured portion of the advance, while provisions rise progressively to 50 percent of the value of the secured portion over three years following the classification as doubtful. An asset is considered a 'loss' asset when it is so identified by the bank, its auditors (either internal or external), or the RBI inspectors.

Concurrent with these regulations, capital adequacy requirements linked to risk-weighted assets have been imposed. A four percent capital adequacy ratio is to be attained by March 31, 1993, rising to 8 percent by March 31, 1996 (March 31, 1994 for Indian banks with overseas branches). Foreign-owned banks operating in India were to attain the 8 percent standard by March 31, 1993. As has been prescribed by the Basle Committee, two forms of capital have been distinguished: Tier I consisting of common equity and unencumbered reserves and Tier II consisting of long-term subordinated debt and various forms of hidden reserves. The total of Tier II elements may not exceed Tier I or core capital.

Implementation of Norms

To facilitate the introduction of these new standards, the RBI provided the banks with certain transitional reliefs. As minimum provisioning standards were being specified for the first time, banks were allowed to apportion minimum provisioning identified for end-March 1993 as follows: at least 30 percent to be taken into the 1992–93 accounts, and the remaining 70 percent in the 1993–94 accounts. Such phasing was not however permitted for provisions against loss assets which had to be fully provided for in the 1992–93 accounts. Second, primarily as a matter of administrative convenience, advances with an outstanding balance of Rs 25,000, consisting of a very large number of borrower accounts but only about 12 percent of total credit outstanding, were exempted from the need for detailed classification for provisioning purposes, although a classification into performing or nonperforming was needed for income recognition purposes. For the first year banks were allowed to make a minimum general aggregate provision of 2.5 percent of total loans outstandings in this category for 1992–93, and then a minimum of 5 percent in 1993–94.

The impact of the new accounting norms was reflected in the accounts of the banks for 1992–93. Even after these transitional provisions, as well as the relatively generous definition of non-performing assets in the first year, the accounts revealed what were officially acknowledged to be "significant weaknesses" in the financial position of the public-sector banks. For loans above Rs 25,000, the share of nonperforming loans in total loans ranged between 8 to 10 percent in the better managed banks to as high as 35 to 45 percent in the worst ones. For the public sector banks as a whole, non-performing loans were estimated at around 21 percent of the total loan portfolio, both domestic and foreign (Government of India, 1993). Furthermore, the introduction of tougher income recognition standards and minimum provisioning requirements had a dramatic effect on the published profits of the public sector banks: of the 28 banks 13 were forced to report losses as against only two the previous year. Combined losses amounted to Rs 33.7 billion (approximately US$1 billion) as against a modest profit in the previous year. In regard to minimum capital, it was estimated that the public sector banks as a group faced a capital shortfall of approximately Rs 25 billion in 1992–93, and could require additional capital amounting to Rs 170 billion to attain the 8 percent level by 1996.

Rehabilitation and Restructuring

With the financial position of the public sector banks more objectively established, the task of rehabilitation and restructuring has begun to be taken in hand. Achievement of minimum capital levels was given first priority. While presenting the Union (Central Government) Budget for 1993–94 in February 1993, the Finance

Minister articulated the broad policies that would be foliowed in replenishing capital and restoring viability to the public sector scheduled commercial banks (Government of India 1993c). This framework been followed since and consists of these principal elements:

- The government would subscribe capital to help banks meet capital requirements mandated for the first capital adequacy test date of March 31, 1993, to a principal value of Rs 57 billion. A further Rs 56 billion has been provided in the 1994–95 budget.

- The capital would carry a counterpart obligation for investment in government bonds. It has been subsequently decided that the bonds would be of finite tenor (twelve years, with six years grace) and carry a coupon of ten percent, somewhat below prevailing market rates. The bonds are marketable, but not eligible for SLR.

- The State Bank of India as well as such nationalized banks financially able to do so would be allowed to access the capital markets to raise fresh equity, subject to the constraint that government retain majority ownership and control. In the case of the nationalized banks (but not the State Bank of India) such dilution of government equity entails legislative action which has recently been initiated.

- Specific commitments would be sought from each bank to ensure that its management was taking adequate steps to prevent recurrence of the erosion of portfolio quality and of capital. This has since taken the form of "memoranda of understanding" executed between the Reserve Bank and the boards of each of the nationalized banks, setting out agreed performance targets as a *quid pro quo* for the infusion of government capital.

Events in the intervening year have more or less followed the above course. The tougher accounting standards have thrown into sharp relief the range of performance across the public sector banks. Fortunately the stronger banks are the larger ones in terms of deposits and advances; however there exists a handful of weaker banks whose longer-term viability as independent units is questionable. One of the weakest has recently been merged with one of the stronger nationalized banks. Memoranda of understanding have been concluded with each of the nationalized banks prior to the infusion of capital. The approach that is being followed could in this sense be considered 'case-by-case' rather than generic, reflecting the different financial and managerial context of each bank. The process has served to stimulate greater attention within the banks on issues of loan recovery and profitability, and to highlight the very

different cost structures of the banks, particularly with regard to numbers employed and payroll costs.

Banks are slowly beginning to exploit the greater flexibility available to them to rationalize their branch structure in urban and semi-urban areas; closure of rural branches however remains subject to Reserve Bank review. The banks have been able to negotiate an agreement with their unions to permit computerization on a substantial scale. The government has provided a blanket assurance that either on account of computerization or on account of other restructuring there will be no involuntary retrenchment; nonetheless the banking unions have initiated token industrial action to protest against branch closures. On the financial side, the State Bank of India was successful in floating a large public issue (Rs 24 billion approximately US$775 million) of both equity and debt in the domestic market, establishing a precedent that the stronger nationalized banks will be able to follow once the necessary legislative changes are in effect, and once their balance sheets have been strengthened. Important first steps have therefore been taken, but full recovery and restoration of profitability will require sustained action on a number of fronts which are now discussed.

Asset Recovery and Exchange

The high proportion of nonperforming loan assets in the portfolios of the public sector banks are partly attributable to the weak legal framework in India for enforcement of contracts and realisation of collateral, and the delays in prosecuting default cases through the civil courts. Earlier committees had suggested that special tribunals be set up to handle cases of default. This proposal was endorsed by the Narasimham Committee and accepted by the government. Such special tribunals are about to commence operations in the major cities shortly, and should help improve the prospects for recovering interest due or collecting on pledged collateral. The Committee also argued, however, that:

> ...the impact of the setting up of the Special Tribunals will be felt by the banks only over a period of time...In the meanwhile it is necessary to work out an arrangement to deal with portion of the portfolio of banks which has already become bad and doubtful and whose recovery is being hampered by the slow legal process. To continue to keep such assets in banks' balance sheets would not be desirable even ...substantial provisions are made there against... It would be far more appropriate if these assets were taken off the balance sheet of banks and institutions, so that the funds realised through this process can be recycled into more productive assets...(Government of India, 1991).

Accordingly, the Narasimham Committee proposed the establishment of an Assets Reconstruction Fund (ARF), to purchase doubtful assets from the banks at market value, not the book value. It was felt that this would serve to maximize

recovery, give the banks immediate liquidity, and to concentrate managerial energies on the future rather than the past.

While such recovery agencies have worked successfully in other countries, the ARF concept has not been accepted by either government or the Reserve Bank. Given the large geographic expanse of the country, there is doubt that any new body could quickly develop the reach to enforce collection. There is also the concern that absolving banks from responsibility for collection will weaken their own credit discipline in the future, and may even contaminate the behaviour of borrowers in good standing. Finally, there are significant problems foreseen in capitalising the ARF, over and above the existing capital needs of the banks (Government of India, 1993a). Accordingly, current policy is to permit the originating banks retain responsibility for recovery, aided by the institution of the Special Tribunals.

The issue of loan recovery is much broader than the creation of a one-time ARF, and is deeply affected by both the overall policy framework governing so-called sick (i.e. bankrupt) companies and the politicization of the banking system so openly referred to by the Narasimham Committee. As has been pointed out by yet another government appointed committee dealing with industrial sickness and corporate restructuring, the Goswami Committee (Government of India 1993b), a series of policies, institutions and interventions militate against corporate restructuring and liquidation in India. These policies are often referred to as 'exit policies'. The net outcome for debtors is that funds remain congealed, good money is poured after bad, and the firm's residual value is often lost through delay, fraud or political intervention. As measures to curb dishonest and repeated default, the Finance Minister in his speech presenting the 1994–95 budget (Government of India 1994) announced that the RBI would circulate among banks and financial institutions names of defaulting borrowers above a certain limit, as well as publishing a list of defaulting borrowers in cases where suits have been filed by banks and financial institutions. The efficacy of these measures is as yet unproven, but they should be seen as part of an overall package of measures and incentives designed to deter default.

Asset Composition and Profitability

While recognition and resolution of past losses is the indispensable starting point for bank rehabilitation, the process will not be sustainable without a restoration of profitability. There is little prospect of the commercial banks approaching the markets for Tier I or Tier II capital without assurance that the pricing and policy framework will permit an adequate return to creditors and shareholders. The Narasimham Report dwelt extensively on the reasons for declining profitability of the public sector banks, and the measures that would be needed to reverse this decline. The major policy causes cited by the Committee were the massive preemption of funds by the government through the SLR and the CRR, both remunerated at well below the

opportunity cost of funds, and the directed lending to the priority sectors, also at below market rates.

Action has begun to be taken. Along with the reduction in the fiscal deficit of the central government, the combined burden of the CRR and the SLR has declined from 63.5 percent of incremental deposits in 1991–92 to 25 percent in early 1993. The Narasimham Committee set the goal of an *average* SLR of 25 percent over the medium term. This goal has been accepted by the Reserve Bank, which aims to reach this level by March 1996. The implied portfolio shifts are large. If the commercial banks were to avail of the full reduction in mandated SLR, that is, if they do not elect to hold government securities in excess of the minimum, and put all the released resources into advances, the incremental credit-deposit ratio could be extremely high. One can question the capacity of the existing banks to handle such an expansion judiciously at a time when their own credit assessment capacities are weak, and when, in response to liberalization in the real sector, the quality of credit risks themselves will be rapidly changing.

The appropriate response is twofold. The first, obviously, is strengthened supervision. The second, as argued more fully below, is a rapid shift to market determination of government security rates, to provide a 'safe haven' for funds before they can be prudently deployed.

The authorities have partially followed the latter course. While there remain elements of guidance, rates offered on government securities have become more attractive, and auctions are now widely used to place the debt. The combination of high yields on government debt, weak capital positions of banks, the zero risk-weight assigned to government securities in assessing capital adequacy and the continuing industrial recession have led to a major shift at the margin from advances to investments in government paper, such that the banks are now voluntarily holding SLR-eligible securities well in excess of their requirements. Thus the first response of banks to greater portfolio freedom has been a 'flight to quality' rather than unsound lending, which is all to the good. Such voluntary holding of government paper would in turn make possible use of indirect tools for managing monetary policy, as discussed below.

Interest Rates, Government Debt, Exchange Rates

Deregulation of interest rates will be among the most important, but delicate tasks in the process of financial sector reform. The present structure is itself the product of gradual deregulation from the exceedingly rigid and compartmentalized structure that existed till the mid-1980s. At that time the role of interest rates in deposit mobilization was well recognized, but there was little allocative role assigned to them on the asset side of the balance sheet. A shift in direction was first recommended in

the report of the Committee to Review the Monetary System by the Chakravarty Committee in 1985, which noted a number of weaknesses in the interest rate structure that had emerged (Reserve Bank of India, 1985). At the macro level, the low yields on treasury bills and dated securities were leading to excessive monetization of public debt.[3] At the same time, they were constraining the development of the capital market, while reducing the profitability of the commercial banks. At the micro level, concessionality on interest rates had permitted projects of doubtful viability to be undertaken. Insulating banks from price competition had also not served to improve customer service.

The Chakravarty Committee proposed a cautious liberalization of the then prevailing structure, within the framework of an administered interest rate system. The proposed reforms were to be based on across-the-board increases in the rates offered by government on its debt obligations. The Committee recommended that the discount on short-term Treasury bills (91 days) be set to provide a yield marginally positive in real terms, and that the rest of the yield structure be adjusted accordingly to return expected real yields of one per cent to three percent per annum, depending on maturity. The primary purpose of this increase in yields was to make government securities sufficiently attractive to induce voluntary holding of government debt by the public at large, so as to reduce the monetization of the public debt, while concurrently boosting commercial bank profitability.

These adjustments in government security yields were to provide the foundation for the interest rate structure offered by the commercial banks. The Committee recommended that the RBI specify a maximum deposit rate for fixed deposits of five years and above, and a floor lending rate for the non-concessional advances of banks. This approach was intended to prevent unequal competition between banks of different sizes, and also to ensure a minimum spread between the deposit rates and lending rates which was broad enough to provide a basis for viable banking operations, and yet narrow enough to prevent laxity in bank administration. On these grounds, the Committee recommended a three percentage point spread between the maximum rate on deposits and the basic minimum lending rate. The Committee further recommended that the RBI specify the one-year deposit rate at a suitable level so as to ensure adequate incentives for mobilization of longer-term deposits by the banks. With regard to priority sector lending, the Committee recommended a move to just two concessional rates: the minimum lending rate, and one concessional rate below this minimum rate.

The general evolution of interest rate policy in recent years has been broadly consistent with the above scheme. The Narasimham Committee on the issue of interest rates noted that while interest rates on government debt had been progressively increased in recent years, they were still not at levels to attract voluntary subscribers. While the medium-term objective was to move to market determination of interest

3. Securities paying coupon interest, with initial maturities in excess of one year.

rates, it advocated a cautious approach to deregulation, insisting correctly that macroeconomic stability and the health of financial intermediaries were essential preconditions for full market determination of interest rates. It therefore concluded that for the time being the RBI should remain the authority to determine the level and structure of interest rates. It suggested that a rediscount or refinance rate ('Bank Rate') be used as the anchor for the structure of interest rates, and that the structure be calibrated along the lines recommended by the Chakravarty Committee.

The present situation is as follows. The RBI specifies a ceiling deposit rate approximately 2 percent above the current inflation rate, applicable to fixed deposits of maturities between 46 days and three years and above. Currently, this rate is at 10 percent. Commercial banks are free to set intermediate rates below this ceiling, but in practice these rates are established in accordance with guidelines of the Indian Banks' Association. The RBI prescribes outright the rate of interest to be offered on savings deposits, currently at 5 percent. Banks are subject to no rate restrictions on certificates of deposit which are a wholesale instrument subject to a high minimum size.

In the case of advances, banks are stipulated a minimum rate for advances in excess of Rs 200,000, currently set at 15 percent; there are currently three concessional rates below this, linked to size of advance rather than to sector of beneficiary as was previously the case. Apart from a highly concessional rate of 4 percent offered to the extremely indigent, the two other specified rates are 12 percent for advances below Rs 25,000 and 15 percent fixed for advances above Rs 200,000. In addition exporters enjoy access to short-term preshipment and postshipment credit at 13 percent. These rates for exporters are in turn underpinned by access to refinancing facilities from the RBI, although this refinance is not currently being availed of to any significant extent.

There has been evolutionary change in rate determination on government securities. At the time of the Chakravarty report all government security rates were determined unilaterally by the RBI in consultation with government. Market demand factors were cautiously introduced in 1986 with the auction of 182-day Treasury bills. This instrument was replaced in 1992 by a 364 day bill, also placed by auction, and, in common with the 182-day bill, not held in portfolio by the RBI. In early 1993, the RBI introduced a 91 day bill also placed by auction, but which is being held by the RBI in its portfolio. This instrument could potentially be used for future open-market operations. Since April 1992, the RBI has also moved to auction of the entire primary issue of Central Government dated securities, although with RBI participation in the auctions. The one category of debt which is still placed at fixed, preannounced rates is the debt of State governments, although here too there has been a move toward market levels: the rate offered in 1993–94 was 13.5 percent for a ten-year security. This yield constitutes an effective cap on the term-structure of SLR-eligible securities, and the RBI's effort in the auctions for other securities is to maintain a well-behaved yield curve with respect to this cap. The RBI has also in the last year introduced repurchase

operations with banks and financial institutions against collateral of dated securities, in an effort to influence conditions in the short-term money market.

It is the declared intention of the government to move to market rates of interest on government debt, while the RBI also has declared its intention to move to indirect instruments of monetary control. The need for flexible monetary instruments will be all the greater with the increasing trade and financial openness of the economy, and market determined exchange rates. Thus far, interest rate and monetary policies have been set largely with domestic conditions in mind. Movement in these directions requires that the primary financing needs of government be met outside the central bank, with the central bank intervening in the secondary market to achieve its monetary policy goals. A major step in this direction has been the announcement in the Budget Speech for 1994–95 (Government of India 1994) that the government will progressively reduce its recourse to direct funding from the Reserve Bank so-called *ad hoc* Treasury bills with the intention to phase out this instrument altogether in the next three years. This move, taken together with the reduction in SLR requirements, will lay the policy basis for healthy primary and secondary markets in government securities.

These initiatives will need to be accompanied by a vigorous regulatory and institutional effort, comparable to that which has been underway in the equity markets over the last two years. Indeed the regulatory challenge may be even greater, since fraudulent broker dealings in government securities were at the heart of the financial irregularities uncovered in 1992. While a move to market determination might involve a temporary increase in rates, the long-term impact of wider ownership and more efficient markets should be to *lower* the cost of any given quantum of borrowing. While the Union Budget may be in a position to absorb such a temporary increase in rates, the State governments, who are at an earlier stage of their fiscal adjustment, may not. Accordingly, special arrangements will need to be devised to ensure that the constraints facing State governments do not impede progress in the overall market for government debt. The secondary market yield on government paper should in time become the reference point for other interest rates in the system, including deposit rates offered by banks. Provided that the capital position of banks has been strengthened, effective supervision is in place and a modicum of competition has been introduced in the system, the moment would then be ripe for complete deregulation of interest rates.

Directed Credit

The scope for subsidizing interest rates to preferred sectors will clearly narrow in a market-based interest environment. A rather different set of issues is raised by the priority sector concept itself, i.e., directed portfolio shares, not necessarily at subsidized rates. Charges of discrimination by banks against certain sectors arise in all societies. The case for government intervention is usually justified by the considerable regulatory protection given to banks. By the same token regulators in industrial

countries typically resist explicit portfolio requirements on the argument that these lower credit standards and dilute accountability. A market response, sometimes stimulated by policy, is to foster specialized institutions who are more adept at assessing credit risk and recovery in individual niche markets.

Considerable action has been taken in recent years to reduce the number of concessional rates. Concessionality is now linked to size of advance rather than to recipient sector. The Narasimham Committee recommended that the share of priority sector advances be reduced from 40 percent to 10 percent and apply to a more restricted group of sectors. No reduction in the 40 percent target has yet been approved; however the list of eligible priority sectors has recently been widened. Since the incremental lending capacity of banks will rise sharply as the SLR declines, there is a danger that the expansion in lending to these sectors would be in excess of their absorptive capacity, and could perpetuate the problems of poor credit quality associated with such lending.

Regulation, Supervision and Governance

As noted above, the focus of supervision in the post-nationalization period was either on achievement of quantitative targets, or on monitoring large individual credit accounts, but not particularly on the financial soundness of banks. The Narasimham Committee urged a refocusing of the supervision effort on prudential issues. It also recommended a shift in the organizational structure of supervision, from the present arrangement as a department of the RBI to a quasi-autonomous board under the Reserve Bank, but with responsibility for all depository institutions. The new structure has been designed and will become effective shortly. Supervision is not intended to substitute for management: modern bank transactions are vast in volume and multifarious in scope, and cannot be controlled, let alone run by a central bank. Indeed, the focus of most supervision in industrial countries is largely on the internal systems of banks, and not on their individual credit decisions, and is increasingly directed at identifying and addressing systemic risks.

This raises perhaps the most difficult and controversial issue: what will be needed to improve the managerial accountability of the nationalized banks. As noted, the judgment of the Narasimham Committee was that public ownership of the banks was not the issue, but rather bureaucratic and political interference. The Committee offered a range of solutions, the most important of which was to concentrate regulatory powers in the Reserve Bank of India and the new supervisory board, while limiting the role of the Banking Division of the Ministry of Finance. The Committee also made various suggestions on the appointment and powers of chairmen and bank boards, and on areas for greater autonomy for banks. There has been no consolidated response from the authorities to these proposals, other than to reject any immediate diminution

in the role of the Ministry of Finance. There has, however, been an official airing of the very deep-seated and substantial managerial difficulties of the banks, indicating that changes in their governance are perhaps forthcoming (Government of India 1993a). The dilution of government shareholding in the nationalized banks, as and when it occurs, will involve changes in the composition of bank boards, although the right of appointment of the chairman will remain in government hands.

Adjustment in the Banks

When the commercial banks were nationalized they were permitted to retain their individual identities in the interests of stimulating limited competition. In practice, a number of centrally determined policies, such as central recruitment of staff, rotation of bank chairpersons across banks, policies assigning lead roles to individual banks in particular geographic areas and in lending consortia, and powerful industry-wide trade unions have all served to dilute rather than intensify competition. Despite these pressures toward homogenization, differences in managerial traditions of individual banks are noticeable in their financial results. However all of them are, by international standards, overmanned and technologically antiquated. Further, the quality of their internal controls, communications and human resources was greatly overstretched by the rapid expansion of the last twenty years.

A major task of institutional upgrading thus lies ahead. While the agenda will clearly differ from bank to bank, manning levels, human resources, technology, internal controls, and improved risk management are clearly common areas for all banks. The Narasimham Committee was of the view that this process would be best facilitated by giving full operational autonomy to the management of each bank. While managerial autonomy is no doubt desirable, it is questionable whether a completely laissez-faire approach would work for the weaker banks. More fundamentally, the banks will need to rethink their role in the financial marketplace. Given the cost structure of banks (in large part the result of regulatory constraints) the better credit risks will continue to look elsewhere for their funding needs. As access to external funding has widened, this process will accelerate. In common with banks worldwide, fee-based income will need to become a larger part of the total, and more creative ways found of using the extensive branch network which is the banks' major competitive advantage.

In order to increase the competitive pressure on the public sector banks, the Reserve Bank of India in 1993 announced new guidelines for the entry of new domestic private sector banks. A minimum paid-up capital of Rs 1 billion has been established, with new banks required to meet the 8 percent capital requirement from the beginning. These banks will be required to meet the same priority sector lending goals as existing banks. Several private and semi-official promoters have been granted in principle approval and actual operating licenses have started to be awarded.

Conclusion

This paper has concentrated largely on the challenges facing the Indian public sector commercial banks, and changes in the environment within which they operate. While such a narrow focus may be criticized, the justification is that these remain the core institutions of the Indian financial system, with the greatest capacity to retard or assist the broader programme of real sector adjustment and growth that is underway. The fundamental preconditions for a healthy financial system are clearly in place in India: high saving rates and low inflationary expectations. However, the role assigned to the banks has been radically altered. From institutions designed to channel resources to public investment and to highly regulated private uses, the banks are now being asked to become globally competitive, and to develop risk assessment capacities that may have rusted.

The sequencing of reforms so far has followed the "new orthodoxy". Real sector reform has preceded financial sector reform, so that the future pattern of real returns is clearer; fiscal adjustment and disinflation was to provide the foundation for liberalization, although this process has received a setback in the last year; diagnosis and clean up are preceding new freedom. Perhaps the only departure is that entry of new banks is being permitted early in the process. The major issues thus revolve around the management of the process and the pace of change. As the banks take up the task of globalization, though, it is as well to remember the persistence of the populist agenda that has colored past policy. It is only if those demands are seen to be met by the new policy framework, that the recent changes will be politically sustainable.

Equally, policymakers have so far had the luxury of treating reform in each segment of the financial system in isolation: the capital markets, the banking system, government debt markets and foreign exchange markets. A surge in capital inflows in the last six months have demonstrated the linkages between these areas. Liberalization of borrowing abroad has affected the offtake from the domestic banking system; capital inflows have eliminated short-term exchange risk, leading to attractive arbitrage possibilities. These new developments are straining the existing framework of economic management and will entail the development of new skills and capacities on the part of policymakers.

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14

FINANCIAL SECTOR REFORMS AND LIBERALIZATION IN THE REPUBLIC OF KOREA: CURRENT STATUS AND PROSPECTS

Choon Taik Chung

Recent Trends in Korean Financial Policy

Since the early 1960s the Korean government has made an enormous effort to accelerate its economic development. In order to industrialize in as short a time as possible, Korea adopted a government directed strategy for its economic growth, investing heavily in basic and export-oriented industries. Although Korea has its share of failures in some key sectors, its industrial strategy was instrumental in and credited for phenomenal growth in a short time. Consequently, such growth resulted in the expansion of aggregate output and a more complex industrial structure.

Following the growth of the Korean economy in both size and structure, the direction of economic policy in Korea shifted from a basically government-led scheme to a free market system during the early 1980s. In terms of international trade, Korea began to make a serious effort to open its market. At the same time, domestic companies were encouraged to enhance their competitiveness in the world market. With widespread consensus among Korean economists for less government intervention, the process toward an open market system gained needed momentum in the last two decades. Subsequent government efforts to remove trade barriers resulted in substantial increases in both international trade and financial transactions.

Since the 1980s, the Korean government has embarked on financial liberalization as part of a comprehensive economic liberalization program. The government allowed the domestic banking market to open up to foreign banks in order to introduce more competition in the industry. The liberalization of the foreign exchange market and capital flow subsequently followed in the latter half of the 1980s.

An Overview of Korea's Financial Liberalization Process

During the 1960s the government exercised strict control over assets, liabilities, and management of individual banks to extend loans to industries judged to be of strategic importance to the nation's economy.

This system of preferential loans was probably seen as quite useful in the early stage of the economic development. But as the nation's economy grew and became more complex, many of the defects of financial repression became apparent. As long as the interest rates remained low, the excess demand for loans was seen as inevitable.

This, in turn, led to extraordinary growth in the money supply and inflationary pressure. The policy loans encouraged investment beyond optimal levels and decreased efficiency in the allocation of resources. The low interest rates paid by banks on deposits discouraged the growth of domestic savings, which led to a greater dependence on the inflow of foreign capital to finance investment. Government regulations on the banking industry also retarded the development of the banking system. The securities market and other financial institutions were unable to grow out of their infant stage in the 1960s.

By contrast, financial repression contributed to the rapid growth of the unorganized market or the curb market. It was difficult to regulate these unorganized money markets. The government realized that an underdeveloped financial sector could impede economic growth and that policy reforms to liberalize the financial market were desperately needed.

One of the most serious problems in Korea's financial market was the government control of interest rates. In fact, real interest rates often turned out to be negative because of the government's tight control. To solve this problem, the government drastically raised nominal interest rates in 1965. This brought an unprecedented increase in domestic savings and contributed to the efficient allocation of resources. However, high domestic interest rates led to a sudden increase in international borrowing, and because of the negative-margin interest rate structure, the profitability of the banks deteriorated drastically. Because of these and other side effects, the government lowered interest rates at the end of the 1960s and returned to completely controlling the interest rate policy.

Partial Liberalization in the 1970s

The strict banking regulations of the 1960s brought about a dual structure in the Korean financial market. The market was divided into a regulated market and an unregulated market. Remarkable discrepancy between the interest rates existed in the parallel markets. To absorb the curb market, the most important step would have been to abolish interest rate controls. Nevertheless, the Korean government decided to establish nonbank financial institutions (NBFIs).

With NBFIs the organized market was not only expanded, but it was also segmented and regulated in a discriminatory way. The government reduced regulations on the NBFIs, including the easing of interest rate control, while it continued to hold banks under tight control. The regulatory differentiation on these two financial markets resulted in the unbalanced growth of financial institutions. Various types of

NBFIs were established in the 1960s. Since then they have grown much faster than the banking industry.

During the 1970s the government adopted a set of new industrial policies to promote heavy and chemical industries (HCIs). This change required large investment capital for HCI projects. To provide needed capital, the banks were directed to make loans to HCIs and other strategic industries on a preferential basis. This caused a serious distortion in the allocation of funds and resulted in a huge amount of nonperforming loans, excessive and inefficient investment, and a stifled banking system.

Integration of Domestic Financial Markets in the 1980s

By the late 1970s it became clear that the government-led economic policy had caused serious adverse effects, such as aggravated inflation, stagnated economic growth, inefficient resource allocation, and sectoral imbalances. As a result the government changed its economic management strategy from government led to private sector led. Accordingly, policy reform required financial liberalization and restoration of the market mechanism in the financial industry.

Financial reform commenced in 1981 and financial liberalization was adopted. Detailed regulations governing the organizational, budgetary, branching, and business practices of banks were relaxed. The government privatized commercial banks and gradually reduced policy loans. In addition, the scope of operations expanded. For banks, this included certificates of deposit, credit cards, commercial papers, government securities, factoring, and trust business. NBFIs also expanded their range of operations. The overlap and expansion of financial services stimulated competition among financial institutions, thereby upgrading their efficiency.

To promote competition, new entries were allowed into the financial market. Two nationwide commercial banks opened in 1982 and 1983, and short-term finance companies and mutual savings and finance companies were established. During 1988–89, the government approved the further establishment of commercial banks specializing in small and medium-sizes firms, securities companies, leasing companies, and life insurance companies.

By June 1982, most preferential interest rates applicable to various policy loans were abolished, making it easier to scale down policy loans. In 1984 the government reduced the interest rates gap between banks and the NBFIs and allowed financial intermediaries within a given range to determine their own lending rates according to the creditworthiness of borrowers. In earlier efforts of interest rate deregulation the Korean government had adopted the strategy of introducing new financial products with interest rates that moved closely with market rates. This strategy seemed to have worked well at gradually providing an environment for wider-scale interest rate

deregulation at a later stage when macroeconomic and other conditions for deregulation matured. But these measures sometimes produced outcomes that did not meet expectations, because the government was so worried about an interest rate (cost of capital) burden on the business sector, and thus intervened whenever interest rate levels for new financial products became unpalatable.

Low and stable inflation since 1983 and high national savings in excess of domestic investment narrowed the gap between the regulated and free market rates.

Against this background, the government initiated the plan for interest rate deregulation in December 1988. Most bank and nonbank lending rates and some long-term deposit rates were decontrolled except for rates on some policy loans and short-term deposit rates for the fear of excessive competition among financial intermediaries.

A few months after the deregulation, however, the government and business sector became so concerned about the drastic rise in interest rates that the government again intervened, giving tacit consent to a collusion on interest rates by financial institutions. As a result, bank lending rates and most rates in the primary securities market again became very rigid and unresponsive to market conditions. Thus, the first attempt at interest rate deregulation ended as a futile exercise.

Financial reform contributed to the integration of domestic financial markets. Unlike the financial reforms in the 1960s and 1970s, financial reform in the 1980s harmonized differential regulations between banks and NBFIs and integrated financial markets that had been segmented. The government has been more concerned with preventing further shrinkage of the banking sector while still keeping it under control. Meanwhile, restrictions still existed on foreign participation in many businesses within the domestic financial markets and on international capital movements during the 1980s.

Current Status and the Issues of Reform in the Korean Financial Industry

In the process of Korea's economic development, the main role played by Korea's financial industry was to successfully support growth in the real sectors of the economy, even with the acute shortage of domestic capital. At the early stage of the economic development, Korea's banks functioned as quasi-government organizations in supplying capital from the international sources. They were managed more like public entities, and the development of the financial industry was delayed.

At the same time, it was necessary for the government to intervene in the financial system to allocate funds for promoting the growth of the economy. As such, no financial institution in Korea has gone bankrupt. Despite the lack of a deposit insurance system, there was high public trust in the financial institutions. In this respect, Korea's financial system is different from that of the developed countries where financial institutions operate in a free market with minimum government intervention.

Having accomplished the initial economic goal, the financial industry is in a position to be fostered to meet the challenges of the new world economic order. To this end, financial institutions must first be allowed to operate under market mechanism to achieve higher efficiency in the allocation of financial resources, while government influence can gradually be reduced. Second, Korea must strengthen the competitiveness of the financial industry through continued innovation and scientific management. Third, Korea's financial industry must improve and modernize its micro-structure while training professionals to handle new financial techniques and products.

Korea's Financial Deregulation and Market Opening

The Korean government has pursued deregulation, liberalization, and internationalization of its financial market. Since the early 1980s it has supported the privatization of the banking sector and the self-regulation of financial institutions. Last year a four-stage interest rate deregulation plan was announced, and foreign exchange management was converted from a positive to a negative system to encourage full-scale overseas activities. In particular, the government has augmented the competitiveness of the markets by applying an equal treatment policy to foreign financial institutions. The insurance market was fully opened in 1988, introducing twenty-seven foreign insurance companies to the Korean market.

Since January 1992, the stock market was opened to direct foreign investment, and since then thirty-eight foreign securities firms have entered Korea. As of October 1992, about US$1.7 billion in foreign capital have been invested in the equity market. In the meantime, Korean companies gained permission to issue securities in overseas markets, and the limit on direct foreign investment in local stocks has been raised.

The Korean government's efforts toward financial liberalization are reflected in the Uruguay Round negotiation on financial services and in Korea-U.S. financial relations. The Korean government has actively participated in the Uruguay Round since it began. In January 1991 Korea became the twelfth participant from more than one hundred participants to submit the offer list to the General Agreement on Tariffs and Trade (GATT). During this last stage of negotiations, Korea plans to make further endeavors to lower global barriers in financial services.

With regard to Korea-U.S. financial relations, the Korean government has held the Korea-U.S. financial policy talks since 1990, and many issues raised by the United States have been resolved through this bilateral negotiation. Participation in the trust business, the elimination of ceilings on operating funds, and restrictions on branch establishments are some of the latest achievements of these talks. A detailed list of measures includes about twenty-four items (see the appendix).

As a result of these actions the business environment for foreign banks has improved. For instance, the return on assets of foreign banks rose to 1.6 percent in

1991, which is over four times the 0.4 percent for Korea's five major commercial banks. The Korean government continues to make an effort to foster its financial industry in the spirit of the deregulation and opening policy through the Uruguay Round and the financial policy discussions.

The Road Ahead

Considering the current international economic environment, such as globalization of the international financial and capital market and the progress of financial services negotiations in the Uruguay Round, it will be very difficult for the Korean government to maintain the current level of liberalization of its financial market and capital movement. Furthermore, because the Korean economy is growing rapidly and the restricted and oligopolistic structure of the Korean financial industry has resulted in inadequate services and high profits, foreign financial institutions may see many opportunities for effective and rewarding market penetration. The United States initiated financial policy talks with the Korean government in February 1990 to press further financial sector liberalization, regulatory transparency, and national treatment of U.S. financial institutions. All these factors will lead to Korea's rapidly and further liberalized financial system in the near future.

The government is now focusing more attention on a comprehensive liberalization of the financial system. The government's plan to liberalize interest rates, initiated in December 1988, was largely abandoned several months later because of the sharp rise in interest rates. It was not until November 1991 that the government reintroduced a comprehensive interest rate liberalization plan to be implemented in four phases. This plan is a gradual process, with deregulation of most short-term deposits and government instruments deferred until the latter two phases. Complete liberalization is not envisaged until 1997 at the earliest.

In early 1992 the government initiated a more comprehensive reform program and announced its three-stage Blueprint for Liberalization and Opening of the Financial Industry (see table 14.1). The first stage, which was already implemented, includes measures to facilitate the Korean currency funding for foreign banks, to improve transparency in bank supervisory regulation, and to widen the range for foreign exchange rate fluctuations. The second stage, announced in June 1992, included plans to open the investment trust industry, relax restrictions on foreign exchange positions of banks, and internationalize the Korean currency. The third stage deals with long-term and structural issues in the development of Korea's financial industry. These include deregulating interest rate, relaxing lending regulations, opening a bond market, and liberalizing capital transactions, to mention a few.

The Korean government plans to finalize the blueprint for these measures by the end of 1992. By continuing with such measures the Korean government plans to liberalize and open up Korea's financial industry to the level of developed countries in

the near future. However, as the experience of some Latin America countries shows, what the Korean government worries about is the fact that hasty liberalization could invite undesirable side effects and destabilize the economy. As such, implementation depends on certain macroeconomic conditions, including narrowing the interest rate differential between domestic and international rates, restoring the balance in the current accounts of payment, and achieving lower inflation.

Table 14.1. *Blueprint for Liberalization and Opening of the Financial Industry*

Implementation schedule	*Items*
First stage (1992–93)	1. Expand CD issuance quotas, extend maturities, and lower minimum, denominations. 2. Improve the transparency of regulations. 3. Extend maturities on the short-term call market. 4. Allow securities companies to hedge funds against exchange rate risks. 5. Allow over-the-counter trading of domestic bonds. 6. Liberalize over-the-counter option transactions.
Second stage (1994–96)	1. Allow more branches of foreign securities companies. 2. Open securities investment trust businesses. 3. Allow Koreans individual access in the foreign securities market. Macroeconomic conditions: Current account in balance, Korean-international interest rate differential narrowed to half that of 1992, below 7 percent.
Third stage (1997-onward)	1. Complete the proposed liberalization of interest rates. 2. Open the domestic bond market. 3. Eliminate the mandatory purchase of monetary stabilization bonds by foreign banks. 4. Permit foreign banks to establish subsidiaries. 5. Expand limits on foreign investment in the stock market. Macroeconomic conditions: Current account in surplus, interest rate differential narrowed to 2 to 3 percent, inflation of 5 percent.

Appendix

Liberalization Measures Implemented by the Government through Financial Policy Talks (FPT)

Banking

Measures taken to expand access to won (W) funding for foreign banks:

- The W 12 billion ceiling on local capital was eliminated (April 1991).
- The swap facility (preferential arrangement for foreign banks) reductions by 10 percent annually were suspended (June 1991).
- The limit on CD issuance was raised on three occasions: to 175 percent of local capital (June 1991), to 200 percent of local capital (October 1991), and to 225 percent of local capital (May 1992).
- The scope of eligible trust business was expended to include specified money trust and non-money trust (May 1991).
- The call market was integrated to equalize interest rates between Korean and foreign banks (May 1991).
- The blind brokerage system was introduced to the call market (December 1991).
- The establishment of ATMs on outside walls of branch buildings was permitted (January 1991).

Measures taken to expand treatment of foreign banks:

- Differential criteria on the acquisition of the trust business license were abolished (August 1991). The criteria included requirements for three years of operation in Korea, US$10 billion in head office capital, and employment of trust business specialists.
- Differential criteria on the establishment of multiple branches were abolished (June 1991). The criteria included requirements for the bank's minimum of 10 years of operation in Korea, assets over W 300 billion, and ranking among the world's top 100 banks.
- The multiple branch network was recognized as a single entity to simplify procedures on and management of ceilings, financial statements, and various approvals (December 1991).
- A channel for dialogue between domestic and foreign banks was established for foreign bank participation in Giro/ATM networks (September 1991).

Measures related to liberalization of foreign exchange operations:

- Underlying documentation requirements accompanying foreign exchange transactions were eased (July 1991). As a result, for spot transactions between the won and foreign currencies, instead of original documents the application for funds transfer may be presented as evidence of the transaction. For spot transactions between foreign currencies, no documentation is required as long as it is executed prior to the maturing of the spot transaction.
- To ease restrictions on and widen the scope of foreign exchange operations, the requirement to maintain foreign exchange overbought position from 2 percent of the previous month's average purchase was gradually relaxed to the square position (July 1991, September 1992).
- The multiple currency basket system for exchange rate determination was converted to the market average exchange rate system (MAERS) (March 1990). The range for daily exchange rate fluctuation was widened from within 0.4 percent of the previous day's rate to 0.6 percent (September 1991) and to 0.8 percent (July 1992).
- The Foreign Exchange Management Act was converted from a positive to a negative system (December 1991).

Securities Market Operations and Foreign Investment

- Establishment of branches and joint ventures by foreign securities firms was permitted (January 1991), and ten branches and one joint venture have been subsequently approved.
- Membership to the Korea Stock Exchange of foreign securities firms was allowed (June 1991).
- The stock market was opened to direct investment by foreigners (January 1992)
- The limit on foreign investment in stocks of foreign-invested firms or Korean companies with overseas securities issues was raised to less than 25 percent (July 1992).
- The definition of foreign investor was widened to include foreign governments, pension funds, and unit trusts (January 1992).
- The ratio of equity participation of foreign securities firms in domestic securities firms was increased from 40 percent to 50 percent (January 1992)
- The four-stage interest rate deregulation plan was announced (August 1991).

15

CLOSING ADDRESS

J. B. Sumarlin, Minister of Finance, Indonesia

Distinguished fellow speakers and guests:

As one who has been very much involved in the economic and financial reform in my own country, Indonesia, I am delighted to have been invited to give the closing address at this seminar. The quality of discussions reflects the caliber of this distinguished group of policymakers brought together this week from South America and Asia.

Our common interest on this occasion lies in the challenge we all face in grappling with the complex and dynamic process of economic and financial reform. In seeking to chart our individual paths, there is much that can be learned from the different approaches of other countries. Through their joint sponsorship of this seminar as a follow-up to the seminar held last May in Santiago, the World Bank and Bank Indonesia are to be warmly congratulated for facilitating this further sharing and learning process.

You have already heard from previous speakers something of the detailed circumstances in their individual countries. I would like to focus on some of the broad lessons that not only ring true from Indonesia's experience, but also, I believe, have relevance for all of us here today.

My starting point concerns the issue of economic stabilization, which I am sure we all agree is an absolute precondition of economic reform. An economy gripped by instability or inflationary pressures is highly unlikely to produce the circumstances conducive to successful reform. Excessive inflation grossly distorts the price incentives that are central to securing fundamental structural adjustment. Advances in the real economy are also held back as resources, especially scarce entrepreneurial talent, are diverted from efforts to boost efficiency and productivity to more lucrative speculative activities aimed at simply beating inflation. Finally, high rates of inflation and instability are typically accompanied by high levels of capital flight, depriving the economy of the financial resources that could ease the reform process.

Experience also teaches us that while stabilization measures, such as credit restriction or currency devaluation may symbolize resolving of a problem, their effectiveness is likely to be short-lived in the absence of steps to remedy more fundamental constraints. Structural adjustments, ranging from fiscal reform, trade

liberalization, and deregulation to the creation of sound capital markets and financial intermediaries, are equally essential.

Indonesia provides a good example of stabilization going hand-in-hand with structural reform. Stabilization measures constituted our immediate survival kit in the wake of the severe economic reversals brought about by the oil price crash and the international currency realignments of the mid-1980s. Yet, even as we struggled to stabilize the economy, we had already embarked upon the structural reforms necessary to secure renewed growth.

Tax reform in 1983, some three years before the collapse of oil prices, laid the foundation for subsequent enhanced non-oil revenues. And once stability had been restored, we were able to move ahead swiftly with a wide-ranging program of economic restructuring. As a result, we have ushered in a transformation of our economy that has seen diversified manufacturing activity and exports, instead of oil as the primary engine of growth. This change has resulted in an annual average real GDP growth of 6.3 percent since 1986, well above our target of 5 percent while inflation has been kept within single digit figures.

A second broad lesson from our experience is that countries need to be both competitive and creditworthy if they are to attract the risk capital needed to supplement government funds for development. The urgent need to attract private risk capital and the increasingly stiff global competition for these funds reinforces the importance we in Indonesia have attached to structural and institutional reforms, removal of the rigidities and inefficiencies associated with a high-cost command economy, and providing scope for competition and market forces to work both in the financial and real sectors of our economy.

It also explains our moves to implement swift remedial action before our hard-earned favorable credit rating with the international lending community is in any danger of being compromised. For example, this occurred in 1990 and 1991 when investors turned increasingly to overseas commercial credit to fund new developments, including a number of very large state-related projects with long gestation periods and uncertain payback. This combination of factors not only brought additional pressure on our balance of payments but also threatened to erode creditworthiness for all our borrowing needs.

Our policy response came in the form of rescheduling a number of costly projects, and setting up a high-level government team charged with coordinating all public sector related borrowing commitments. I am pleased to report that these responses have succeeded in restoring overseas commercial borrowing to manageable levels while helping reduce balance of payments pressures.

Risk capital is, of course, also averse to high inflationary pressures, which is why in 1990 Indonesia embarked on measures to control growing inflation within the domestic economy. The very success of earlier reforms was propelling development at too rapid a pace. Domestically, flourishing aggregate demand, fueled by rapid credit growth, had pushed inflation to a disturbingly high rate. Tighter control of the money

supply was our remedy for reducing inflation to 4.9 percent rate in 1992, around half the 9.5 percent in each of the previous two years.

Success in controlling inflation has enabled us more recently to cautiously ease the monetary policy, which we hope will boost business activity in the days ahead.

Of course, measures of stabilization, adjustment, and reform are not ends in themselves but constitute the means for achieving longer-term goals. Although other nations may articulate them slightly differently, I suspect that our trilogy of goals in Indonesia—growth, stability, and equitable distribution of development gains—are not significantly different from those in your home countries.

While each of these goals depends on the others, there are, I believe, particular lessons to be learned from experiences related to achieving equitable development. Important among these are the need to effectively communicate the benefits of reform at all levels of society. This is especially important where, for whatever reason, economic reform would otherwise give interests that are opposed to change the ability to negate what has already been achieved and thwart further attempts at reform.

Just as important, if not more so, is the need for all sectors of society, the poor as well as the economically strong, to feel a genuine sense of sharing in the benefits of reform. Without doubt the most significant achievement of our development strategy in Indonesia has been the attainment of a substantial reduction in poverty. Whereas just twenty years ago some 60 percent of the population, nearly 70 million Indonesians, lived in absolute poverty, by 1990 the estimated figure had fallen to only 15 percent. Continued reduction in poverty is a major priority for our future development efforts.

In addition to the broad lessons, there are issues related to the sequence and timing of economic and financial reforms. Developing countries are not short of advice from experts about the benefits of structural adjustment and the precise reforms that should be undertaken to achieve these benefits. What is often less clear, and where advice can be contradictory, is the timing and sequence in which reforms should be undertaken.

While these are obviously crucial questions, it is doubtful that there are any definitive answers. I would suggest, however, that many critical lessons are to be found in the cumulative experiences of the countries represented at this seminar.

The first lesson learned is the need for a case by case approach, which takes into account and reflects the full range of political, economic, social, and cultural realities in a country, together with its abilities to absorb and digest change. The very distinct differences in culture, national resources, infrastructure, institutions, and stages of development that exist between one country and another preclude the likelihood of a single prescription being equally applicable to all cases.

The second lesson is that successful reform does not come about overnight. Transition takes time to achieve: time to plan and implement the adjustments necessary for reform, and time to sort out the mistakes that are sometimes associated with the tremendous undertaking involved in securing fundamental change. In

Indonesia, we needed about twelve to thirteen years simply to lay the basic principles for economic reconstruction. Only after that we could seriously begin to forge closer integration with the international economy and use to our advantage the processes of globalized production and marketing. All this has taken time, almost twenty-five years, and we are not finished yet.

In contrast with many other developing countries, our endeavors have benefited from political stability, which has facilitated a gradual or evolutionary approach to the timing of change. Gradualism has the further advantage of helping progressively win new constituencies for reform. As business people begin to recognize the benefits of a low-cost economy, new voices appear in support of further reform.

The third lesson related to timing is that, paradoxically, government intervention is a necessary and vital component of the reform process. Centralized direction and control is essential if transition to a more open economy is to proceed in an orderly fashion. A market economy will not be secured simply by allowing people the freedom to manage it in any way they deem expedient.

Central coordination and direction are required for course corrections that may be needed from time to time to keep the transition process on track. Just as important, deregulation does not mean no regulation. Prudential safeguards, which frequently can only be implemented and supervised by government, are necessary to ensure the soundness of key institutions and enhance protection of the public interest. This is particularly true for the financial sector if public trust and confidence are to be maintained. Having secured expansion and internationalization of Indonesia's banking system and capital markets through previous reforms, a major focus of more recent measures has been the strengthening of prudential oversight and supervision of our financial sector.

Let me conclude with a final lesson from Indonesia's reform experience and, I suspect, that of other nations. That is, reform programs are likely to be less effective than they might be in the absence of balance in the development process. In Indonesia we strive for a balance in all aspects of development: between different sectors of the economy, between public and private sector interests and goals, between new operational freedoms for business and prudential regulation, and between the needs of the individual and those of society as a whole. This, I believe, is well evidenced by the example of Indonesia's experience. It is through this balanced, evolutionary approach that we see our surest route for achieving our development goals.

Distinguished participants, in conclusion, as I commented at the outset of my remarks, the path of economic and financial reform is a complex and difficult route. I very much hope and believe that this seminar will prove to have been helpful to each of us as we continue to grapple with these complexities in the days ahead. We appreciate the efforts of the sponsors of this seminar, the World Bank and Bank Indonesia, to provide us the opportunity to share our experiences and to learn from one another.

Thank you for your kind attention.

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