*Chapter 7*

# Financial Liberalization: What Went Right, What Went Wrong?

THE FINANCIAL LIBERALIZATION that took place in the developing countries in the 1980s and 1990s was part of the general move toward giving markets a greater role in development. It was also a reaction to several factors specific to finance: the costs, corruption, and inefficiencies associated with using finance as an instrument of populist, state-led development; a desire for more financial resources; citizens' demands for better finance and lower implicit taxes and subsidies; and the pressures exerted on repressed financial systems by greater international trade, travel, migration, and better communications.

The financial reforms went beyond the interest rate liberalization that had been recommended by the so-called Washington Consensus. To varying degrees, governments also allowed the use of foreign currency instruments and opened up capital accounts. Domestic markets developed in central bank and government debt, and international markets expanded in government and private bonds. Capital markets developed, but less rapidly, and were most successful in the larger, already rapidly growing, East and South Asian countries. State banks continued to have a major role for much of the 1990s; their privatization was gradual and often proved costly. Central banks moved away from trying to finance development; they became more independent and successfully focused on keeping inflation low, but their debt increasingly absorbed bank deposits.

Certainly the reforms produced some gains. But the growth benefits of the financial and nonfinancial reforms in the 1990s were less than expected. Financial crises raised questions of whether financial liberalization was the wrong model, what had gone wrong, and the appropriate direction of future financial sector policy. Overall, the 1990s is probably best considered a precursor of better things that will take some time to achieve.

Section 1 of this chapter describes why and how financial liberalization occurred. Section 2 discusses the outcomes of financial liberalization during the 1990s, including the crises that occurred and their relation to macroeconomic policies, financial liberalization, and the overhangs of old economic and political systems. Section 3 summarizes the lessons from the experience of the 1990s, and section 4 draws suggestions for future policy. Section 5 concludes the chapter.

## 1. From Financial Repression to Financial Liberalization

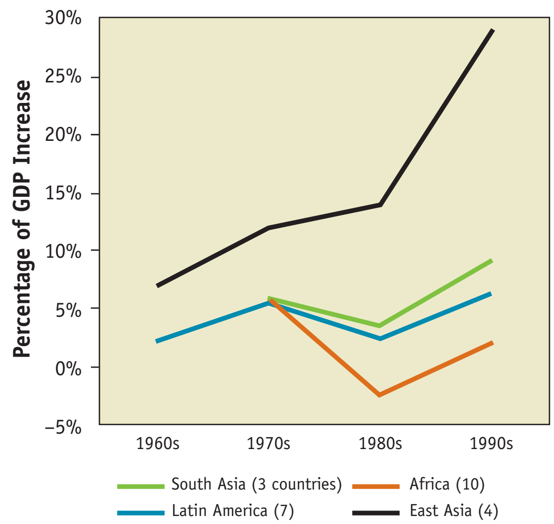
The financial repression that prevailed in developing and transition countries in the 1970s and 1980s reflected a mix of state-led development, nationalism, populism, politics, and corruption. The financial system was treated as an instrument of the treasury: governments allocated credit at below-market interest rates, used monetary policy instruments and state-guaranteed external borrowing to ensure supplies of credit for themselves and public sector firms, and directed part of the resources that were left to sectors they favored. State banks were considered necessary to carry out the directed credit allocations,[1] as well as to reduce dependence on foreigners. Bank supervisors focused on complying with the often intricate requirements of directed credit rather than with prudential regulations. Interest rates to depositors were kept low to keep the costs of loans low. In some cases, low deposit and loan rates were also populist measures intended to improve income distribution.[2]

Repressed finance was thus an implicit tax and subsidy system through which governments transferred resources from depositors receiving low interest rates (and from those borrowers not receiving directed credits) to borrowers paying low rates in the public sector and to favored parts of the private sector. Governments had to allocate credit because they set interest rates that generated excess demand for credits. Capital controls were needed not (as often argued) to protect national saving, but to limit capital outflows fleeing low interest rates and macroeconomic instability, and to increase the returns from the inflation tax.[3] In effect, capital controls were a tax on those unwilling or unable to avoid them and they encouraged corruption (Hanson 1994).

FIGURE 7.1

**Increase in Average Deposits/GDP in Major Countries, by Regions, 1960s–-90s**

(difference between 3-year average of bank deposits/GDP at the end of each decade)




*Source*: IMF, *International Financial Statistics*.

*Note*: Countries and regions covered are:
East Asia: Indonesia, Republic of Korea, Malaysia, the Philippines, Thailand.
Latin America: Argentina, Brazil, Chile, Colombia, Mexico, Peru, República Bolivariana de Venezuela.
Africa: Ghana, Kenya, Nigeria, Tanzania, Uganda, Burkina Faso, Cameroon, Côte d'Ivoire, Mali, Senegal.
South Asia: Bangladesh, India, Pakistan.

## *Factors behind Financial Liberalization*

Three general factors provided an impetus for the move to financial liberalization: poor results, high costs, and pressures from globalization. This section discusses each in turn.

### Poor Results

Together, the limited mobilization and inefficient allocation of financial resources slowed economic growth (McKinnon 1973; Shaw 1973). Low interest rates discouraged the mobilization of finance, and bank deposit growth slowed in the 1980s in the major countries (figure 7.1). Capital flight occurred despite capital controls (Dooley et al. 1986). Allocation of scarce domestic credits and external loans to government deficits, public sector "white elephants," and unproductive private activities yielded low returns, crowded out more efficient potential users, and encouraged wasteful use of capital.

Financial repression also worsened income distribution. Subsidies on directed credits were often large, particularly in periods of high inflation, and actual allocations often went to large borrowers.[4] The low interest rates led to corruption and to the diversion of credits to powerful parties. Diversions tended to grow over time, particularly when inflation reduced real interest rates on credits, and rising fiscal deficits and directed credits absorbed more of the limited deposits.

### High Costs

The repressed systems were costly. Banks, particularly state banks and development banks, periodically required recapitalization and the takeover of their external debts by governments. Political pressures and corruption were widespread. Loan repayments were weak because loans financed inefficient activities, because loan collection efforts were insufficient, and because borrowers tended to treat loans from the state banks simply as transfers. Typically, banks and other intermediaries rolled over their nonperforming loans until a period of inflation wiped out depositors' claims and permitted a general default. Since intermediaries were not forced to follow reasonable prudential norms or mark their portfolios to market, the losses were nontransparent, even to the governments that often owned them. Inflation also helped to conceal the problems of commercial banks through their earnings on low interest deposits. The hidden costs of the repressed systems became more apparent once financial liberalization began.

### Pressures from Globalization

Perhaps most important, financial repression came under increasing pressure from the growth of trade, travel, and migration as well as the improvement of communications.[5] The increased access to international financial markets broke down the controls on capital outflows on which the supply of low-cost deposits had depended.[6] Capital controls may be effective temporarily, but over time mechanisms (such as overinvoicing imports and underinvoicing exports) develop to subvert them (Arioshi et al. 2000; Dooley 1996). These mechanisms became more accessible as goods and people became more internationally mobile.

## *The Evolution of Financial Liberalization*

The shift in policies differed in timing, content, and speed from country to country and included many reversals. Broadly:

- African countries turned to financial liberalization in the 1990s, often in the context of stabilization and reform programs supported by the International Monetary Fund and World Bank, as the costs of financial repression became clear.
- In East Asia, the major countries liberalized in the 1980s, though at different times and to different degrees. For example, Indonesia, which had liberalized capital flows in 1970, liberalized interest rates in 1984, but the Republic of Korea did not liberalize interest rates formally until 1992. Low inflation generally kept East Asian interest rates reasonable in real terms, however. In most countries, connected lending within industrial-financial conglomerates and government pressures on credit allocation remained important.
- In South Asia, financial repression began in the 1970s with the nationalization of banks in India (1969) and Pakistan (1974). Interest rates and directed credit controls were subsequently imposed and tightened, but for much of the 1970s and 1980s real interest rates remained reasonable. Liberalization started in the early 1990s with a gradual freeing of interest rates; a reduction in reserve, liquidity, and directed credit requirements; and liberalization of equity markets.
- In Latin America, episodes of financial liberalization occurred in the 1970s but financial repression returned, continued, or even increased in the 1980s, with debt crises, high inflation, government deficits, and the growth of populism (Dornbusch and Edwards 1991). In the 1990s, substantial financial liberalization occurred, although the degree and timing varied across countries.
- In the transition economies, financial liberalization took place fairly rapidly in the 1990s in the context of the reaction against communism (Bokros, Fleming, and Votava 2001; Sherif, Borish, and Gross 2003).

The earliest policy changes generally focused on interest rates. In many instances governments raised interest rates with a "stroke of the pen" to mobilize more of the resources needed to finance budget deficits and to enable the private sector to play a greater role in development. (Some interest rate increases, designed to curb capital flight, were intended more for stabilization than for liberalization.) New financial instruments were introduced that had freer rates and were subject to lower directed credit requirements. Some countries also began admitting foreign currency deposits, to attract offshore funds and foreign currency holdings into the financial system as well as to allow residents legal access to foreign currency assets (Hanson 2002; Honohan and Shi 2003; Savastano 1992, 1996).

Partial interest rate liberalizations soon generated pressures for more general freeing of interest rates (albeit in some cases after reversals of liberalization). As borrowers directed funds into deregulated instruments and sectors, demand for low-cost loans increased and repayments on them deteriorated.[7] Unfortunately, when the macroeconomic situation was unstable and interest rates were freed, very high real interest rates developed, creating corporate and banking problems that added to the overhang of weak credits that were exposed by liberalization.

At very different speeds in different countries, interest rate liberalization came to be supplemented by other changes:[8]

- Central banks were made more independent. They abandoned their earlier developmental role to focus on limiting inflation, often in the context of stabilization programs.
- Reserve requirements and directed credit were eased.
- Capital accounts were liberalized, even in countries where domestic foreign currency instruments remained banned. Foreigners were allowed to participate in capital markets[9] and private corporations were allowed to raise funds offshore.
- Markets were set up for central bank debt and government debt. Equity markets were set up in the transition countries and liberalized where they already existed.
- In some countries, pension systems added defined contribution/defined benefits elements, often operated by private intermediaries.
- Gradually, state banks were privatized. Banking competition increased, as a result of the entry of new domestic and foreign banks and, in some cases, nonbank intermediaries.

In general, however, the financial reforms of the 1990s focused on freeing interest rates and credit allocations, and made much less effort to improve the institutional basis of finance—a much harder, longer task.

## 2. Outcomes in the Financial Sector during the 1990s

Private sector credit is a key factor in growth.[10] Banks can intermediate funds and take risks only if private credit is not crowded out by government debt. Over the 1990s, deposits grew faster than in the previous decade, but in many countries bank credit to the private sector from domestic sources grew only slowly. The increase in loanable funds was largely absorbed by the public sector.

### *Deposit Growth*

Bank deposits grew as a share of the gross domestic product (GDP) in the 1990s, unlike in the 1980s (figure 7.1 above and Hanson 2003b). Thus, most major countries and most regions achieved a major objective of financial liberalization. And in India and some East Asian and Latin American countries, nonbank deposits supplemented the rapid growth in bank deposits.

Box 7.1 discusses the resumption of deposit growth in India as it gradually liberalized, as well as the growth of India's capital market.

Many factors contributed to the deposit growth, including the slowdown in inflation in the 1990s,[11] the positive real deposit rates, and new deposit instruments. Another factor was the legalization of foreign currency deposits. Deposits in foreign currency grew as a share of total deposits in many countries in the 1990s, and in some cases they supplied more than half the total by the end of the decade (Honohan and Shi 2003).[12] Not surprisingly, the foreign currency deposits were popular

**BOX 7.1**

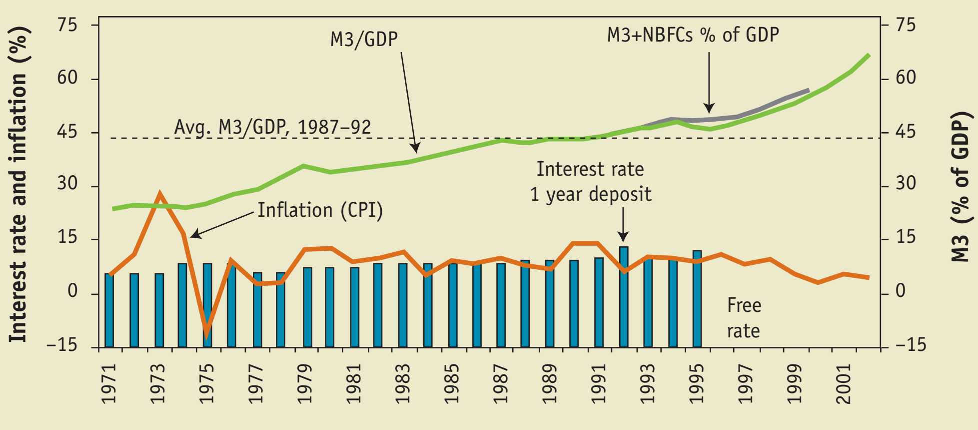
## India—A Successful Liberalizer with Strong Capital Markets

India liberalized its financial sector gradually over the 1990s, with particular success in capital markets, while avoiding any major crisis. In the 1980s, India had a repressed financial system (Hanson 2001, 2003a). This, plus increasing macroeconomic instability, slowed deposit growth. Financial liberalization was part of greater reliance on the private sector after the 1991 foreign exchange crisis. Interest rates were raised and gradually freed, bank regulations and supervision were strengthened, and nonbank financial corporations (NBFCs) were allowed under easier regulations (Hanson 2003a). After a 1991 capital market crisis, regulations were strengthened, listings were liberalized, foreign investors were allowed in, and infrastructure was substantially improved (Shah and Thomas 1999; Nayak 1999).

Bank deposits of nationals and nonresident Indians resumed their growth and NBFC deposits grew sharply after 1992. The stock, bond, and commercial paper markets became among the most vibrant in developing countries, providing nearly one-fourth of India's corporate funding from 1992 to 1996 (Reserve Bank of India 1998) with listings more than doubling from 2,000 in 1991 to over 5,000 (Standard and Poor's 2003). The post-1997 economic slowdown led to a stock market fall, problems in the NBFCs (which were wound down), and crises in the government development banks and mutual fund, though public sector commercial banks performed surprisingly well. Recently, large capital inflows and higher growth have led to low interest rates and better bank performance.

Although India's approach to financial liberalization served it well, three major issues remain: (1) crowding out, with government debt now absorbing more than 37 percent of bank deposits compared to about 24 percent at the end of the 1980s; (2) a weak information and legal framework, which, despite efforts at improvement, still contributes to nonperforming loans and limits access to credit; and (3) the still-dominant role of public sector banks.

**India: Money (M3 in Sept.)/GDP, Deposit Rate and Inflation**




*Source*: Reserve Bank of India data.
CPI. Consumer price index.
GDP. Gross domestic product.

with members of the public, many of whom had lost their savings and pensions in inflation and repressed financial systems.[13] But foreign currency loans were also popular with borrowers.[14]

The reforms reduced the burden on banks, widening their discretion over the allocation of resources and lowering required reserves. Now that governments could raise resources from newly developing debt markets, they had less need to require banks to invest in government debt or to hold low-return reserves with the central bank that were invested in government debt. In many of the 25 largest developing countries, the average ratio of reserves to deposits fell over the 1990s (Hanson 2003b). Directed credit requirements were reduced, interest rates were raised on remaining directed credits, and nominal market rates fell.

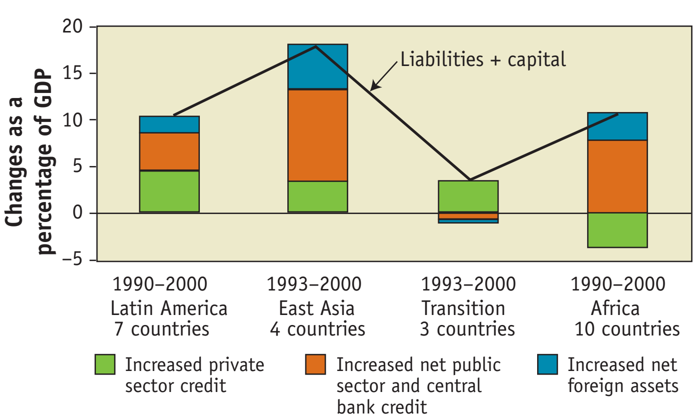
## *Credit: Absorption of Deposits by the Public Sector*

Bank credit to the private sector grew much less than bank deposits and other bank liabilities in the 1990s (figure 7.2).

FIGURE 7.2

**Changes in the Ratios of Bank Assets and Liabilities Plus Capital to GDP, 1990s**

(averages by country group)




*Source*: IMF, *International Financial Statistics*.

*Note*: Countries covered are the same as in Figure 1. South Asia is excluded because countries in that region do not report private credit or capital separately.

Access to credit expanded less than many observers hoped after the financial reforms, though it improved toward the end of the1990s. Panel studies had suggested that financial liberalization would make more credit available to a wider group of borrowers. (See, for example, Schiantarelli et al. 1994, and works cited there.) After liberalization there was some growth, but in practice government and central bank debt crowded out many borrowers. In some countries where nonbank intermediaries (henceforth, nonbanks) grew, they did increase lending to nontraditional borrowers. But both banks and nonbanks were hindered by the lack of information on borrowers and weaknesses in the legal and judicial systems in the areas of collateral and creditors' rights.

Instead of increasing private credit, the rise in bank deposits over the 1990s tended to be absorbed by government and central bank debt, and by banks strengthening their offshore positions. In particular, in the 25 developing and transition countries with the largest banking systems, the average ratio of net government debt to bank deposits rose by more than 60 percent, from about 13 percent in 1993 to about 21 percent in 2000 (Hanson 2003b).[15] Similar patterns prevailed in the larger African countries.[16]

The main reason for the rise in government debt was postcrisis bank restructurings, involving replacement of weak private credits, particularly in Brazil, Indonesia, Jamaica, Mexico, and some African countries. But growing government deficits also played a key role in some cases, notably India and Turkey. In general, the increases in banks' holdings of government debt reflected rises in the stock of government debt, rather than any increased attractiveness of government debt to banks, or decreased willingness of banks to take risks.[17]

Banks also increased their net holdings of central bank debt—substantially in some countries—despite falling reserve requirements. On average in the 25 developing countries with the largest financial systems, banks' net holdings of central bank debt rose by nearly 5 percentage points of GDP over the 1990s (Hanson 2003b). As a monetary policy instrument, central bank debt had advantages over the previous instruments of credit controls on individual banks, changes in reserve requirements, and variations in central bank lending, which had tended to limit competition, to affect banks bluntly, and to affect weak banks heavily. But the use of central bank debt had costs, in that it crowded out would-be borrowers. Central banks often sold their debt to sterilize capital inflows as well as to tighten money when capital flowed out.[18] Central banks may also have sold debt to mop up some of the liquidity that arose from lowered reserve requirements, or when they needed to fund their own quasi-fiscal deficits that arose from negative spreads between their assets and liabilities.

Another reason for the slow growth of private credit was that banks themselves increased their net holdings of foreign assets for hedging purposes (see figure 7.2 above). Those in the largest 25 developing-country markets went from essentially a balanced foreign position in 1990, on average, to net borrowing of nearly 1 percent of GDP in 1993 and nearly 3 percent of GDP in 1997, before reverting to being net holders of foreign assets in 2000 (Hanson 2003b). After 1997, external lenders cut credit lines, banks wound down their external borrowings, and banks increased their external assets.[19]

Given the limited growth of private sector credit, a variable that has been shown to be linked with economic growth,[20] it is not surprising that the rise in GDP growth associated with the financial (and general) liberalization of the 1990s was less than hoped for.

However, the story is more complex than the slow growth of private credit. In the major developing countries, especially in East Asia, the average growth of private sector credit (especially including external credits) and of GDP was much faster before 1996 than after. About 1995, some countries began to experience financial crises. Much of the private credit extended by banks and nonbanks proved to be unproductive, in the sense that it became nonperforming before or during the crises. During bank restructurings, these credits were replaced with government debt (to ensure depositors were paid); when eventually executed, the associated collateral was usually worth less than 30 percent of the face value of the loans, suggesting how unproductive the growth in private sector credit had been. In the transition countries and African countries the quality of credit issues was typically more related to the public sector's use of the credits.[21]

## *Bond and Equity Markets*

Government and central bank bond market development was fairly successful in the 1990s. By 2000, more than 40 developing countries, including all but one of the 25 with the largest financial systems, had government bond markets (Del Valle and Ugolini 2003), and more than 20 had central bank debt markets. The government bond markets allowed governments to reduce their reliance on foreign borrowing. The supply of this debt was inelastic, but it was attractive to banks for several reasons: its interest rates had been freed, it carried a low capital requirement, it was less risky than private debt, and it had liquidity once the markets became active.

The growth of domestic equity and bond markets contributed to private sector financing in East Asia and India during the 1990s. In the major East Asian equity markets, market capitalization exceeded $20 billion in 2000, having risen 80 percent or more (except in Thailand) since 1990. Turnover averaged more than 50 percent and listings in the individual countries rose at least 40 percent between 1990 and 2000, to the point where they all exceeded listings in every Latin American country except Brazil (Standard and Poor's 2003). The Indian market was even more successful in providing resources to a wide group of firms after listing regulations were eased (see box 7.1 above). Chile's market also did reasonably well, though its turnover was low because of the pension funds' buy-and-hold policies. However, even in these countries, banks remain the main source of finance.

Elsewhere, equity markets were less successful. On the seven largest Latin American stock exchanges, listings have declined since 1997, and on five of those seven they have declined ever since

1990; turnover in all seven is less than 50 percent of market capitalization (Standard and Poor's 2003). In transition countries, equity markets were created as part of the privatization process,[22] often with only belated recognition of the importance of regulatory frameworks. Listings declined in most of these markets as some privatized companies were taken off the market. Market capitalization is less than $20 billion, except in Poland, and the Russian Federation, and turnover exceeds 50 percent only in Hungary (Standard and Poor's 2003).

Several factors lie behind the slow development of equity markets in developing and transition countries. The first is that potential investors are deterred by the low turnover in these markets (usually much less than 75 percent compared with 85 percent in even the smaller deciles of traded companies on the U.S. NASDAQ) and by low liquidity, which reflects the small sizes of the listed companies as well as the low turnover (Shah and Thomas 2003). Second, listings on stock exchanges have been reduced by takeovers of firms by multinational corporations, and trading has been reduced by the migration of major firms' listings to industrial-country markets. In 2000, companies listed offshore accounted for about 55 percent of the market capitalization in 15 middle-income countries, and for 27 percent of the market capitalization in 25 low-income countries; much of the trading in these stocks also takes place offshore (Claessens, Klingebiel, and Shmuckler 2003). Family firms that could list often do not, partly because the benefits are not great, partly because these firms often have privileged access to credit through related banks, and partly because they fear that dilution of ownership will reduce their control. Third and more fundamentally, weak institutional factors—poor information, poor treatment of minority shareholders, and weak regulation of market participants—weaken the interest of investors, both domestic and foreign, in many equity markets (Glaesner, Johnson, and Schleifer 2001; LaPorta, López de Silenes, and Schleifer 2002b; Black 2001).

The better performance of the East Asian and Indian markets seems to result more from superior economic performance than from any obvious institutional advantage. This suggests that in the short run, equity market growth mainly reflects general economic performance, which attracts foreign investors willing to risk sums that are small to them but large relative to the market. Simply setting up a market may not add much to growth or allow firms to raise funding. Over time, however, as institutions improve, equity markets do seem to contribute to economic growth (Levine 2003; Levine and Zervos 1998). Another important element in equity market performance seems to be foreign investor participation (Bekaert, Harvey, and Lundblad 2003).

Private bond markets grew even less than equity markets in the 1990s. They share the problems of equity markets as well as having some of their own. Concerns about potential future macroeconomic instability have led bond buyers to demand high returns for committing funds for the long term, and deterred issues of long-term bonds. Often only public sector firms issued long-term bonds, and then only in a few countries, notably in South Asia. Potential buyers of private bonds were also deterred by lack of protection in law and in fact for bondholders' rights, and by the lack of good bankruptcy legislation and enforcement. Nonetheless, some private bond markets have developed, for example in India, and in Mexico, recently, for securitized housing finance.

## *External Finance for the Private Sector*

Within the private sector in developing countries, external borrowing grew faster than domestic borrowing in the first part of the 1990s, as large private companies increasingly drew on external credits. For example, in 17 of the countries with the largest financial markets, the ratio of private sector foreign borrowing (of more than one year's maturity) to borrowings from domestic banks increased fairly steadily, from 16.5 percent in 1990 to 27 percent in 1997.[23] Short-term borrowing also grew substantially. However, after 1997 these credits slowed in dollar terms. In the same 17 countries, external credit to the private sector changed little in dollar terms. However, the ratio of these credits to domestic credit rose by 50 percent by 2000, reflecting crisis-related devaluations and the removal of private sector credits from banks in restructurings in these countries.

The external credits to the private sector were narrowly distributed. They went only to internationally creditworthy borrowers, and four countries accounted for the bulk of private sector external borrowing (in dollars) in 2000: Brazil (27 percent), Mexico (12 percent), Indonesia (9 percent), and Thailand (7 percent).

Offshore equity sales were another source of capital for many large private companies in the 1990s. The numerous developing-country companies that were listed offshore in 2000 largely reflected issues of global depository rights and American depository rights during the 1990s. Of course, this source of capital was also narrowly distributed.

While financial liberalization benefited large, well-run companies and, indirectly, other borrowers in developing countries, it raised banks' risks. The best firms obtained loans and equity finance offshore at less cost than in the domestic market, albeit with currency risk.[24] This left a larger portion of the limited domestic private credit available to other borrowers, but it also increased the average risk in the banks' loan portfolios. Moreover, banks in developing and transition countries increased their net intermediation of external loans up to 1997, especially in East Asia, and they also guaranteed some direct external borrowings by the corporate sector, typically off their balance sheets.

The external borrowings were a major factor in the East Asian external payments crises and were also important in other crises of the 1990s. As external borrowings grew, lenders shortened maturities, creating maturity mismatches for borrowers. Further, loans made by financial intermediaries based on their own external borrowing, though typically matched in terms of currency, entailed substantial risks when the borrowers lacked an assured source of foreign exchange. Eventually, lenders refused to roll over their credits because they considered the risks too high. This generated both a banking crisis and a foreign exchange crisis. The resulting sharp devaluations increased debt-servicing problems on many foreign currency loans and led to calls on the guarantees, worsening the difficulties of firms and banks.

## *Financial Intermediaries*

Most of the impact of financial reforms on the institutional structure of the financial sector was not felt until the latter half of the 1990s. This limited the gains from liberalization during the decade and contributed to crises.

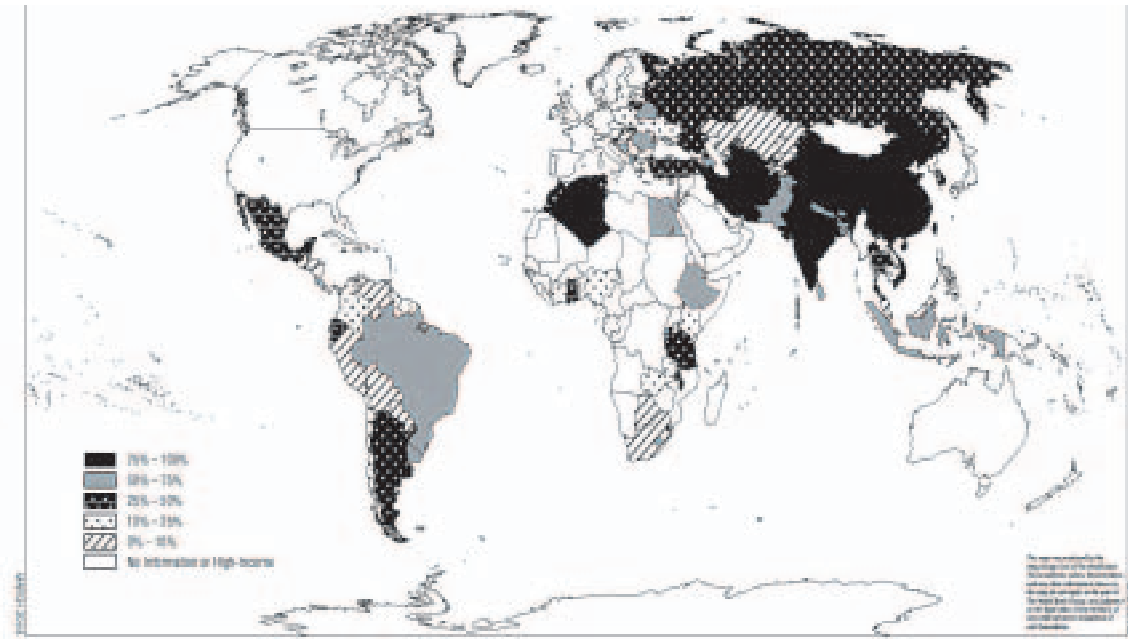
State banks, with their well-known problems (LaPorta, López de Silanes, and Schleifer 2002a), decreased in importance only after 1995, and indeed still dominated many financial systems in 2000 (figure 7.3). The continued large state bank presence meant that credit allocations changed only slowly, despite liberalization. The problems of state banks after liberalization were most obvious in the transition countries,[25] where the banks often simply continued to lend to traditional clients or were captured by politically powerful groups; as a result, their loans were unproductive and their already large portfolios of nonperforming loans increased. State banks in other countries had similar problems. The continued dominance of these banks, the associated weakness in credit allocation, and the implied state guarantees that allowed them to raise increasing deposits despite their high incidence of nonperforming loans, all limited the gains from liberalization and accounted for a substantial part of the cost of crises in the 1990s.

Private banks changed gradually with liberalization, entry of foreign banks, and fiercer competition, but their deficiencies also contributed to unproductive lending and crises. Their credit management skills did not keep pace with changes in the environment such as the growth of foreign currency operations and the greater competition that their traditional borrowers were facing in the real sector. Moreover, many private banks in East Asia and some Latin American countries were parts of industrial-financial conglomerates and continued to provide funding to their increasingly unprofitable

FIGURE 7.3

**State Ownership in Banking, 1998–2000**

**[Pls. provide vector image of this map.]**



*Source:* Map Design Unit, World Bank.

industrial partners. State banks that were privatized to local buyers in weak institutional environments often suffered similar problems and had to be renationalized.

Foreign banks enlarged their role as new policies eased restrictions on their entry in the latter half of the 1990s, particularly in transition countries but also in Latin America and Africa.[26] Their entry increased competition in banking and cut costs for bank clients. They competed fiercely for the best clients and drove down profits on business with them, and they also competed in lending to small firms.[27]

A second approach to increasing competition, taken by a few countries, was to simply allow more banks, by lowering entry requirements.[28] Unfortunately, many of these new banks were "pocket banks," capturing deposits to lend to their owners' businesses and often suffering problems. A third approach was to allow the growth of nonbank financial corporations (box 7.3). These intermediaries also often suffered from problems of risky and connected lending and were often the first to fail when credit tightened.

Greater competition can also create problems for banks by cutting their profits (Caprio and Summers 1996; Dooley 2003). Although this problem seems to be mainly one of adjusting to competition (Demirgüç-Kunt and Detragiache 1998), it does force owners to decide whether they should continue costly competition, try to exit, or loot the bank. Thus regulation and supervision, particularly with regard to bank intervention and exit, are important issues when liberalization increases competition.

## *Regulation, Supervision, and Deposit Insurance*

### Banking Regulation and Supervision

Improvements in the prudential regulation and supervision of banks lagged behind the liberalizations of the 1990s and contributed to crises. The

**BOX 7.3**

### Nonbank Financial Intermediaries (NBFIs) in the 1990s

NBFIs such as finance companies, co-op banks, and nonbank financial corporations exist in many countries and in the 1990s some of them were an important factor in private sector credit and deposit mobilization. For example, India eased restrictions on nonbank financial corporations in 1992 and by 1996 their deposits were equal to more than 5 percent of broad money (box 7.1 above). In Thailand and Malaysia, finance companies' deposit and credit growth picked up in the early 1990s. In Latin America, co-op banks and housing banks in Colombia have been important for some time. NBFIs usually offered higher deposit rates and credit in different forms and to different clients than banks—for example loans for construction, consumer credit, and small borrowers. NBFIs also were often subject to easier regulations on interest rates, reserves, and capital than were banks, as well as less supervision. However, NBFIs had a history of periodic crises in Latin America and East Asia, as for example in Thailand in the 1980s (Sundararajan and Balino 1991, 47–48). After 1997, many NBFIs in India, Malaysia, and Thailand went bankrupt, depositors shifted to banks, and, to some degree, banks increased their loans to the former NBFI borrowers.

oversight of banks in developing countries started from a low base in the 1990s because, during the period of financial repression, bank supervisors had focused on compliance with directed credit rules.

International standards for supervision—the 25 Basel Core Principles—were not agreed upon until September 1997. Countries did enact their own prudential regulations and upgraded supervision, but implementation—a political as well as a technical issue—often lagged, even after costly crises. Enforcement was patchy, even of weak regulations on income recognition, provisioning, capital, and connected lending, and weak banks continued in operation. International standards on minimum bank capital were not set until 1988, in the Basel agreements between industrial countries for internationally active banks.

The issues in improving regulation and supervision were not just technical but also political. The crises of the 1990s did engender attempts to improve regulation and supervision. But even then, regulations were often not strengthened immediately and forbearance was used to limit the capital injections that governments otherwise would have had to make. For example, in East Asia, regulations on capital, income recognition, and provisioning lagged behind international standards after the 1997 crisis (Barth, Caprio, and Levine 2001), and actual capital in many Indonesian and Thai banks was still well below the Basel standard in 2000.

By letting weak banks overexpand, the poor oversight contributed to the crises of the 1990s. In developing countries, weak banks that were allowed to continue operations often opted for a high-risk/high-return lending strategy or, in the worst case, were looted, as has also occurred in industrial countries. Market discipline, which might have restrained the expansion of weak banks, was limited by poor information and implicit or explicit deposit insurance.

### Deposit Insurance

Deposit insurance and, in crises, blanket guarantees, were standard recommendations of many financial advisors, and formal deposit insurance was initiated or improved in nearly 40 countries in the 1990s, mostly in transition and West African countries (Demirgüç-Kunt and Kane 2002; Demirgüç-Kunt and Sobaci 2001). In addition, countries such as Ecuador, Indonesia, Korea, Malaysia, Mexico, Thailand, and Turkey introduced blanket guarantees of bank liabilities. Deposit insurance and blanket guarantees are mainly attempts to reduce the risk of bank runs. Deposit insurance also has the secondary, consumer protection benefit of protecting unsophisticated depositors. Governments liked deposit insurance as it appeared to give benefits yet had no costs, at least until a crisis arrived. Local private banks, often politically important, liked it because it improved their competitiveness with state and foreign banks.

The actual impact of deposit insurance and guarantees has been mixed. The statistical evidence suggests that the gains from deposit insurance depend on its particular features, its credibility, and the institutional environment (Demirgüç-Kunt and Kane 2002; Demirgüç-Kunt and Detragiache 2002). In many cases, the insurance created large contingent guarantees, increased moral hazard, and reduced market discipline (Demirgüç-Kunt and Kane 2002; Demirgüç-Kunt and Sobaci 2001; Demirgüç-Kunt and Huizinga 1999). Large lender-of-last-resort support and blanket guarantees in effect provided unlimited insurance not only for depositors but for owners, many of whom looted their banks. They were particularly ineffective in the context of open capital markets and political and economic turmoil: for example in Ecuador (IMF 2004b) and in Indonesia, liquidity support to banks was almost as large after the introduction of blanket guarantees as it was before. One reason may be that as the likelihood increases that the deposit insurance or a blanket guarantee will be used, its cost and credibility comes into question, and runs on banks and the currency may increase (Dooley 2000).

Various attempts have been made to adjust deposit insurance so as to reduce moral hazard and increase market discipline ex ante, but usually depositor losses have been socialized ex post. For example, insurance limits have been placed on large deposits and on deposits carrying the high rates that are often offered by weak banks, but often the limits have not prevented the insurance from extending to all depositors in a crisis. Another approach has been to use risk-based deposit insurance premiums, in an attempt to offset the moral hazard and market discipline problem, but in practice the differentials in premiums have been substantially smaller than the differentials in bank risk (Laeven 2002a, 2000b, 2000c). This probably reflects the political power of the local bank owners who benefit most from deposit insurance.

To sum up, the schemes that were introduced for the support of depositors tended to create large contingent liabilities and to increase moral hazard while reducing market discipline. They contributed to crises and volatility by encouraging the funding of weak institutions after liberalization. Depositors and external lenders, expecting to be bailed out of any problems by a government guarantee, tended to supply too much funding, particularly to state banks and well-connected financial-industrial conglomerates. Market discipline, which might have limited this funding, was negligible, not just because of weak information but also because of the implicit and explicit guarantees.

### Equity and Bond Market Regulation

Improvements in equity and bond market regulation began in the 1990s and also proved difficult to implement. Even improving trading rules was difficult because of the difference between the interests of buyers and sellers, on the one hand, and the short-run interests of market operators, on the other. Also difficult to resolve has been the conflict between the interests of majority and minority shareholders. Attempts to create markets overnight have had only limited success not only in cases of limited regulation (Czech Republic), but also where investor protection rules appeared to be reasonably good (Russia). Regulation in Poland seems to have been relatively successful, however (Black, Kraakmen, and Tarassova 2000; Glaesner, Johnson, and Schleifer 2001). As with bank regulation and supervision, the issues are not merely technical but also political.

## *Pensions*

As described in chapter 6, a major change in pension systems occurred in the 1990s, with many countries shifting from pay-as-you-go systems to systems in which at least part of pension income is based on full funding for individual accounts. Chile was the first developing country to adopt this approach, in 1981. Among the countries with large financial systems, Argentina, Colombia, Mexico, and Peru in Latin America, plus Hungary, Poland, and Thailand, all adopted variants of this system after 1994 (Fox and Palmer 2001). The new systems gave individuals much better access to their pensions and held the promise of generating demand for long-term financial instruments and thereby stimulating capital markets.

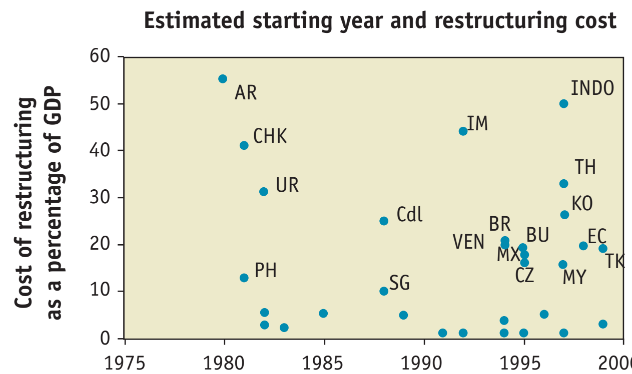
The results were not as good as anticipated. First, all systems had to cope with the change-over problem of paying existing pensioners while investing the contributions to the new system into assets. Without large fiscal surpluses, the change-over generated a large increase in government debt that the new pension system had to hold, as occurred in Argentina. As a result, the demand for long-term private instruments did not rise much. Thus the initial impact of pension reforms was simply to make the government's liability transparent. A second issue is that because capital markets typically are small, pension funds either generated price rises, as happened even in Chile, and/or had to invest in bank debt, as happened in Peru. Third, costs have been high in many of the private pension funds, reflecting set-up costs, insurance linked to the pensions, and a response to advertising that encouraged excessive shifts between funds. Some of these problems could have been reduced and country risk decreased for the individual accounts by allowing the funds to invest externally, but countries have usually tried to retain pension contributions and avoid possible balance of payments pressures.

## *Financial Sector Crises*

Financial sector and external payments crises were features of the 1990s.[29] Costly crises occurred in Mexico, the East Asian "Miracle" countries, Russia, Brazil, and some Eastern European and African countries. The new millennium began with crises starting in Argentina and Turkey and high nonperforming loans in China. Africa also suffered costly financial crises (figure 7.4).

FIGURE 7.4

**Selected Financial Crises, 1980–99**




*Source:* Caprio et al. 2003.

*Note:* The figure illustrates the estimated financial costs of restructuring after selected crises, but not the losses in GDP.

What role did financial liberalization play in the financial and currency crises of the 1990s, dubbed the "twin crises" by Kaminsky and Reinhart (1999)? The discussion below first assesses the roles played by macroeconomic problems, financial liberalization, and weak lending by state banks and financial-industrial conglomerates and then outlines the difficult tradeoffs that policy makers faced in responding to crises over a short time horizon.

### Macroeconomic Problems

Most crisis countries had high debt and larger than usual current account deficits and were pursuing exchange rate–based stabilization policies.[30] Many also had open capital accounts, but a causal association with crises is not clear: not all countries with open capital accounts experienced crises and, in the 1980s, crises had developed even in countries whose capital accounts were nominally closed.

The combination of high debt and exchange rate–based stabilization seems to be associated with unsustainable booms in capital inflows, imports, and GDP and shifts in relative prices, followed by reversals in these variables as financing slows and maturities shorten, while interest rates rise. The slowing of inflows reflects both the inherent characteristics of portfolio adjustment and the growth of investor concerns regarding debt-servicing capacity and exchange rate pegs.[31] The rises in interest rates may reflect a combination of smaller inflows, growing concerns about the sustainability of the exchange rate peg, and attempts to defend the peg with tight money, often for long periods. Eventually, the exchange rate depreciates and debts need to be restructured. Not surprisingly, the financial sector suffers a crisis in the downward phase of such cycles, reflecting liquidity squeezes on banks that have borrowed externally; problems with borrowers, especially those indebted in foreign currency; and runs on the banks to speculate on the currency.

Various events may trigger a crisis. External shocks include deteriorating terms of trade, increases in international interest rates, and increases in risk premiums in industrial-country markets that automatically affect developing-country debt.[32] Contagion in financial markets has also been cited.[33] Domestically, unstable or inconsistent macroeconomic policies sooner or later lead to pressures against banks and the currency. Political developments, such as the ouster of presidents Marcos in the Philippines in 1986 and Soeharto in Indonesia in 1998, lead connected parties to liquidate their assets, putting pressure on banks and lenders with whom they did business.

### Financial Sector Liberalization

Financial sector liberalization seems to have been a factor in crises (Demirgüç-Kunt and Detragiache 1998, 2001; Kaminsky and Reinhart 1999). It increased capital inflows and deposits, which allowed rapid growth in credit to weak public and private enterprises and the government, as well as to real estate. Over time, the quality of the lending deteriorated. This may be one explanation for the lags between liberalization and financial crises (Demirgüç-Kunt and Detragiache 2001), and between financial crises and currency crises (Kaminsky and Reinhart 1999).[34] Eventually, corporate bankruptcies, banking problems, and runs on banks and currencies developed, particularly when the rapid credit growth and inflows slowed, real growth declined, and real interest rates rose.[35] These problems were often connected to unsustainable fiscal policy and the defense of unsustainable currency pegs with long periods of high interest rates. Problems in the timing and sequencing of liberalization, sometimes related to political issues, also contributed to the crises (box 7.4).

In assessing the role of financial liberalization in the 1990s crises, an important question is why international lenders and domestic depositors supplied so much funding. Part of the large increases in loanable funds may have reflected a natural overshooting tendency in financial markets (Kindleberger 2000; Minsky 1992). But any such tendency was certainly exaggerated by the explicit and implicit guarantees that governments provided to lenders. Government debt was directly guaranteed (although after crises it was sometimes restructured). Growing private external debt, funneled through banks or guaranteed by them, and growing deposits carried at least an implicit guarantee, which ex post often became explicit. Moreover, when liberalization led banks to lose franchise value and capital, weak regulation and supervision did not prevent bank owners from engaging in high-risk/high-return lending or even looting. Nor did it limit banks' overexposure to related borrowers. Thus market discipline was eroded by government guarantees, implicit or explicit, while weak regulation and supervision did not limit moral hazard.

Guarantees and their credibility may also explain why the crises in the 1990s seem to have happened relatively quickly (Dooley 2000). According to this explanation, avoiding a crisis depends on maintaining foreign investors' and depositors' perceptions that the guarantees (and the exchange rate peg) are credible. Events, including fears of political change, can quickly change these perceptions, leading to shifts into foreign exchange, curtailment of short-term credits, and rollovers of maturing loans, triggering banking and exchange rate crises.[36]

### Weak Lending

A third factor in the 1990s crises was the weak lending, old and new, by the old financial intermediaries,

**BOX 7.4**

### Problems with the Process of Financial Liberalization

In the late 1980s Nigeria liberalized interest rates and bank entry but retained a multiple exchange rate regime that was accessible only through banks. This raised the demand for bank licenses, many of which went to well-connected parties who were interested in arbitraging foreign exchange between the multiple rates, not in banking. Though the number of banks tripled, the ratio of deposits and credit to GDP fell, and, by the 1990s, banks were experiencing significant distress (Lewis and Stein 2002).

In Korea, the de facto rapid liberalization of short-term borrowings in the early 1990s, both internationally and internally, led the heavily leveraged corporations to be increasingly financed by short-term inflows and through less regulated intermediaries. In the run-up to joining OECD, Korea had opened its capital account by freeing short-term foreign borrowings, but left longer-term borrowings subject to restrictions in an attempt to limit total capital inflows (Cho 2001). This policy encouraged a maturity mismatch in lending and a currency mismatch on the part of borrowers, especially since rates were much lower on foreign currency loans than domestic ones. Although deposit rates were formally liberalized in 1993, their rise was limited by moral suasion, government guidance, and high reserve requirements until 1996. New intermediaries (finance companies converted to merchant banks) sprang up to meet demands for funds by intermediating external inflows. Bank trust accounts were liberalized and grew relative to bank deposits; they also were allowed to take short-term commercial paper, which had relatively free interest rates. Finally, the freeing of interest rates on consumer loans contributed to a shift of loanable funds to these activities and may have dampened Korea's saving rate, augmenting the country's increased reliance on (short-term) external borrowing.

Thailand set up its "offshore"/onshore Bangkok International Banking Facility in 1993 with tax and regulatory advantages that were justified as an attempt to create a regional financial center operated by national banks. The facility allowed locals to deposit in foreign currency and local borrowers to escape (albeit with short-term loans) from the government's tight money policy and foreign currency–denominated loans. Its operations became a major factor in the expansion of Thailand's external debt (Bordo et al. 2001; Alba, Hernandez, and Klingebiel 1999). Pressure on the government from these borrowers was probably a factor in the government's lengthy, costly attempt to defend the *baht* even as it supported the borrowers, taking a monetary stance inconsistent with the fixed exchange rate. After the devaluation, these obligations were a major factor in the banks' problems and in the closure of many finance companies.

notably state banks and industrial-financial conglomerates. Before liberalization these intermediaries had large overhangs of bad debt, which had been rolled over several times to favored borrowers. Financial liberalization made these debts worse because of higher real interest rates and lower inflation. Moreover, lower protection and increased competition reduced traditional borrowers' ability to service their debts. However, the increased deposits and capital inflows associated with financial reform provided new funds that enabled the banks to roll over their loans again, adding to the ultimate volume of nonperforming loans. For example, in the early stages of liberalization in the transition countries, "most state banks continued to lend as instructed or for patronage purposes" (Sherif, Borish, and Gross 2003, 21). In East Asia, banks expanded their lending to related industrial conglomerates, which were increasingly overleveraged (Claessens, Djankov, and Lang 1998). In addition, crises tended to generate a shift of deposits to state banks, because of expectations of government guarantees.[37] This allowed further increases in lending to favored clients who often used the loans to buy foreign exchange and then defaulted on the loans.

The overhang and growth of state banks' nonperforming loans, and their cleanup, were substantial elements in the crises of the 1990s. A notable example is Indonesia (box 7.5). In Thailand, more than 80 percent of Bank Krung Thai's loans became nonperforming. Brazil's BANESPA (the state bank of Sao Paulo) was estimated to have more than 90 percent nonperforming loans; the estimated cost of the federal government's 1997 cleanup, prior to privatizing the bank, was about $20 billion or nearly 3 percent of GDP. The Finance Ministry has estimated that restructuring Banco do Brasil and Caixa Economica Federal may cost $50 billion. In Argentina, the bankrupt state of the smaller provincial banks was exposed by the spillover of Mexico's "Tequila" Crisis; the support needed for their privatization amounted to about half their assets (Clarke and Cull 1999). In Eastern Europe, the cost of the public sector banks' bad debt overhang was enormous—for example about 16 percent of GDP in Bulgaria and about 18 percent of GDP in the Czech Republic (Sherif, Borish, and Gross 2003). In China, official estimates of the nonperforming loans of the four largest state banks exceeded 20 percent of loans in 2003; various private estimates were much higher.

Privatization is often considered as a remedy for the weak lending of public sector banks, but it has been costly in cases where the state has retained a controlling interest or where sales have been made to weak owners whose operations were poorly regulated and supervised. Mexico's 1991 privatization is perhaps the best known example. Soon after privatization, partly because of the currency crisis, the

**BOX 7.5**

### Indonesia: Early Liberalization and Weaknesses Related to Political Connections

In Indonesia the freeing of interest rates and easing of capital and reserve requirements contributed to large deposit growth, as well as a doubling of the number of commercial banks (Hanson 2001). By 1996, competition and the expansion of 10 private banks had reduced state banks to about 45 percent of the system. However, all banks were very weak (World Bank 1996, 1997a). Despite the rules, state banks were overexposed to well-connected borrowers, and private banks to their owners. State banks reported low capital and their reported nonperforming loans, though high, were understated, given the rollover of bad loans and other maneuvers. At least two state banks were insolvent. Loans were often inflated by "commissions" to loan officers. Private banks reported better figures but weak supervision provided no check on them. Exposure limits were not enforced and many small banks were bankrupt.

The spillover from the July 1997 Thai devaluation exposed these weaknesses and the dependence of finance on the political regime. Capital outflow developed and rollovers of the large amount of short-term external loans stopped as investor concerns mounted (despite the imposition of limits on currency speculation). Monetary policy was loosened to ease borrowers' problems. The November IMF program brought little relief—runs on private banks and the currency speeded up with the closure of 16 banks (small depositors did not begin to be paid until January 1998) and the December illness of Soeharto. State banks, which benefited from shifts in deposits, made loans to well-connected borrowers on the basis of projected exports that did not materialize. In January 1998, outflows increased with the poor reception of the 1998–99 budget, panic buying of goods, riots that frightened Indonesians of Chinese origin, and the possibility of introducing a currency board. The exchange rate fell to less than one-seventh of its precrisis level. Massive central bank liquidity support, often well in excess of banks' capital and in some cases up to 75 percent of their assets, would have doubled the money base had

(Box continues on the following page.)

Mexican government was forced to renationalize the banks; it then cleaned up their balance sheets at an estimated cost of more than US$70 billion and reprivatized them to international banks, beginning in 1998 (box 7.6).

In Eastern Europe, the initial bank privatizations went poorly, particularly where governments retained a controlling interest (Clarke, Cull and Shirley 2003). In Africa, too, the experience with bank privatization was often bad, with long delays and sales eventually made to undercapitalized owners who did not improve credit management and abandoned the banks when they lost their capital (box 7.7).

### Difficulties in Policy Responses to Crises

The crises presented difficult new policy problems. Traditional macroeconomic policies of tighter fiscal and monetary policy and devaluation were appropriate for reducing excess demand and current account deficits to financeable levels. But the financial sector problems, and their implications for the balance of payments, raised a new set of more complicated issues and tradeoffs, for which no single best practice exists.

To deal with an individual bank's problems, the standard recommended response is to provide liquidity support at high interest rates and then intervene with protection for small depositors. But banks become insolvent well before they become illiquid, and owners of insolvent banks may then choose a risky lending strategy or even attempt to loot the bank (de Juan 2002).[38] Moreover, problems in one bank typically indicate more widespread problems, and closing a bank without promptly compensating depositors may trigger runs on other banks and looting by bank owners.

**BOX 7.5**

**(continued)**

reserves not fallen (Kenward 2002; World Bank 2000c). Imposition of a blanket guarantee at the end of January temporarily slowed outflows. Soeharto's reelection in March was followed by severe riots, often directed against Indonesians of Chinese origin and Soeharto cronies. Capital outflows rose once again, as did liquidity support. In May 1998 Soeharto resigned but pressures on banks continued.

In sum, liberalization encouraged deposit growth and foreign inflows, but credit access depended not on profitability but on political connections, including access to external loans from international banks (corporations did much of Indonesia's external debt borrowing; the state banks' external borrowing was limited by policy). Lenders and depositors looked at connections, not at risk and corporate leverage. The easing of bank licensing and the lack of enforcement of exposure limits worsened this problem. Then, when political concerns developed, the well-connected tried to withdraw their assets and an outflow developed, exacerbated by the concerns of the middle-class Indonesian Chinese. As a result, the blanket guarantee stopped the bank runs only temporarily—total liquidity support was nearly as large after the blanket guarantee was imposed as before, according to the figures in Enoch et al. (2001). Of the US$20 billion liquidity support that went mostly to private banks, 96 percent was unrecoverable and a substantial amount was diverted into foreign exchange speculation, according to an ex post study by the National Auditor. The cost of the crisis is estimated at more than 50 percent of GDP. Bank Mandiri, a merger of four state banks of which at least two were bankrupt before the crisis began, accounted for about 30 percent of the cost of the crisis (more than 17 percent of GDP). More than 70 percent of the losses in the state banks were in loans that had to be taken off the books. The poor quality of these loans is shown by the eventual recovery rate of less than 30 percent, most of which was realized four to five years after the crisis.

**BOX 7.6**

### Bank Privatization in Mexico

Mexico nationalized its commercial banks in 1982. It decided to privatize them in 1991, as part of liberalization and to raise fiscal resources. At the time, the privatization was acclaimed as a resounding success, fetching higher prices than predicted. Although open only to domestic purchasers, the sale was considered technically well designed and executed. Bidders were first qualified, and the auctions were transparent and quick, without scandal.

The macroeconomic (Tequila) crisis of 1995 took the shine off this success: loan defaults increased sharply with the collapse of the *peso* and the rise in interest rates. Failing banks were found to have made poor loans under the relaxed regulatory framework, often to politically powerful groups connected to their controlling owners (Haber and Kantor 2003; LaPorta and López de Silanes 2003). The connected lending meant that the banks had effectively financed much of their own purchase. Taking into account loans from development banks, the buyers actually had minimal equity, but this had not prevented their purchase of the banks. The government renationalized the failed banks and protected the depositors but taxpayers were left with a huge bill, estimated at 18 percent of GDP.

The features of the sale that were praised earlier are now often criticized: the privatization for being too hasty and the purchase prices as too high. Yet a sale was considered necessary to raise fiscal resources and sustain the government's commitment to reform. The main mistakes were the exclusion of foreigners and the acceptance of purchases by politically powerful but heavily leveraged buyers. The exclusion of foreign bidders was partly a calculated risk to shore up domestic support in a nationalistic country. Even with foreign participation, highly leveraged locals might have bid more for the banks through their access to loans. Thus, above all, the Mexican experience illustrates not just a flawed privatization but the complicated issues that bank privatizers must juggle, including the difficult problems associated with dealing with local elites in a sector as sensitive as banking.

As a bank problem becomes systemic, bank runs turn into currency runs and pose severe problems for which there is no standard answer. The government faces the unpleasant choice of either intervening in weak banks, thus possibly provoking runs on other banks,[39] or providing liquidity support—loose money—that will spill over into pressure on the exchange rate and international reserves, especially in open economies (World Bank 2000c).

Another choice is that of how much to support the exchange rate with reserves and tight money (offsetting the loose money from liquidity support) versus how much to allow a depreciation. Tight money helps to protect the exchange rate, as in the traditional policy response, and thus helps borrowers in foreign currency, but it hurts borrowers in local currency and it hurts banks, particularly if it is maintained for a long time. Liquidity support and loose money will help borrowers in local currency, but put additional pressure on the exchange rate that will hurt borrowers in foreign currency. Use of reserves delays this problem, but reserves are finite and their decline can provoke a speculative attack on the currency.

Nontraditional policies have had only mixed success. Capital controls have not been effective in stopping currency runs.[40] A blanket guarantee may or may not halt bank or currency runs, depending on how it affects concerns about the credibility of the guarantee and the burden of future costs (Dooley 2000). A few countries, including Argentina and Ecuador, have tried to stop bank runs by freezing deposits and devaluing, but the disruption to the payments chain has led to massive recessions. If deposits are to be written down, in parallel with loans, it is probably best to make a politically

**BOX 7.7**

### Bank Restructuring and Privatization in Sub-Saharan Africa

At the end of the 1980s many African banks were insolvent and illiquid. Governments undertook major restructuring programs over the 1990s to deal with these problems. A gradual return to macro-stability and balanced government budgets—a prerequisite for bank restructuring—occurred in programs supported by the International Monetary Fund (IMF) and the World Bank. Directed credits were abandoned and interest rates liberalized. Government arrears to the banking sector were often securitized on various terms, with debt service often guaranteed. Money markets were established. Many countries issued new banking laws, overhauled regulations, and set up supervisory authorities.

Bank restructurings were both organizational and financial and sometimes led to privatization, but the process also often required multiple restructurings and was hesitant (World Bank 2001, box 3.3). Some banks, particularly public sector banks, were closed or weak branches were turned into agencies. In Benin, the extreme case, all public sector banks were closed in 1990, leaving the country without banks for some months until new private banks entered the market. In other cases, bad assets were provisioned and losses were absorbed by existing shareholders (governments and the private sector); in a few cases, new capital was injected by the private sector; and in others, bad loans were removed from banks. Asset recovery corporations were set up to manage bank liquidations and/or to recover loans and reimburse depositors/creditors (for example in Cameroon, Côte d'Ivoire, Ghana, Uganda, and Senegal) with mixed results. Management was changed, staff retrenched, internal controls were put in place, and new loan procedures were gradually developed.

Treatment of depositors in failed banks varied from country to country. In some, the government left the deposits in the restructured bank or reimbursed all depositors. In others, repayment of depositors depended on the asset recovery of the failed institutions. Priority was given to compensation for small depositors. Depositors incurred substantial losses in Cameroon and the Republic of Congo, for example. Some countries introduced deposit insurance in the late 1990s, but it is unclear whether these systems could handle banking crises as large as those of the 1990s.

Privatizations generally went to a major institutional partner, often foreign. In some cases the foreign banks were large and well known, with a reputation to protect. African private banks that operate in several countries have developed (Ecobank, Bank of Africa, Financial Bank, CBC, Stanbic) as a result of privatization involving foreign partners. However, in some cases, the foreign banks provided little improvement.

As a result of the restructurings, African commercial banks have become more solvent, liquid, and profitable and a safer haven for deposits, but many problems remain. In many countries, banks are still weak in their lending and operations. Bank deposits have declined in some countries, probably reflecting a mix of bank closures, discouragement of small deposits, and civil strife. Commercial bank lending has generally been limited, reflecting crowding out of government debt and bankers' selectivity in lending.

*Source:* World Bank 2001, box 3.3.

unpalatable exchange of tradable bonds, as Argentina did in its January 1990 Bonex plan. Whatever is done, GDP growth is almost certain to slow if not decline (Frankel and Wei 2004).

In sum, the crises of the 1990s appear to be related to macroeconomic problems, but also to financial liberalization in the context of the overhang of old political and economic relationships, manifested in state banks and politically powerful financial-industrial conglomerates. Government guarantees encouraged a rise of funding for these intermediaries, which they channeled into weak loans. Eventually crises developed and the depositors and external creditors were bailed out by governments. Privatization in these environments did not solve the problems, and often required costly renationalizations.

## 3. Lessons of the 1990s

In the 1980s and 1990s the approach to finance shifted from the repression of prices and markets and the use of government credit allocations to a more market-based, internationally open system. Yet this shift, along with the other reforms, had less than the expected effects on growth. Access to financial services does not seem to have improved substantially in the 1990s, though there are indications of improvements recently. Expectations may well have been too high. Another reason was an apparent "boom in bust[s]" (Caprio 1997), related to macroeconomic policies but also to financial liberalization in the context of an overhang of weak institutions—financial intermediaries, financial markets, and informational, legal, and judicial frameworks. Problems in these areas reduced the impact of liberalization and in some cases led to perverse results.

The weaknesses of institutions were not just a technical issue: they reflected the difficulty of changing the previous state-led development system and, more fundamentally, its underlying political-economic basis within a short period, while restraints on markets could be and were quickly lifted. The overhang of these factors during the 1990s was an important reason behind the following:

- Credit allocation was weak and continued to go to the public sector, well-connected individuals, financial-industrial conglomerates, and traditional state bank clients.
- Bank privatization was slow and partial privatizations left control of intermediaries in the hands of government in many transition and African economies, leading to continued preferential treatment of the traditional borrowers from state banks.
- Privatizations and restrictions on foreign entry in the financial sector often allowed local elites to retain or increase their economic and political power.
- Implicit and explicit guarantees of deposits and international loans supported local elites' ability to raise resources.
- Liberalization of bank licensing led to "pocket" banks that mainly engaged in connected lending or regulatory arbitrage, not expansion of access (the record of nonbank intermediaries is somewhat better but they too were often linked to industrial-financial conglomerates).
- Development of the framework for capital markets—such as reasonable information, legal and judicial treatment of bankruptcy, treatment of minority shareholders, conduct rules for market participants—was slow, compounding the problems that capital markets in developing countries face in terms of concerns about macroeconomic stability, high costs, and low liquidity.

The process of liberalization and the limited nature of the results in the 1990s suggest four major lessons, discussed next.

### Finance Depends on Institutions

Perhaps the most important lesson of the 1990s for finance is that the financial sector's contribution to development depends not just on resource mobilization but also on attention to institutions: intermediaries, markets, and the informational, regulatory, legal, and judicial framework. Resources need to be allocated to those that offer the best combination of return and risk, and this depends on the quality of institutions. Building up these institutions is not easy, takes time, and requires political support.

In the 1990s, the traditionally weak loans of state banks and financial institutions linked to industrial conglomerates were further weakened by the higher interest rates that followed liberalization, as well as by increased import competition and real appreciations that cut the profitability of traditional borrowers. Explicit and implicit guarantees allowed these financial institutions to obtain much of the liberalization-induced increase in deposits and capital inflows, and to substantially expand lending to their traditional borrowers, private and public. Regulation and supervision did not prevent this; their weaknesses reflected not just technical but political issues. Market discipline was eroded by poor information and, more important, by implicit and explicit guarantees. Better capital market development could have relieved some risks and absorbed part of the shocks. However, the capital markets faced competition from implicitly or explicitly guaranteed deposits and external loans. Market development also was hindered by the inherent problems of capital markets in developing countries and the difficulties of building up a reasonable institutional framework quickly.

By the end of the 1990s, it became clear that much of the increased deposits and capital inflows had gone into (1) unproductive private borrowing or state enterprise debt that had to be replaced by government debt in order to bail out depositors and lenders, (2) deficit finance, and (3) central bank debt to stabilize the economy. Thus it is not surprising that the financial liberalizations of the 1990s did not live up to the high expectations regarding sustained increases in growth or credit access.

Focusing on the poor quality of credits exposes a common thread in the slow growth and financial crises of the 1990s: the continuation of preferential access, related to the overhang of old institutions, that was changed only slowly by the financial reforms. In many countries in the 1980s and 1990s, public sector borrowing, with its implicit guarantee from future tax revenues, was excessive and eventually led to crises and slow growth. But even in countries with smaller public sectors and relatively limited fiscal problems, such as Chile in the late 1970s and East Asian countries in the 1990s, loans to industrial conglomerates—made from the guaranteed deposits in the private financial intermediaries that they controlled or from state banks and international lenders, to which they had preferential access because of the institutional set-up—eventually became nonperforming and contributed to crises. As noted earlier, the poor contribution of such loans to sustained growth is shown by the low value of the associated collateral when it was eventually sold.

### Delaying Needed Policies Is Costly

Limiting the incidence and cost of financial crises depends on resisting political pressures to prolong unsustainable booms and to delay action on weak banks,[41] as well as on avoiding socializing their losses. In the 1990s, governments often tried to prolong booms and did not limit the expansion of weak banks.[42] Unfortunately, such policies increased the ultimate volume of bad loans and the size of the crises. Then, after crises occurred, governments typically responded by bailing out depositors and external investors through liquidity support, expansion of whatever deposit insurance existed, and blanket guarantees, all of which generated large increases in government debt and contingent liabilities.

Expectations that losses would be socialized, through explicit and implicit guarantees, also contributed to crises and volatility by encouraging weak institutions to mobilize funds after liberalization. Depositors and external lenders, expecting to be bailed out of problems by a government guarantee, supplied funding to state banks and financial intermediaries that were part of financial-industrial conglomerates. The funding was well in excess of what could be used productively. Market discipline, which might have limited this funding, was weakened by the implicit and explicit guarantees.[43] The process was unstable, however. When a rise occurred in the subjective probability that the guarantees would be called, net capital outflows developed, as depositors and investors became concerned about how the guarantees would be paid and funded.[44] The capital flight was facilitated by the liquidity support to weak banks and the support of the exchange rate by reserve sales. The combination of high initial returns, limited losses on the funds that were taken out of the countries just before the crises, and the ultimate provision of government guarantees left the depositors and investors with good returns during the 1990s.[45]

Improvements in these policies will depend not just on new measures but also on strong implementation, which has been difficult even in industrial countries.

### Financial Liberalization Increases Financial Resources

A financially liberalized economy tends to generate more financial resources than a repressed economy. This is an old lesson (McKinnon 1973; Shaw 1973) that had been forgotten during the financially repressed 1980s. During the 1990s, the growth in bank deposits (relative to GDP) speeded up in many countries. This acceleration reflected lower inflation, more realistic interest rates, and a wider menu of financial instruments, including foreign exchange–denominated instruments. In addition, domestic capital markets were started and developed and private firms increased their external borrowing and external equity issues.

Deposits and domestic capital markets performed best where growth was already rapid, where there was a history of high deposit mobilization, and where investors were willing to take risks to get equity shares in rapidly growing corporations: East Asia and India. Elsewhere, deposit growth was less and capital market performance was less good. Deposit growth picked up much less in Latin America, reflecting the region's history of inflation and government intervention. Also, much of the growth was in foreign currency deposits that complicated policy making. The decline in listings in equity markets in Latin American and transition economies suggests that access to finance through equity issues did not widen much. Even where capital market performance was better, access suffered from the lack of scale and liquidity in the markets; multinational takeovers of major firms; migration of listings to less costly, more liquid industrial country markets; and, more fundamentally, weak institutional frameworks—in particular the lack of information, regulatory protection of minority shareholders, and bankruptcy protection for bond holders. Private external borrowing and offshore equity issues did provide lower-cost funding but only to larger corporations in a few countries, and the loans were subject to currency and rollover risk. The slowdown in net private-to-private disbursements and short-term loans was a major factor in the crises. Though it will be difficult, better development of domestic capital markets, even in the countries that have done relatively well, would reduce the impact of future crises.

### Successful Finance Depends on Macroeconomic Stability

Another old lesson is that successful financial liberalization and successful finance depend on macroeconomic stability (World Bank, *World Development Report 1989*). If anything, open capital accounts and volatile international capital flows place a larger premium on sound macroeconomic management. However, financial reforms, or at least more market-based interest rates, were often put in place in the 1990s in the midst of macroeconomic imbalances, complicating what was already a technically difficult problem.[46] For example, countries with unsustainable fiscal policies often used financial liberalization to continue their debt buildup and delay adjustment.[47] Even when fiscal deficits were smaller than in the 1980s, the countries that liberalized finance often had large external and internal debt overhangs that contributed to volatility.

Even a strong financial system has difficulty protecting itself against default by an overindebted government, as the recent Argentine crisis illustrates.[48] Also, many countries that liberalized were pursuing exchange rate–based stabilization, or had relatively fixed exchange rates. These macroeconomic policies, and the tight monetary policy and the credibility issues associated with them, often meant extended periods of high real interest rates and burdensome external borrowing, which eventually contributed to countries' inability to service debt and to financial crises. Thus, the problems with financial liberalization, the crises, and the limited results from financial liberalization in the 1990s often reflected macroeconomic policy deficiencies and the overhang of large external debts.

## 4. The Future of Finance

Looking ahead, the general pattern seems likely to remain one of more market-based finance. In most countries the financial liberalizations of the 1990s are unlikely to be reversed in their broad aspects, barring large macroeconomic policy errors. A widespread return to financial repression is probably now untenable for two reasons. One reason is political: lower inflation and a more market-based, more open financial system became political imperatives in the 1990s. Repressed finance had high costs and regressive distributional effects. Over time, increasingly politically active households have demanded protection for their savings and access to the investment opportunities that were once available only to political and economic elites. A second reason, noted earlier, is that the increased access to external financial markets brought about by the enormous growth in trade, travel, and migration and by improvements in communications has made financial repression difficult.[49]

Although macroeconomic stability, on which good finance depends, seems to exist in many countries, macroeconomic issues remain. First, in today's open economies, slow policy responses or policy errors quickly translate into macroeconomic instability. Second, large government debt overhangs and/or large unfunded pension liabilities are problems in many countries. The burden of these problems has been eased by low world interest rates, but rising world interest rates, as well as other shocks, may lead macroeconomic policy astray. As the 1980s and 1990s show, excessive government debt can interact with inconsistent exchange rate and monetary policy to lead to massive capital flight, large currency depreciations, and costly financial sector collapses. When the government goes bankrupt, the financial system and the whole economy suffer.

The financial liberalizations of the 1990s have created a sounder basis for finance in at least six ways:

- Crises cleared away the "debris" of past nonperforming loans, although they left large holdings of government debt that created problems.
- Intermediaries and capital markets have improved. In Eastern Europe, Latin America, Africa, and even East Asia, many financial intermediaries were gradually replaced by reputable foreign banks. Such banks have better lending skills, are more able to engage in arms-length lending and resist government pressures, and, potentially, impose fewer demands on government for bailouts than the intermediaries they replaced. Capital markets have also been set up or improved, but they still face many structural and institutional challenges.
- Government and central bank debt markets have developed. They allow central banks to carry out monetary policy more efficiently, increase banks' liquidity, and allow less inflationary finance of fiscal deficits. The growth of government debt markets also helps provide a benchmark that can make private debt markets more efficient.
- Access to credit is growing in some countries, from foreign banks (Clarke et al. 2004), new domestic banks, and bank-like intermediaries. With the closure of the old intermediaries, bad credit no longer drove out good credit. New intermediaries that hold the promise of a sustainable increase in small-scale lending were able to grow. In Ecuador, for example, the collapse of the public sector intermediaries has left room for dramatic growth in private banks' small credits in the last two years.
- Information is improving. The accounting and auditing of intermediaries and borrowers is improving. So is information on small borrowers—public credit bureaus have been established in 23 (mostly transition countries) since 1994 and the private credit bureaus that already existed in many countries are improving (World Bank 2003d).
- Prudential regulation and supervision seem to be improving and, in a few cases, the combination of regulation, supervision, and a better safety net have limited the impact of crises in individual banks, for instance in Peru, although supervision has also missed major weaknesses in some countries, such as the Dominican Republic.

## *Improving Finance*

Further improvements in the contribution of finance to development depend on improving the key tradeoff between safe and sound finance and risk taking in the financial sector's intermediation between savers and investors. The crises of the 1990s naturally have raised concerns about financial instability that can lead to poor growth. Governments, attempting to reduce the future costs of crises, have often tended to emphasize prudence. But there is a tension between stability and the ability of the financial system to carry out the key intermediary roles for development—mobilizing funds from savers, allocating these funds to investors that will yield the best combination of return and risk, reducing risk, and shifting risk to those most willing to bear it. A financial system that does these tasks well will contribute greatly to development.

Improving the tradeoff between stability and intermediation in finance depends not just on maintaining the systems of market-based interest rates and credit allocations that arose during the 1990s, but also on the following:

- Reducing the crowding out of private credit by the current large overhang of government debt;
- Reducing the volatility of resource flows, particularly on the upside of cycles and to weak institutions;
- Improving intermediaries and markets; and
- Widening access to credit.

The discussion below addresses each in turn. Progress will depend heavily on countries' success in building institutions, improving their informational and legal frameworks, and, ultimately, achieving more competitive political systems that will reduce the power of political-economic elites.

### Reducing the Crowding out of Private Credit

Perhaps the most immediate obstacle to the ability of the financial system to carry out its intermediary role, as well as a threat to stability, is the large overhang of government debt in many countries.[50] It is often said that private credit is currently limited by the unwillingness of banks and markets to take risks. In fact, it is limited by the large volume of inelastically supplied government debt. This is because, to ensure that all government debt is held (either by financial intermediaries or by individuals), the spread between interest rates on government debt and private debt has to be big enough to crowd out enough private debt. Hence the way to expand the supply of private credit is not to try to make government debt less attractive but to leave more space for funds for the private sector in the financial system, or to make private debt and equity more attractive, so that more financial resources can be raised in total.

### Reducing the Volatility of Flows and Its Impact

Governments have made various efforts to reduce the volatility of flows, especially on the upside of a boom, and to ease the impact of volatility, particularly by building up international reserves to offset shocks and, within banks, by externally hedging foreign currency liabilities.

But much remains to be done. Some analysts have argued for reducing incentives to excessive capital inflows that can easily turn into excessive outflows. They argue, for example, that India's success in avoiding the 1997 crisis was related to its limits on banks' (and firms') offshore borrowing, even as it allowed inflows into the stock market and liberalized direct foreign investment regulations. Chile's implicit taxes on short-term inflows also appear to have had some success in reducing inflows, extending their maturities, and in limiting the impact of shocks, but at the cost of reducing credit availability to the private sector (Edwards 1999; Forbes 2003).

Another approach would be to reduce the incentives to banks for increasing their net offshore borrowings. This would involve at least leveling the playing field through application of the same reserve, liquidity, directed credit requirements, and premiums for "deposit insurance" as on domestic deposits. Here, too, little has been done. In the area of international bond issues, some countries have begun to try to reduce the bias in bond buyers' beliefs that any restructuring will favor them, by making restructurings easier in terms of lowering the percentage of bond holders that is needed to accept a restructuring offer (the Collective Action Clause). However, it remains to be seen how this change will operate—U.S. courts have often allowed individual creditors to seek preferential treatment. In the case of Elliot Associates vs. Peru, settled in 2000, Elliot Associates obtained a restraining order on the payments on the restructured debt to which Peru had agreed with other creditor representatives. Peru eventually settled by paying Elliot Associates $56 million for the debt that they had bought for $11 million in 1996. Ultimately, all attempts at limiting excessive inflows depend on political will to limit a boom, while in practice, countries often have eased restrictions on capital inflows in order to prolong a boom.

Internally, governments have tried to develop capital markets as a shock absorber for the volatility of external and internal flows. Funds invested in equity or long-term domestic government and private debt represent much less of a threat to the economy than do volatile short-term external capital flows.[51] Thus, capital market development could contribute to stability as well as assisting the allocation of funds to promising activities. One problem, of course, is that investors in such instruments demand high returns under the current environment in developing countries, so such instruments are often unattractive to potential issuers. This problem adds to the structural problems of small size, lack of liquidity, and high costs that limit capital market development. Domestic capital markets, particularly in the larger countries, could be stimulated by improvements in institutional factors, such as better information on firms, better rules on market conduct and corporate treatment of minority shareholders, and better legal and judicial treatment of bankruptcy. Generally, such improvements require substantial time and effort.

Better market discipline is another approach to enhancing both intermediation and stability. Market discipline means ensuring that depositors and international lenders have appropriate incentives to limit their funding to weak intermediaries, by ensuring that they stand to receive lower returns on deposits and investments if problems occur. Market discipline complements government regulation and supervision and evidence exists that it can work in developing countries (Martinez-Peria and Shmuckler 2001; Calomaris and Powell 2001). Unfortunately, market discipline depends on good information. Though accounting and auditing are improving, much remains to be done. For example, regulations could encourage prompt dissemination of accurate information and impose stiff penalties for failure to do so.

Perhaps more important, market discipline is blunted by widespread implicit and explicit government guarantees that developed in the 1990s. To make market discipline work, governments face the difficult task of establishing credible limits on liquidity support, blanket guarantees, and deposit insurance, so that at least the holders of banks' large obligations consider themselves at risk. One way to begin improving market discipline might be to limit payoffs to large providers of funds, especially since the latter can be expected to have relatively good information about the strength of individual banks. It would also help to prevent problems in one bank from contaminating the rest of the system. However, the policy would immediately pass the problems of a weak bank on to the central bank as lender of last resort—a role that also would need to be limited, to contain costs. Deposit insurance would also come into play, and would need to be truly limited to small deposits. Premiums for deposit insurance would need to reflect differences in risk in different classes of banks. Unfortunately, the systems of risk-based premiums that have been adopted have largely copied the pricing from industrial economies and, though better than flat, premiums still provide substantial subsidies to domestic private banks, probably because of the banks' political power.

When banks' problems have become more systemic, the past responses—large lender of last resort support and blanket guarantees—have undermined future market discipline and been costly to future generations. In effect, they have provided nearly unlimited insurance not only for depositors but also for owners who can loot their banks. Alternative options for dealing with crises would need to begin with a different approach to dividing the costs of the crises between current holders of liabilities and future generations. Lengthy suspensions of deposit withdrawals have proved to be undesirable: they break down the payments chain and have contributed to large declines in output, as has happened in Argentina and Ecuador. But brief suspensions of deposit withdrawals, while term deposits are replaced by long-term, marketable instruments that involve a substantial discount (in present value terms), are a possible alternative that would make current depositors bear part of the cost of the crisis (Beckerman 1995; IMF 2004b). Of course, such policies are politically difficult to implement. But they would not only limit the burden of crises that future generations would have to pay, they might also reduce the size of future crises, by strengthening market discipline.

To limit weak lending and crises, governments have also improved their banking laws and prudential regulation and supervision. Since the strengthening of prudential regulation and supervision only began in the later 1990s, not much evidence has accumulated on how well it can work to prevent crises. At the simplest level, regulators and supervisors in developing countries may lack the technical skills even to deal with loan quality and provisioning, not to speak of more complicated aspects of banking, such as evaluating complex operations in capital markets and foreign exchange, swaps and derivatives that are poorly valued in imperfect markets, and risk management models. Deficiencies exist in the consolidated supervision of financial-industrial conglomerates and in the supervision of offshore activities—important areas in developing countries that will not be improved simply by giving supervisors more power.

Partly these problems reflect incentives: typically supervisors are poorly paid and have an incentive to shift into banking, especially once they have been trained to handle tasks well. Often supervisors are subject to lawsuits by bankers, even for actions in performance of their duties—which makes them hesitant to raise issues.[52] Protecting supervisors completely from legal action raises another issue—the risk that they will engage in malfeasance. Hence a tribunal separate from the court system is needed to deal with accusations of malfeasance by supervisors.

More fundamentally, improvements in regulation and supervision face substantial political roadblocks, which have arisen in industrial as well as developing countries. For example, from time to time, U.S. financial economists have raised concerns about some U.S. banks being too big to fail. Also in the U.S., political forces and regulatory forbearance are often cited as a contributory factor in the U.S. savings and loan crisis. In many developing countries a few large banks dominate the system, and bankers and major borrowers are often one and the same. In this context, regulatory capital does not have even the minimal incentives that it does in arms-length transactions between intermediaries and borrowers. The industrial-financial groups are the principal entrepreneurs in many countries, even large ones, so limits on connected lending are not feasible. If problems of loan quality develop, the strength of the economic and political elite is likely to lead to regulatory forbearance. Even if supervisors can identify capital insufficiencies and other regulatory violations, it would be difficult for them to stand up to monolithic political elites, particularly when the alternative is simply to ignore a problem in return for a supplement to their small salaries. Finally, the potential strength of regulation and supervision is limited by the still-important role of large state banks that carry out government policies and are nontransparent almost by design. In sum, regulation may not be successful unless it also empowers the market to monitor banks better, by encouraging market discipline.

### Improving Intermediaries

The entry of reputable foreign banks is one way to improve intermediation as well as to limit the cost of crises. Reputable foreign banks bring better trained staff to the country and generally have better systems for evaluating and managing credit risk than local banks. These advantages often spill over into the local banking system, from competitive pressures and the movement of personnel. In addition, reputable foreign banks also are likely to cover any losses on their loans or operations without demanding government support, so as to avoid damaging their reputations.

Reputable international banks have entered many countries in recent years, but losses and, in some cases, their own lack of capital have limited their interest in further expansion. Some banks that expanded in Eastern Europe, in hopes of establishing a presence before countries acceded to the European Union, suffered losses as competition developed. Some that expanded in Latin America have suffered losses from operations and from the developments in Argentina. In the recent re-privatizations of Indonesian banks, only one bid came from a well-known global bank. Lesser-known banks have been expanding internationally, but such banks can generate more supervision problems than local banks, because of the problems with international supervision. Moreover, without reputations to lose, such banks may pull out when things go bad in the country or in their home market, leaving governments to bear the costs.

## Improving Access to Finance

Increasing small clients' access to finance is a critical issue for the financial sector in its support of development. It involves the tradeoff between making banks safe and sound and making sure they continue to intermediate. A prerequisite to increasing access is to reduce the absorption of loanable resources by the government and the central bank.

Pressures remain great to direct low-cost credit to small borrowers. Historically, however, these efforts have usually been unsuccessful, undermining sustainable finance for rural and small and medium-sized enterprises, just as occurred under financial repression.

A few intermediaries have successfully sustained loans to small borrowers (box 7.8). The more traditional banking operations among them have common features that explain their success: interest rates that cover costs, good deposit mobilization, containment of administrative costs, and a high rate of loan collection, all backed by appropriate internal incentives for good staff performance (Yaron, Benjamin, and Piprek 1997). Their example needs to be followed. The informational infrastructure for small lending also improved toward the end of the 1990s with the founding and improvement of credit bureaus.

Greater competition in banking services, through greater entry of banks and nonbanks and looser regulations and supervision, is sometimes recommended to improve access and lending in general. Certainly, regulations should provide room for intermediaries that take funds from groups of well-informed investors/depositors and "nip at the heels" of banks, by offering better returns to depositors (though with greater risk), along with better service and innovation in products and lending.

Exactly how these entities should function—for example as venture capital funds or deposit takers—and where the lines should be drawn between them and "banks," are country-specific details. Such intermediaries operated in some East Asian and Latin American countries and in India in the 1990s, and

**BOX 7.8**

### Extending Credit for Small Borrowers

In addition to the well-known examples of the Grameen Bank (begun in 1976) and Bank Rakyat Indonesia after its 1983 reform (Robinson 2002), other successful lenders began to expand toward the end of the 1990s. These included CrediFe in Ecuador, MiBanco in Peru, CrediAmigo in Brazil, and, in India, SEWAH (which uses a Grameen-type approach) and self-help groups that use a mixture of the Grameen approach and traditional banking. Some of these intermediaries received support from donors. The Grameen approach relies on the social responsibility of borrowers who belong to a narrow group—an approach that has also been used by some banks.

the outcomes illustrate their positive and negative sides. Before they fell victim to crises in 1997, the nonbank intermediaries increased finance for underbanked sectors such as consumer durables and construction. But to some extent their success was not in competition and innovation but based on regulatory arbitrage relative to banks, which were constrained by interest rate controls (in India) or tight money policy (in Thailand). A critical issue with such intermediaries is whether politically they can be denied access to the bank safety net, or whether they should be regulated and supervised in the same manner as banks to protect taxpayers as well as depositors. India appropriately resisted bailing out depositors, but Thailand's attempt to offer these intermediaries access to liquidity funding contributed to an easing of monetary policy that was inconsistent with the pegged exchange rate.

Another related issue is the size of the investor/depositor base: as it widens, the distinction blurs between these institutions and banks, the pressures for claims on the safety net increase, and the government may be drawn into supervision and regulation. Such problems have occurred in co-op banks in India and in countries such as Indonesia, Nigeria, and Russia, where banks were allowed to set up with negligible capital. In Indonesia, 48 of these banks, many run by the politically well-connected, borrowed from the lender-of-last-resort facility well in excess of their capital during the crisis (Kenward 2002), and used the funds to support foreign exchange purchases and related businesses (see box 7.5 above).

Improving access, as well as the quality of credit allocation in general, depends heavily on improving the informational, legal, and judicial framework. The poor supply of information about borrowers, though improving, limits lending to smaller clients. In some countries, this problem has been circumvented by lending through third parties that in effect guarantee the loans.[53] More generally, however, better information would enhance competition for sound borrowers while giving borrowers an incentive to service their loans to maintain good credit records. Thus, the continued spread and improvement of credit bureaus will be an important development in improving access to credit as well as the quality of loans. Important issues that need to be addressed in this process are banking secrecy; how to make banks comply promptly and accurately with the requirement to provide information; whether the credit bureau is to be private or public; the inclusion of related information such as installment purchases; and consumers' rights to challenge and amend the information.

Improvements in the legal and judicial framework, notably the definition and execution of collateral and bankruptcy laws, are also important in improving credit access and lending in general. Financial intermediaries prefer not to execute collateral—they are mobilizers and allocators of funds, not managers of firms—but the threat of executing collateral gives an incentive for prompt debt service. Good bankruptcy laws make the survival of viable firms easier and allow shifts of physical capital from nonviable firms to others, with creditors receiving the maximum settlement. The potential to improve credit access through better information, contract enforcement, and technology is great: in the United States, the cost of processing a small loan is now below the price of a modest lunch.

Good access to financial services also involves efficient deposit and payments services—important facilities given the increase in domestic and international migration. In Africa, unfortunately, the strengthening of the banking system has in some cases reduced access to deposit and payments services for small transactions. In other parts of the world, payments services are often limited and uncompetitive. Post office banks—narrow banks, holding only government debt—with better technology, and banks providing only these services (for example in Tanzania and Mongolia) are examples of innovative ways to serve these needs.

## 5. Conclusion

While financial liberalization delivered in some aspects during the 1990s, its benefits are likely to lie in the future and to depend on further institutional reforms. The crises of the 1990s, and the limited contributions of liberalization to growth and access to finance, reflect to a large degree the continuation of the weak institutional framework related to the overhang of the old financial system and, more fundamentally, the persistence of old political and economic power centers. The freeing of interest rates and credit allocation increased resource mobilization. But the persistence of the former institutional framework meant that resource allocation improved less rapidly. Implicit and explicit guarantees, by removing market discipline, contributed to excessive expansion of lending for the low-productivity projects of well-connected borrowers. Weak regulation and supervision reflected not just technical problems but also political pressures for regulatory forbearance. Large, generalized liquidity support during the crises often went to favored parties that bought foreign exchange with it. Information, which might have helped market discipline and limited excessive lending had guarantees been less, was not a focus of regulation, and it suffered from the lack of transparency typical of many developing countries. Limited credit access reflected the crowding out of public sector and central bank borrowing. In addition, it reflected a lack of information related not only to technical issues but also to the unwillingness of established intermediaries to share information on their borrowers. Weak legal and judicial frameworks, designed to protect borrowers and often responsive to economic and political elites, reduced the incentives to service debts and made it difficult for new borrowers to gain access to finance by pledging collateral effectively. Capital markets, which might have absorbed some of the shocks, grew slowly because of the weak institutional framework and underlying structural problems.

The lessons of the 1990s are that improving the contribution of finance to growth depends heavily on macroeconomic stability, governments that are willing to take steps to limit unsustainable booms, a market-based approach, and the quality of institutions (financial intermediaries, information, and the quality of the legal and regulatory framework). The quality of institutions was not changed much by the stroke-of-the-pen liberalizations of interest rates and credit allocations. Improving these institutions, and thereby improving financial intermediation, will depend on institution building, better informational and legal frameworks, and, ultimately, more competitive political systems. Success will depend on a mix of increased market discipline and limiting guarantees, better regulation and supervision that includes encouraging greater market discipline of intermediaries, greater participation of reputable foreign banks, and capital market development. Government is needed to support better markets, without intervening excessively in them, backed by an open political process that limits the distortions of finance in favor of well-connected parties.

## Notes

1. As Lenin cogently put it, "The big banks are the state apparatus which we need to bring about socialism and which we take readymade from capitalism" (quoted in LaPorta, López de Silanes, and Shleifer 2002a, 266). Thus communist, socialist, and planned economies nationalized domestic and foreign commercial banks. Gerschenkron (1962) was among the first to provide academic support for the provision by government and state banks of funds for industrialization and long-term credit. In addition to state banks, specialized development finance intermediaries, generally public, were set up to provide credits for small-scale industry, agriculture, housing, and long-term industrial credit. They were financed by government-guaranteed external borrowing, including bilateral and multilateral loans; by low-cost directed credits from banks and other intermediaries; and by government revenues. Often these intermediaries went bankrupt, reflecting failures to collect debt service and dependence on unhedged external borrowing.
2. For example, Brownbridge and Harvey (1998) describe such financial repression in Africa.
3. Dornbusch and Edwards (1991); Alesina, Grilli, and Milesi-Ferreti (1994); and Garrett (1995, 2000).
4. Estimates of aggregate subsidies range from 3 to 8 percent of GDP annually (World Bank, *World Development Report 1989*; Hanson 2001). Regarding allocations, in Costa Rica in the mid-1970s for example, the public Banco Nacional's interest rate subsidy on agricultural

credits was equal to about 4 percent of GDP and 20 percent of agricultural value added. About 80 percent of the credit went to 10 percent of the borrowers; the average subsidy on these loans alone would have put each recipient into the upper 10 percent of the income distribution (World Bank, *World Development Report 1989*). The situation in other countries was similar. See Adams and Vogel (1986); Adams, Graham, and Von Pischke (1984); Gonzalez-Vega (1984); and Yaron, Benjamin, and Piprek (1997). Larger firms often accessed directed credit and on-lent it to their suppliers, capturing the spread between repressed and free rates. Directed credits were also diverted into loans with free rates, for example through curb markets, or, when some deposit rates were freed, into deposits that paid higher rates than the loan rates on directed credits.

5. Abiad and Mody (2003) note the link between greater openness to trade and financial liberalization.
6. Capital controls, particularly in the context of macroeconomic imbalances, increase incentives for corruption, worsen the income distribution, and, because they fail, create disrespect for laws. Even in the 1970s, a high proportion of the massive capital inflows into Latin America leaked out (Dooley et al. 1986). More recently, in China, net short-term outflows of capital and errors and omissions in the balance of payments were very large (World Bank 1997a, 2000c).
7. For example, in Mexico after the post-1982 high inflation, the limits on interest rates on agricultural loans were below the rates on some deposits for a period. Rural borrowers often simply took their loan proceeds and deposited them, earning a positive return on the loans with much less effort than by farming.
8. Abiad and Mody (2003).
9. Stock markets were opened to foreign investors between 1986 and 1993 in the major East Asian and Latin American countries and in India and Pakistan (Bekaert, Harvey, and Lundblad 2003).
10. Levine and Zervos (1998); Levine, Loayza, and Beck (2000).
11. The sharp fall in inflation in the 1990s made interest rates more realistic, even with declines in nominal rates; it also reduced other financial distortions associated with inflation. Among the 25 developing countries with the largest financial systems, those with hyperinflation at the beginning of the 1990s reduced inflation sharply (in some cases, such as Argentina, to single digits), while most of those with initial inflation of 10–50 percent annually reduced inflation to single digits by 2000. In Africa, inflation also fell and in most transition countries, inflation fell sharply from initial high levels.
12. Foreign currency holdings also were often large relative to financial systems (Hanson 2002).
13. As an example of the popularity of these measures, in Peru after hyperinflation at the end of the 1980s, the 1993 Constitution (Article 64) guaranteed citizens the right to hold and use foreign exchange. More than 50 percent of deposits are in dollars, even in the non-Lima savings banks.
14. The interest rates on foreign currency credits avoid the high, up-front cost of an expected depreciation that may not occur for some time—the "peso problem"(Hanson 2002). This improves cash flows (lower deficits for governments using cash accounting) and increases a loan's effective maturity. Moreover, when a depreciation does come, the cost is spread out in the amortization period. Not surprisingly, governments borrow externally and, many countries, for example Mexico in 1994 and Brazil and Turkey recently, have indexed some domestic debt to foreign currency. For private firms, there is also the hope that a depreciation may lead to a government bailout, either by a favorable takeover of their foreign loans or an asymmetric conversion of domestic foreign currency debts and deposits to local currency, as occurred in Mexico (1982) and Argentina (2002). However, foreign currency loans do increase bank risks, even when matched with foreign currency deposits, since the borrowers may not have easy access to foreign currency earnings. Banks could have adjusted the foreign and domestic currency proportions of their balance sheets by varying interest rate differentials, but, given the demand for foreign currency deposits, the spread probably would have been high, creating moral hazard problems in loans in domestic currency.
15. These figures understate the relative growth of public sector debt because they include China, where deposit growth was large and banks' accumulation of government debt was relatively small, but the accumulation of state enterprise debt was large. In those transition countries for which relevant data are available, privatization reduced borrowing by public enterprises, thereby offsetting the rise in government debt, but deposits grew only slowly and were largely absorbed by increased central bank debt.
16. Note that these figures understate the growth of private credit in India and East Asia before 1997 and overstate it after 1997, because of the growth and decline of the nonbank sector.
17. Government debt was either injected into the banks as part of restructurings or, in the case of deficit finance, sold at whatever rates would ensure its purchase. Thus, as a first-order approximation, the supply was inelastic (except for changes in the proportions sold internally and externally). The liquidity, low risk, and low capital requirements on government debt affected only the rate

differential between the debt and private credit that was needed to crowd out the equivalent amount of private credit, rather than the amount of government debt held, which was determined by the inelastic supply.

18. In some cases, the central banks also temporarily acted as large lenders of last resort.
19. The increase in external assets probably reflected an attempt to hedge the risks from their foreign currency liabilities, including deposits (Honahan and Shi 2002). Although banks' net external positions were small in 2000, gross external assets and liabilities were much larger than earlier (Hanson 2003b), suggesting that financial liberalization had increased banks' ability to diversify themselves.
20. For statistical evidence on the importance of private sector credit in growth see Levine and Zervos (1998); Levine, Loayza, and Beck (2000). The evidence of the link between savings/investment and financial sector liberalization is mixed (see, for example, Bandiera et al. 2000), but the investment ratio does seem to have risen in the 1990s in the larger Asian countries, though not in the larger Latin American countries and it actually declined in the larger African countries. The difference between saving and investment ratios may, of course, reflect differences in capital inflows.
21. Crises, unproductive credits, and their links to the unreformed institutional and political framework that remained after liberalization are discussed in the section below on financial crises.
22. Stock markets were reported as of 1991 in Hungary and Poland; in 1994 in Croatia, the Czech Republic, Romania, Russia, the Slovak Republic, and Slovenia; in 1995 in Bulgaria, Latvia, Lithuania, and Mongolia; in 1996 in the Former Yugoslav Republic of Macedonia, Moldova, and Uzbekistan; and in 1997 in Estonia, Kazakhstan, and Ukraine (Standard and Poor's 2003).
23. This average is for the 17 of the 25 largest financial markets for which data are available on banks' domestic credit to the private sector. It excludes China, India, and Korea, which do not report separate data on private sector credits. These three countries are large external borrowers in absolute terms but are likely to have smaller ratios of private external borrowings to bank credit than the average for the 17 countries.
24. The additional currency risk of these funds was less than it might seem, as domestic credit in many countries was increasingly denominated in foreign exchange.
25. "[The state banks'] commercialization as joint stock companies was not accompanied by sufficient commercialization of their credit management, product development, service levels, operational efficiency, or risk management. All this meant poor loan performance and eventually insolvency. Many factors worked against early detection of such problems—poor accounting and auditing standards, inexperienced supervisory personnel, inadequate prudential regulations, decentralized and incomplete information systems (often branch accounts not consolidated with headquarters accounts) and the traditional reliance on the government for additional funding when liquidity became short.… Management information systems were weak. All these factors worked against timely and effective scrutiny of management behavior" (Sherif, Borish, and Gross 2003, 21–22).
26. Western European banks entered Eastern Europe hoping to gain market shares before the European Union expanded. The shares of foreign banks in the number of banks and in total bank assets grew rapidly in Bulgaria, the Czech Republic, Hungary, and Poland. In Russia and Ukraine, however, foreign banks represented only a small fraction of the total number of banks, even in 2000 (Sherif, Borish, and Gross 2003). In Latin America, Spanish banks became a major force by taking over state and private banks. In Africa, foreign banks reentered and South African banks were playing an increasing role in southern Africa at the end of the 1990s.
27. Research suggests that in Latin America foreign banks are at least as good as domestic banks at lending to small firms (Clarke et al. 2004), and in India foreign banks' lending to small and medium-size firms has grown faster than that of state banks.
28. Indonesia took liberalizing bank entry to an extreme, with almost "free banking" (box 7.5). Russia and Nigeria later followed a similar approach. Most new banks in these countries were "pocket" banks, capturing funds for their owners' firms. In Indonesia, these banks were hit hard by the crisis and proved costly to the government when deposits were guaranteed.
29. Caprio and Klingebiel (2002) list 117 systemic financial crises (in which most of banks' capital was exhausted) in 93 countries and 51 borderline crises in the period 1970–99. See also Sundararajan and Balino (1991) and World Bank, *World Development Report 1989*.
30. Argentina, Russia, and some African countries had high public sector debt compared to public revenues (IMF 2004a). Other countries, notably in East Asia, had high private debt, including high external private debt, relative to GDP. Variants of exchange rate–based stabilization were being used by Argentina, Chile, and Uruguay in the late 1970s and by Argentina, Brazil, and Mexico in the 1990s. Other countries, notably the East Asian countries and Turkey in the 1990s, limited the flexibility of their exchange rates. The relation between the 1990s crises and the current account deficits is similar to but not the same as "Generation I" models of balance of payments crises (Krugman 1979). In the 1990s crises, the problem was not just financing the current account

deficit but net amortizations of long- and short-term loans, which could change suddenly.

31. Portfolio adjustments to improved investment opportunities generate rapid inflows initially, followed by a slowdown in inflows and net negative foreign exchange flows (because of interest payments that require internal adjustment).
32. See, for example, Demirgüç-Kunt and Detragiache (2002); and Kaminsky and Reinhart (1999). In the crises of the early 1980s, high U.S. interest rates, as well as the fall in petroleum prices, probably played a role, while lower interest rates contributed to the large capital inflows to developing countries in the early 1990s and again recently. The rise in international interest rates that started in 1993 probably contributed to a gradual tightening of credit conditions for developing countries.
33. A substantial literature has evolved over the possibility that the crises in the 1990s, particularly those in East Asia, reflected contagion in financial markets, not fundamentals; see Claessens and Forbes (2001) and works cited there. Contagion is one explanation of "Generation II" models of crises in which there are multiple equilibria, associated with high and low rates of capital inflow. No doubt international investors exhibit some herding behavior for various reasons. Another explanation is that events in one country could lead external investors to reevaluate the subjective risks in others and reduce their exposures. This also would seem like contagion.
34. The lag between liberalization and crises seems fairly long (Demirgüç-Kunt and Detragiache 2001, 105). The lag may also reflect the difficulty of pinpointing liberalization and crises, both of which occur over time, as discussed in Eichengreen (2001). Demirgüç-Kunt and Detragiache (2001) date liberalization from the removal of some interest rate controls and note that the estimated lag may reflect the gradualness of interest rate liberalization. Of course, the initial rise in deposit interest rates may also reflect part of a defense against a run on the currency, as for example in India in 1991. The lag between financial crises and currency crises may reflect liquidity support to weak banks at the start of financial crises, as discussed below.
35. See Diaz Alejandro (1985); the capsule discussions of country experience in Sundararajan and Balino (1991, 40–49); and the descriptions of financial crises in Kindleberger (2000).
36. Of course, this explanation is related to Generation II models of crises, discussed in footnote 33.
37. State banks have not been closed without paying off depositors, except in a few African countries.
38. The United States has required intervention in weak banks well before capital is exhausted, and explanations if bank failures lead to deposit insurance payments (Benston and Kaufmann 1997). It is unclear how well this approach would work in developing countries.
39. Even if small depositors are promptly paid off, large depositors may switch to foreign exchange.
40. Arioshi et al. (2000); Dooley (1996). The Malaysian controls are often cited as an example of effective controls, but they were put in place after the crisis was largely over (World Bank 2000c).
41. To paraphrase William McChesney Martin, former chairman of the U.S. Federal Reserve Board, the role of governments is to take away the punchbowl before the party gets too wild.
42. Such government behavior occurs not only in developing countries but also in industrial countries, for example in the U.S. savings and loan sector before its crisis.
43. This weakness would have existed even if good information had been available.
44. Interestingly, additional deposits often flowed into state banks during these periods. Despite the weakness of their lending, the public typically considered them to have better guarantees. These banks, in turn, often made additional loans to weak borrowers.
45. See, for example, Klingen et al. (2004).
46. Financial liberalizations, even gradual ones, are not easy to manage. Errors in liberalization are not always technical; they sometimes reflect pressures by influential groups.
47. Financial liberalization also tended to increase the fiscal deficit and make it more costly to finance, as the government lost seigniorage revenues and had to pay more market-based interest rates on its debt.
48. World Bank (1998a) describes the substantial strengthening of Argentina's financial system in the mid-1990s.
49. Some policies and some countries will of course deviate from the general trends. Some governments where democracy is limited may attempt to impose capital controls and return to the inflation tax as a means of capturing resources. And many countries remain concerned about the narrowness of credit access for their citizens, and seek ways to provide funds for rural and small and medium-size enterprise lending at below-market rates through specialized intermediaries, notwithstanding the past failures of this approach and the increases in access that are occurring.
50. Such debt is not completely bad—it can serve as a liquid asset to improve the payments system and as a way for individual banks to deal with limited runs. However, governments' low revenue-generating capacities make it difficult to service these debts, lead to cuts in public social and infrastructure spending, and divert governments from developmental issues by the day-to-day

problem of rolling over the debt, raising the risk of a return to inflationary finance. These potential problems have been eased by the fall in interest rates worldwide. However, when interest rates begin to rise again, and the costs of debt service correspondingly increase, the problems may reappear.

51. International equity market markets can also act as a shock absorber, but only the largest and most transparent firms can list in these markets. Offshore bond markets also are developing in private as well as public bonds; they reduce the risk of credit crunches but increase currency risk.
52. Protecting supervisors completely from legal action raises another issue, the risk that they will engage in malfeasance. Hence, a tribunal separate from the court system is needed to deal with accusations of malfeasance by supervisors.
53. For example, making loans for scooters, cars, and homes to workers in the formal sector who often cannot be fired; making loans to farmers that are repaid by deductions from the contracts the farmers have with crop buyers; and lending to small and medium-size enterprises either through larger firms or by discounting their orders from such firms.