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Financial Sector Reforms in Adjustment Programs

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and
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Reform programs call for more prudential supervision of financial institutions but fewer restrictions on interest rates, the direction of credit, and financial innovation generally. The planning of financial reform must be predicated on an appropriate macroeconomic framework, without which reform efforts can result in costly failure.

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Policy, Planning, and Research

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Financial Policy and Systems

The recent upsurge of concern with financial sector policy issues in developing countries arises primarily from three characteristics of their financial systems:

• Many of the financial institutions in developing countries are extremely unsound.

• There is often excessive control over interest rates and the direction of credit, amounting to repression of the financial systems.

• The domination by banks of the financial system in many countries has led to a need for institution-building to enrich the range of services that the financial sector can provide.

The typical financial sector reform package involves policy changes to increase the power of centralized decisionmaking in some areas and to reduce it in others.

For prudential regulation and supervision, reforms seek strengthened information systems, stronger and more detailed regulations, and closer credit supervision. At the level of the intermediaries, reforms seek improved procedures, some of which (credit policies, loan review, and management information systems) are natural complements to improvements at the central level.

But insofar as the relative cost and availability of credit are concerned, the typical reform program calls for a reduction in government control, and tries to broaden the range of options for finance. Called for are increases in, and ultimately liberalization of, interest rates, as is a reduction in the scope and severity of restrictions on bank lending and financial innovation generally. A reduced burden of taxation, implicit and explicit, of the financial system is often required.

Many needed financial sector reforms are of an institutional nature requiring the acquisition of scarce skills. For instance, development finance institutions may need to reconsider their fundamental objectives and their entire method of operating. These changes take time to become effective, and it is not clear that the typical quick-disbursing policy-based operation is the ideal medium for effecting them.

Experience has shown the importance of the links between financial sector policies and performance and the macroeconomic situation. Without an adequate degree of macroeconomic stability, financial sector reforms can fail, with serious consequences. Therefore the planning of a financial sector reform must be predicated on an appropriate macro-policy framework.

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FINANCIAL SECTOR REFORMS IN ADJUSTMENT PROGRAMS

1 Why Financial Sector Reforms?

The recent upsurge of concern with financial sector policy issues in developing countries arises primarily from three characteristics of their financial systems.

First, many financial institutions in developing countries are extremely unsound.

Second, there is often excessive control over interest rates and the direction of credit, amounting to repression of the financial systems.

Third, in many countries the financial system is dominated by deposit money banks. This suggests a need for institution building to enrich the range of services which the financial sector can provide.

Financial sector adjustment loans (FSAL's) are a recent innovation for the World Bank. Up to mid 1988 there had been four loans so designated, one each to Argentina and Ecuador and two to Turkey, and there has been one "trade and financial sector adjustment" loan to Jamaica[1]. Financial reform has also been a major component of a few structural adjustment loans, notably SAL's II and III to Chile and the Economic Recovery Loan to the Philippines. Changes in financial policies have also been incorporated in the Bank's financial intermediation loans (i.e. loans intermediated through financial institutions in borrowing countries); these have a longer history, but the scope of policy reform has been more limited. Financial sector loans now in

1 The loans to Argentina (actually termed a banking sector adjustment loan) and Ecuador, and the second to Turkey were approved in Fiscal Year (FY)88. The Jamaican loan was in FY87 and the first to Turkey in FY86.

preparation include Ghana, Nepal, Kenya, Hungary, and Nigeria, and further loans are possible in a number of other countries. However, the empirical evidence on loan conception, implementation and effects is still limited in this area.

1.1 Soundness, Prudential Regulation and Supervision

In possibly the majority of financial systems in developing countries institutions covering a sizable fraction of the market are technically insolvent. In a smaller number of countries many institutions, large and small, have lost their capital several times over. This phenomenon is observed in both public-owned and private institutions, but especially in the former.

As with most bank failures in the industrial countries, poor quality of bank management - including fraud and insider abuse - has been at the root of many failures in developing countries[2]. Thus, for example, managements have allowed undue concentration of risks in certain sectors, or to certain individuals. Lending to uncreditworthy clients at the behest of directors, or of government, has also been a factor. In many countries close ownership links between banks and their borrowing clients have been at the root of the problem. A special case of this is when public banks lend to public clients.

There have also been causes external to the financial system.[3] Unforeseen macroeconomic shocks have upset the calculations on the basis of which loans had been advanced, leaving the borrowers unable to service the loans. In particular, large devaluations have sometimes created difficulties, as when the business of many borrowers is import related or they have incurred dollar debts, or when a bank has held a foreign exchange exposure. Deflationary policies generally result in a deterioration of the quality of banks' loan portfolios. Trade liberalization measures also weaken the

2 For an assessment of the causes of bank failure in the US, see US Government, 1988.

3 It is extremely hard to assign relative weights to internal and external causes of financial institution failure. Macroeconomic disturbances often hasten the demise of a weak financial institution and may be mistaken for the underlying causes. Conversely an institution weakened by external shocks may be particularly prone to deteriorating quality of management (De Juan, 1987).

ability to repay of those previously protected by tariffs or other trade barriers. Thus bank failures may be entailed by some aspects of desirable macroeconomic adjustment programs. Not all of these problems could have been forestalled by adequate supervision and prudential regulation, including adequate accounting and auditing standards, but some could have been, and the cost of dealing with the problem promptly would have been far lower.

Furthermore, an inadequate regulatory and supervisory framework is a barrier to effective financial liberalization, because liberalization places different, and in many respects heavier, demands on prudential regulation and supervision than a directed credit system[4]. Liberalized financial markets also require different skills in the banking institutions from those needed in markets where interest rates and credit flows are heavily controlled.

In most cases, if banks collapse, the potential losses to depositors are ultimately indemnified by the state, with adverse budgetary impact. This is because of the perceived need to preserve confidence and avoid a flight from deposits. But the consequences of bank insolvency go beyond this. Distressed banks and borrowers can impede the access to credit of good borrowers and sound investment projects. While the bank's difficulty goes unrecognized, management continues to lend to nonperforming borrowers in the hope of some reversal of their fortunes. To support this unsustainable behavior they may bid up interest rates in a scramble for liquidity, to levels well above the likely return on investments. New lending projects are not entertained by banks in these circumstances; nor can finance be raised outside the banking system at a reasonable cost even by worthwhile investment projects because of the liquidity squeeze. Repositioning of the economy's productive capacity to a new set of relative prices or to an export-oriented policy is thus inhibited; meanwhile the volume of "paper assets" and the government's potential liability mushrooms[5].

4 Dooley and Matheson, 1987, Diaz-Alejandro, 1985.

5 For the consequences of widespread insolvency see Hinds, 1988.

The correction of insolvency problems in the banking system is thus an urgent task. Its character is more that of crisis management than of a long-term development effort. Nevertheless the task must be accomplished with a view to the longer run if the problems are not to recur. Certain "infrastructural" components are needed to restructure a banking system. For example, accounting and auditing standards must conform with generally accepted principles. A system of loan classification by quality is necessary so that capital inadequacy can be corrected and that there can be early warning of any future problems. Adequate systems of prudential regulation and supervision must be installed to ensure the health of the restructured system. To implement these may require legal and institutional changes in the relationship between banks and their regulators and, more generally, between lenders and borrowers.

1.2 Financial Repression

Excessive regulation of interest rates, unduly heavy taxation of financial intermediation and extensive direction of credit severely inhibits the effectiveness of financial systems in many developing countries. Such repressed financial systems may not, for example, offer savers an asset which can be expected to retain its real value over time. Financial intermediaries will then be little used, with savers relying on relatively unproductive assets or capital flight.[6]

The disposition of such funds as are made available to financial institutions may also be constrained: intermediaries may not be able to avoid lending to sectors and projects where the risk of failure outweighs the likely returns nor, conversely, to expand credit to the most promising projects. In many developing countries over half of bank credit is directed, and in some all is. The productivity of aggregate investment in the economy may thus be seriously impaired, resulting in wasted resources and slower growth. Central direction of credit allocation might, from certain perspectives, result in a good distribution of credit even though

6 There is some evidence that countries with repressed financial systems grow more slowly and that their incremental output/capital ratio are low: see Gelb, 1989.

it does not take advantage of the informational gains offered by a decentralization of credit decisions.[7] But by withholding responsibility from the financial institutions it tends to weaken the process of loan recovery and can wreak havoc with the financial viability of the intermediaries.

In the absence of such controls, and given a reasonable degree of macro-stability, the financial sector could be performing the important role of assessing the potential of different projects and adjudicating between them. Because of the prevalence of credit direction, credit assessment skills may not be developed anywhere in the economy.

Some of these regulations may have been instituted with a view to avoiding the risks of unduly vigorous competition, or to ensuring that "priority" borrowers are adequately served. But it is now quite generally recognized that the regulations of many countries often go beyond what is necessary or desirable and in the end not only result in a diminished quantity of misdirected credit, but also present prudential risks of their own. The spreads obtainable on directed credit are often insufficient, and they may limit portfolio diversification of the banks.

In most cases repression has a pronounced fiscal dimension. The financial system has traditionally been an administratively convenient source of tax revenue. A zero or low rate of remuneration on high reserve requirements (often in excess of one-fifth of deposits and occasionally approaching two-thirds) has also contributed to the fiscal burden on financial intermediation and to widening the spread between borrowing and lending rates in many developing countries. The total tax burden levied on financial systems in developing countries is often as high as two to three percent of GDP, and sometimes as high as seven or eight percent of GDP.

1.3 The Non-bank Financial Sector

In most developing countries the financial system is dominated by banks, with comparatively little by way of non-bank intermediation including money and stock markets. If not too heavily regulated, banks can perform many of the most important functions of a financial system: they

7 For a discussion of this see Cho, 1988.

can provide a safe and liquid repository for savings, they can operate an efficient payments mechanism, they can provide the necessary financing for trade. However, when it comes to other financial services, such as financing of long-term industrial development (by debt or equity) or the provision of high-yielding long-term savings media, the performance of banks has often been questioned. It is widely believed that additional institutions are needed to complete the picture and ensure the maximum contribution of the financial sector to economic development -- as well as to stimulate the banks by competing with them.

The Bank Group's main focus in this area has been on the development of capital markets and money markets.

Capital markets are desirable in that they can give investors access to long-term funds and equity. Long-term loans are suitable for financing investments with a long gestation period and whose returns will only materialize over a long period. Equity capital is desirable for financing risky investments: it allows the investor to go through a bad patch without the fear of bankruptcy and the real disruption which that would cause. Banks in most countries are reluctant to commit themselves to long-term lending or equity investment[8], considering that their own liabilities are fixed, and generally short-term in nature. There is also concern that industrial equity bases are insufficient in many developing countries to provide a robust basis for long-term growth.[9] From the saver's point of view, equity and long-term investments can offer a higher expected return, with maturities matched to the saver's own needs. An effective capital market can thus result in greater mobilization of resources and more productive investment.

Money markets represent the short-term end of capital markets: their development allows large firms and institutions to satisfy their short term borrowing and lending needs without requiring the intermediation of banks; this can improve efficiency and cut costs.

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8 And in some countries banks are prohibited from holding equity.

9 It appears that corporations in developing countries often have higher debt/equity ratios than those in the "developed" countries, apparently due to low profit retentions.

But the emergence of a successful capital market requires, besides reasonable macro-stability, the development of an adequate regulatory framework to limit fraud and prevent conflicts-of-interest and ensure adequate disclosure. Without this the market will be distrusted by savers, who individually are unable to assess the probity and creditworthiness of borrowers. This third area of bank involvement is thus primarily an institution-building activity.

1.4 Financial Intermediation Loans.

The Bank's involvement in financial sector issues is not confined to adjustment lending. Of quantitatively greater importance have been operations involving the use of domestic financial institutions to on-lend Bank funds to final borrowers. The first loans of this type were channeled through specialized development finance institutions (DFIs), some of which were established specifically or primarily for this purpose, often with Bank involvement. Over 150 DFIs around the world have been used by the Bank for industrial sector lending alone. Over time a larger share of loans has been channeled through the commercial banking sector via some "apex" institution (often the Central Bank).

This lending responded to a perceived deficiency in the provision of long-term finance and was seen as the only way to reach smaller, private, borrowers in the industrial (and agricultural) sectors. During the last few years industrial lending through financial intermediaries has averaged about $2 billion per annum, and this type of lending is likely to increase.

Unfortunately, many of the loans made by the DFIs did not perform satisfactorily, and by the start of the 1980s the parlous financial state of many of these DFIs had become apparent. As many as one-third had severe portfolio problems, due to a variety of macro and sectoral causes and to poor lending procedures. A review in 1985 concluded that about half of the DFI's were in reasonable condition, but that only about 10 - 15 were sufficiently profitable to turn to the market for financing.[10]

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10 World Bank, 1985.

The expansion of World Bank lending activities to include a wider range of intermediaries (notably the commercial banks) was an attempt to reach a wider range of clients. But it also served to sidestep the serious portfolio problems in many of the development banks. The doubtful soundness of many banking systems raises questions, however, about the allocation of resources intermediated by the commercial banks as well, and also about the ability of these banks to assess credit risk.

To the extent that intermediated lending operations have included general financial policy conditions, they have been largely confined to interest rate reform, usually involving the raising of rates on subsidized lines. This often reflects concern that other, heavily subsidized, lines of credit would undercut demand for the Bank-financed credit lines and prevent the loans from disbursing. As is suggested by the prevalence of repeat loans to intermediaries with poor loan recovery records, the solvency of the intermediaries, their managerial capabilities and their credit processes have often received little attention, although these aspects have now begun to be addressed more seriously.

2 The Content of Adjustment Policy Packages

2.1 The Prudential Framework and Bank Restructuring

The key elements of policy typically required for restoring financial systems to a solvent state are:

1) Measures to determine the state of the banks' portfolios and the necessary provisions and write-offs. These measures typically include the strengthening of accounting and auditing, implementing external audits, and classifying the portfolio according to loan quality. Legal changes to facilitate the intervention of regulators may also be needed.

2) For the banks less severely affected, implementing provisioning rules; for the weaker ones, a cleaning up of the loan portfolio (possibly transferring bad loans to a special facility), installing new management, recapitalizing and reducing costs or merging if a satisfactory business plan can be developed, or else liquidation.

3) For the system, establishing an improved regime of bank supervision together with a regulatory regime which will ensure timely provisioning against losses and provide information to both bank management and the regulators. This will usually require an overhaul of the accounting and auditing rules and systems, of rules for portfolio classification and for the treatment of unpaid interest. Measures to permit a credible, flexible, response by regulators may also be needed, for example, the introduction of "cease and desist" orders to permit a graduated tightening of conditions, and the creation of a deposit insurance corporation (not only to insure depositors but especially to free the central bank from the task of intervening banks, which is extraneous to its main function). Another area in which changes may be needed is the law concerning loan recovery.

Step 1. These measures, though apparently prosaic, constitute a vital part of the process. They may amount to a veritable cultural revolution in the way in which the financial system and the corporate sector interact. Adequate accounting and auditing constitute the information infrastructure needed for financial markets to operate well, in the sense that claims on real assets are able to be properly valued. In most developing countries, this infrastructure is sadly lacking.

Step 2. Why are insolvent banks not simply allowed to fail? Preserving depositor confidence is considered important for two main reasons. First, if depositors do not have confidence in the banking system, the potential for resource mobilization will be severely limited, and the efficiency and convenience gains therefrom will be accordingly diminished. Second, a wave of depositor nervousness may lead to a bank run. Runs which result in bank managements making forced liquidations of assets can be most disruptive to the economy and represent a significant set-back to growth efforts. Even if a bank run is forestalled by closure of the bank or banks concerned, this in itself impedes the operation of the payments system and disrupts economic activity. For these reasons most, though not all, governments have arranged for at least some depositors to be indemnified from loss when banks fail. Mostly this has been an *ex post* indemnity, but some countries have explicit deposit insurance schemes.

For various reasons, an explicit deposit insurance scheme may be preferable to an implicit guarantee by the state. Establishment of such a scheme has formed part of some adjustment programs,[11] and where this has been the case, the insurance agency has had functions beyond paying out depositors of failed banks. In particular, the agency can intervene in banks identified as in serious difficulties; this allows the central bank, which might otherwise be the only agency equipped to undertake the work, to concentrate on policy as it affects the continuing banks.

The task of the intervening agency, whether it be a deposit insurance agency or not, is to decide whether the failed bank should be liquidated, or whether it is realistic and worthwhile to consider a restart with a capital injection. It is essential to introduce new management; in the initial, transition phase this might come from the intervening agency, but these should be replaced by outsiders as soon as possible. The next stage is to identify the non-performing parts of the portfolio and separate these from the remainder of the banks assets. If left with bank management, the job of salvaging whatever can be obtained from a large block of non-performing loans, could hamper a successful restart of the banks' operations.[12] A restart can only be contemplated in the context of a carefully worked-out business plan probably involving considerable reforms to the internal procedures and policies of the bank. Invariably a substantial reduction in staff and branch expenses will be required. It may be quite some time before the rehabilitated bank is in a position to operate independently (in the case of a public-owned bank) or be bought by private interests. An important consideration in this area is that the financial restructuring should not include anything for the former shareholders: it is banks (or their depositors) rather than bankers which are "bailed out".[13]

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11 For example, SAL II to Chile. In this case a separate Superintendency of Banks already existed, but there was no formal deposit insurance system.

12 The task of recovering bad loans was left with the banks in Chile, but given to a special Trust in the Philippines.

13 In some cases debt-relief programs may also assist borrowers, as in Chile where loans were reprogrammed to reduce interest rates and extend terms, and preferential exchange rates were introduced after devaluation. This may be done to avoid a massive sell-off of assets which would further reduce their prices and add to the burden of bailing out the system.

Whether liquidation or rehabilitation is decided upon, the protection of depositors is costly. Even in those countries where a deposit insurance scheme has been in operation, the fund built up with the insurance premia is rarely sufficient to meet the deficits which emerge in the course of a major crisis. In most cases the cost falls directly or indirectly on the government. A cost borne in the first instance by the central bank eventually tends to fall back on to the budget, and must be managed and spread out over time so that it does not lead to an excessively inflationary expansion of domestic credit. Part of the counterpart funds generated by a policy based loan disbursed against general imports can be earmarked for capitalization of the insurance scheme, as in Turkey FSAL II.

Step 3. In order to avoid a recurrence of bank failures there is invariably a need to strengthen prudential regulation and supervision. Adjustment programs typically recognize this by proposing an increase in the number and quality of bank inspectors to allow an adequate frequency and depth of on-site inspections of bank management and portfolios. There is usually also scope for improvements in the procedures for off-site review and analysis by the bank regulators of returns made by banks. Many problems could have been avoided by strict adherence to formal procedures for loan diversification, for loan classification, for non-accrual of interest and for provisioning of non-performing loans. Establishment of such procedures, which should also ensure that problem loans are not concealed by allowing delinquent borrowers to roll over unpaid interest into new loans, is also part of the typical policy package.[14]

2.2 Freeing-up the Financial System

The policy agenda for removing excessive regulation of interest rates and credit allocation includes some or all of the following features:

- increase in controlled interest rates to ensure that deposit rates are positive in real terms.

- removal of controls on maximum deposit interest rates.

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14 The introduction of standardized accounting and external audit was a key condition of the 1986 Turkish financial sector operation.

- removal of all interest rate controls.

- withdrawal of interest subsidies and cross-subsidies.

- reduction in the complexity of sectoral credit targets and the degree to which they differ from what would be the uncontrolled outcome.

- removal of bank-by-bank credit ceilings, or of overall credit ceilings in favor of broad instruments of monetary control.

- removal of prohibition on commercial banks from activities such as underwriting or investing in private corporate securities.

- ensuring that barriers to entry into banking are no more than is required for prudential reasons (though in some cases an increase in capital and other requirements is needed for precisely those reasons).[15, 16].

- reduction in fiscal or quasi-fiscal burdens on the financial sector such as those caused by low remuneration of heavy reserve requirements.

- liberalization of exchange controls.

All of these measures have the general objective of improving the effectiveness of the financial sector's performance in mobilizing and allo-

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15 The procedures for restructuring or liquidation of insolvent banks can be seen as a parallel reduction in the barriers to exit.

16 Reducing entry barriers can actually strengthen the banking system in cases, such as Chile, the Philippines and Turkey, where it has been dominated by industrial-financial groups relying too much on within-group lending. In 1980 the Philippines offered universal status to banks with sufficiently diversified ownership, and the entry of foreign shareholding partners was encouraged. The success of this measure can be debated; ownership of many Philippine banks remains dominated by family groups, though the leavening of outside shareholders may have had beneficial effects.

cating resources, by using broad market signals wherever possible. As noted below, the timing of liberalization and its extent are sometimes debatable issues, especially when financial reforms interact with other reforms or macroeconomic imbalances. Also, the extent to which reliance on market signals in otherwise suboptimal environments is wholly adequate in meeting development needs for credit is still disputed (though it may be argued that the allocation of resources to desirable uses is better dealt with by fiscal means than by credit allocation). In practice, and for a variety of reasons, most countries choose to retain some degree of control over financial resource allocation and some degree of subsidy in their financial systems. Bank programs often focus on reducing the most egregious deviations from a market configuration, such as the prevalence of credit at negative real interest rates, or at rates below those available on deposits which encourages the substitution of borrowed for own funds.

No uniform approach has been adopted to the ideal regime of taxation of financial intermediation. Such taxes add to the wedge between borrowing and lending rates thereby contributing to inefficiency in the allocation of resources. It should be emphasized that, where inadequacy of capital is a major constraint to development, distortions of this type may be more severe than in capital-rich countries. For this reason, a reduction in financial sector taxation is often a priority in financial sector reform. At the same time, it could happen that undue zeal in eliminating fiscal burdens on the sector might result in undue taxation elsewhere in the economy. A comparison of the amount of indirect tax collected with the value added of the financial sector gives some basis for comparing tax burdens across sectors. So far as tax design is concerned, it is desirable that the tax should not be linked to nominal interest receipts in inflation-prone countries, otherwise it may quickly grow in importance and contribute to a severe widening of interest rate spreads if inflation and nominal interest rates rise sharply.[17]

17 This happened, for example, in the Philippines where, without any change in tax rates the burden of the tax on gross receipts of financial institutions approximately tripled in 1984. The remuneration of large reserve requirements at fixed low rates has a similar impact as market rates increase.

2.3 Capital Market Development

Capital market development typically involves four main areas of policy. First, legislative: establishing an adequate regulatory framework for both primary and secondary markets so that a variety of securities can be sold with adequate requirements for systematic accounting and disclosure of accounts, and protection of minority interests.[18] Second, taxation: reducing differences between the effective rate of taxation applying to different types of security in order to reduce fiscal disincentives, especially to the use of equity and long-term debt.[19] Third, technical assistance and training in the setting up of necessary institutions and intermediaries. Fourth, liquidity: ensuring an institutional framework for providing adequate liquidity to the market. This might, for example, include increased authority for banks to participate in securities markets, a measure which poses problems both of prudential regulation and potential conflicts of interest.[20]

3 Problems and Issues for Financial Reforms

3.1 Interaction with Other Adjustment Programs

Major problems emerged with the financial sector liberalization experiments of the 1970s which occurred in the Southern Cone. These may be attributed mainly to inappropriate macropolicies (especially exchange rate

18 The enactment of a Capital Market Law (in 1981) and the establishment of a Capital Market Board (1982) were among the conditions of structural adjustment lending in Turkey. Unfortunately macroeconomic conditions did not favor the growth of the market and its role in financing private investment remained minor.

19 Chile, Jamaica and Malaysia are examples of countries where bank deposits have benefited from a favorable tax status, such as exemption from withholding tax that applies to securities, so that the holding of corporate debt, and capital market development in general is discouraged. Removal of this distortion was a feature of the reform program in Jamaica.

20 There is at present no consensus on the optimal structure of financial intermediation and its relationship with capital markets. Some developed countries, notably Germany and Japan, have done well with "bank-based" systems where banks and firms have close relationships; in others, the system is "market-based" with more of an arms-length relationship between banks and firms. In some countries banks are "universal"; in others, financial institutions are more specialized. At the risk of over-generalization, *how* the various elements of a financial system perform is probably far more important than the precise *configuration* of the system.

policy), but inadequate prudential supervision and regulation was also to blame. How financial reforms should be phased in relation to other reforms has therefore become an important policy question.

Mention has already been made of the possibility that macroeconomic and trade policy adjustment can have undesirable side-effects for the financial sector, notably in worsening the condition of the portfolio of the banking system.[21] Conversely, the distortions caused by unduly rigid financial regulation can be much greater in the absence of macroeconomic balance. High inflation, for example, can cause a fixed nominal interest rate to diverge even more from the market clearing level and result in deteriorated resource allocation and a worsening of credit rationing.[22]

This raises difficult issues of phasing and sequencing of different reforms:

A. Some considerations argue for delay in the liberalization of financial markets until other aspects of reform are implemented. The speed and magnitude of the response of a liberalized financial sector to changes in the environment may mean that some firms and financial institutions which could have survived under a more controlled regime will fail if the system is subjected to a significant shock to the macro, trade or fiscal policy environment.[23]

Abrupt financial sector liberalization can itself generate undesirable side-effects. For example, if interest rates are all deregulated at once, the (typically) shorter maturity of deposits

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21 It could be argued that the emergence of this problem in Turkey in the early 1980s could have been anticipated far earlier in the SAL program. Perhaps more should have been done to improve auditing and bank supervision so that the problem could at least be monitored. By the time actions of this type were introduced (in the financial sector operations in Turkey) the damage to banks' portfolios was already serious.

22 For example, fixed rates on rural lending in Brazil resulted in large losses on official credit lines as inflation soared following the breakdown of the cruzado.

23 In Chile, for example, liberalizing the capital account of the balance of payments in an environment of market-determined interest rates resulted in a surge in the external value of the currency, over-borrowing, and crisis with the puncturing of the speculative boom in real assets.

than loans will imply a severe profitability squeeze for banks. This is especially acute for housing loans, because of their long maturity[24]. Unless the low interest rates can be renegotiated, permanent increases in the level of interest rates may imply some form of state subvention if depositors are to be protected. Also, an easing of the fiscal burden on the financial system will generally result in pressure on the budget which may manifest itself in a distorting tax imposed elsewhere in the economy or inflation or explosive issue of public debt which further raises interest rates and contributes to financial instability[25].

The consensus is that financial sector liberalization is best introduced at a time of macroeconomic and policy stability, and that the absence of such stability can frustrate financial reforms.

B. It must, however, be recognized that every delay in eliminating distortions represents a real loss to the economy (via the adverse effect on resource allocation) and also the buildup of off-balance sheet government liabilities. Some measures to promote competition, such as opening the system to foreign banks, might be needed to induce reform in an oligopolistic domestic financial system. Nervousness concerning the fragility of the financial system should not be used as an excuse to delay reform indefinitely. Rather, it should be a spur to ensuring that financial reform is sufficiently thoroughgoing as to result in robust institutions.

In practice, the timing of financial reforms will probably follow "windows of opportunity" (as, for example, in Argentina), and the possible shocks which might arise in the course of other likely reforms must be factored in.

24 Hungary provides one example where a very high proportion of the portfolio of the financial system is in the form of long-term fixed interest housing loans which are now well below market levels.

25 The Turkish experience shows the damaging effects of high government borrowing on the stability of the domestic financial system.

3.2 Dissenting Voices

As with most issues in economic policy, there are some who feel that conventional financial sector reforms may neglect important institutional considerations.

An important general point is that financial sector adjustment may be unsuccessful or even counterproductive if not supported by *adequate macroeconomic policies*. Financial policy loans have been made to countries where the macro situation was less than satisfactory,[26] despite the close connection between the macro situation and the health of the financial sector. A review of experience suggests that countries have generally complied with the specific financial policy conditions contained in the loan. Indeed, some governments took measures which went even beyond the conditions of the loan.[27] But is it realistic to expect a favorable result when macro-stability is not being achieved?[28] Some argue that financial sector reforms should be deferred until a more stable macroeconomic environment can be assured.

On financial liberalization there are various strands of dissent. Some commentators regard the *higher interest rates* which would result from liberalization as likely to reduce growth and increase inflation at least in the short-run. This is an empirical issue which is not wholly resolved, but evidence is against the dissenting view, at least in the long run context (see below). There are two separate issues here, first whether real interest rates "overshoot" or rise to unduly high levels following liberalization; second, whether the higher interest rates do actually depress economic activity and worsen inflation. The experience of the

26 Turkey and Argentina faced major macro-imbalances during the implementation of financial sector reforms; floods and a disastrous earthquake in Ecuador during early 1987 resulted in an expansion of the fiscal deficit and an acceleration of inflation. Implementation of a financial sector reform in such a sharply worsened environment was clearly going to be more difficult.

27 There are examples of this in the case of Argentina and Ecuador. But there have also been cases where reforms have subsequently been partially reversed, as with the financial transactions tax in Turkey, reduced from fifteen to three per cent, but subsequently increased.

28 For example, continuing high budgetary deficits in Turkey have kept real interest rates high and inhibited recovery of the financial sector despite the sectoral adjustment measures. For a discussion of the consequences, see Atiyas, 1989.

Southern Cone countries, and especially Chile, in the late 1970s is often mentioned in this connection. It is true that real interest rates soared; in Chile real bank lending rates averaged 74 per cent over the four years 1975-78. The difficulty lies in isolating the role of interest rate liberalization in a period of extensive policy changes. Not only were tariff reforms and an opening of the capital account undertaken at more or less the same time as liberalization of the domestic financial sector, but inadequate supervision of financial institutions and an unsustainable exchange rate policy also contributed.[29] Despite the rapid growth experienced by Chile (and Uruguay) in the years immediately following the reforms, the financial instability which ensued remains a specter which is hard to exorcise in evaluating financial liberalization for other countries.[30]

An area of potential conflict between short- and long-term objectives is monetary control and anti-inflation policy. Structural changes which substitute market-based monetary policy instruments for bank-by-bank credit ceilings pose potential short-term risks for monetary control. It should in principle be possible to neutralize any undesired side-effects of the change on macroeconomic conditions, but lack of experience in the operation of the new (mostly indirect) system could result in problems. An adjusting country may be operating under an IMF program which was drawn up in the context of the existing, unreformed, financial system, and it could also happen that there was some concern to retain features such as credit ceilings despite their structural inefficiency, because of a perception that they allow the authorities to achieve monetary control more easily. This concern may make reform programs less ambitious than they might otherwise be.

A closely related point is the controversial theory that, in a liberalized financial system, *monetary restraint* might be comparatively

29 McKinnon, 1988, compares financial sector reforms in Chile with those in other countries, notably in Asia.

30 Though interest rates in the Philippines also jumped, this was due to the political crisis and devaluations of 1983-84. There had been an interval of stability following the interest rate liberalization, which therefore cannot be blamed for the later disturbances. Indeed it can be argued that the crisis would have been even deeper and more prolonged had the authorities not had at their disposal a flexible interest rate regime.

ineffective (or even counterproductive) in restoring balance in international current payments and the macroeconomy in general. In this neo-structuralist view, monetary restraint might choke off production as much as, or even more than demand. It is argued that, in a system of directed credit, monetary restraint could be confined mainly to less productive sectors or consumer spending. This line of argument is particularly relevant to the short-run, and it is weakened if fiscal policy instruments more appropriate to achieving macroeconomic balance are available.

Among the financial instruments which the Bank has always sought to expand in developing countries are *long-term loans*.[31] But is the provision of long-term loans really so vital? If it were, one might, for example, expect to see long-term resources made available from World Bank funds commanding much higher interest rates than short-term loans. It seems likely that unsatisfied demand for long term loans comes mainly from less credit-worthy clients. Top-grade borrowers might feel reasonably confident of being able to roll-over short-term bank borrowing and not be prepared to pay much of a premium for long-term funds. Preparedness to pay a maturity premium thus could signal low creditworthiness, making a competitive banking system reluctant to make long-term loans to a broader spectrum of clients, even at a premium. The advantages to a bank of being able to review and recall loans at regular intervals should not be minimized. Early evidence of a borrower's deteriorating position can be acted upon promptly, possibly allowing the position to be turned around, whereas the holder of a long-term claim may have no comparable sanction.

More generally, it is sometimes held that the financial system will not on its own channel funds to the most socially, as opposed to privately, productive sectors. In particular, are we convinced that a "sound and totally liberalized" financial system is always the most desirable for development? What of *second best considerations*, for example where a poor legal framework in a volatile economy leads the formal sector to only consider short-term, heavily collateralized lending and inhibits

31 Among the policy measures adopted to encourage this, apart from the establishment of specialized DFIs in numerous countries, has been the differentiation of reserve requirements and lower taxes in respect of long-term resources in the Philippines and other countries.

equity markets?[32] A conventional response to this point is that deviations between social and private valuations are best met with explicit tax/subsidy measures. Using directed credit can conceal a very large implicit subsidy which, if made explicit, would be seen to be well in excess of the difference between social and private valuations. The use of subsidized credit also usually involves high leakages because of fungibility. But this is only a partial response. To the extent that what is being identified is an institutional failure, as with the absence of certain financial instruments, it may well be that the best cure lies partly in policy interventions in the financial sector. But this does not necessarily argue for programs and institutions of types common at present.

Theoreticians have observed that *partial liberalization* of a formal banking system may actually worsen the supply of credit to the productive sector to the extent that it diverts deposits from a curb market which may be more efficient in channeling its deposit resources to the productive sector. This argument seems to be based mainly on a reading of the Korean experience, where curb markets are extensive and are not subject to reserve requirements like the formal banking system. It is not evident that curb markets are generally more efficient than the formal banking system that this point might have application; the use of unregulated intermediaries also increases the risks of crisis.[33]

It has also been remarked that *taxation*, explicit and implicit, of financial intermediation could be used to offset the adverse effects of cartelization and monopoly power in the banking system. If the authorities are faced with a situation where banks are able to depress deposit rates and increase lending rates unduly, skilful use of unremunerated reserve requirements might offset these distortions.[34] The ideal long-run solution

32 This point has been much discussed in the context of the Philippines. Investor confidence was badly jolted by the celebrated Dewey Dee affair, where a prominent financier suddenly absconded leaving large money market debts behind him. It is to fill this perceived gap that many see the proper role of DFIs, not only in the Philippines, but in many other countries, notably in sub-Saharan Africa. If the gap is an imaginary one, then not only the role, but also the viability of DFIs is placed in question.

33 For the example of Malaysia see Sheng, 1988.

34 In Ghana, for instance, the interaction of credit ceilings and an inflow of funds from abroad resulted in a situation where banks were able to command a very high spread between borrowing and lending rates.

in such circumstances is, of course, to encourage greater competition through liberal (though prudent) policies towards entry of new banks; but the results of such a program may be slow. Furthermore, to the extent that economies of scale exist in financial intermediation[35] some degree of monopoly power may remain even if entry is free.

In the case of *insolvent state-owned banks*, one line of dissent takes the form of suggesting that immediate action to reveal the poor quality of the loan portfolio and clean-up the balance sheet may be unnecessary and imprudent. Unnecessary because the fear of a bank run may not be great in the case of state-owned banks and because changing the management may be sufficient to avoid a recurrence of the poor lending policies. Imprudent because announcement of the insolvency may damage business confidence, diminish the chances of good recovery on doubtful loans, and present the government with a budgetary commitment which it can ill afford to absorb in the short run. The choice between the orthodox and dissenting view here hinges on the likely success of an attempt to cover up the insolvency and on the likely effectiveness of a bank management encumbered with a balance sheet so bad as to make profitability unattainable for years.

The best *institutional arrangements* for ensuring an adequate implementation of monetary policy and prudential regulation and for dealing with failed banks are often the subject of discussion. Should these functions be united under one institution - say the central bank - or is a separation of functions desirable? Also, should insurance intermediaries and the securities markets have their own regulators, or does the need for coordination argue for a single regulatory body?

The experience in different countries is very varied, and this is as it should be, bearing in mind for instance the varying degree of complexity of the financial systems, and the resources which can be made available to the implementation of financial system policy. Many countries accept the importance of a degree of independence of the monetary policy

35 This itself is a much debated question.

authority from other aspects of government, though the degree of independence varies.[36] The responsibility for bank supervision is sometimes given to the central bank, sometimes to a government ministry. In some countries there is a separate superintendency of banks. To the extent that this is needed to ensure that sufficient attention is devoted to prudential supervision in the face of competing demands on the attention of senior central bank or ministry officials, there can be merit in having a separate superintendency. But whatever institutional arrangement is preferred, it is essential that the bank supervision function be adequately funded, and that there be an adequate two-way flow of information between it and the monetary policy function.[37] The case for a separate agency with the authority to intervene and deal with failed or failing banks has already been mentioned.

The importance of coordinating prudential regulation in different segments of the financial system grows with increased liberalization of the financial markets. There is a tension between, on the one hand, the requirements of coordination and, on the other hand, the need for specialized agencies with clearly defined and focussed priorities.

There is also discussion as to whether a formal *deposit insurance* scheme is really desirable, and as to what form it should take. Should such insurance be compulsory? Insurance of deposits eliminates the incentive for depositors to satisfy themselves as to the prudence with which the financial institution is being managed and makes them indifferent even to reckless management behavior. An insurance fund is rarely sufficient to meet ' 'or calls upon it. Limitation of insurance to small deposits is routinely sidestepped by such practices as deposit splitting. Alternative approaches which might restore incentives, such as relating the insurance premium to the regulator's perception of the risk of the portfolio, are not easily effected, especially in developing countries. The main response to this line of criticism is to observe that, as ex post indemnification of

36 Perhaps the greatest degree of independence is provided by adherence to a multi-country currency zone, such as the CFA zones in Africa, where the central banks, being international institutions, are not answerable to any one government.

37 It should go almost without saying that supervision must be completely free of improper pressures from prominent personages.

depositors has been widespread, the problem of moral hazard already exists and that explicit insurance is preferable to implicit, not least because it provides a "lever" for regulators to intervene.

Another debatable issue is the extent to which a financial system can be made to be self-regulating by mandating extensive *disclosure* of information by the constitutions and the regulators, and relying on depositors to police the banks. For various reasons, such an approach is not generally thought to be robust. However, this forms the philosophical basis of the most comprehensive banking reform undertaken in a developing country, that of Chile.[38]

While the introduction of *universal banking* has been recommended in some Bank programs[39] there is the view that allowing banks to become involved in corporate securities weakens prudential safeguards as well as obstructs the development of autonomous capital markets. This conflict mirrors the long-standing debate between adherents of the traditional Japanese/German approach to banking and the UK/US approach. By now, however, it seems clear that attempts to retain rigid barriers between segments of the financial sector can have, at best, a finite lifetime.

All in all, the dissenting voices serve to call attention to the need for reforms to be carefully thought through and to the need for attention to be paid to the specific institutional features of each country.

3.3 Winners and Losers

Achieving consensus on financial sector reforms is usually difficult because of the powerful special interests who are affected.[40] A highly regulated banking system is typically a cartelized and potentially profitable one. Opening up competition will erode excessive profits and

38 Note that the Chilean system also mandates an active role for the bank superintendency.

39 An early example was the Philippines.

40 This is true for all policy reforms; spurred on by a massive insolvency crisis, some financial reforms have been more easily accomplished than, for example, tariff reforms.

allow new institutions and markets to flourish at the expense of the old. Anticipation of such effects will result in strong lobbies against liberalization.

There are losers too from the establishment of tighter prudential regulation. Uncreditworthy borrowers who received loans from badly managed banks will no longer have access to credit. The very fact that they have received loans in the past suggests that they will form a powerful lobby against reform. In most developing countries, major banks and borrowers have extensive ties; moving to an "arms-length" relationship attacks the basis of the economic power structure and is therefore slow and difficult.

It is often asserted that financial liberalization will have favorable effects on income distribution and on reducing the concentration of economic power. There is probably something to this, though the evidence is not fully conclusive. Credit allocation is normally more concentrated than the holding of deposits, and it tends to follow the distribution of assets available for collateral.[41] Many examples suggest that subsidized credit is in practice mostly available to the larger or more prosperous segments of the targeted sectors. Small savers benefit from the liberalization of deposit rates. The very poor have little or no access to formal credit; their interests lie in the improvement of economic growth and employment which may be expected to flow from reform, which may also end the artificial stimulus to capital-intensive production from severely negative interest rates.

At the same time it cannot be neglected that drastic changes in interest rates can have very large distributional effects to the extent that they affect long-term loans. This is especially important in respect of housing credit which is heavily subsidized in many countries. Middle-class borrowers may have entered into long-term commitments wholly unaware of the fact that the interest rates which they have been offered are subject to large increase if the subsidies are removed. Even though these borrowers have gained substantially from the subsidy, they may be unable to meet their commitments at the unsubsidized rate. In practice both equity

41 For an interesting analysis of the impact of collateral on credit allocation and thence on efficiency, see Feder, 1988.

and political considerations may call for some degree of partial compensation for long-term borrowers especially badly-hit by a change in the interest rate regime. But such schemes of compensation must be strictly circumscribed if the benefits of the reform are not to be lost: certainly the new interest rates must apply to all new borrowing and the scheme of compensation should be simple, transparent, and preferably funded out of fiscal resources.

Given the sensitivity of the issues addressed, governments and the Bank sometimes prefer to leave implicit some of the steps which may need to be taken, and these may, accordingly, not be in loan documents. As with other policy based loans, the chances of full implementation are best when government is firmly committed to reform; in this case some actions may well have preceded the loan. On the other hand, expectation of a series of sectoral adjustment loans, which promise continued balance of payments support, may have induced a tendency to be satisfied with conditionality in any one loan which falls short of what is both feasible and desirable.

4 The Success or Potential of Financial Adjustment Policies

4.1 Financial Policies and Growth

The ultimate objective of financial sector reform is a higher sustained rate of economic growth. Measuring success in these terms, however, is compromised by the multitude of other factors which contribute to economic growth. The effectiveness of financial sector reforms needs to be addressed also in terms of intermediate objectives. For example, has interest rate liberalization contributed to a higher savings rate, to a higher rate of monetization, or to reduced capital outflow? Has removal of sectoral credit controls led to more productive investment choices? Has removal of bank-by-bank credit restrictions reduced bank margins? Have programs of bank rehabilitation and improved supervision resulted in a sound and energetic banking system? Has the elimination of programs of directed credit resulted in reduced loan delinquencies? Have structural improvements in capital markets led to increased recourse to the capital market?

In most cases the adjustment programs developed by the Bank have not run long enough to provide anything like definitive answers to these questions on a case by case basis. From the cases reviewed, it does seem that countries have complied with most of the conditions of the programs.[42] But, being quick-disbursing, policy-based operations, the programs have also sometimes been introduced in problematical macro-circumstances which have continued through loan implementation.

More generally, the degree to which an efficient financial system can contribute to the process of economic growth is not precisely established. Certainly, a well-performing financial system is no substitute for policy weakness elsewhere in the economy. Nevertheless, when things go wrong in the financial system, such as with a hyperinflation or - more relevant in the present context - widespread bank failures, the impact on the economy can be sudden and dramatic and long-lived. Recent research on the 1930s depression in the US attaches considerable importance to the impact of bank failures on credit availability (independent of the deflationary effect of monetary contraction). Cause and effect have been difficult to disentangle in some of the developing country episodes of financial insolvency in that the insolvency of the banks became evident at a time of recession.

Some indirect evidence may be obtained by cross-sectional examination of countries which vary in their structure - some approximating the ideal of liberalization programs, some very repressed. The relative contribution of liberalized and repressed financial systems to economic growth has been considered in a number of statistical studies.[43] In an IMF review of 21 countries over the period 1971-80, the six countries with positive real interest rates grew more rapidly than the ten with moderately negative rates which, in turn, had average growth rate well above the five

42 Further, examination of the Chilean case suggests that financial sector reform can have such beneficient effect if the macroeconomic situation is kept under control. Real interest rates and bank spreads have moderated and real volume of deposits and bank credit grown since the reforms, to support rapid growth of output.

43 Fry, 1988, and Gonzales Arrieta, 1988.

with severely negative rates. A recent study by one of the present authors, using data for 34 countries 1965-84 also finds a positive impact of interest rates on growth.[44]

Evidence on the impact of distortions caused by directed credit is even less easily quantified, essentially because of fungibility which makes it very difficult to assess what would have happened in the absence of directed credit. Few, if any, studies exist which conclusively attribute favorable results to programs of directed credit. Institutions implementing directed credit programs have faced serious loan quality problems in many countries, which suggests poor credit allocation. But even where directed and subsidized credit proves profitable for the financial intermediary, it may be socially loss-making, to the extent that it results in diversion of funds from still more worthwhile projects.[45]

4.2 The Structure of Financial Loans

A policy-based loan has the effect of financing part of the borrowing country's international payments deficit, as well as supporting the budget through the provision of counterpart funds.[46] A typical financial reform policy loan might be disbursed against general imports over a period of two years in two tranches. Counterpart domestic funds are generated as importers turn in domestic currency for foreign exchange; what then happens

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44 Gelb, 1989. This study identifies a causal chain from higher interest rates, through greater mobilization of saving through the financial system, to increased efficiency of investment and thereby to growth. Analyses also suggest that high deposit interest rates encourage additional saving in developing countries (notably in Asia), but that the effect is very small. There are a number of clear-cut examples of the effect of real interest rate increases on monetization; often this seems to have been attributable to a reflow of funds previously held outside the country.

45 Korea is sometimes mentioned as a counter-example, for that country experienced rapid growth even though a selective credit policy was in operation. But it should be noted that in Korea a rapid growth in the uncontrolled financial curb market substantially offset the impact of this policy on the overall distribution of credit. A more conventional story is that of Indonesia, where a system of administrative allocation of credit was introduced in 1974 (and abandoned in 1983). Despite the higher rate of investment which was experienced in Indonesia after 1974, the growth rate of output actually declined, suggesting that investment had not been especially well-directed.

46 For discussion of counterpart funds and the relationship with monetary policy, see Roemer, 1988.

depends on how government uses these payments. For example, it may retire domestic debt; after disbursement government then has a foreign liability and a domestic asset (or reduced domestic liability) and the private sector has a domestic debt (or reduced asset) and foreign goods. The question naturally arises as to what costs are being covered by the funds disbursed in financial sector loans. The major fiscal costs of financial sector reforms are of two types:

(i) In a repressed financial system, high, unremunerated reserve requirements may yield government the annual equivalent of 2-3% of GDP and lowered debt servicing charges from repressed interest rates on public debt may amount to a further percentage or two. A move to financial liberalization which substantially removes the financial system out of the tax base may therefore have appreciable fiscal cost, especially in present value terms. The fisc may also need to bear some cost in compensating for the elimination of interest cross-subsidization.[47]

(ii) A second fiscal cost component comes with financial restructuring, as depositors and/or debtors are bailed out. As the experience of Chile and the Philippines suggests, this one-off cost can represent as much as 20-30% of one year's GDP. But it can be spread out over time, for example, if the government provides intermediaries with interest-bearing paper in exchange for the bad portfolio to enable depositors to be serviced.[48]

Compared with these two components, the fiscal costs of institutional changes, such as introducing external auditing, are naturally small. The major cost of such actions can be a political one, inasmuch as they

47 This has been a notable factor in the case of Turkey. In the Philippines, by contrast, the higher interest rates of 1984 probably contributed to government revenue.

48 Of course, in the absence of restructuring government would incur costs also (as well as the buildup of claims due to weakening institutions) because subsidies will be needed to sustain the liquidity of insolvent intermediaries.

affect powerful interest groups. Financial sector reforms of the type being discussed do not typically have important direct foreign exchange costs.[49]

The counterpart funds from Bank loans for financial reforms are usually not closely related to the fiscal costs of financial policy reforms nor to the time-profile of such costs. Such loans may therefore cover only a part of the fiscal costs (Philippines, Chile, Ghana) or more than the fiscal costs (Turkey) depending on the loan size and the nature of the policy reforms. The loans will generally far exceed any direct foreign exchange costs of the reforms.

Bearing in mind that balance-of-payments considerations have considerable weight in determining loan amounts, it seems that the nature of financial sector reforms does not provide a good yardstick for judging the appropriate size of policy-based loans. Should loans therefore be designed to establish a tighter link between disbursements and fiscal costs? In the present context, this would mean: (i) severely reducing the size of tranches linked to the reform of accounting and auditing practices etc., (ii) linking disbursements to market liberalization (but only to ease adjustment to a better fiscal system: there is little point in reducing taxes on financial transactions only to have taxes raised in other distorting ways, e.g. on exports), and (iii) establishing a link between disbursement and the fiscal costs incurred in the process of financial restructuring.[50] This has implications for the speed of disbursement which are noted below.

The disbursement of financial intermediation loans, on the other hand, depends on the speed of disbursement of the corresponding credit lines to final borrowers,[51] even when such loans include policy reform as a

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49 It might be argued, however, that if depositors were to suffer losses they would reduce their spending on imports as well as on domestic output. If so, a recapitalisation of the banking system, which protects deposits, could be said to have indirect foreign exchange costs.

50 The second FSAL to Turkey set aside a component specifically for restructuring, which would link disbursements with the cost of system reform.

51 Note, however, that the term of the Bank loan is typically far longer than the terms of the loans offered to final users of funds, and that there may be no requirement that domestic repayments be relent again up to the term of the bank loan. In such cases, the Bank loan initially funds the private sector, but later it funds government.

condition. As noted above, the policy content of financial intermediation loans has been limited, typically to the raising of subsidized interest rates. Raising these interest rates is often necessary so that lines of credit disbursed on terms acceptable to the Bank will not be undercut by cheaper domestic lines. This introduces a link between policy reform and disbursement, but it is implicit rather than explicit.

4.3 Some Practical Issues In Financial Loans

1. It may not be realistic to expect the "real" economy to be reformed prior to a financial sector operation, but financial policy loans must be part of a viable package. They need to be designed in the context of an adequate macro-policy framework if they are not to misfire, or even result in deferral of needed macro-adjustment.

2. It is essential to ensure that the granting of a large and quick disbursing financial sector loan does not result in a deferral or slowing of other measures needed to ensure lasting macroeconomic adjustment. Adherence to specified macroeconomic conditionality should be required for the disbursement of financial sector adjustment loans.

3. Should the size and disbursement of loans be linked to fiscal costs of policy reforms? As noted above, this would require large changes in the type of loan from that now established. Major disbursements would be linked to the adjustment costs of fiscal reforms and to restructuring only, with small components of a technical assistance nature for reforming the financial "infrastructure". It would be perhaps necessary to supplement this by an explicit balance-of-payments component, with its own appropriate conditionality.

4. In cases where the "financial infrastructure" is deficient, is it realistic to expect rapid results from reforms? Banks may never have had to develop the credit processes appropriate for a market economy, and it is known that deep institutional reforms take time. How soon can we expect a change in the banking culture of a country? On the side of supervision, it takes at least five years to train a bank examiner. Legal reforms may also take time, especially in countries with a division of powers between executive and legislative branches. The experience of Chile and the Philippines shows how slow and difficult it can be to dilute ownership links between

banks and firms. In such cases, quick-disbursing policy based operations may not be ideal. It may be better to consider smaller technical assistance packages disbursing over periods of about five years to be complemented by larger, quick-disbursing, loans at the time of financial restructuring.

5. The adverse consequences for bank portfolios (i.e. for the 'stocks' of asset value) of adjustment measures to redirect "flows" of factors and goods, (notably exchange rate adjustments and trade liberalization) are not sufficiently taken into account in planning such policy reforms. They should be anticipated and measures be taken to prepare for them. For example, bank regulation and supervision could be addressed at an early stage, rather than waiting for the problems to multiply.

6. Towards what kind of financial system should we be trying to restructure? In particular, what role should development banks play in the more liberalized systems of the future? If this question is not thought through, the restructured banks may face a long-run earnings problem and quickly become distressed again.[52]

7. Given the very poor financial condition of banking systems in many countries (and the adverse implications for resource allocation that follow) should the volume of financial intermediation loans increase rapidly? Is there a danger of further weakening the system by piling still more debt onto undercapitalized borrowers? Given the poor history of directed credit, at least in terms of repayments, is debt the right instrument to foster development? Can equity or pseudo-equity contracts be used instead, to strengthen capital structures? How would such a move be compatible with the lending policies of the Bank?

5 Conclusion

The typical financial sector reform package involves policy changes to increase the power of centralized decisionmaking in some areas and to reduce it in others. In the area of prudential regulation and supervision, reforms seek strengthened information systems, stronger and more detailed

52 This issue is now being faced by at least one large institution restructured according to a Bank program.

regulations and closer central supervision. At the level of the intermediaries, reforms seek improved procedures, some of which, such as credit policies, loan review and management information systems, are natural complements to improvements at central level. But insofar as the relative cost and availability of credit are concerned, the typical reform program calls for a reduction in government control, and also tries to broaden the range of options for finance.

The internal consistency of policy packages of this type follows from the assumptions which underlie the market economy model, especially that the qualities of goods and services must be reasonably apparent to participants in the market who can only then formulate their production and spending plans in an appropriate way. Liberalizing the financial market without ensuring a correspondence between financial contracts and the values and productivity of the real assets underlying the contracts does not contribute to the strengthening of market mechanisms and may even undermine them, as indicated by the experience of more than one country. It is, of course, possible for a pendulum to swing too far, and in several directions. For example, given deep-seated information shortcomings and macroinstability problems, a fully market-based financial system might sometimes usefully be complemented, from a developmental perspective, by measures to encourage certain types of financing. If carried too far, prudential regulation can conceivably strangle financial innovation. An exclusive drive for privatization can cause much-needed public-sector reforms to be neglected. However, given the starting positions of the financial systems in most developing countries, financial reforms in the indicated directions are vital for strengthening the role of the market in allocating resources, both internally and internationally. They will also be needed if developing countries are to take advantage of the globalization of finance which is currently under way.

How should financial sector operations evolve? This paper has tried to extract some implications of past experience. Many needed financial sector reforms are of an institutional and "infrastructural" nature, and require the acquisition of scarce skills. They take time to become effective, and it is not clear that a quick-disbursing policy-based operation is the ideal medium for effecting them. It might therefore be better to formulate medium-term, lower-intensity operations for certain components of financial sector reform. Given the close links between financial sector policies and performance and the macroeconomic situation, the latter needs to be taken

into account when planning reforms, especially when these have fiscal implications. The implications of other reforms, such as that of trade, for the financial system, need to be considered at an earlier stage than has so far been the case. Disbursement of financial reform loans could be tied in more closely to the costs of the reforms, which would be primarily those of restructuring and fiscal adjustment. And, as with other reforms, if financial reforms are not embraced intellectually by the governments of adjusting countries, they will be adopted reluctantly and will surely fail.

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