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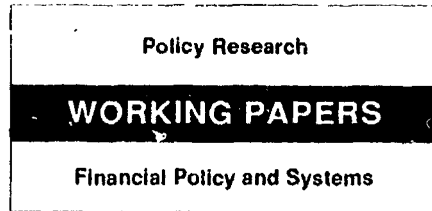

Country Economics Department
The World Bank
November 1991
WPS 803

Financial Regulation

Changing the Rules of the Game

Millard Long
and
Dimitri Vittas

Financial regulation in the 1980s was characterized by far-reaching changes in the rules of the game in both developed and developing countries. Three criteria — stability, efficiency, and fairness — can be used to evaluate financial structures and regulation. Tradeoffs between them must be determined on a country-by-country basis.

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Policy Research

WORKING PAPERS

Financial Policy and Systems

WPS 803

This paper — a product of the Financial Policy and Systems Division, Country Economics Department — is part of a larger effort to study the impact of regulation on financial structure. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Wilai Pitayatonakarn, room N9-003, extension 37666 (18 pages). November 1991.

In a brief history of financial regulation, Long and Vittas note the removal or relaxation of controls on credit and interest rates in the 1980s and the growing emphasis on prudential controls.

They argue that the 1980s were not a decade of financial deregulation but a period when the rules of the game were substantially changed. They discuss three criteria for evaluating financial regulation and structure: stability, efficiency, and fairness.

For forty years, financial *stability* was not a significant concern, but today it is, as a result of massive losses suffered by financial institutions. Financial stability can be enhanced by increasing capital requirements and strengthening financial supervision. But the stability of the financial system is also affected by its structure. Systems with "narrow" banks or "nonpar" banks would be exposed to fewer systemic risks.

The relationship between structure and *efficiency* is also complex. In the research literature, the issues of economies of scale and scope in finance remain unresolved. In developed countries, there is growing concentration and a spread of universal banking, suggesting economies of both scale and scope. Moreover, available evidence suggests that concentrated banking systems tend to have lower margins and operating costs as well as higher profits.

But in developing countries, large banks tend to be inefficient. Their size is the result of controls and restrictions on competition and entry rather than superior efficiency. Allowing universal banking might exacerbate the dominant position of large banks, with adverse effects on competition and efficiency.

Fairness covers many issues, such as protecting users of financial systems from abusive behavior by the financial institutions, creating a level playing field for competing institutions, and tackling the problems caused by potential conflicts of interest. Fairness can be more easily achieved in systems with simple structures, but limits on the permissible range of activities of different types of institutions might undermine efficiency and, to a lesser extent, stability.

Clearly there are tradeoffs between these three criteria for evaluating financial regulation and structure. Long and Vittas suggest no general answers to the questions inherent in these tradeoffs. They contend that answers must be sought on a country-by-country basis, although clearly extreme solutions that promote one criterion and disregard the others would not be optimal.

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Millard Long and Dimitri Vittas

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Introduction

The financial systems of most countries experienced dramatic changes over the past decade or so in both financial regulation and structure. At one level, there was extensive deregulation as country after country eliminated or relaxed credit and interest rate controls and removed or softened restrictions on market entry and diversification. But, at a different level, the past decade was characterized by a growing emphasis on prudential and other regulations that were increasingly deemed essential for the smooth and efficient functioning of financial systems. Thus, the decade of the 1980s was one of regulatory reform rather than simply one of deregulation. The most notable feature of financial regulation was the extensive and far-reaching change in the rules of the game rather than the adoption of a laissez-faire approach in finance.

Much of the change in regulatory approach was an endogenous response to forces in financial markets. Advances in electronic technology and telecommunications increased the international links of financial systems and weakened the effectiveness of many of the pre-existing controls. Moreover, three decades of extensive regulation of credit flows and interest rates gave rise to many instances of misuse of selective credit flows. These prompted a reconsideration of the underlying philosophy that placed central emphasis on government direction of funds.

The changes in regulation and technology were accompanied by changes in financial structure. In most countries nonbank financial intermediaries and financial markets emerged as significant competitors to the commercial banks that had long dominated the financial system. In addition, changes in philosophical approach were

fuelled by the impact of an increasing volume of nonperforming loans on the financial position of commercial banks.

This paper tracks the evolution of regulatory thinking in the post-war period. It discusses the main criteria that could be used in evaluating financial regulation and structure and highlights the questions that policymakers need to address in reforming their regulatory frameworks and reshaping their financial systems.

Historical Perspective

In the 1950s and 1960s, the financial systems of most developing countries, especially the newly independent countries of Africa and Asia, were dominated by foreign owned banks, with limited branch networks located in the capital and port cities, providing primarily short term trade finance, much of which went to firms that were themselves foreign-owned. In Latin America and Southern Europe, the role of foreign banks was less dominant, but the financial systems were similarly oriented towards short-term trade and working-capital finance. The governments of most countries decided the existing institutions did not provide the type of financing needed to develop their countries. Among other objectives, governments wished to promote industry and small scale agriculture. They wanted financial systems that would mobilize deposits and make loans in the rural areas, provide long term finance for investment, and fund local than foreign owned firms.

To accomplish their objectives, governments introduced rather sweeping changes in financial practices. In Africa most governments tended to nationalize the largest commercial banks. In South Asia they nationalized practically all the commercial banks. In almost all developing countries governments took control of a substantial segment of the financial system. In addition, they started specialized industrial and agricultural banks

under public control. With regard to policies in the financial area, governments directed financial institutions to lend to selected industries on subsidized terms. Interest rates were kept quite low, usually below the rate of inflation. In other words, governments used finance as a tool to reach their development objectives. Given the financial systems then in place, and the models of development prevailing in the 1960s, the approach taken was quite understandable.

By some measures, the policies followed were successful: banks did open many rural branches, government deficits were funded, and credit was channelled to priority sectors and local businesses. But the policies did not create robust financial systems. With rates of interest on deposits below the rate of inflation, much of the domestic saving did not go into financial assets. Some of the funds went abroad in capital flight, others into physical assets. Financial systems remained small in terms of assets and undiversified in terms of institutions and financial instruments. Because of the shortage of domestic credit, borrowers relied heavily on funding from abroad. For a sample of countries in 1987, 22 out of 29 had foreign loans greater than the total of loans from the domestic financial system. Governments and public enterprise were the main recipients of domestic credit receiving more than half the loans. Many private firms were crowded out of the market.

The problems created by the approach taken to finance were not so apparent in the 1970s when there was easy access to foreign funding. But after the onset of the debt crisis in 1982, it became much harder to borrow abroad. Governments and state enterprises turned to borrowing from the domestic markets, further crowding out the private sector and in many countries exacerbating inflationary pressures. While many developing countries were able to maintain price stability, the average rate of inflation in

developing countries rose from 10% per year in the 1965-73 period, to 26% per year in 1974-82, and to 51% per year in 1983-87. The number of developing countries with inflation rates above 20% rose from 4 to 15 to 27 over the same periods (World Bank, 1990).

The economic problems experienced by the developing countries in the 1980s are well known. In Africa and Latin America, but not in Asia, lack of access to foreign funds, higher interest rates, lower commodity prices, etc. have led to much slower growth. Recessions have reduced the incomes of business firms in both the public and private sectors; devaluations have increased the domestic burden of the firms' foreign debts; and much higher real interest rates in some countries have made domestic loans harder to service. As a result, many firms have been unable (or unwilling) to service their debts and the level of arrears has built up dramatically in financial institutions.

The external debt crisis has had an internal counterpart of equal severity. The level of arrears is such that financial institutions in many developing countries have been decapitalized --in fact losses are several times book capital. There have always been occasional bankruptcies in financial institutions, but never before, not even in the 1930s, has the problem affected as many institutions in so many countries. A growing number of countries are dealing with the problems in their financial sectors. But other countries have not dealt with the problem, or dealt with it only in the most pressing cases.

Reforming Financial Systems

To develop financial systems that can in the future finance their private sectors efficiently, countries need to undertake a variety of reforms. First, the financial institutions need to be restored to vitality. Second, countries must restore macro-economic balance and adjust relative prices, where distorted. Third, they must build their financial

infrastructure by developing modern and effective information, legal and regulatory systems.

Financial institutions and markets should make choices among investments to be funded on the basis of expected return and risk. Good information is needed in order to make those choices, to monitor firms' behavior after funding, and to take appropriate corrective action if things are not going as planned. For all three reasons. financial institutions require reliable company data, which in turn depends upon better accounting, auditing and information disclosure rules.

Also, there must be adequate legal protection for both debtors and creditors. In some countries, the company law, the banking and securities laws, and the bankruptcy law are all outmoded or weakly enforced. Financial agreements are legal contracts and for finance to flourish, there must be an adequate basis for drafting and enforcing contracts.

In most developing countries bank supervision has focussed on the implementation of economic directives, such as credit allocation, to be certain bank lending was in compliance with government directives. Very little attention has been paid to the quality of the loan portfolios, the adequacy of capital and the soundness of bank management. The huge losses now found in the banks' portfolios in many developing countries are testimony to the poor quality of this oversight function.

Both the financial needs of the countries and financial technology have changed substantially over the last twenty-five years. In many of the developing countries the laws and regulations, and correspondingly financial practices, have not kept pace. Governments need to pay more attention to prudential and less to economic regulation, leaving the decisions of who is to get credit and at what price to the bankers. The regulators need to focus on the safety and efficiency of the financial systems.

The line between economic and prudential regulation is thin. Any specific aspect of regulation may--and most do--have components of both. But the focus is different between using regulation to control credit allocation and pricing and using regulation to maintain a healthy and efficient financial system. It is not a matter of a complete reorientation of focus, but rather a reweighting of the importance of economic and prudential regulation. The rules of the game need to change. This does not suggest a laissez-faire approach--for all save a few academics believe that the financial process must be regulated--but a different orientation to regulation.

With regard to prudential regulation there is an emerging consensus in some areas, not in others. The area of consensus includes the points made above about limiting allocative controls and strengthening prudential controls and supervision. There is also agreement that there should not, in general, be discrimination, say in terms of tax policy, among financial instruments and institutions. There is agreement on capital requirements, on criteria for entry and exit, on asset diversification, on limits on loans to insiders, on provisioning for non-performing loans, etc.

With regard to the structural issues, there is far less consensus. There is little agreement on how to define institutions for regulatory purposes (e.g. what is a bank?) or, what amounts to more or less the same thing, on how to delimit the financial services different classes of institutions should be allowed to provide. Indeed there is dispute whether regulators or market factors should set such limits. The dominant school of thought in Europe, though not in the United States, believes that financial intermediaries should be allowed to offer any combination of financial services they find most profitable. The concept of the universal bank flows from this approach; a universal license does not mean that a bank will provide all financial services, simply that it is allowed to choose

what services it will provide. But even the exponents of universal banking have some differences about how such banks should be structured and regulated, namely whether the more risky services should be provided in the banks, by subsidiaries of the banks or through subsidiaries of a holding company. The latter two models permit universal financial institutions, but limit the activities that can be done by each sub-unit.

Today in Eastern Europe the systems' change has forced the restructuring of the entire financial system. The systems that are emerging in some of the countries in the first stage of reform do not seem to be appropriate[1]. But even in the remainder of the developing countries, the need to modernize their financial systems - and to deal explicitly with the pressing problem of widespread bankruptcy of financial institutions - is leading to significant changes in financial structure. Though not the only factor at work, the future structure of financial systems will be affected by regulation; to that degree at least, governments can influence the financial structures of their countries.

Alternative Models of Financial Structure

In using regulatory reform for shaping the structure of the financial system, policymakers can choose between several alternative models of financial structure. Historically, the main distinction was between bank-based and securities-based systems. Bank-based systems are those systems where banks operating as universal institutions dominate the provision of corporate finance, other than retained earnings. These banks typically offer both short- and long-term loans and both commercial and investment banking services. In securities-based systems, deposit banks confine themselves to short-term lending and other commercial banking services. Much of corporate funding is from

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[1] Long and Sagari (1991) discuss some of the issues involved.

the securities markets, which are more active than in bank-based systems in issuing and trading corporate securities[2].

Increasingly the distinction between bank- and securities-based systems has lost its relevance, at least in developed countries. In terms of both the sources of finance and the services provided by various components of the system, differences have narrowed. Furthermore, in most OECD countries, internally generated funds have become the primary source of corporate finance with banks and securities markets playing a secondary role in the financing of industrial corporations. Under these circumstances, the basic distinction between alternative models of financial systems has gradually shifted from one based on differences in sources of funding for industrial corporations to one based on differences in the handling of information problems.

The principal differentiation is between relationship-based and transaction-based systems. In relationship-based systems, banks and industrial companies cultivate close links and long-term relationships that govern not only the provision of finance but also the provision of other financial services, such as assistance with mergers and acquisitions. In transaction-based systems, the relations are less close; industrial corporations tend to assign their business on a case by case basis to the lowest bidder.

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[2] Not all bank-based systems involve banks operating as universal institutions. In most developing countries, banks have traditionally specialized in trade and short-term finance while specialized institutions have provided long-term industrial and investment finance. Moreover, in many, perhaps in the majority of developing countries, governments have played a significant role in the financial system both through owning intermediaries and through directing the allocation of financial resources. However, whether financial systems can be more aptly described as credit-based or government-based, a feature they share in common with bank-based systems is the predominance of bank loans as opposed to corporate securities.

Different types of systems have different implications for financial regulation. Universal institutions are more difficult both to manage and to supervise. They also raise more problems of conflicts of interest and moral hazard. But as managerial and supervisory capabilities improve, universal institutions providing a range of services appear to have significant advantages in overcoming the problems of informational asymmetries and investment uncertainty.

Policymakers are not required to take irreversible decisions. Regulation can be adapted in the light of changing circumstances. However, regulatory caution suggests that policymakers should proceed slowly and at least initially encourage the creation of simple structures that are more transparent and easier to manage and supervise.

Evaluating Financial Regulation and Structure

Three criteria can be suggested for evaluating financial regulation and structure: stability, efficiency, and fairness.

Stability. Financial systems the world over have been shocked by loan losses in the 1980s. For forty years the stability of financial systems had not been a significant concern; it is today. Much has been written about the new capitalization rules as specified by the Basle Committee. Clearly financial institutions with more capital and less leverage are less subject to shocks. But the stability of the financial system is also affected by its structure.

To protect the payment mechanism, regulators could limit access to the payment clearing and settlement system to so-called "narrow" banks that would be allowed to engage in only the safest activities. Only those institutions would be allowed to issue liabilities insured by government. Milton Friedman proposed in the early 1950s to require intermediaries with access to the payment system to hold 100% reserves. Recent

suggestions on so-called "narrow" banks are more liberal but would require banks issuing demand deposits to hold only safe assets[3].

This approach would increase the stability of the payment system but not necessarily that of the credit system, for other intermediaries would hold the more risky assets. If a country were threatened by wide-scale bankruptcies and debt deflation, the government might still be compelled to intervene.

Another financial structure that would be more stable with regard to credit would be Islamic or "non-par" banking in which payments on all liabilities would be contingent on asset performance. "Non-par" banks would resemble mutual funds. Their successful operation would require well developed financial markets and adequate supervision and disclosure of information.

These are only two examples, but they illustrate that the stability of the financial system will be affected by its structure as well as its capital. A practical issue affecting stability concerns the effectiveness of supervision. Structures involving universal banks appear to be harder to supervise than more specialized institutions. This suggests that countries in which supervision is poorly developed might consider limiting the scope of activities of their intermediaries until supervision can be improved.

Efficiency. The relationship between structure and efficiency is clearly complex. As a practical matter we observe in many countries growing concentration in financial

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[3] The concept of the "narrow" bank is a recent innovation by academic economists. However, narrow banks have long existed in several European countries in the form of postal giros that offered transaction accounts and invested in government securities. It is interesting to note that postal giros have gradually been merged with postal savings banks and later on have been converted into, or merged with, fully fledged commercial banks with universal functions. Thus, historically and absent regulatory impediments, the model of "narrow" banks has yielded to that of banks with wider powers. This raises doubts about the feasibility and economic efficiency of "narrow" banks.

markets and expansion in the range of financial services offered by individual institutions, suggesting economies of both scale and scope[4]. In the research literature the issues of economies of scale and scope in finance still seem unresolved. Evidence from developed countries suggests that banking systems with high levels of concentration tend to have lower margins and operating costs as well as higher profits. Banks in Canada, the Netherlands and Sweden, all of which are characterized by highly concentrated banking systems, have outperformed banks in the United States, Norway and Italy, where banking systems tend to be fragmented and concentration is low (Vittas, 1991).

In many of the developing countries the financial markets are dominated by a few large, often inefficient banks, which may control as much as 80 per cent of financial assets. Their size may be based less on economies of scale and more on restrictions on new bank licenses, on interest rate and credit controls that discourage competition, on forced branching, etc. In many of these countries the efficiency of the financial markets would probably be increased by greater competition, which could come from licensing new banks and by allowing international trade in financial services.

With issues of structure we are as concerned with economies of scope as scale. Portugal, in reforming its system in anticipation of the single European market after 1992, opted for universal banks on the grounds that to restrict function would put its banks at a competitive disadvantage with banks from other European countries that allow universal banking. Of course, that presumes there are economies of scope; there are no disadvantages in terms of efficiency to specialized intermediaries if scope economies do

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[4] One suggested economy of scale is the realization that institutions can be too large for the government to allow them to fail; hence the liabilities of large intermediaries may be considered more secure. From the social perspective, this may be a diseconomy of having large intermediaries.

not exist. Canada recently allowed the banks to enter the securities business and over a short period of time the banks came to dominate the business suggesting the existence of economies of scope. The Canadians are now considering whether to allow the banks to offer insurance as well.

For developing countries, the question of the desirability of universal banking is hard to resolve. First, as already noted, universal institutions are more difficult to supervise effectively. Second, allowing universal banking might exacerbate the dominant position of large banks. The experience of developed countries shows that securities markets develop faster in countries where banks' activities are limited to short term commercial finance and less rapidly in countries with universal banking. In countries allowing universal banking a broad array of financial products appears less likely to develop. Whether this indicates that universal banks can efficiently provide the financial services needed by corporations or whether large banks have been able to block the development of competing institutions is unclear. Product and market development needs to be considered in assessing efficiency and structure.

There is also a question of competitive equality. In the early 1980s the World Bank was asked by the Philippine government to prepare a report on the advantages of universal versus specialized banking. Two departments in the World Bank gave the government contrary advice: one for, the other against, universal banking. Those in favor argued that universal banking would increase the availability of term finance; those against maintained that, because of implicit and explicit government insurance, universal banks would be able to provide cheap term finance, but only by passing some of the risk to taxpayers through understated deposit insurance premiums. Thus, universal banking

would forestall the development of the securities markets and might even over the longer run reduce the availability of term finance.

Fairness. Fairness covers many issues such as protecting users of financial services from abusive behavior by financial institutions, creating a level playing field for competing institutions and tackling the problems caused by potential conflicts of interest. The interests of small savers, investors, borrowers and policyholders, who are deemed to be nonprofessional users of financial services, are safeguarded by appropriate protective regulations. The interests of professional users, including participating financial institutions, are best protected by appropriate regulations regarding disclosure of information and market practice.

Serious conflicts of interest can arise when the ownership and management of financial and non-financial firms are not kept separate. It has been argued in the case of both Germany and Japan that the close ties between financial and non-financial firms has contributed significantly to the development of the productive sectors. After providing funds, lenders must supervise and enforce their contracts with borrowers. It has been recognized in the German and Japanese cases that interlocking ownership and control allows lenders to monitor borrowers' activities more effectively, thus allowing banks to take financing risks that would be unacceptable if post-lending control were not well developed.

Because of the poor quality of information and the difficulty in enforcing contracts, the problems of asymmetric information, moral hazard, and adverse selection are more serious in developing countries. Because contracting with related firms is far less risky than contracting with outsiders, there has been a tendency in developing countries for conglomerates to evolve. But there are well known cases in developing countries where

interlocking control --in both the public and private sector-- of productive and financial enterprises has led to less than arm's length decision making on loans, leading, in some cases, to rather disastrous misallocation of resources. Such arrangements, when in the private sector, are likely to lead to excessive concentration of wealth and power. Interlocking control has also been used to prevent competition within the industrial sector by excluding potential competitors through control of finance.

Those concerned about conflicts of interest argue for strict separation of control and management of banking and industrial firms. But in fact historically ownership and management of financial and non-financial firms has been linked in most countries, possibly because it improves information flows and economizes on managerial skills. Strict separation of function may limit abuse, but it may also slow the process of development. Hence this is an important and contentious issue.

Of course in the United States concern over conflicts of interest goes beyond the interlocking of industrial and financial firms. Conflicts can also arise from interlocking financial services. For instance, the proceeds from an underwriting by a bank can be used to repay outstanding loans to the bank. To limit such frauds, the United States has attempted to impose "Chinese walls" among different types of financial services. Of course finance and fraud are inseparable, but interconnected financial activities have been said to make fraud that much easier. There seems to be some reconsideration of that view going on at the present time, with the regulators allowing banks to provide some underwriting services even in the United States. The regulators today seem to feel that while they cannot eliminate such conflicts, through supervision they are now better able to control them. But considerations of the potential conflicts of interest and the ability of a

country's supervisors to control them must enter into decisions on structure and regulation.

Questions of Regulation and Structure.

The analysis presented indicates the complexities of these structural issues and the difficulty of reaching a consensus. There are clearly trade-offs between the three criteria suggested above to evaluate regulation and structure. These will lead to different decisions among countries about preferred structures and therefore about the proper regulatory environment. In taking decisions about regulation and structure, the following questions need to be addressed by policymakers. These questions do not have general answers but must be answered in the context of particular countries:

a. In terms of ownership and management, what should be the "allowed" relationship between financial and non-financial corporations? Related to this is the question of the scope and extent of public ownership.

b. Within the financial sector, are there principles for deciding what products can safely and efficiently be offered by a single financial institution? In other words should the regulatory system encourage or discourage the formation of universal, as distinct from more specialized, financial intermediaries?

c. In countries electing to have broad based intermediaries, what are the advantages and disadvantages of different forms of arrangements: universal banks, "narrow" banks that are part of financial holding companies, or banks which own but are legally separated from subsidiaries which offer other financial products?

d. Is regulation by function to be preferred to regulation by institution? Regulation by function appears to be a way of avoiding the problems of

overregulation and unequal treatment of institutions engaging in similar functions, but is it feasible? Closely related to the last issue, is it feasible to define intermediaries for regulatory purposes? That is, can the regulators reasonably define in terms of assets and liabilities as well as in terms of other financial services a "narrow" bank, a finance company, a leasing company, a broker-dealer, etc.? A number of suggestions that have been made about regulation depend on the regulators being able to impose reasonably clear rules.

e. How is financial structure affected by limiting deposit insurance to some institutions, imposing reserve requirements on some institutions but not others, double taxation of dividend income, etc.?

f. Non-bank intermediaries and markets raise other regulatory issues. Insurance companies like banks must be subjected to solvency regulation and supervision. Also like banks, entry and exit constraints, pricing control and excessive intervention on investment decisions affect their development. The question of consumer protection is also important in the insurance business as in banking.

g. For their part, securities markets require trading and disclosure rules to ensure both efficiency and fairness. How detailed should these rules be? Is there a danger of overregulation impeding the development of markets?

h. An issue that is shared by payment clearing systems and settlement and clearing systems for securities transactions is who should have access to such systems and under what criteria and conditions.

h. Finally, one problem posed by diversified financial systems for countries at an early stage of development is the heavy burden of regulation and supervision. Perhaps such countries may be better off with simpler financial systems based on competitive and sound commercial banks.

In conclusion, in the last fifteen years, there have been very marked changes in financial regulation and structure in both developing and developed countries. These reflect in part a change in philosophy and in part changes in technology and the internationalization of markets. The regulations that are being changed were in many cases the outgrowth of the excesses of the 1920s, followed by the financial collapse in the 1930s. As was said in the 1989 World Development Report (World Bank, 1990):

> "The lessons to be learned from the experience of the high-income countries is that the financial decisions of private agents are also imperfect.... Market-based financial systems, like public ones, are subject to fraud and instability. The goal is not perfection but a system which mobilizes resources efficiently, minimizes allocative mistakes, curbs fraud, and stops instability from turning into crises.... A main concern of financial regulation has been the achievement of stability without undermining efficiency. But finance remains a dynamic field, changing far too rapidly to achieve a perfect balance between the freedom needed to stimulate competition and growth and the control needed to prevent fraud and instability."

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