This book examines the analytical basis and practical experience of financial reforms in a number of countries, primarily developing countries. A key finding is that financial reforms have led to improved resource allocation – an a priori belief not hitherto tested. This finding is consistent with the argument that efforts in developing countries to maximize efficiency of resource utilization cannot be underestimated in their importance. Three key lessons suggest the importance of managing the reform process rather than adopting a laissez-faire approach: First, more successful reform must take account of information capital; second, initial conditions in finance – balance sheets, human and information capital, and incentive systems – are fundamental in determining how to go about reform; and third, different sequences of reforms can be tolerated and, with certain preconditions, do well.

Financial reform

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Theory and experience

Edited by
GERARD CAPRIO, JR.
IZAK ATIYAS
and
JAMES A. HANSON
The World Bank

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Foreword

The reform of financial systems is an area of economics that has led broader swings in economic thought. At times economists – going back to John Stuart Mill – and policymakers have viewed the financial sector as irrelevant, except in times of crises, and hence have tried to repress finance and use it for the convenience of government. More recently, the pendulum has swung back toward Schumpeter, who viewed finance as the key sector for its role in allocating credit efficiently. In the past 20 years the move has been toward financial sector deregulation, in part out of ideology and in part in response to technological change, which has made regulatory arbitrage a popular sport. Among developing countries, initial reform efforts in finance – the Southern Cone experience – had such well-publicized problems that the reform effort lost some momentum.

However, other countries did persevere in attempting to reform their financial systems, not always as dramatically as in the earlier experiments, and in some cases in a less far-reaching manner. But reform they did, making it appropriate to look at these cases and review their successes and failures. While economists always want a bigger cross section and a longer time series, authorities in many countries, including those with very low incomes and the formerly socialist economies, need to know what has worked and what has failed. Thus the present study is without doubt a timely one.

The most notable finding, that financial reforms have led to improved resource allocation, confirms beliefs that had been held but had not previously been as convincingly tested. This finding is consistent with the argument that efforts to maximize the efficiency with which developing countries utilize resources cannot be underestimated in their importance. The three key lessons, that more successful

reform must take account of real sector links, that initial conditions in finance – balance sheets, human and information capital, and incentive systems – are crucial in determining how to go about reform, and that different sequences of reforms can be tolerated and may even do well, with certain preconditions, all suggest the importance of managing the process rather than adopting a laissez-faire approach. This message surely is crucial for countries emerging from a period of significant government intervention in resource allocation.

The study turns up some evidence that banks may need to be sheltered from competition at times of reform. What it does not address directly is whether or not this is more widely true. If governments are providing some type of deposit insurance, and if, judging from the experience of industrial countries, bank supervision alone is not sufficient to prevent large losses, then as I have argued elsewhere (with Jerry Caprio), it may make sense to increase the charter value of bank licenses so that bank management will have greater incentive to police itself.

This volume is part of the World Bank's ongoing effort to disseminate best practices in various aspects of financial sector reform, and it is hoped that it will be of value to policymakers and to those who study developing countries. Special thanks go to the Korea Development Institute, Bank Negara Malaysia, the Central Bank of Turkey, and the Reserve Bank of New Zealand, both for providing expert researchers and data. In keeping with usual practice, the views expressed should be regarded as personal ones: they do not necessarily reflect the views of any institution.

Lawrence H. Summers
Undersecretary for International Affairs, U.S. Treasury
Formerly, Vice President and Chief Economist,
The World Bank

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Gerard Caprio, Jr.

Contributors

Ismail Alowi
Bank Negara Malaysia

Izak Atiyas
The World Bank

John Chant
Boston University

Gerard Caprio, Jr.
The World Bank

Hasan Ersel
Central Bank of Turkey

Mark Gertler
New York University

James A. Hanson
The World Bank

John Harris
Boston University

Awang Adek Hussin
Bank Negara Malaysia

Dean Hyslop
Reserve Bank of New Zealand

Dimitri Margaritis
University of Waikato, New Zealand and Reserve Bank of New Zealand

Sang-Woo Nam
Korea Development Institute

Mari Pangetsu
Centre for Strategic and International Studies, Jakarta

Salvador Valdés-Prieto
Pontificia Universidad Católica de Chile

David Rae
Reserve Bank of New Zealand

Andrew Rose
University of California, Berkeley

Fabio Schiantarelli
Boston University

Lim Chee Sing
Bank Negara Malaysia

Sukhadave Singh
Bank Negara Malaysia

Andrew Weiss
Simon Fraser University

Zainal Aznam Yusof
Bank Negara Malaysia