Financial reform calls for more nuances than simply “letting the market work.” An eclectic approach to financial reform is more difficult to manage than immediate, complete deregulation, but it appears to have more chance of success. Unless a country can count on good fortune, it seems wisest to move gradually and improve the fundamentals, until certain basic conditions are met — especially given most governments’ explicit or implicit commitment to providing deposit insurance.
This paper — a product of the (former) Financial Policy and Systems Division, Country Economics Department — presents lessons on financial reform derived from two World Bank research projects on both the real and financial sector effects of financial reforms in selected countries. This paper is adapted from chapter 7 of the draft manuscript, *Financial Reform: Theory and Experience*. Copies of this paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Wilai Pitayatonakarn, room N9-003, extension 37664 (February 1993, 35 pages).

The argument in favor of gradual — but sustained — financial reform is based on two factors. First, the development of borrower net worth will determine the health of the real and, ultimately, the financial sector. Thus, speeding up reforms when borrower net worth is subject to positive shocks — or slowing them when it is subject to negative shocks — appears sensible and appears to have worked better in practice. Second, the initial conditions of the banking sector — not just its net worth but its stock of human capital, the initial portfolio mix, and the internal incentive systems — will also determine the success of any reforms. Thus the speed of financial reform must be related to these conditions: rapid reform with unskilled bankers, unbalanced portfolios, and pervasive “bank cultures” is a sure recipe for financial crisis. Of course, political factors can present unique opportunities to point an economy rapidly and permanently toward a more market-based system. And these opportunities should be seized. But where possible, financial reforms should consider links to the real sector and institutional development.

The case for gradual reforms is not one for inaction, as the conclusions of this study suggest that financial reform is worth the effort and that, with due attention to the institutional environment, the lessons can be applied elsewhere.

Authorities can do much to increase the market orientation of their financial system, with all its benefits, even without a “big bang.” They can eliminate the grossest interest subsidies, move toward market financing of government debt, and raise deposit rates at least to only slightly negative or modestly positive levels, paying attention to budget realities. In several countries, authorities ended modest financial repression early in their reform efforts, while still retaining some controls. Of those that moved fastest on interest rate deregulation, Indonesia and New Zealand met most of the foregoing conditions, with some uncertainty about the health of their banks at the point of deregulation. But in both cases banks had a window of a few years before new entry was permitted, allowing them time to adjust before competition intensified. Caution regarding entry helped to limit the reduction in the franchise value of bank licenses, especially given the limitations on supervisory skills. And in both cases, deregulation coincided with falling world interest rates.

Although an eclectic approach to financial reform is more difficult to manage than one of immediate, complete deregulation, it appears borne out by the country cases and the theoretical approaches reviewed here.
Financial Reform: Lessons and Strategies

by

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The World Bank

This paper is adapted from Chapter 7 of the draft manuscript, Financial Reform: Theory and Experience. The authors wish to thank John Chant, Yoon Je Cho, Hasan Ersel, Patrick Honohan, Ross Levine, Dimitri Margaritis, Sang-Woo Nam, Fabio Schiantarelli, Andrew Sheng, Salvador Valdes-Prieto, and Zainal Aznam Yusof for comments.
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1. General Considerations

Financial reforms -- and doubts about them -- are documented at least as far back as the Scottish free banking era of the 18th - 19th century, and it is likely that, in the wake of the banking crisis of 33 A.D., Romans debated putting a hitherto liberal banking system under government control.¹ Financial reform in the modern era is unusual at least in its frequency: most industrialized countries have embarked on measures to liberalize finance in some manner in the last two decades, and a growing number of developing countries are moving along that course more recently. Even if university courses in development traditionally have attributed little role to finance in the development process, practitioners in the field as well as increasing numbers of academics seem to be convinced both that finance matters and that "market-oriented" financial systems can exert a positive influence on the economy, albeit with significant differences as to the proper or optimal role for market forces.

This paper presents lessons on financial reform, which are derived from two World Bank research projects on both the real and financial sector effects of financial reforms in selected countries [Caprio, Atiyas, and Hanson, 1992]. Table 1 presents a thumbnail description of the reforms in the cases studied -- Chile, Indonesia, Korea, Malaysia, New Zealand, and Turkey. These countries differ markedly in their economic, political, and institutional development, which, along with their meager number, raises problems in drawing lessons.² Moreover, it is difficult to describe any of these efforts as complete. Reforming the financial system should be thought of as a process, not an event, both because most governments enact reforms in stages and since institutions take substantial time to adjust. Even in the case of New Zealand, where many liberalizing changes were introduced abruptly and virtually simultaneously in late 1984, it would be premature to consider reform as complete.

Conclusions about financial reforms also should be viewed with caution because these experiments -- even in Malaysia and Chile, where reforms began in the early 1970s -- are
<table>
<thead>
<tr>
<th>Country</th>
<th>Summary of Reforms</th>
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<tr>
<td>Chile</td>
<td>Big Bang: complete interest rate deregulation in 1975, privatization of all banks by 1978, reserve requirements reduced 1974 onwards. Capital controls on nonbanks lifted within 2 years, on banks within 5 years; all financial institutions given &quot;universal&quot; banking powers. Simultaneous dramatic reforms of real economy, with average tariffs reduced from nearly 100% in 1973 to below 30% in 1976, and budget deficit eliminated by 1975, with large surplus by 1979.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Eliminated bank-by-bank credit ceilings, reduced subsidized credit program, decontrolled most deposit and lending rates, and ended subsidies on deposit rates. Second stage (5 years after start) saw lifting of ban on new entry into banking, easing of branching restraints on domestic and foreign banks, sharp reduction in reserve requirements (15% to 2%). Later strengthened prudential regulation and abolished remaining subsidized credit lines from central bank. In 1990 partially reversed reforms by requiring that 20% of lending go to small firms. Concomitant with real sector reform program: 2 large devaluations, reduction of tariffs, shift away from commodities, especially oil.</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Gradually lifted controls on long term deposits and opened capital account in early 1970s, full liberalization of deposit and lending rates in 1978, then re-introduced administering of rates through mid-1980s; complete deregulation again in 1991. Reduced scope of priority lending program from mid-1970s, with no bank credit below banks' cost of funds. Active central bank role in developing money and securities markets throughout period. Non-performing loans rose in mid-1980s but declining by end of decade. Major budget deficit reduction program in the early 1980s.</td>
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<tr>
<td>Country</td>
<td>Description</td>
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<tr>
<td>New Zealand</td>
<td>Big Bang in 1984-5: interest rate controls and bank-by-bank credit guidelines removed, currency devalued then floated, all capital controls lifted, portfolio requirements and reserve asset ratio dropped, tariff reductions announced. Allowed new entry into banking in 1987, began selling state-owned firms and commenced tariff reductions in manufacturing sector. Also eased restrictions segmenting various financial institutions. Reserve Bank bill legislating price stability goal passed in 1989; tightening of monetary and fiscal policy from 1987 onwards.</td>
</tr>
<tr>
<td>Turkey</td>
<td>Phase 1: abolishment of interest rate ceilings on deposits and loans, introduction of CDs in mid-1980; entry into non-bank financial sector eased significantly. Crisis led to re-regulation and limits on entry. Phase 2: introduction of partial deposit insurance, new banking law (1985) with higher capital requirements, strengthening of supervisory system and development of on-site supervision, requirement of external auditing. Development of interbank money market. Heavy portfolio requirements on banks continued, and interest ceilings continued until 1988.</td>
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relatively recent. New regulatory structures require at least a full business cycle, and preferably several, to permit a balanced assessment of the resiliency of the financial system in good times and bad. Indeed, the moral hazard problems of the U.S. deposit insurance scheme were present in the 1950s and 60s, but serious problems -- and a reconsideration of deposit insurance -- did not develop until the 1980s. An important factor likely was the gradual erosion of the franchise value of bank licenses -- reflecting regulatory and technical change -- which in turn led to greater voluntary and involuntary risk taking by banks. The changes associated with low franchise value, which contributed to the problems in the United States and, as seen in Chile, may do so in developing countries, take time to become evident because they involve alterations of bank incentive systems ("bank culture"). Thus, a degree of circumspection is called for in making claims of success for policy changes in this area.

In addition to these caveats, there are serious challenges to measuring the success of financial reform. The main tasks of finance are to mobilize resources and allocate them efficiently; as part of this process, intermediaries provide instruments that allow for the diversification and hedging of various risks, thereby permitting economic agents to concentrate on other productive activities and utilize financial resources efficiently.

Regarding mobilization, the present consensus is that the relationship between interest rates and aggregate saving may be only at most mildly positive, though higher rates will tend to increase the share of saving intermediated by the financial system. Other aspects of reform -- more branches, better service, more diversified savings vehicles -- may contribute to a deepening of the financial system and thus might raise aggregate saving as well. However, without much more and better data covering several business cycles for a number of countries, it will be difficult to provide convincing evidence for this effect. Still, it is at least interesting that of the six countries mentioned above, all but New Zealand have experienced their highest sustained rate of savings since the early 1970s (figure 1), and in New Zealand there is at least a hint that savings in the post-reform era is above what it might otherwise be.

Savings in the financial sector increased in all the countries. The standard financial
Figure 1: Gross Domestic Savings (% of GDP)

Malaysia

Korea

Indonesia

Turkey

New Zealand

Chile
depth ratios (some measure of money relative to GDP) rose, in some cases considerably, and quasi-liquid liabilities, which can be thought of as a non-transactions component of broad money, expanded rapidly following reforms (Figure 2), except in New Zealand, where the innovation of electronic funds transfer directly to the point of sale led to a temporary shift toward narrow money within an overall financial deepening. The countries’ financial deepening typically involved a broadening of the menu of assets available to firms and individuals, as appears for example in Korea [Nam, 1992], which is at least suggestive of a greater use of finance to hedge risks.

Assessing improvements in the efficiency of resource allocation also is problematic: the presumption is that an effective financial system will maximize efficiency by allocating credit to industries and firms where it can be best used. However, total factor productivity is subject to a myriad of influences, is difficult to measure on an economy-wide basis, and ideally a number of years -- pre- and post-reform -- would be desirable to sort out its determinants. Moreover, in most countries financial reform has been carried out simultaneously with significant policy changes in other areas, in particular in foreign trade, which also are likely to increase aggregate efficiency; hence the impact of changes in financial policy are often difficult to isolate. As noted in Schiantarelli et al (1992), the standard measure of efficiency, the incremental output-capital ratio (IOCR), only gives a good indication of efficiency under the assumption that factors of production are used in fixed proportions. For those who accept these simplifications, gains in the IOCR were seen in five of the seven cases examined in that study from the pre-reform period to 1988-89. And in Malaysia, which, along with New Zealand did not experience efficiency gains over this period, the comparison is biased by including pre-1973 data; more recently there has been a recovery of the IOCR there.

More tellingly, Schiantarelli et al show that firm level data in a few countries reveal an association between financial reforms and significant increases in the allocation of credit to efficient firms, even when the firms’ efficiency is judged solely on the basis of pre-reform data. In Ecuador, not only does average efficiency rise but the dispersion of efficiency
Figure 2: Quasi-Liquid Liabilities / GDP, (1960-1990)

Note: Quasi-Liquid Liabilities = M2 - M1 (IFS, line 35).
among firms declines by the end of the period. While large firms have seen a relaxing of the extent to which investment decisions are constrained by financing, in Indonesia small and large firms enjoyed this benefit of reform, as these firms were more efficient than their medium size counterparts. Small firms are precisely those that might be expected to be discriminated against in formal directed credit programs, even in programs designed to direct credit to this group. Although these results do not prove that financial reform increases allocational efficiency -- after all, they are only for a few countries and cover a short period -- they do represent the first micro level evidence of the positive real effects of financial reform, effects which have been assumed but never substantiated. In sum, these results, along with the cross-country studies of Gelb (1989) and King and Levine (1991), are the most promising evidence to date of efficiency gains from financial reform. Together, the findings should influence the way in which development economists think about finance.

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

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

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

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

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

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

2. Some Lessons

Real and Financial Sector Linkages

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

Indeed, to the extent that financial reform entails an end to subsidized or negative real interest rates, reform itself induces a drop in the net worth of existing borrowers and the value of bank loans to them. This will reduce banks’ willingness to lend to the existing clients. However, it should be noted that while ending interest rate subsidies reduces the net worth of subsidized borrowers, it may improve that of other borrowers, who likely were paying high premiums to obtain non-subsidized credit in informal credit markets.8 Thus an important additional issue, discussed in the next sub-section, is the extent to which intermediaries can locate and finance these potential new clients in the short run. If the banks are unable to do this, then the net result of reform could be lower investment and more finance for government, as appears to have occurred in the early 1980s in Turkey (Atiyas and Ersel, 1992) and in Uruguay in its financial reform of the mid-1970s. Thus, the results of financial reform are likely to be much better when other shocks are at least expected to be neutral, or when the government has taken steps to offset negative shocks.

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

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

Indonesia also undertook reforms in less favorable circumstances but with good results [Chant and Pangestu (1992)]. The first phase of reforms, in 1983, came with oil prices near historic highs but clearly declining, budget and current account deficits growing, and protection actually increasing (up to 1985). However, initial financial reforms followed on the heels of a 46% devaluation, with more significant financial sector reforms coming in the late 1980s (after a second large devaluation). Importantly, banks had 5 years to adjust to the significant retreat of the government's role in allocating credit before new entry into banking was allowed, thus providing time for the banks to workout their bad portfolios before strong competition was introduced. Moreover, Indonesia for quite some time had an open capital account, and financial repression in the decade prior to reform was not severe. Thus it was unlikely that there would have been an information capital problem, and indeed the quite rapid rate of credit expansion there has been the antithesis of a credit crunch. So the lesson here is that macro conditions need not be ideal in order for financial sector reform to pay large dividends.
Turkey’s experience with two interest rate liberalization episodes also supports the Gertler-Rose hypothesis. During the first episode, Atiyas and Ersel [1992] note that in the early 1980s, removal of controls on interest rates and an opening of entry was carried out in an environment of disinflation, and was accompanied by a significant deterioration of operating earnings in the corporate sector. The ensuing period of distress borrowing further weakened company balance sheet positions and generated a fierce competition between weak banks to attract deposits to finance non-performing loans, endangering the stability of the banking system and leading to a re-control of interest rates and entry. By contrast, the rapid increase in interest rates following deregulation in 1988 did little damage to corporations which, thanks to comfortable operating earnings, could rely on internally generated funds to reduce their demand for short term borrowing.

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

Initial Conditions in the Financial Sector

Various aspects of the initial condition of the banking system must be considered in determining the impact of reform [Caprio, 1992, 1992a]. Not only banks’ net worth, but the initial composition of their assets and liabilities, their information set, or "information capital", their endowment of human capital, and their internal incentive systems, all reflect the pre-existing set of controls and will determine the banks’ response to reforms. Those reforms that take account of the initial portfolios of banks, their information capital, and their stage of institutional development are expected to fare better. For example, financial reforms when banks have negative net worth -- as arguably was the case with the U.S. S&Ls -- are likely to lead to unwise risk taking activities. Thus banks’ net worth matters as well as the real sector’s net worth. When banking skills are in short supply and bank incentive
systems are geared for following government instructions on credit allocation, a sudden move to a laissez-faire system would most likely result in large losses. Similarly, when there are severe information asymmetries, banks' main source of information will arise from longstanding relationships with their clients. Destruction of this information capital, through devaluation, reduction in protection, or cutbacks in public investment spending, can lead the banking sector to retreat from lending and thereby deter investment. This consideration does not imply that such changes should not be made, only that their impact on banks' willingness to lend should be taken into account.

The argument that post-reform developments likely will depend greatly on initial conditions highlights the key role played by banks' portfolios and the stock of information capital. Not just aggregates of assets and liabilities, but the division between different categories of each can have an impact on the response of individual institutions and the entire financial system to reform. For example, in many countries -- both among those reviewed here and more widely, including the industrialized economies -- problems with non-performing loans in the real estate sector followed on the heels of attempts to deregulate finance. In addition to the possibility of interest rate mismatching, in some markets it has been argued that there was a run-up of property prices spurred by bank lending.\textsuperscript{10} In certain cases it appears that, prior to the onset of financial reforms, real estate loans had been "crowded out" of banks' portfolios by other priority sectors, so that as intervention was lessened, banks began to adjust their portfolios in favor of this sector. However, a widespread portfolio reallocation always entails some dangers: it can lead to higher asset prices in the favored sector, and persuade bankers that their initial portfolio reshuffling was so profitable that they should invest even more in the growing sector, thereby contributing to real resource shifts that later may well be reversed.\textsuperscript{11}

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

Abrupt portfolio shifts might be prevented by some "speed limits" on portfolio diversification -- that is, a gradual relaxing of forced lending and other portfolio controls -- along with prudential oversight of the total portfolio. The great difficulty is in deciding on appropriate limits. Total lending in real terms by Indonesian banks rose at an average annual rate of 24\% over the 1983-90 period, that is doubling in real terms approximately every 3 years, a speed that would defy many supervisors' estimate of a safe rate for loan growth. Yet signs of widespread distress are not overt, real investment has grown rapidly, and inflation has decelerated and remained in the single-digit range during the second half of the 1980s. However, some warning signs apparently led the authorities last year to raise capital requirements in order to slow lending. And in Malaysia, the rise of property loans in bank portfolios occurred steadily over the 1971-87 period, making it difficult to determine an excessive pace of diversification.\textsuperscript{13} Outright regulatory limits on exposure to various sectors are both difficult to defend and can resemble in practice the highly interventionist approaches that many governments are abandoning because of their negative effects.

A less recognized and perhaps more crucial initial condition is the banks' stock of human and managerial capital at the time of reform. Reform programs should take account of the absence, in countries with prolonged financial repression, of incentives for banks to invest in risk assessment and monitoring skills. Longstanding pay restraints in the financial sector will also contribute to a weakening of the skill base in this area. A history of severely repressed interest rates means that the market -- in most cases, the banking system -- has not been allocating credit; consequently, it is not surprising that the stock of human resources and internal controls in such a banking system will be far less than in one charged with the credit allocation task. In Malaysia, banks were left in control of a large portion of their
portfolios during the decade prior to reforms. However, Korean, Indonesian, New Zealand and Turkish banks faced far greater intervention by government authorities in the pre-reform period. In Korea, a well developed non-bank financial sector helped mobilize and allocate resources, but part of the reason for the Korean Government's direct involvement in the restructuring of private companies was the financial system's perceived deficiency of workout specialists. In Indonesia and New Zealand, banks were given time to improve their skill base before new entrants were allowed, and the reform process began with an already significant foreign presence. Malaysian banking remained relatively concentrated, with the 10 largest banks accounting for about three-fourths of bank assets over the last 20 years. In Turkey, foreign banks remained insignificant in terms of market share after the reform. However, they played an important role in training a new generation of middle level bank managers, who were subsequently employed in domestic banks.

More flexible attempts to deal with exposure questions through the supervisory process may be preferred, but it may well prove difficult for supervisors to recommend a halt to a boom in individual sectors. In theory, supervisors could even take the lead in requiring risk management systems in banks. However, supervision alone does not appear capable of preventing sizeable losses in banking, judging from the experience of industrial countries.

Higher capital requirements -- or risk-based capital requirements, which could be geared to rise with the exposure to individual sectors -- are one effective mechanism for limiting exposure: the 8% risk-adjusted Basle ratio is just coming into force in most industrial and a few developing countries, but this ratio may not be high enough, especially in less diversified economies. Indeed, some highly regarded international banks have operated with 10% to 12% capital ratios. These banks also consistently rank among the highest in terms of profit rates, suggesting that restoring some franchise value to bank licenses may be important, and indeed may be the quickest way to ensuring that banks invest in upgrading their skills and management systems. Bank supervisors, of course, can assist bank management in planning for various scenarios, such as commodity price reversals and
swings in real estate prices; this focussing of attention on the impact on bank portfolios of various shocks may prove sufficient to avoid unbalanced expansions. Finally, it must be realized that when more than one sector is booming, the policy problem is more in the domain of monetary and fiscal authorities. The best supervisory authorities -- and perhaps even the best bank managers -- will have little success reigning in risk taking behavior if aggressively expansionary policies remain in effect for very long.

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

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

**Liberalizing the Capital Account**

The presumption, based on the experience of Latin American countries, that capital account opening should necessarily be the last step in the liberalization process. Hanson [1992] argues that if capital liberalization will lead to currency appreciation, then it will produce this appreciation whenever the capital account is opened. Moreover, the same forces producing an appreciation will lead to greater availability of resources and may provide some credibility for government policies, so early opening cannot so easily be ruled out. Governments often argue that capital controls are needed in order to tax capital and financial assets (including the inflation tax). Put differently, an open capital account may force authorities to rely more on taxing income or consumption, rather than savings. Hanson notes that the de facto internationalization of capital may greatly circumscribe the ability to tax capital -- such taxes mainly fall on those with less access to international markets. Viewed in that light, an important reason for an open capital account is to allow all citizens to reduce the burden of taxes on savings. Finally, the argument of the paper strongly emphasizes the need to put both the domestic fiscal accounts and the financial system in order before opening the capital account and allowing foreign financial intermediation. Otherwise, large capital outflows may develop and the government could then end up bailing out the weakened domestic financial system at a cost to the taxpayer, as discussed above.

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

*Liberalization Fears*

Popular perceptions of the impact of financial reform are heavily colored by the Southern Cone experience. As noted above, however, the causes of difficulties there went beyond the financial sector, and experience outside this area is quite different. Margaritis [1992] recounts that New Zealand authorities also suddenly reformed a highly protected economy all within matter of months, removing tariffs, floating the exchange rate, and embarking on rapid financial sector reforms. When similarly rapid reform, albeit with a different exchange rate policy, was attempted in Chile, unsustainable capital inflows and a real exchange rate appreciation, according to conventional wisdom, were argued to have unravelled the reform program. In particular, false signals were thought to have been sent by a disequilibrium relative prices. However, part of the sharp (166%) rise in Chile’s terms of trade over the 1973-82 period occurred in the wake of widespread political and economic change; over a shorter period (1977-82) the terms of trade rose by 26%, comparable to the 30% rise following reforms in New Zealand. While these shifts are large, huge swings are not a foregone conclusion; actual or incipient exchange rate movements will depend on the combination of monetary and fiscal policies pursued at home and abroad, to which officials should only respond by not putting policy, including that towards the capital account, on automatic pilot. The real appreciation of Chile’s currency likely could have been limited by not providing an exchange guarantee, in effect a free option investors. And New Zealand’s terms of trade gain certainly was in part attributable to the shift in monetary policy towards
fighting inflation since the mid-late 1980s. Tighter fiscal and easier monetary policy would have reduced the upward pressure on interest rates, thereby reducing capital inflows.

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

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

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

3. Towards a Strategy for Financial Sector Reform

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

These problems argue for keeping targeted credit schemes small, leaving them broad based, so that responsibility for credits remains with individual banks, and limiting as much as possible the subsidy element, not only to reduce the distortion of the cost of capital but also to remove any notion that directed credit is a grant. Establishing a "sunset provision" for the ending of the scheme would ensure that credit today is not being directed at old priorities, in effect forcing authorities to re-visit the debate over which activities should be favored. And where subsidies are desired, they should be done directly from the budget. Of all the countries reviewed here, Malaysia comes closest to this type of intervention.

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

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

i) **Institutional assessments**

The need for and emphasis on institution building will depend to a great extent on the history of financial repression. If interest rates have been severely repressed -- say below negative 5% -- for a significant period of time, then experience indicates that banks will have underinvested in credit assessment and risk monitoring skills. But even without significant financial repression, governments should first "get out of the dark" about the condition of their financial sector, especially of their banks. **Simple financial audits often reveal little**
about banks. Instead, risk asset reviews (RARs) are needed to assess borrowers' financial condition, collateral values, portfolio risks under various scenarios, and the adequacy of provisions, complemented by an inventory of the human capital in the banking system.\\(^{19}\) RARs help form an assessment of banks' ability to plan and to evaluate the risks they face, and can assist in changing their internal incentive systems; in effect, these reviews can be a form of technical assistance in training bank managers to think about and evaluate their business. In the limited cases in which risk asset reviews have been attempted, a typical finding is that internal systems are (often grossly) inadequate for an evaluation of the risk confronting banks, and RARs have been instrumental in establishing such systems. Highly and even mildly repressed banking systems, also typified by low levels of bank capital, will sorely need precisely this type of assistance.

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

**ii) Restore and recapitalize?**

Ordinarily, at this stage in the reform process the government must decide either to restore the financial health of banks with negative net worth or close them down. In general, restoration efforts are not likely to pay off and the banks should be closed unless there are well-run banks as merger candidates or other sources of managerial expertise, or unless the needed institution building, mentioned above, is well underway. This point must be modified where doing so would involve essentially closing down the entire financial system (see Box 1). Restoration -- either through replacing bad loans with government bonds, merger with another institution, or a combination of the two -- and recapitalization are recommended only when the resulting institution(s) will be less likely to make bad (nonperforming) loans than
Recapitalization will have to be paid for either by the public (through higher taxes or lower government spending), if the government provides the capital; or by borrowers and depositors (through higher spreads), if banks are allowed to work out their own problems and new entry is limited (an approach followed in Turkey, Indonesia, and Malaysia among the countries studied). Fiscal arguments often are made that cleaning up banks is expensive, and will enlarge the budget deficit. But the replacement of bad loans with government bonds has no macroeconomic effect given that the authorities have effective control over monetary policy. The proper measure of the government’s current deficit used to gauge the impact of fiscal policy on the economy does not change at all from the stock effect of the operation, although the cost of the interest payments will, indeed, have to be financed, and may be substantial.

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

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

Among the countries studied, Korea managed to enjoy a rapid growth of investment against the backdrop of banks saddled with large nonperforming loans only because it had an exceptionally deep -- and much less regulated -- nonbank financial sector that was able to help finance investment, as well as booming macro conditions and an already high savings rate that facilitated an increasing degree of self- and equity-finance.\(^1\) In addition, the Government funded substantial restructuring of some of the indebted enterprises and, as noted earlier, injected funds directly into the banking system.

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

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

iii) **Restructuring of the Real Sector**

Restoration of banks' financial health unavoidably requires decisions about what to do with non-performing loans. Whether these remain in banks' balance sheets or are transferred to a government agency, such as the Central Bank, serious efforts to collect the loans are desirable. Collection reduces costs of the financial sector restructuring and indicates to future borrowers that they should expect to repay their loans. This often implies that borrower companies will be liquidated, for example, through bankruptcy courts. Efficient cleaning of banks' balance sheets often also entails substantial reorganization of banks' claims over the corporate sector, provided that borrowers may regain profitability once they are restructured. In such cases, restructuring in the financial sector becomes the mirror image of that in the real sector. If extensive interventions by the government, which may involve bailing out of enterprises or widespread and economically unjustified liquidations, are to be avoided, banks likely will need to play an important role in the restructuring of the assets and liabilities of borrowers, especially since in most developing countries they are the major claim holders of companies in the real sector.\(^{22}\)
Financing real restructuring is a complicated and risky activity. It presents a case where informational and contractual problems of the type described above are severe and requires banks to assume sufficient control rights to ensure that resources they advance are used to maximize their claims (or the value of the debtor company) rather than being unproductively consumed by managers or owners. Banks may be unwilling to assume such a role, either because of regulations that limit their ownership of non-financial institutions, or because they lack the managerial and technical expertise that would be necessary to monitor restructuring efforts in the real sector. Whenever restructuring needs in the real sector are widespread, such as after a substantial trade reform, reform of the bankruptcy legislation (so as to introduce a reorganization procedure that provides banks with adequate control rights) or introduction of time-bound special legislation may be useful in allowing the banking sector to play a constructive role in real restructuring. Promotion of private institutions that provide turnaround skills also may help overcome a critical institutional barrier and speed up bank restructuring. These institutions provide specialized skills in financial engineering and have a deep understanding of problems in industry; hence, they are in a good position to design and obtain agreement on restructuring programs that are acceptable to both banks and the borrowers.\textsuperscript{24} As difficult as this process is, success in financial reform critically depends on and can be enhanced through appropriate policies that encourage and facilitate restructuring in the real sector.

iv) Next steps

Beyond the initial institutional building phase, and assuming that the banking system has positive net worth, attention should be switched to the institutional capacity to adapt to reforms and the expected near term evolution of borrower net worth. With respect to the former, where banks already appear to be able to allocate prudently the fraction of their assets over which they have had control, and where capital levels are high, more rapid rates of decline of requirements on portfolio composition and directed credit can be considered. But where banks have faced substantial reserve and liquidity requirements, it would be unwise even where budget situations permit, to shrink abruptly or end these requirements
until banks are prepared to deal with the ensuing portfolio decisions. The dangers of simultaneous portfolio adjustment noted above can be minimized by a gradual reduction of the control of assets. Moves toward market financing of government debt may be constrained by budget realities. However, even where these constraints are severe, it is important to begin the transition to market funding in order to maintain pressure to shift taxes away from the financial sector. Waiting instead for "free" budget resources may well delay reforms indefinitely.

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

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

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

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

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

Other steps and sequences also can be ruled out. For example, deregulating interest rates completely in a country just entering a recession, or with a large percentage of shaky banks can never be advocated. Nor would an open entry policy for banking ever be recommended, but especially not for a country with little or no bank supervisory capacity. New entry can be dangerous if banks need to build up their capital; it may be especially
dangerous if domestic banks have positive but low net worth, in particular if the new entrants are foreign banks who may be able to take some of the less risky banking business. Nor is suddenly raising capital requirements desirable. Although it is an effective way in the long term to increase the safety of the banking system, in the short term it may lead to a cutback in credit growth, as has been intentionally accomplished in the last year in Indonesia. Therefore governments might make sure at the least that the schedule for attaining a target capital ratio is consistent with the macro environment: too steep an increase can produce a recession, while an excessively slow increase can lead to a prolonged continuation of unsafe banking practices.

4. Conclusions

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

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

In contrast, the reforms in the Southern Cone during the 1974-82 period, which are usually cited as reasons to avoid reform, took place in the context of a lengthy history of severe financial repression, numerous weak banks, macroeconomic instability, limited attention to improving bank regulation and supervision or to maintaining the franchise value of intermediaries and, towards the end of the period, sharply higher world interest rates. So unless one can count on good fortune, it seems wisest to move gradually and improve the fundamentals until the above conditions are met, particularly given most governments' explicit or implicit commitment to providing deposit insurance. Although this eclectic approach to financial reform is more difficult a process to manage than one of immediate, complete deregulation, it appears born out by the experience of the country cases and the theoretical approaches summarized above. Financial reform, as judged from these experiences, calls for more nuance than simply "letting the market work." Still, in many countries the direction of change is clear, in favor of greater, rather than lesser, reliance on the market to allocate credit, and policy makers need to "keep their eye on the ball."
Financial Reform in TSEs

Some of the lessons and the strategy advocated here seem irrelevant for Transitional Socialist Economies (TSEs), which have in effect no financial sector — at least by Western Standards — nor many skilled in various aspects of central or commercial banking, insurance, securities issuance, and other financial sector activities. And it certainly is true that building a financial system from scratch is different than reforming an existing one once a certain level of development has been attained. But the focus on institutional building as the heart of financial reform is quite relevant. TSEs, endowed with relatively a well-educated labor force, require technical assistance on an unprecedented scale in all aspects of finance, including in most cases the establishment of a payments system. Immediate deregulation of interest rates, however, is fraught with danger, as argued in the text below.

With no supervisory capacity, which will take years to develop, and with former financial wealth in many instances reduced by inflation, TSE authorities will need to create pools of capital and ensure that banks are conservatively managed, so as to minimize the future cost of a bank bailout. Both goals likely can be met by licensing only a few banks, thereby creating a high franchise value for bank licenses. The cost of this policy is that it will necessitate high spreads for banks, but this is actually a benefit: although greater competition might limit spreads, in a high risk environment, which surely will characterize most TSEs for years to come, banks need large spreads to balance the possibility of large future losses. As supervisory capacity grows and the economic environment stabilizes, greater competition can be allowed, but it would be wise to keep capital requirements high, at the very least the 8% risk-adjusted ratio of the Basle guidelines, or higher, as is being recommended even in the United States. Such an approach would encourage equity finance, which is inherently a better tool for spreading risk.

One point that deserves some modification concerns foreign banks. Their entry might be destabilizing in countries where the banks are fragile. However, with so little expertise in banking, and in many cases with banks already confronting substantially negative net worth, TSEs have little to lose and much to gain from foreign banks. Some fear that foreign banks may be more likely to curtail lending sharply when activity slows, while domestic banks will have more of a long term view and thus will keep lending and thereby alleviate the slowdown. This view has not been tested; more diversified foreign banks would be less affected by a local recession than would domestic banks, and so might be less swayed by cyclical forces. To the extent that authorities want to encourage the development of domestic banks and other financial intermediaries, they should not give away licenses to any foreign bank but instead grant licenses to institutions willing to commit resources for the training of local staff, including those working at domestic institutions. As noted in Part III, Turkish and Indonesian banks in particular have benefited from the presence of foreign financial institutions.

Another point that needs modification concerns the recommendation in the text to shut down "bust banks" when there are no merger candidates or other sources of managerial expertise. However, even though other institutions would eventually emerge, it would be unwise to shut down an entire banking system. Old state enterprises need restructuring or closing and new private firms will need financing. Instead, an attempt could be made to carve out the few clearly good assets and staff trained in Western banking methods and to privatize the resulting institution. Other new private banks could be licensed, using local residents alone where there is sufficient experience, or as a joint venture bank with foreign institutions. And foreign branches or subsidiaries should be encouraged. But authorities should "keep their eye on the ball." The great danger in reforming TSEs is that the demands for credit from all quarters will overwhelm the monetary authorities, and lead to pressures to license many new banks and to allow banks to leverage themselves highly. In addition to the short run monetary control issue, there is a longer term risk that new institutions growing at an excessive pace will produce substantial loan losses, creating a future fiscal problem. Limiting bank licenses and requiring banks to hold high levels of capital are the main hopes of preventing this scenario from becoming reality.
Notes

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

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


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

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

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

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

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

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

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

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

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


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

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

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

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

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

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

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

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

23. Such a legislation is currently being considered in Poland.

25. Occasionally it is mentioned that in much of the post-war period up to the late 1970s, Japanese authorities relied on captive financing of government debt, implying that the same reliance should be possible for developing countries. However, this argument overlooks the point that Japan ran budget surpluses until 1965, and that deficits remained small until after the 1973-4 oil shock. When the tax imposed on the banks by forced holdings of government paper grew large, the banks' rebellion in 1979 was an important factor in beginning the financial reform process.

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

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

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


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