CHAPTER 1

Introduction

Gerard Caprio, Jr.

> Money . . . is a machine for doing quickly and commodiously what would be done, though less quickly and commodiously, without it; and like many other kinds of machinery, it exerts a distinct and independent influence of its own only when it gets out of order.
>
> John Stuart Mill

> One can easily exaggerate the importance of finance, both when it is skillfully conducted and when it is not, but the suggestion that it usually falls into line and accommodates real forces – discoveries, inventions, population change, and the like – stretches belief.
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> Charles P. Kindleberger, *A Financial History of Western Europe*

Interest in reforming financial markets in developing economies has been rising, especially since the early 1980s, in part as a result of the reduction in international lending by commercial banks and the consequent need to increase domestic resources and maximize the efficiency with which they are invested. Reform programs also have often been the by-product of recognition of widespread financial distress. Developing countries' authorities that have embarked on reform recognized the inefficiencies associated with heavy intervention in the financial sector, especially with interest-rate controls and large directed-lending programs, and in many cases also were responding to difficulties in maintaining the efficacy of controls. Moreover, reforms have by no means been confined to developing nations: Rapid and sizable declines in computing and communication costs, product innovation, increased competition, and deregulation have changed the financial landscape in many industrialized countries in the last 20 years.[1]

Attempts to adopt more market-oriented policies plainly have not been limited to the financial sector. Many developing and formerly socialist economies have begun in recent years to adjust their so-called real – that is, nonfinancial – sectors through deregulation of prices, realignment of overvalued currencies, reductions in the degree of protectionism, and decreases in inefficient government expenditures. In this environment, efforts to reform finance often reflect a general reconsideration of government's role in the economy. The near simultaneity of financial sector and real sector reforms complicates attempts to evaluate the separate contribution of either.

Moreover, the types of financial reforms undertaken in developing countries subsume a diversity of phenomena. Various expressions, such as deregulation, liberalization, innovation, privatization, and internationalization, have been employed to describe different parts of the process. A key aspect of most reforms has been a shift toward market-oriented allocation of credit through an easing or abandonment of portfolio requirements, directed-credit programs, and credit and interest-rate ceilings. In some cases, public sector entities have been privatized and entry, by domestic and foreign institutions, has been eased. Decreased segmentation between different branches of the finance industry has promoted greater competition among various types of intermediaries. New financial products and new combinations of existing instruments have appeared and, less frequently, barriers to international capital transactions have been reduced. Last, reform programs at times have included a reduction in the taxation of the financial sector. To be sure, these changes have been neither uniform nor universal, and have depended not only on the disposition of the authorities but, often more important, on the institutional structure preceding reforms. As will become clear in Parts II and III, the reform episodes reviewed here constitute a diverse set of experiences.

Financial reform has been recognized to have both benefits and costs. Borrowers and investors usually gain a wider choice of financial products (added breadth), including new and increasingly sophisticated tools for hedging various risks, and may enjoy lower transactions costs as well. Some observers expect savings to rise, though the more certain effect is that the portion of saving intermediated by the financial sector rises with increases in real interest rates and with added savings vehicles. The financial sector itself usually is expected to become more efficient following liberalization. Moreover, and most important, a more market-based allocation of capital is expected to enhance efficiency by allocating capital to its most productive uses. However, at least until now, there has only been some broad macroeconomic evidence pointing toward efficiency gains; Part II includes evidence, using firm-level data, which confirms the presence of these gains following the onset of financial reforms.

Some countries have clung to controls, perhaps out of concern for the destabilizing forces that could be released by reform. Financial reform entails a number of risks, associated with more variable asset prices and the consequences of trying to operate financial markets with institutions and a supervisory framework often unsuited to evaluating the risks inherent in a liberalized system. Most notably, bank behavior is susceptible to significant change following reform, especially if state intervention previously had been shielding bankers from market forces. Two dramatically opposite reactions – on the one hand, a retrenchment from all but the lowest-risk lending and, on the other, a reckless expansion of lending, even to insolvent clients – have been observed following reform.

Moreover, the manner in which monetary policy is implemented often must change following reforms. Officials long accustomed to direct methods of implementation often are reluctant to adopt less direct and seemingly less certain instruments.[2] Even more visibly, those countries that deregulated interest rates often saw them rise relative to actual inflation rates and, in some cases, remain at elevated levels in (ex post) real terms for extended periods of time. Dramatic fluctuations of real rates have also been noted. In certain countries interest rates increased generally, while in others spreads rose, reflecting changed tax or reserve policies, or perceptions of increased risk.

In fact, some experiences – most visibly, the episodes in South America (in the "Southern Cone"), during the late 1970s and early 1980s with sustained high real interest rates and financial crises – have been sufficiently turbulent to deter officials of developing countries from liberalizing. Indeed, many identify financial reform with these episodes. Chile, Argentina, and Uruguay suddenly reformed highly controlled financial markets in the 1970s and saw a dramatic expansion of intermediation centered around instruments with short maturities and high returns. In Chile, for example, the period was one of increasing domestic and external indebtedness, high real interest rates, and financial crisis (1982–3), ultimately requiring massive bailouts of a large portion of the domestic banking system. Many of these problems cannot be laid at the doorstep of the financial sector: A perverse macroeconomic environment (and policies) and a series of real shocks are widely recognized as having played an important role in the crisis. Still, the Southern Cone experience has been generalized to suggest that financial reforms should be delayed until after real sector adjustments have been made.

In addition to misleading relative prices, poor decisions by financial institutions were related at least in part to an underinvestment in risk assessment and monitoring skills during the long period of repression, as well as to portfolios dominated by nonperforming loans at the start of the reform process. Officials in liberalizing countries, when confronted by high real rates and collapsing financial institutions, have tended to slow or halt further liberalizing moves.[3] An emerging consensus, and one that is based overwhelmingly on the Southern Cone experience, appears to be that gradual financial liberalization – indeed, perhaps very little – is to be preferred. Cho and Khatkhate (1989), McKinnon (1988), and Villanueva and Mirakhor (1990) all urge caution in liberalization, emphasizing the achievement of macroeconomic stability and adequate bank supervision as preconditions for successful financial reform, while Calvo (1988) and Rodrik (1989a,b) use credibility arguments to support a narrow focus of adjustment programs, leaving the financial sector for last.

Dornbusch and Reynoso (1989) are even more doubtful about the benefits of liberalization in all but the most repressed economies, arguing that it instead exacerbates macroeconomic instability by robbing the government of tax revenue. Indeed, they go so far as to echo the sentiments of John Stuart Mill when they state that "financial factors are important only when financial instability becomes a dominant force in the economy."[4] This sentiment is an extreme, old-style Keynesian (but certainly not Keyneslike) view of the world, namely that money – worse still, the entire financial system – is just a veil. And the apparent consensus is supported by the notion that since asset prices adjust quickly and may be prone to overshooting, they should be restrained, perhaps permanently. One point made in this book is that while asset prices adjust quickly, financial institutions do not, hence the need to begin some financial reforms – those on the institution-building side – early in the broader reform effort. In terms of the epigraphs to this chapter, the view of Kindleberger seems more defensible than the view associated with Mill, especially given the efficiency gains that were uncovered in this study.

The intellectual heritage for the modern approach to financial sector reform dates back to the work of Gurley and Shaw (1955), and found its more recent expression for developing countries in the seminal works of McKinnon (1973) and Shaw (1973). Their argument, in brief, was that financial repression – a combination of heavy taxation, interest controls, and government intervention in the credit-allocation process – led to both a decrease in the depth of the financial system and a loss of the efficiency with which savings are intermediated. This argument has been extended to suggest that immediate and complete liberalization of finance is a preferred approach, but several papers, including the aforementioned work by McKinnon (1988), suggest at least a more gradual approach to reform. The seminal article by Stiglitz and Weiss (1981) emphasizes that even a free market system may be characterized by credit rationing, suggesting therefore that neither a rapid nor complete withdrawal of government from credit decisions is likely to be optimal.

With all of this controversy, it is timely both to reexamine the role of finance and financial reform, and, most important for policymakers charged with decision making about the financial sector, to look at a diverse group of cases to see how countries have reformed their financial sectors and how they have fared. This book is intended to do both.

Scope of the study

The present study, which took shape in the form of two research projects organized at the World Bank beginning in 1989, aims to examine financial reform analytically and empirically, focusing several key issues:

- The relationship between the financial and real sectors, and how these linkages affect reforms
- The behavior of banks around the time of reform, and how this behavior can affect the economy at large
- The process of reform and the sequencing of various elements, including in particular the timing of opening of the capital account
- The impact of financial reforms on the efficiency with which capital is allocated

The first part of the study focuses on theoretical and empirical overviews of some of these issues. Chapter 2, Finance, public policy, and growth, by Mark Gertler and Andrew Rose, applies insights from the recent literature to draw out the connection between finance and macroeconomic performance, emphasizing how the financial sector depends on real sector performance and how this dependence affects the reform process. Chapter 3, Banking on financial reform? A case of sensitive dependence on initial conditions (Caprio), complements this analysis by focusing on the behavior of banks and on how various aspects of their initial condition at the time of reform can affect subsequent performance. This chapter also touches on the links between structural (real sector) and financial sector reforms; here, in effect, the links go both ways, but the emphasis is on the dependence of the real sector on finance.

Chapter 4 examines the real effects of financial sector reforms in selected economies for which detailed firm-level data were obtained. Many have doubted the importance of finance, but in this chapter Schiantarelli, Atiyas, Caprio, Harris, and Weiss provide concrete evidence of real sector effects of financial reform. We also find cases in which small firms become less credit constrained following financial reform, in contrast to the branch of the literature that suggests that market-oriented financial systems tend to ration credit to small firms.

Part II, on the reform experiences, begins with an overview of the case studies it includes (by Atiyas, Caprio, and Hanson). It summarizes the macroeconomic background on the eve of reform in the countries covered, surveys the initial state of their financial systems, succinctly reviews the steps taken, and comments on the adjustment issues following the onset of reforms.

The case studies of domestic financial reform for Turkey, New Zealand, Korea, Indonesia, and Malaysia present the elements of the financial reform experiences and focus on the key issues in each episode. A variety of factors determined country coverage. Malaysia and Korea are known to have reformed at a very gradual pace, and are usually viewed as success stories, so it seemed logical to include them. New Zealand is at the opposite extreme, having reformed at least as abruptly as any of the Southern Cone countries but without some of the latter's macroeconomic constraints.[5] Turkey and Indonesia present interesting "in between" cases, with reform programs that are rapid in some areas and gradual in others, so they offer an intriguing middle ground.

Part III, on links between domestic and international financial reforms, commences with Chapter 11, by James Hanson, who focuses on the analytics of when to open the capital account. Domestic and international financial liberalization can be accomplished simultaneously or in different sequences, with the overwhelming body of the literature arguing that the domestic financial system should be liberalized first, and that international liberalization can be delayed. Hanson reviews the literature in this area and questions both the optimality and practicality of delaying capital account opening, and notes that it is a process that must be managed.

Chapter 12 follows with a study of the Chilean case. Much of the domestic financial reform story is well known for Chile, but the role in this process of its international financial reform effort has been of a "post hoc, ergo propter hoc" nature. An open capital account and large inflows were followed by, and perceived to have contributed to, a period of economic instability in Chile. However, Chapter 12 analyzes Chile's experience with capital account opening and argues that this popular conclusion is at best misleading, as a variety of other factors were dominant in their role in the crisis. Moreover, Salvador Valdés-Prieto maintains that the precise manner in which Chile opened its capital account, by not allowing banks to perform international financial intermediation until several years after nonbanks were performing this function, may have contributed to these problems. This chapter also shows clearly the consequences of allowing free entry into banking, which erodes the franchise value of bank licenses.

Chapter 13 ends with a review of some of the main lessons of the reform experiences studied here, and sketches the elements of a strategy for financial sector reform. The main lessons concern the importance of real and financial sector linkages in financial reform, and of the initial conditions in the banking sector. Not just analytically but in practice a number of sequences appear sustainable, including that of reforming the domestic financial system with an open capital account. However, where this unconventional sequence appears to have worked, special factors may well have helped to prevent the disasters feared in the literature. In particular, the domestic authorities achieved fiscal control and thus were able to avoid excessive reliance on taxation of financial intermediation.

The importance of institutional development – arguably the key initial condition in the financial sector – comes through in the experience of reforming economies and thus is emphasized both among the lessons and in the construction of a strategy in reforming a financial system following a period of marked government intervention. Countries that begin reform attempts with a heavily repressed financial sector will need to devote much time and effort in developing market-oriented institutions, staff, and incentives. Reforms can readily encounter severe problems, as in the Southern Cone in the 1970s and Turkey in its first reform attempt, when these fundamentals are ignored.

For those readers not inclined to wade through the entire volume, in addition to the summary chapters, those concerned with the issue of monetary control and financial reform will find Chapter 7 (New Zealand) of greatest interest, as well as Chapters 9 (Indonesia) and 10 (Malaysia). Chapters 8 and 10 will appeal not only to those who enjoy (still) happy endings, as Korea and Malaysia certainly stand out on various macro indicators, but also by those interested in comparing how significant nonperforming loan problems were handled, in particular the related difference between these two countries in the balance between banks and nonbanks as a result of reforms (or lack thereof). Readers interested in reform in more difficult macroeconomic circumstances will likely first jump to Chapters 6 and 7 (Turkey and New Zealand), to see how authorities there have either stayed or strayed from the reform course. And, as noted, Chapters 10 and 11 are for those most interested in reconsidering the conventional wisdom on sequencing of domestic and international reforms, while Chapters 2 and 3 offer a conceptual framework of finance and its reform.

Both the country coverage and the topics highlighted were chosen on the basis of their perceived relevance to policymakers, in addition to the availability of data. All of these liberalization experiments have attracted the interest of government authorities worldwide, but often there is a misunderstanding of the actions taken and the apparent results. Most important, misconceptions about reform attempts often induce authorities to resist changes for fear of repercussion, when in fact, as in the case of Chile, the disturbances experienced appear to have been the result of a number of perverse circumstances. It is hoped that the cases presented here provide a more balanced mix of successes and failures.

As is emphasized in several places, the reform effort in these economies is not over, and financial reform is most definitely not an event, but rather a process. The episodes reviewed in this book are relatively recent, and their evaluation will undoubtedly continue for many years to come, as is the case with ongoing reexaminations of finance in various industrialized economies. However, authorities in developing countries facing the need to utilize their domestic resources more efficiently cannot await "final" lessons, but rather must make decisions based on what is known at present. In view of the determination of authorities to continue the reform process, albeit at different paces, they certainly seem convinced of its benefits. And the very real efficiency gains turned up in Chapter 5 suggest that they are right. So to recall again Kindleberger, it is easy to exaggerate the role of finance, but the papers presented here suggest that it is a key sector in economies, and in many of them it is one in which the direction of change, in favor of less intervention, rather than more, remains clear.

NOTES

1 Australia, Denmark, France, Greece, Italy, Japan, New Zealand, Portugal, Spain, Sweden, the United Kingdom, and the United States are prominent among the industrialized countries in their liberalization efforts.

2 Perceived complications for monetary policy, which have been noted mainly in the industrial countries, include enhanced substitutability among financial assets and the loss of precision involved in the reliance on indirect means of achieving monetary targets. In part, however, these changes have resulted not just from changes in the way monetary policy is implemented but from competition and technology, both of which have combined to make more and better substitutes for money.

3 To take two examples, in the United States, despite the popularity of deregulation in the last 15 years, the combination of the savings and loan (S&L) crisis and the stock market crash of 1987 has put moves to dismantle the Glass–Steagall act on hold. The Zambian authorities reregulated interest rates even though ex post real rates remained negative throughout the 18-month period of freely determined interest rates, in part reflecting high and variable inflation.

4 Dornbusch and Reynoso (1992, p. 204).

5 While New Zealand's presence may be objected to in a volume otherwise focusing on developing countries, it is useful to note that with 35% of GDP in the agricultural sector, it is the least industrial of the economies of the member-countries of the Organization for Economic Cooperation and Development (OECD) and actually is more commodity oriented than some countries classified as developing. Also, the uniqueness of its reform effort and the relevance for transitional socialist economies were advantages that could not be resisted.

PART I

REFORMING FINANCE: APPROACHES AND IMPORTANCE