FORGING GREATER INTEGRATION AND INTERNATIONALIZATION OF FINANCIAL MARKETS

A Policy Framework for A.I.D. Assistance to Developing Countries

Draft Final Report

January 15, 1991

Office of Government Services
1801 K Street, N.W.
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Price Waterhouse

January 15, 1991

Mr. Fred Kirschstein, AP/PPC/PDPR
Agency for International Development
U.S. State Department
320 21st Street, N.W.
Washington, D.C. 20523

Dear Mr. Kirschstein:

Attached please find ten (10) copies of our Draft Final Report on "Forging Greater Integration and Internationalization of Financial Markets--A Policy Framework for A.I.D. Assistance to Developing Countries." This report is the result of research conducted by FMIRI, subcontractor to Price Waterhouse under the Financial Sector Development Project (FSDP). We will look forward to receiving comments from you in order to put this report into final form.

It has been a pleasure to work with you on this activity. We look forward to continuing to work with you on other projects in the future.

Sincerely,

Barbara E. Friday

Barbara E. Friday
Deputy Director, FSDP

cc: Ms. Sandra Frydman, APRE/EM

Attachments

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A POLICY FRAMEWORK FOR A.I.D. ASSISTANCE TO DEVELOPING COUNTRIES

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A Report

to

U.S. Agency for International Development

FMIRI, INC.
WASHINGTON, D.C.

OCTOBER 1990

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FORGING GREATER INTEGRATION AND INTERNATIONALIZATION OF FINANCIAL MARKETS
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OVERALL REPORT

Introduction

U.S. Agency for International Development, as part of its Financial Sector Development Project, has commissioned the Financial Markets International Research Institute (FMIRI), Inc., to study the implications of the recent trend towards greater integration and internationalization of financial markets for the financial sector development in developing countries and to make recommendations to U.S. AID in its policy formulation for effectively assisting LDCs in this important sector of the economy.

The researchers of FMIRI, Inc., have prepared three reports for AID in 1990: a comprehensive Literature Review on the overall subject under the primary responsibility of Dr. Marta Oyhenart, and two country case studies on the Chilean Financial Sector by Dr. Fariborz Ghadar and on the Pakistani Financial Sector by Dr. Yoon S. Park. This Overall Report, prepared under the primary responsibility of Dr. Yoon S. Park, constitutes the final stage of this important project.

What are the major lessons learned in our study of the recent trend toward greater financial integration and internationalization? What is the current stage of financial market integration in various developing countries? And how can an international development agency such as AID help developing countries to adjust effectively to this change? Finance is a development resource, just as manufacturing inputs and labor are resources, the availability of which determines whether and which programs and projects are undertaken. As a key element of investment and growth, the efficiency with which financial resources are distributed within an economy largely determines economic growth. No matter what resources countries have in abundance, "the biggest difference between rich and poor is the efficiency with which they have used their resources. The financial system's contribution to growth lies precisely in its ability to increase efficiency."[1]

Development of efficient financial markets in developing countries has been severely constrained by the neglect of institution building in both private and public sectors. Efficient financial markets require a certain threshold in both the number

[1]World Bank, World Development Report 1989, p.26.

and variety of market institutions that compose the market infrastructure. Lack of adequate government support and regulatory back-up has also hampered the growth of essential market institutions in developing countries. Even when some LDCs retain market institutions, the latter often suffer from lack of expertise, capital, and experienced staff. Perhaps it is understandable that institution building does not take place overnight, and that it requires a careful strategy and long-term commitment on the part of the government as well as the market participants.

In recent years, however, promoting the efficient functioning of financial institutions and markets has become a major policy goal for many developing countries. The process of financial development has two dimensions: domestic financial deepening and international financial integration. While both dimensions are important to economic growth, they may become the cause of either success or failure of an economic plan, depending on the sequence and intensity of their implementation.

Domestic financial deepening refers to the promotion of financial activity and capital formation resulting from an increase in the level of competition in domestic capital markets. Some of the measures frequently used include elimination of credit controls and credit rationing, interest rate ceilings, differential reserve requirements, and also elimination of discriminatory practices and capital requirements that curtail free entry of local participants into domestic financial markets.

International financial integration occurs when exchange controls are removed and the capital account is freed to allow financial resources to flow freely in and out of the country. Barriers to the entry into the local market by foreign financial institutions are removed and their access to various financial services and market activities is liberalized. As a result, the domestic economy acquires the characteristics of the international economy, such as entrepreneurship, competition, innovation and dynamism. The free market compensates for domestic inflation with adjustments in the exchange rate and domestic interest rates. In theory, the speed with which inflation, exchange and interest rates reach equilibrium is evidence of the degree of integration between the domestic financial system and international financial markets.

Characteristics of International Financial Integration

International financial markets have enjoyed a remarkably long period of linear expansion over the past four decades. The Eurodollar market, which stood at around $10 billion in the late

1950s, has ballooned to $5 trillion now.[2] Total international banking assets, which were barely noticeable until the mid 1960s, have grown to close to $6 trillion now. The growth in international financial activities is noted not only in such stock measures as above but also in the flow aspect as well.

Cross-border international financial flows, including those related to Eurocurrency transactions and foreign exchange trading, are conservatively estimated at $1 trillion per every business day, or $200 trillion on an annual basis. The daily volume handled by the New York Clearing House Interbank Payments System (CHIPS), which clears mostly international financial transactions including Eurodollar and foreign exchange trading, averages about $1 trillion. In comparison, the Fed Wire network maintained by the U.S. Federal Reserve for domestic fund transfers handles a daily volume of about $700 billion on average. This large volume of cross-border financial flows may be compared to the total annual trading volume of goods and services, counting <u>both</u> exports and imports, of about $5 trillion on a worldwide basis.

It appears, therefore, that the total cross-border financial flows are about 40 times that of cross-border flows in goods and services. International financial flows, which in the earlier days were largely influenced by international trade, have now turned the table. In the international market, the tail now wags the dog, not the other way around.

Financial integration on the international scale can be measured not just in its numerical magnitude, though almost astronomically large counting in the units of trillions of dollars, but also in terms of its diversity in both financial products and services. A real-time 24-hour trading in foreign exchanges is well established. The global, continuous 24-hour trading now extends to many debt and equity securities as well as their derivative products such as futures and options in interest rates, currencies and indexes. The existing linkages among major international futures and options exchanges are likely to be further strengthened by the soon-to-be operational Globex trading system. We can expect a continuing expansion in the volume of global trading in interest rate and currency swaps, zero-coupon bonds, FRNs, Eurosecurities, major government securities and their derivatives such as CATS, TIGRs, LIONs, ZEBRAs. If the sun indeed sets in today's British Empire unlike her former colonial days, nowadays the sun never sets on Citibank, Nomura, Merrill Lynch and Dai Ichi Kangyo of the world in a literal sense. These international financial institutions can no longer afford missing even one hour of trading on the 24-hour trading market due to both the high risk and the high opportunity cost involved.

[2]IMF, <u>International Financial Statistics</u>, May 1990.

However, financial market integration, even though impressive by itself in both volume and diversity, has to be viewed within the broader context of the overall economic integration now in progress around the world. Apart from the EC 1992 economic and monetary union, opening up of Eastern European countries' economies, closer economic policy coordination under the aegis of the G-7 as well as the IMF Interim Committee and the Committee of Twenty-Four, etc., it has been an inexorable historical trend over the past several decades that national economies have become more open and more integrated into a world economy. Thus, we can consider financial market integration as an integral part of the worldwide economic integration.

Objectives of Financial Market Integration

Financial policy in developing countries has increasingly focused on the objective of improving the efficiency of the financial system, without, however, neglecting the two other main objectives, namely to ensure the stability and soundness of the financial system and to maintain an adequate level of investor protection. Efforts towards modernizing national financial systems have gathered considerable momentum since the early 1980s under the impact of increasing internationalization of financial markets and intensifying competition within and between national financial systems. Competition policies have become a major, although not the only, policy tool for improving the efficiency of the national financial systems. In this context it needs to be stressed that competition is not seen as a goal in itself; the ultimate objective is efficiency.

In implementing policies towards improving the efficiency of national financial systems, a wide range of measures have been devised to stimulate competition and strengthen the role of market forces. These measures include the deregulation of interest rates and other financial service fees such as stock broker's commissions to promote price competition and the liberalization of various financial activities to enhance the role of market forces.

A most striking feature of developments on the supply side of the markets for financial services has been the trend towards diversification and decompartmentalization, or blurring of demarcation lines between formerly separated sectors of the financial system. The driving forces behind this trend have originated both from the market side and from the authorities' side. While financial institutions have used diversification strategies as a major weapon for competing vigorously in the rapidly growing and increasingly widening markets for financial services and products, the authorities have generally supported this trend also, often in connection with broader financial reforms designed to improve the efficiency and the functioning of their countries' financial systems.

The diversification and despecialization process has no doubt been one of the major factors contributing to intensified competition in the vast markets for financial services and products, although the speed and intensity of this development has varied from country to country depending on differences in historical and legal frameworks and tradition and on regulatory changes. In the process of regulatory reform designed to build more integrated financial systems, the authorities have often paid considerable attention to the question of competitive equality and have taken measures to ensure that the "players" in the market compete with equal weapons on a level playing field.

Types of Financial Market Integration

Financial market integration manifests itself in three major formats: functional, regional, and international.

(a) Functional integration has lessened the operational identities among those financial institutions with formerly distinct product lines, such as commercial versus investment banks, savings and loan associations, insurance companies, postal offices, and consumer credit companies. Policies towards despecialization and diversification of financial services and products which banks and other financial institutions are allowed to offer, were generally more important in countries with historically more segmented financial systems than in countries with more open and homogeneous systems.

This applies in particular to savings institutions which in a number of countries traditionally acted as collectors and guardians of small savings that were to be channelled into narrowly defined uses such as housing finance or government securities. In most of these countries such savings institutions have gradually been allowed to become full-scale retail banking institutions and have thus been integrated with the banking system. In the United States, for example, the current S & L crisis has accelerated the trend towards transformation of S & Ls from traditional, narrowly-defined home financing services into broader full-service financial institutions.

In a similar way, the financial service powers of post office systems have sometimes been enhanced by the authorities with a view to making more efficient use in the distribution of financial services and products of the wide branch network that postal systems usually have at their disposal.

A third trend within the broader development towards diversification and the blurring of demarcation lines within financial systems has been the process of integration of the banking sector with the securities markets and the specialized institutions operating in them. This process has in particular affected those countries in which the two sectors have historically been separated by law or tradition. Among the industrialized countries, the United States, Japan and Canada are the main examples where the separation between commercial and investment banking has been maintained rather strictly, whereas in the Continental Europe and other countries the role of banking institutions has been traditionally more widely interpreted and practiced, including both commercial and investment banking activities.

In recent years, however, we are witnessing a growing trend toward broadening financial activities by banking institutions. Even the commercial banks of the United States and Japan can engage in investment banking activities outside their own home countries, while their domestic financial activities have been progressively liberalized and extended to include an increasing array of previously forbidden investment banking activities such as underwriting of certain corporate bonds, mortgage-backed securities and commercial paper.

Regional financial integration has been particularly noteworthy in commercial banking. In addition to providing more scope for price and product competition, the authorities have often taken measures designed to increase the number of competitors in the markets for financial services by the abolition of obstacles to territorial competition, i.e., by removing restrictions on the extension of domestic branch networks in the banking sector. In the United States, the McFadden Act of 1927 has effectively prohibited the development of inter-state or nationwide branch networks for U.S. commercial banks. The authorities now seem to believe that the ban on inter-state branch networks has negatively impacted the growth of the U.S. commercial banks in meeting the new international competitive challenges of large banking institutions from other industrialized countries such as Japan, Germany and the United Kingdom, where nationwide branching and/or universal banking (including the investment banking powers) has been freely allowed for a long time. Therefore, various measures have already been taken and others are on the way to dilute or even abolish the McFadden Act.

(b) <u>Regional financial integration</u> has also been accelerated by the technological progress in the financial system. Widespread installation of automated teller machines (ATMs) provides a powerful weapon for commercial banks to overcome any barriers to interstate branching. Technological breakthroughs in computers and telecommunication make it possible for a financial institution to more easily gain access to the previously blocked market regions. Furthermore, the "regional branch networks" have been increasingly adopted in the United States whereby neighboring states collectively allow branching by each other's commercial banks on a reciprocal basis. Thus, banks in Virginia, Maryland and the District of Columbia can now establish banking establishments freely within the tri-state region. The same is true for the banks in the New England states as well as in the South Eastern states of Florida, Georgia, South and North Carolinas, etc. In some developing countries such as Indonesia and Pakistan, commercial banks are more freely allowed to open branches nationwide outside their traditional banking markets, thus accelerating the trend toward regional integration in financial services.

(c) Internationalization or cross-border integration is perhaps the most significant financial integration. In fact, among the most noteworthy financial market developments during the past ten years have been the trend toward internationalization, financial innovation, and securitization. While all these three developments interact among each other, internationalization has been instrumental in providing a fertile ground for financial innovation and securitization. The degree of international financial integration can be seen by various measures to facilitate a free flow of capital and financial services across national boundaries.

International Financial Innovations

Both the richness and complexity of international financial flows bear a testimony to the robust spirit of financial innovations that has pervaded the globalized financial markets. Some of the innovations turned out to be faddish, but others have gained wide acceptance and made valuable contribution to the depth and liquidity of financial markets. Both the development of markets for new financial instruments and the expansion and deepening of markets for the pre-existing instruments are the results of the innovative spirit in the markets.

Financial innovation involves more than development and diversification of new borrowing sources. It affects the entire range of financial intermediation, both domestic and international. In fact, the variety of services offered by financial intermediaries has been equally impressive on the liability side of their balance sheets. Liability management of modern financial institutions has become an important part of their integrated approach to financial intermediation. Innovations on the liability side have significant policy implications for monetary authorities.

The rapid pace of financial innovations in recent years is due to several factors:

i) The first of these is the high level of interest rates worldwide since late 1960s. Not only the high level of interest rates but also the greater fluctuation of interest rates increased significantly the risk exposure of most market participants. Savers and investment managers have been exposed to larger capital losses, as well as capital gains, on their financial portfolios due to widely fluctuating interest rates, since the market price of debt instruments moves inversely with interest rates. Also, banking institutions that have traditionally engaged in maturity transformation by funding medium to long-term loans with short-term liabilities are subject to greater uncertainty over their funding costs due to widely fluctuating money market rates.

Financial institutions have devised various countermeasures to cope with this increased risk. On the one hand, the interest rates on medium to long-term loans have shifted increasingly from fixed rates to floating ones tied to certain short-term base rates such as three- or six-month LIBOR or the prime rate. Floating-rate loans significantly reduce the funding cost risk for financial intermediaries. Floating rates have been adopted not just for bank loans in the form of Eurocredits but also for long-term debt securities such as floating-rate notes. On the other side of their balance sheet, financial institutions have also diversified their liabilities and lengthened their maturities. The trend toward liability diversification in terms of both instruments and maturities has intensified recently concomitant with the general deregulatory movement in the financial sector.

High interest rates increase the opportunity cost of holding noninterest-bearing assets and encourage the economizing of such assets. Thus, high interest rates provide incentives for savers to shift out of demand deposits and into high-yield alternatives provided by new types of money market instruments. In order to slow down the disintermediation process, banks have had to devise new types of bank liabilities. Banks, forced to pay increasingly market-related rates in order to attract deposits, started to use actively a variety of new instruments for raising interest-sensitive funds, and they have also contributed to the creation of new secondary markets in which these assets are traded actively. Variable rate financing such as FRNs and floating-rate CDs have enabled banks to raise medium- and long-term funds at a time when fluctuating interest rates continue to act as a major disincentive for savers to purchasing and holding long-term investment assets. The fast-growing interest rate futures and options market also serves as an example of continuing efforts to reduce risk exposure created by high and volatile interest rates.

ii) The floating exchange rate regime, which has been in force since early 1973 with the breakdown of the Bretton Woods system, greatly increased the volatility of exchange rate movements, increasing the level of financial risk exposure for market participants similar to widely fluctuating interest rates. Before 1973, many economists expected exchange rates to be fairly stable under the flexible exchange rate system. Because most market-determined prices are not volatile, it was believed that the market-determined price of foreign exchange would not be volatile, either.[3] Instead of being stable, however, exchange rates have been highly volatile under the floating exchange rate regime. For example, the absolute percentage changes in the U.S.-German spot exchange rate between 1973 and early 1984 were 29.8 percent on a monthly basis and 107.4 percent on a daily basis.[4]

When spot exchange rates are volatile, the differences between forward exchange rates and future spot rates tend to be amplified[5], thus lessening the degree of accuracy of the forward exchange rate as a predictor of the actual spot rate on a particular future date. Widening divergences between forward exchange rates and the subsequently observed spot rates for corresponding dates increase the degree of risk present in the financial market. Innovations such as currency swaps, currency options and currency futures contracts reflect the attempt by market participants to mitigate or even circumvent the heightened exchange rate risk perceived during the past decade of floating exchange rates. A number of innovations in the financial market have been designed specifically to lessen the foreign exchange risk exposure for international investors. They include currency option bonds, commodity-linked bonds, and bonds denominated in SDRs and European Currency Units (ECUs).

iii) As the volume of outstanding loans to developing countries increased rapidly in the 1970s, international credit risk became a critical issue for financial intermediaries in the Euromarket. The current world debt problem has accentuated the need for devising new ways to deal with the mounting international credit risk in general. In an attempt to supplement or even substitute the traditional syndicated Eurocredit mechanism, the financial markets have experimented with a variety of new financing techniques such as bought deals, club loans, loan swaps, participation certificates, revolving underwriting facility (RUF),

[3]For example, see Harry G. Johnson, "The Case for Flexible Exchange Rates," Federal Reserve Bank of St. Louis Review, June 1969.

[4]Craig S. Hakkio, "Exchange Rate Volatility and Federal Reserve Policy," Federal Reserve Bank of Kansas City Economic Review, July-August 1984.

[5]See, for example, International Monetary Fund, Annual Report 1982, Washington, D.C., 1982, pp. 42-45.

primary underwriting facility (PUF), and so on. These innovations are intended for certain specific needs perceived in this era of heightened international credit risk.

iv) Another reason for proliferation of financial innovations was the rapid development of computer and communications technology, which has provided financial institutions with the capacity to process massive amounts of data and to make financial transfers rapidly and economically. The introduction of such new technology contributes to greater transactional efficiency and a higher degree of integration of world financial markets. The impact of new information processing techniques has been most visible in such new financial services as automated teller machines (ATMs), home banking system, and point-of-sale (POS) terminals. Corporate and individual depositors are now able to carry out significant portfolio shifts in order to economize on cash balances and low-yielding transactions accounts by quickly investing their liquid resources in various money market instruments.

Financial innovations exhibit themselves in numerous forms to serve specific needs of diverse market participants. They can be classified broadly into five groups depending upon their basic purposes.

i) Some of the financial innovations are designed to reduce the cost of transactions. Such efficiency-enhancing innovations have been of two kinds: innovations which substituted one transaction's medium for another because of a difference in the real costs of their use, and innovations which lowered the cost of using a particular medium.[6]

ii) Some innovations are intended to alleviate the perceived risk inherent in international financial transactions. In this regard, the interest rate risk, the exchange rate risk and the credit risk are most noteworthy in recent years.

iii) Some innovations are conceived to mitigate or even circumvent the impact of regulations on financial transactions. The very origin of the Euromarket was closely tied to these efforts to cope with the regulatory constraints. For example, the absence of the reserve requirements and Regulation Q-type interest rate ceiling as well as exemption from the withholding tax on deposit income for non-resident depositors has played a major role in the rapid expansion of the Eurodollar market in the last several decades.

iv) Some innovations are created to take advantage of new

[6]Robert Craig West, "A Theory of Financial Innovations in the United States," Federal Reserve Bank of Kansas City Research Working Paper, 1982, p. 3.

profit opportunities opened up by technology or deregulation. Such "profit niche" strategy is a natural process of market maturity occasioned by increased competition and economies of scale. Such financial swaps as currency and interest rate swaps belong to this category.

v) Some innovations are intended to increase the overall flexibility of financial management. Diversification of both funding sources and lending instruments contributes to operational stability and flexibility in the financial market.

Trends toward Financial Deregulation

The deregulatory environment for international financial transactions has been conducive to the kind of competitive and creative spirit needed in financial integration and innovations. Government authorities have traditionally allowed a greater operational leeway for "Euro" or foreign currency banking. In fact, this regulatory asymmetry between domestic and Eurobanking was originally responsible for the creation of the Euromarket itself in the first place. More than any other financial market, the great Euromarket system, consisting of various submarkets such as Eurocurrency market, Eurocredit market, Eurobond market, Euronote market, Euroequity market, etc., symbolizes the epitome of global financial market integration. Consequently, the international financial market have proved to be a relatively fertile field for financial innovations and new financial experimentation free of stifling regulatory constraints.

In general, deregulation tended to follow rather than precede the introduction of new financial products and services, which first would transform the financial market environment substantially enough to force the change in the traditional regulatory outlook. Deregulation would then accelerate further financial innovations, triggering more deregulation and so on in a self-reinforcing manner. Financial market integration has interacted with this cycle of financial innovation and deregulation/liberalization. Between the Great Depression in the early 1930s and the integration of major financial markets in the 1970s, the bank regulatory philosophy in both developing and industrialized countries was dominated by a preoccupation with the soundness of individual institutions and the systemic stability, mindful of the great financial crashes in the late 1920s and early 1930s. Competition in banking was viewed as a double-edged sword, incorporating notable deficiencies as well as some generally recognized advantages in improving the quality of banking services to the public. However, recent regulatory changes were designed to promote competition not only among banks but also between commercial banks and other financial institutions, encouraging a rapid pace of financial integration both functionally and geographically.

Financial regulation, i.e., the regulation of financial institutions and financial markets, has served essentially three basic policy objectives:

i) to ensure the solvency and financial soundness of financial institutions in order to maintain stability -- and confidence in the stability -- of the financial system as a whole;

ii) To protect investors, borrowers and other users of the financial system against undue risks of losses and other damages that may arise from failures, fraud, malpractice, manipulation and other bad conduct on the part of providers of financial services; and

iii) To ensure a smooth, efficient, safe and effective functioning of financial institutions and markets and a proper working of competitive market forces.[7]

While the dominant regulatory focus during the half century between the 1930s and the 1970s was closely tied to the prudential regulation for the sake of systemic stability and investor protection, the recent trend in financial regulation is toward the efficiency enhancement goal through promotion of competition and market forces. This change in regulatory focus has further encouraged financial market integration and innovations.

Economic Rationales for Financial Integration

After several decades of preoccupation with the dirigistic and interventionistic role of the government in promoting economic growth, an increasing number of developing countries are shifting their development focus to market signals guiding the allocation of resources in which the role of prices is being emphasized, profits are becoming a measure of economic success for enterprises and financial markets are being promoted to allocate resources to profitable activities within a competitive environment. Deregulation and liberalization in the financial system is encouraged to nurture competition among various financial institutions and markets and to enhance allocative efficiency in the economy. While the post-war economic development model was

[7]"Recent Trends in Financial Regulation," OECD Financial Market Trends, October 1989, p.11

inward-oriented, relying upon government intervention to set pricing signals and promoting a strong participation of the state in the production of goods and services, the new approach is outward-oriented through a free market mechanism where the market prices play the dominant allocative role.[8] The role of the government in the new outward-oriented development model is to provide a level playing field for all financial institutions through deregulation and integration. Thus, financial integration becomes an integral part of the new development model. Here the existence of a substantial private sector is a necessary but not a sufficient condition for economic development, which also requires open competition free of oligopolistic and privileged practices perpetuated by protective barriers and subsidized credit.

Financial integration is also predicated upon the efficiency argument. By removing barriers to new entry and promoting competition, financial integration lowers both the cost of funds and the cost of financial services. Liberalized capital movements combined with market determined exchange rates pull down the domestic cost of funds to that of international level. Furthermore, the elimination of national barriers in financial services stimulates competition among the financial institutions, thus lowering the prices of financial services such as service fees and brokerage commissions.[9] While financial market integration may not mean equalization of financial service prices, price convergence toward the lowest denominator is one of its positive results. A study by Price Waterhouse demonstrates that financial subsectors that are already subject to international competition show the least price differentials, whereas the subsectors that have been protected from foreign competition show the widest price differences.[10]

Financial integration also enhances risk diversification for both borrowers and investors. Availability of a wider array of financing sources both domestically and internationally reduces not only the funding cost but also the fund availability risk for a borrower. If one financing source dries up, other sources can be tapped freely. Diversification of funding sources, available for the borrowers from industrialized countries, now becomes a feasible option for LDC borrowers through financial market integration. For international portfolio investors, availability of various

[8]Manual Hinds, "Introducing Competition in the Financial Sector," a paper presented at the Senior Policy Seminar on Financial Systems and Development in Africa, EDI-World Bank, 1990.

[9]Susan Ulbaek and Michel Vaugeois, "EC Financial Integration: Potential Impact on EMENA Countries," World Bank, April 1990.

[10]Price Waterhouse, The Cost of Non-Europe in Financial Services, Bruxelles, 1988.

investment securities in many capital markets including those of developing countries enhances the risk-return profile of their investment portfolio. A study by Bruno Solnik demonstrates that an active strategy of international portfolio diversification including certain Pacific Basin markets improves the portfolio performance. Especially, he noticed that inclusion of some Pacific Basic capital markets such as Korea, Taiwan and Thailand in the U.S. dollar-numeraire international portfolio significantly improves the risk-return profile.[11]

Financial market integration may also bring about the critical mass necessary for a market to enjoy the economies of scale and risk sharing. Modern financial markets require both sophisticated functional expertise and up-to-date market information. Such knowledge cannot be generated in a vacuum; it needs constant innovations and cross-fertilization of ideas among bankers and other finance professionals.[12] Individual national markets, if isolated from other active financial centers of the world, cannot benefit from new financial techniques and products and tend to be dominated by tradition-bound financial institutions that often behave oligopolistically. Integration brings about the critical mass necessary for the financial intermediaries to experiment with new techniques and to stay competitive and innovative. The critical mass argument is particularly relevant for the financial markets of developing countries, which by themselves remain too small and too fragmented to engender the innovative and entrepreneurial spirit essential for modern financial market activities.

Economic Costs of Financial Market Integration for Developing Countries

While financial market integration promotes competition and enhances market efficiency and financial innovations, it can also have a destabilizing effect on an economy, particularly when attempted prematurely. Developing countries are especially prone to this negative effect. One reason is that the financial infrastructure of developing countries, when compared with mature economies, is too weak to withstand the economic shock of changing suddenly from an inward-looking economy to an open economy. Liberalization may even aggravate other deficiencies existing

[11]Bruno Solnik, "Pacific Basin Stock Markets and International Diversification," a paper presented at the Second Annual Pacific Basin Finance Conference, Bangkok, Thailand, 1990.

[12]Yoon S. Park, "The Economics of Offshore Finance Centers," Columbia Journal of World Business, Winter, 1982.

within various sectors of the economy, thus producing an overall negative impact and not achieving the desired outcomes.

An example is the experience of Argentina, Chile and Uruguay, which pursued open market reforms starting in the mid-1970s. In varying degrees, they eliminated constraints on capital flows, decontrolled interest rates, and relaxed many trade restrictions. Initially some efficiency gains were made but these were ultimately overshadowed by problems with policy inconsistencies, implementation difficulties, and overlooked market frictions. A main cause of the failure was the fact that, at the time reforms started, the three countries were experiencing severe macroeconomic imbalances, including foreign exchange shortages and high inflation. Another contributing factor was the absence of adequate prudential regulatory constraints on financial activities. The adoption by the Southern Cone countries of <u>tablita</u> (pre-scheduled exchange rate devaluation table) initially induced capital inflows as domestic interest rates were higher than foreign rates even after the adjustment for exchange rate depreciation. Subsequently, however, tablita also raised domestic inflation due to both money supply expansion induced by capital inflows and driving up the prices of nontradeables.

There are many reasons for the high risk of failure of financial market integration, especially in developing countries. Despite recent progress in some developing countries, most LDC financial markets are still shallow and repressed with no required depth, liquidity and breath as in developed markets. LDC capital markets suffer from poor financial infrastructure. Licenses for new financial institutions are too strictly controlled by the governments, even though the proper role of a government in the securities market, which is quintessentially based upon the private initiatives, should be limited to that of a prudential regulator rather than a controller or interventionist. Such areas as proper accounting and auditing standards, legal rights of investors, and adequate disclosure rules and so on should be the main areas of concern to the government in promoting securities markets.

One of the major hurdles to development of well-functioning financial markets in developing countries is the infant stage of private institutional investors. Private pension funds and insurance companies are not yet any important investors in capital market instruments, mostly keeping the bulk of collected funds in time deposits with commercial banks or tax-exempt savings certificates issued by deficit-burdened governments. In many developing countries, mutual funds are predominantly government operated, and life insurance companies and unit trusts are also dominated by government institutions. Thus, the securities markets are often overwhelmed by government actions and policies, with little room for the private financial institutions to maneuver.

Furthermore, the financial markets of developing countries lack the balance. In almost all developing countries, commercial banks still play an overwhelmingly important role in the entire financial system. This condition has been the result of both an institutional inertia and the government policy orientation. Securities markets are essentially related to an advanced form of business finance, and as a consequence many developing countries find their securities markets at only an early stage of development. Both the volume as well as the institutional structure is inadequate compared to that of industrialized countries where securities markets have played a vital role in the overall allocative process of savings and investment funds. Not only the securities markets but also nonbank financial institutions (finance companies, development finance institutions, investment and merchant banks, insurance companies, pension funds, venture capital firms, and so on) constitute a relatively small part of the financial system.

Instead, commercial banks play the dominant role in intermediating a nation's financial flows among various sectors of the economy. Commercial banks necessarily tend to view securities markets as their competition and have no incentive to encourage the latter's development. Such hostility on the part of commercial banks toward securities markets is shared equally among private as well as government-owned commercial banks. On the other hand, the dominant position of commercial banks in most LDCs stifles both innovation and competition in the financial system essential to the healthy growth of securities markets.

Underdeveloped securities markets deprive investors of the opportunities for investing in long-term financial investment instruments, while business firms are restricted in their ability to finance capital expansion through long-term debt or equity funds. The result is that a significant portion of financial activities are pushed underground into the informal sector beyond the realm of transparency and prudential regulation. Governments may initially have preferred to promote commercial banking due to the ease of control over the country's financial system with only a relatively limited number of commercial banks, but often the unexpected result has been to promote the growth of informal sector of finance in LDCs, making it even harder for the government to control the financial flows of a nation. It is no accident that the informal financial sector has been thriving in those developing countries where the formal financial sector is underdeveloped and distorted due to nationalized banking system, lack of non-bank financial institutions, and primitive securities markets.

The capital markets in LDCs are underdeveloped both from the supply side as well as the demand side. There are generally two basic reasons for this. On the supply side there is a low number of high grade securities in the market brought about by the limited number of listed companies. On the demand side there is a limited number of investors actively involved in the stock market. Most private sector corporations generate financing from short-term loan facilities with commercial banks. This excessive reliance on bank debt financing reduces the need for companies to raise funds through the securities market. In the Philippines, for example, there are over 140 companies listed on the stock exchange, 95 on the Big Board and the rest on the Small Board, of which only 63 are in the top 1,000 corporations of the Philippines.

Few people are willing to invest their money in the stock market. The number of individuals who are investors in the stock market is estimated to be less than one percent of the population in many LDCs. This compares with developed countries where the figure is around 10 percent. The limited amount of shares traded (or the float) leaves the market open to price manipulations. One of the main causes for lack of demand in the stock market is the lack of confidence by investors who perceive the market as highly speculative and open to insider trading abuses. Supply and demand are intrinsically linked together. The thinness of the market resulting from the small number of listed companies makes manipulation easier and prices more volatile, which in turn deters investors from participating in the market. Similarly, limited demand for stocks leads to depressed prices and increases the cost of raising funds from the securities market, providing little incentive for companies to offer their shares to the public. It is in a sense a vicious circle.

The limited supply of equity securities stems from several critical factors including: cheaper alternative sources of financing for corporations; reluctance of family-owned corporations to share control; hesitancy of disclosure of business operations to the outsiders; lack of listings of multinational companies; pre-emptive rights of shareholders; and government financing practices for state-owned enterprises.

Dependence on bank financing is probably the most prevalent institutionalized reason for so few securities issued in the market. Ease of financing and liquidity encouraged by the government and the commercial banks has enabled corporations to use bank financing for virtually all corporate financing needs. Tax policy has contributed to the corporate preference to use debt over equity financing since interest expenses are fully deductible from gross income while dividends are not.

Deeply rooted in the business community of many LDCs is the practice of maintaining tight control of enterprises by a small, generally related group. Reluctant to share power and concerned with privacy, these groups are resistant to the concept of offering shares publicly since it breaches the confidentiality long cultivated. Over years of development, earnings have been understated, taxes consequently underpaid, raising the possibility of penalties if the corporate revelations necessary for disclosure in public offerings are inconsistent with previous filings with the tax authorities.

Even where the private financial sector plays an increased role, the financial system is often dominated oligopolistic institutions. The anti-trust legislation in many developing countries is at an infant stage and large business groups, with privileged access to the government authorities, maintain close linkages with large banking and financial institutions. Thus, in many developing countries the small and medium-sized companies as well as new business ventures suffer from "double crowding-outs" by both the government and the big business groups.

As LDC financial markets are both shallow and oligopolistically controlled, financial market integration can sometimes be exploited by the privileged groups to enhance their oligopolistic control rather than promoting market competition and efficiency. Large business groups in developing countries are often the first to benefit from financial market integration, resulting in a greater degree of oligopolistic market control rather than enhancement of market efficiency through further competition. This risk is heightened in those developing countries where the real sector is not sufficiently integrated. Financial integration without concomitant real sector integration within the overall economy can often lead to further market disruptions instead of economic efficiency.

Furthermore, hasty financial market integration renders a developing country vulnerable to external financial disturbances. This "whipsaw" effect can be especially serious for smaller developing economies where the shallow domestic financial markets are ill-equipped to absorb the external financial shocks. The October 1987 stock market crash in the United States had a far more adverse effect on such relatively more integrated financial markets as Mexico, the Philippines, Thailand and Hong Kong, than Korea and Taiwan which maintained a strict control on foreign access to their securities markets. Transmission of financial market volatility is far speedier and more disruptive in integrated financial markets.

Policy Implications for Developing Countries

In recent years, many developing countries have adopted financial sector reforms and market liberalization measures. In many of these countries, interest rates have been fully liberalized or managed more flexibly than before.[13] Other countries have curtailed their directed credit programs though few have eliminated them entirely. Competition among financial institutions has been promoted by opening the domestic market to foreign banks and by authorizing charters for new banks and nonbank financial intermediaries. Access to local capital markets by both foreign portfolio investors and foreign financial institutions has been significantly liberalized. Several former centrally planned economies aim to stimulate competition through extensive restructuring of their banking and financial systems.

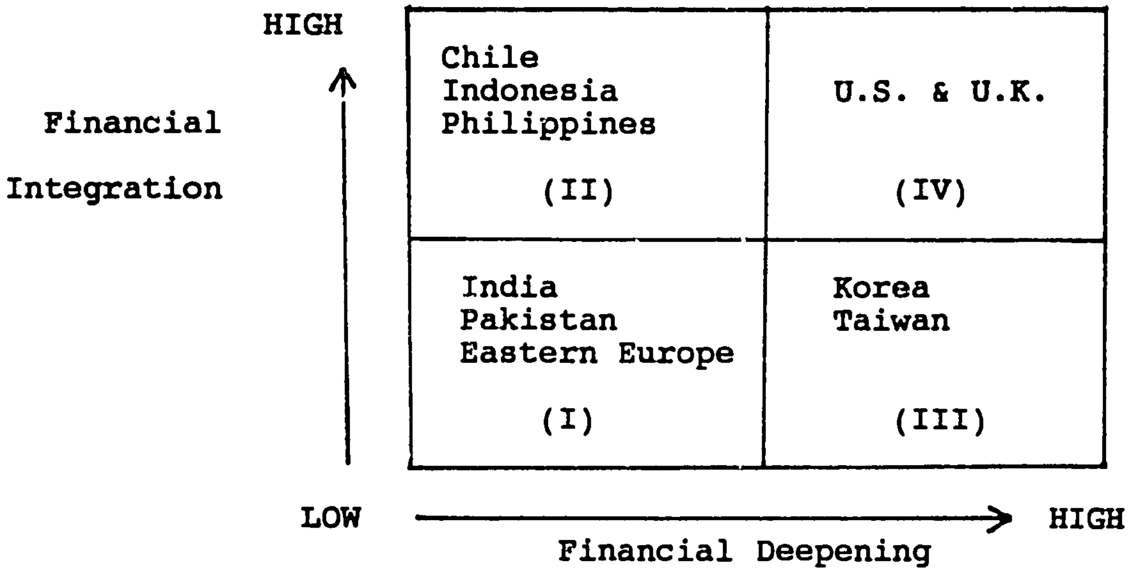
In some countries financial liberalization has been quite comprehensive. As mentioned earlier, Argentina, Chile and Uruguay carried out extensive reforms in the mid-1970s, including the elimination of interest rate controls, directed credit programs, and exchange controls. A number of Asian countries have also moved toward deregulation, but reforms were introduced more gradually and were less comprehensive with the possible exception of Indonesia. Financial liberalization has sometimes proved difficult. In the Southern Cone countries liberalization ended in disarray; the Government of Argentina had to reintroduce controls, and all three governments had to deal with widespread bank failures. The Turkish Government had to reintroduce interest rate controls when real rates rose too far. But in Asia, where macroeconomic conditions were more stable and reforms were implemented more gradually, there has been no need to reintroduce controls.[14]

Experience suggests that financial liberalization needs to be undertaken alongside macroeconomic reform. Countries that attempted financial liberalization before undertaking other needed economic reforms suffered destabilizing capital flows, high interest rates, and corporate distress. Financial liberalization cannot succeed unless it is accompanied by the restructuring of insolvent banks and firms, and by adequate regulation and supervision. Domestic financial markets need to be competitive in order to ensure that local financial intermediaries are efficiently run to meet the new competitive challenges from foreign financial institutions. And opening the capital account must be carefully done in order to avoid the destabilizing capital flows that proved so difficult to manage in a number of countries attempting deregulation. The "Big Bang" approach to financial integration, as demonstrated in the Southern Cone countries among others, accompanies a high degree of risk. It clearly demonstrates that a good policy such as financial market integration can have a bad result through poor implementation. It further demonstrates that

[13]Delano Villanueva, "Issues in Financial Sector Reform," Finance and Development, March 1988.

[14]Yoon Je Cho and Dinanath Khatkhate, Lessons from Financial Liberalization in Asia-A Comparative Study, World Bank, 1989.

financial market integration and liberalization, if not properly designed and implemented, can cause instability of the financial system, which in turn may magnify macroeconomic instability. Proper sequencing and speed is the key to successful financial integration, especially when the countries have shallow and oligopolistic financial markets.



While it has been generally agreed that the benefits of financial market integration tend to outweigh its costs, the real policy issue facing developing countries has been how to sequence the integration process. The policy alternatives available to developing countries can be illustrated with the above figure. Most developing countries at the early stage of financial market development find themselves in Quadrant (I), while most industrialized countries with fully developed and well integrated financial markets are located in Quadrant (IV). There are three strategies open for LDC policy makers to move their financial markets from Quadrant (I) to (IV):

(1) Big Bang Approach is to push from (I) to (IV) directly without any intermediate step involved, simultaneously liberalizing the financial sector and opening up their markets to international competition. Some of the Latin American and East European countries have attempted this strategy, but its final outcome has not been available yet.

(2) Internationalist Approach is to move from Quadrant (I) through (II) to (IV) by internationalizing their financial sector immediately without waiting for the domestic financial markets to grow and mature enough to meet foreign competition. Chile, Indonesia and the Philippines belong to this category.

(3) Gradualist Approach involves moving to Quadrant (III) first before integrating the domestic financial markets with international markets. Japan first tried this approach successfully, being followed currently by Korea and Taiwan. This approach has already demonstrated its proven success record in the case of Japan, even though the country was almost forced to integrate internationally under the pressure of her major trading countries such as the United States.

Lessons and Recommendations

It is too early to evaluate the impact of the recent financial reforms and deregulations, and their interrelationship with the global trend towards greater financial integration and internationalization. It takes time to examine the merits and potential benefit of the new policies. However, there are some signs that point to a degree of satisfaction and optimism and/or desire for more reform and deregulation, especially in the area of processes and procedures where the government is involved. The final outcome of recent moves toward financial market integration will depend upon not only the initial policy measures but also the patient follow-through in such areas as institution building and continuous regulatory reform.

Financial market integration has to be viewed within the broader context of economic and financial liberalization designed to remove structural rigidities in the economy that have impeded efficient resource allocation and factor use. Recent political and economic developments in the Eastern European countries clearly demonstrate that decentralized and privatized decision making is ultimately more successful at promoting economic development and growth. Financial market integration in its various functional and geographic forms reflects an important aspect of decentralized decision making in the environment of deregulation and liberalization, substituting market forces for government controls in global resource allocation. Financial market integration is a logical extension of McKinnon and Shaw's argument for financial deregulation to promote "financial deepening" both in the functional and geographical sense. But the critical issue here is not so much the direction of financial market integration but the speed and sequencing of integration.[15] It is in this area that more study and research is needed.

[15]Mario Blejer and Silvia Sagari, "Sequencing the Liberalization of Financial Markets," Finance and Development, March 1988.

Nevertheless, a tentative conclusion may be drawn on a possible policy sequencing regarding the financial market integration. Viewed within the broad context of a country's macroeconomic development, integration is part of the sequencing in the economic development process. We can delineate three distinct stages in this process.

Stage I (Industrialization and Real Sector Development): In this stage, the government and public sector institutions play the major regulator and controller for financial intermediation. Economic development plans are an important tool for the government at this stage, where directed credit programs are quite extensively applied. The economic structure is rather simple, and there is general lack of key economic infrastructure, such as transportation, energy, telecommunication and education facilities. Directed credit programs, managed by an enlightened government, can channel scarce investment capital into these infrastructure projects as well as key industrial sectors which emphasize export promotion and import substitution, which generates precious foreign exchange.

At this stage of economic development, deficit financing and the state control of financial institutions is frequently used to provide domestic investment resources for key investments, and selected foreign borrowings are utilized to meet the domestic savings gap. If the financial sector is completely liberalized at this early stage, scarce financial resources may be channeled into certain consumption-focused sectors such as residential or rental housing, luxury restaurants, retail outlets, etc.

Stage II (Financial Sector Development): Once the economy has reached certain take-off stage in terms of basic infrastructure and key industrial sector development, the government can afford to promote the growth of financial markets. Commercial banks may be privatized, and money and capital markets are promoted to increase the efficiency in resource allocation in the increasingly complex economy. Large companies, which have benefitted from the rapid industrialization in the Stage I, are encouraged to go public in the stock market in order to broaden their equity base.

Non-bank financial institutions such as merchant banks, insurance companies, pension funds, mutual funds and investment companies, leasing companies, and venture capital firms are also promoted to broaden and deepen the financial system of the country. At this stage, the government can aggressively pursue financial sector liberalization and deregulation to promote competition and diversity in the financial system.

Stage III (Financial Market Integration): Once the local financial market has become an active part of resource mobilization for the economy, the government can move towards internationalizing its financial sector along with the already internationalized trade and investment sectors. International capital flows may be liberalized, and access to local stock markets by foreign portfolio investors is progressively liberalized. Along with the move to make its currency convertible, the government may remove the entry barriers to foreign financial institutions to the local markets, which can encourage competition and infusion of new financial technology.

In this sequencing process, the key issue facing the government policy makers is to identify correctly the right timing on when one stage passes and the economy is ready for the next stage. Too long a delay may cause a drag in the economy, too hasty transition from one stage to the next can contribute to financial disruptions and even financial crises. Government policy makers should be nimble enough to synchronize their degree of regulation and deregulation with the underlying economic development stages. Similarly, an international development agency such as AID has to assist the policy makers of developing countries to proceed with the financial sector reform and integration as part of the overall economic liberalization.

A frequently heard complaint from the policy makers of developing countries has been that in recent years the major external development agencies tend to "force" the process of financial sector deregulation and integration without considering the proper sequencing uniquely tailored to each developing country. According to this complaint, the major issues in financial sector reform are pre-determined generically and tend to be applied more or less universally to most aid-recipient countries without much consideration of each country's stage of economic and financial sector development. Sequencing, along the line developed in the previous section, may be useful for a country to progress smoothly towards the ultimate goal of developing an efficient financial system.

Forging Greater Integration and Internationalization of Financial Markets: A Policy Framework for A.I.D. Assistance to Developing Countries

Literature Review

FMIRI

March 23, 1990

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EXECUTIVE SUMMARY

The process of financial development has two dimensions: domestic financial deepening and international financial integration. While both dimensions are important to economic growth, they may become the cause of either success or failure of an economic plan, depending on the sequence and intensity of their implementation.

Domestic financial deepening refers to the promotion of financial activity and capital formation that occurs in the domestic financial market through such measures as elimination of domestic credit controls and credit rationing, interest rate ceilings, differential reserve requirements, and also to the elimination of discriminatory practices and capital requirements that curtail free entry of local participants into domestic financial markets. Financial deepening results from an increase in the level of competition in the domestic banking market and from the development of a strong capital market.

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International integration occurs when exchange controls are removed and the capital account is freed to allow financial resources to flow freely in and out of the country. As a result, the domestic economy acquires the characteristics of the international economy. The free market compensates for domestic inflation with adjustments in the exchange rate and domestic interest rates. In theory, the speed with which inflation, exchange and interest rates reach equilibrium is evidence of the degree of integration between the domestic financial system and international financial markets.

The *economic liberalization* process encompasses deregulation of all markets: financial, trade, and labor markets. In the domestic markets, liberalization means financial deepening by removing interest rate ceilings, price and wage controls, and any other barriers to capital formation. In the international sense integration occurs by opening the capital account and the trade account to allow imports and exports to move freely.

The most powerful reason to adopt a free market system and decontrolled capital flows is the acute need of developing countries to stimulate capital formation, economic growth, and efficiency. For example, the policy agenda for removing excessive regulation of interest rates and credit allocation can include some or all of the following features:

- increase in controlled interest rates to ensure that deposit rates are positive in real terms.
- removal of control on maximum deposit interest rates.
- removal of all interest rate controls.
- withdrawal of interest subsidies and cross-subsidies.
- reduction in the complexity of sectoral credit targets and the degree to which they differ from what would be the uncontrolled outcome.
- removal of bank-by-bank credit ceilings, or of overall credit ceilings in favor of broad instruments of monetary control.

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

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

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

- liberalization of exchange controls.[1]

Economic liberalization is necessary for the efficient operation of a free market system. Recent liberalization trends in Eastern Europe further emphasize the almost universal recognition of the long-term need of adopting such policies. The issue in the 1990's is not whether economies should be liberalized, but rather how the process of liberalization must be carried out to the best advantage of the country.

A dilemma arises when liberalization is in conflict with past social and economic policies of the country. Years of protecting local industries and encouraging import substitution cannot be eliminated suddenly without causing substantial social and economic disruption. The dilemma is what should be the appropriate *sequence* and *intensity* of those reforms in order to forge a free market system.

Sequencing the liberalization stages for both the trade account and capital account is a crucial task. Some authors advocate gradualism by opening the trade account before the capital account. Yet some economists subscribe to the idea of "shock" economics and

1 Alan Gelb and Patrick Honohan, "Financial Sector Reforms in Adjustment Programs," World Bank Working Papers (Washington, D.C.: International Bank for Reconstruction and Development, March 1989), p. 1.

want to see all barriers to trade and finance lifted, in both the domestic and international markets. An account of the extreme effects of sudden liberalization was given by Diaz-Alejandro: "Chile went from a financially shallow economy, where creditors owned a very large share of real wealth, a clear case of 'too much debt and too little equity.' Inter-penetration of economic and financial power appears to have reached extraordinary levels."[2] After the lessons learned, the Chilean economy has been successfully restructured. A massive nationalization of banks and the assumption of private external debt by the government were followed by a period of successful privatization and debt conversion transactions. Although Chile's external debt remains high at 103.6% of GNP in 1987 (the third highest in Latin America after Nicaragua and Bolivia),[3] tight economic policies under the military government of General Pinochet have transformed Chile into one of the most stable economies in Latin America.

In the past, many governments found expedient solutions to social unrest and political pressures by either reverting to repression and isolation or by turning to sudden market liberalization. Either solution ignores economic realities. A more prudent course of action is to first carefully assess the financial system that exists in each country, select the path that will first lead the country out of domestic repressionism and instability into a stage of responsible controls and regulations, then finally advance toward international integration. That path must be closely monitored and easily adaptable to the political, economic, and social circumstances of each country.

The current consensus is that reforms can best be implemented only in an environment of macroeconomic stability. Reforms to be undertaken initially should include measures aimed at gaining control of the fiscal deficit and establishing macroeconomic stability.

[2] Carlos Diaz-Alejandro, "Good-Bye Financial Repression, Hello Financial Crash," *Journal of Development Economics* 19 (1985): pp. 1-24.

[3] *World Development Report 1989,* The International Bank for Reconstruction and Development (New York: Oxford University Press, 1989), pp. 208-209.

The Process of Liberalization

It has been suggested that in the process of liberalization, developing countries may move from a *repressed* economy, either by going through the stage of *controlled* economy or the stage of *unstable* economy, before they become open to the world economy.[7]

Repressed Economy

A repressed economy, at the extreme, is one characterized by strong domestic controls, a shallow financial system, and an active informal financial market in which financial resources flow in a limited circle of intermediaries and users. Repression also exists in international operations, because of strong cultural ties and traditions, people are distrustful of foreign influence, they accept the domestic economic conditions of the country as a normal state of affairs, and they are reluctant to enter into foreign transactions.

Unstable Economy

An unstable economy, like the repressed economy, has a shallow financial system with strong financial barriers which do not allow financial resources to flow freely. The informal market is a black market of real and financial resources.

In an unstable economy, international integration is high by means of the black market which mobilizes capital in and out of the country. High inflation forces the economy to become "dollarized". Also a high external debt is restructured periodically and paid

[7] The framework of repressed, controlled, unstable, and open economies is taken from "The Process of Liberalization and International Integration," a forthcoming paper by Marta A. Oyhenart and Bryan L. Sudweeks. A more detailed explaination of this framework is contained in Section III of this paper.

position is supported by the work of Edwards on liberalization sequence and the work of Blejer and Sagari on the importance of a strong banking system as the basis for successful financial liberalization.

The first question is: Can a limited number of classifications be developed for LDC's reflecting their general macroeconomic conditions, domestic financial market conditions, and degree of integration with international markets?

A Classification System

The financial liberalization framework of the previous section provides a theoretical visualization of the process. This framework also offers the basis for a subjective classification of countries. Using a modified Delfi method by which a group of experts are asked to rank countries in the four categories shown on the framework, a preliminary classification can be determined.

A more objective classification can be obtained by using selected economic ratios, although there is some disagreement on which are the best variables to use. One of the ratios used by the World Bank is Net Financial Assets as Percentage of GNP. Traditional economic indicators include GNP per capita, growth of consumption and investment, percentage share of merchandise exports, and several balance of payments ratios.

Some interesting ratios are used by the "International Development Review" in its Credit Watch section. In particular one of the ratios could be useful to measure the degree of international integration of a country. It is the spread in basis points between the domestic interest rate and the rate of a comparable instrument in a strong currency such as the U.S. dollar or the German Mark. Countries are ranked numerically and those with the largest spreads are classified as the least integrated into the international

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Proportion of External Debt to Productivity. External borrowing (can be obtained from World Bank Debt Tables) as a proportion of industrial production (line "66" in the IFS) or exports (line "70" in the IFS). This ratio must be interpreted with greater care because, by itself, it does not reveal conclusive information. Rather, it is an alert sign if external debt increases disproportionately to productivity, or if both debt and productivity decline at the beginning of a period of stagnation. More favorable conditions would be signaled by a diminishing proportion of debt to industrial production or export.

It should be noted here that ratio analysis is only a basic form of looking at objective data. There are more powerful statisical analyses which, even in the exploratory stage, could disclose more complete information about a country. This study could have been enriched by that analysis, but the statistical portion was eliminated from the scope of work of this literature review.

A suggested two-stage approach to classifying developing countries according to financial deepening and international integration is as follows:

- Stage 1. Subjective preliminary classification using a modified Delfi method as described above.

- Stage 2. Objective classification by ranking countries according to the indicators selected.

The results must be carefully interpreted in the context of the country and any extraordinary events that may have an influence on the results.

A Typology of AID Countries

The second question is whether such a typology of LDC countries can be useful in helping A.I.D. missions to formulate country strategies. The answer is affirmative. Such analysis can not only be used to help missions but also to give A.I.D. Washington an indication of the degree of financial development and international integration that exist in the universe of A.I.D. countries.

While it is true that other institutions have developed statistical economic indicators, most notably the World Bank, the IMF and OECD, the reality is that A.I.D. needs an accessible classification system that should be updated periodically, not only with the measures described above but also with information on the experience of the missions as the process of liberalization evolves. Furthermore, as the classifications are updated successes and failures will be highlighted. This exercise will serve to encourage the transfer among missions of positive experiences worth replicating, as well as avoiding mistakes.

Conclusions

The major conclusions drawn from this literature, which have direct application to A.I.D. assistance to developing countries are,

1) Reforms implemented in an unstable macroeconomic environment can exacerbate the instability; policy dialogue should focus on stabilization measures prior to liberalization reforms.

2) Internal economic liberalization should be sequenced next. An emphasis should be placed on building a strong financial infrastructure conducive to promote financial deepening.

3) Regulatory reforms must focus on a regulatory balance that supports liberalization with the appropriate degree of flexibility to adapt to changing circumstances. The regulatory framework must recognize that the driving economic force is private initiative. The objective of regulation is not to thwart that initiative but to encourage it within the parameters of national goals and social well-being.

4) The adverse short-term effects of reforms must be anticipated and ameliorated through an economic and social infrastructure that can absorb industrial rehabilitation, labor training, and new business development, as well as assure solvency in the financial industry and sustain economic stability in the country.

5) Opening the financial sector to full international integration can be accomplished most successfully after the domestic economy and financial sector has both been stabilized and liberalized.

These preliminary conclusions will be further complemented by the in-depth case studies of two developing countries. These studies will further assist AID in formulating an effective financial sector reform program for developing countries.

Organization of this Paper

This paper presents a review of selected literature pertaining to financial market development in developing countries, as well as an explanatory framework that illustrates the trajectory followed by developing countries to move from a state of

Another reason for this contraction in bank lending is that interest rate spreads charged by banks on loans to developing countries have deteriorated considerably since 1983, as shown on the table that follows.

Average Spreads in Basis Points over LIBOR

	1983	1988
Spontaneous commitments	80	57
Concerted commitments		
All countries	225	83
Largest debtors: Argentina, Brazil and Mexico	225	81

Source: "International Capital Markets," International Monetary Fund, Washington, D.C., April, 1989, p. 90.

Instead of medium-term lending, banks now favor other financing strategies. They prefer to cofinance loans with multilateral institutions, to extend short-term trade credits, and to use securities in debt restructuring.

Why Financial Sector Reforms?

The recent increase in concern with financial reforms in developing countries arises primarily from the need to transform the stagnant LDC economies plagued by waste and inefficient allocation of resources into productive, independent, and dynamic free market systems. Stagnant economies in developing countries often exhibit three characteristics: 1) financial institutions are in extremely unsound condition; 2) excessive control over interest rates and credit allocation represses the financial systems; and 3) financial systems are dominated by deposit money banks indicating that institution building is needed to expand and enrich the range of services which the financial sector can provide.[14] For example:

> Financial sector adjustment loans (FSAL's) are a recent innovation for the World Bank. Up to mid 1988 there had been four loans so designated, one each to Argentina and Ecuador and two to Turkey, and there has been one "trade and financial sector adjustment" loan to Jamaica. Financial reform has also been a major component of a few structural adjustment loans, notably SAL's II and III to Chile and the Economic Recovery Loan to the Philippines. Changes in financial policies have also been incorporated in the Bank's financial intermediation loans (i.e.loans intermediated through financial institutions in borrowing countries); these have a longer history, but the scope of policy reform has been more limited. Financial sector loans now in preparation include Ghana, Nepal, Kenya, Hungary, and Nigeria, and further loans are possible in a number of other countries. However, the empirical evidence on loan conception, implementation and effects is still limited in this area.[15]

Institutional Involvement

Multilateral and bilateral organizations have played a crucial role in assisting developing countries carry out various activities regarding financial market liberalization and integration. Although functions vary from one development organization to another, the process itself remains fairly consistent. Involvement usually includes all aspects of technical assistance, research, and financial support. Gelb and Honohan see development organizations' role being most useful in the policy stage of implementing reform. The key elements of policy typically recommended by multilateral institutions for restoring financial systems to a solvent state, according to Gelb and Honohan, are:

[14] Alan Gelb and Patrick Honohan, "Financial Sector Reforms in Adjustment Programs," *World Bank Working Paper* (Washington, D.C.: International Bank for Reconstruction and Development, March 1989), p. 1.

[15] Ibid., pp. 1-2.

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

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

3) For the system, establishing an improved regime of bank supervision together with a regulatory regime which will ensure timely provisioning against losses and provide information to both bank management and the regulators. This will usually require an overhaul of the accounting and auditing rules and systems, of rules for portfolio classification and for the treatment of unpaid interest. Measures to permit a credible, flexible, response by regulators may also be needed, for example, the introduction of "cease and desist" orders to permit a graduated tightening of conditions, and the creation of a deposit insurance corporation (not only to insure depositors by especially to free the central bank from the task of intervening banks, which is extraneous to its main function). Another area in which changes may be needed is the law concerning loan recovery.[16]

I. FINANCIAL MARKET DEVELOPMENT

Financial systems provide a range of services within the economy; most importantly, a medium of exchange which allows specialization and trade. Other services include mobilizing savings, allocating credit and trading risks. "A financial system's contribution to the economy depends upon the quantity and quality of its services and the efficiency with which it provides them".[17]

[16] Ibid., pp. 8-9.

[17] *World Development Report* 1989.

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The typical components of a sound financial infrastructure are:

1) financial institutions, including commercial banks (private domestic and foreign, and public), capital market institutions(savings and loans, thrift institutions, leasing companies, provident and pension funds, development finance institutions, insurance companies, societies of capitalization, investment banks and companies, trusts, mutual funds and brokerage houses), money market intermediaries (credit unions, credit cooperatives, and short-term, non-bank finance companies) and informal market intermediaries working outside the banking system;

2) a central bank, the role of which varies from one country to the next;

3) government regulation and intervention, exercised most frequently by the central bank;

4) the legal system and constitutional parameters; and,

5) the accounting principles and practices in use.

In many developing countries this infrastructure is non-existent; therefore, financial resources can not flow effectively to the most productive uses. Development of an appropriate financial infrastructure is thus a necessary task.

Financial Deepening vs. Financial Repression

LDC financial systems have traditionally been characterized by pervasive government intervention that has stymied the development of efficient financial systems which operate on market principles. Government intervention, in monetary, fiscal, and development policy, takes form in controlled interest and exchange rates, directed credit programs for priority sectors and industries, restrictive trade barriers affecting both imports and exports, reserve requirements, regulations on capital flows and investment, tax systems and price controls. The literature suggests that intervention hinders development of an independent, market-oriented financial system, due to the arbitrary and political, rather than economic, nature of policy. The sectors which receive priority

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financing, frequently determined politically, are often not the sectors that economic determinants would identify for investment. The fact that many LDCs financial institutions are frequently not subject to market-determined survival or extinction because government policy mandates their presence or absence, regardless of cost, also leads to distortions in the financial sector.

Several authors have addressed the issue of controlled interest rates in developing countries by proposing models that describe financial repression as the result of interest rate controls. They have also attempted to link, at least theoretically, the process of financial deepening to real economic growth. Most analytical work in this area is based on the conceptual framework developed by Shaw whose premise is that real rates of growth can be stifled by controlled interest rates and other barriers to capital formation. This strategy results in "shallow" finance. In contrast, financial liberalization will create financial "deepening" and promote real growth. Traditionally, financial activity is considered the by-product or effect of trade activity. It is argued, however, that financial development in a liberalized environment is an important promoter of economic growth. Without financial deepening, economic growth cannot take place.

Financial liberalization, according to Shaw, means the removal of artificially low interest rates. Higher interest rates will increase individual's propensity to save. The strategy not only redistributes financial resources in the economy, but it may have the added benefit of discouraging capital flight and redirect domestic savings back into the local economy. Liberalization also will result in allocative efficiency by providing a wider range of investment opportunities for domestic savings.[18] Since investment alternatives

[18] Shaw, 1973.

are ranked purely on economic merits, resources will flow to the most productive endeavors.

Consequently, after achieving macroeconomic stability, reforms should focus on reducing, and even eliminating directed credit programs, adjusting interest rates to bring them into line with inflation and other market forces, and improving the accounting and legal systems pertaining to finance. Early reforms should also include measures to improve the efficiency of the productive sector, namely liberalizing trade and industrial policy.[19]

There is no proven formula for interest rate reform. Industrialized and developing countries alike, while striving towards a policy of free interest rates, have grappled with the timing and nature of specific adjustments in the pattern of interest rates. In Chile, deregulation of interest rates resulted in a flood of capital inflows and soaring interest rates that economists are unable to explain. Korea, on the other hand, continued to control interest rates as reforms were implemented, and deregulation of the rates has proceeded only gradually as the positive progress of other reforms has been confirmed. It seems that particularly in countries that have not restored macroeconomic stability, governments should probably continue to manage interest rates making adjustments that reflect changes in exchange rates and inflation. When good progress has been made toward establishing macroeconomic stability, liberalizing industry, and restructuring the financial system, the government might then move toward the complete liberalization of interest rates.

The evidence suggests that directed credit programs have been an inefficient way of distributing and redistributing income and of dealing with imperfections in the goods market. Directed credit programs have likewise failed in many developing countries to produce the competitive priority sectors which the policies envisioned. Despite an

[19] *World Development Report* 1989, pp. 122-132. See also Cuddington (1985), Corbo and de Melo (1987), and Blejer and Sagari.

unwillingness to dismantle directed credit programs, due to the economic and political ramifications, governments are nonetheless reluctantly increasing the credit available to the private sector and sectors that were not program recipients and reducing their role in allocating credit. Two issues to consider in eliminating directed credit programs or in restructuring reduced programs are the identification of the priority sector(s) and what information is required to price credit for different sectors appropriately. There must be a limit on directed credit programs since a variety of programs means that nothing is being given priority.

With an aim towards eventual elimination of directed credit programs, some measures that can be taken towards that goal are to eliminate the difference between the subsidized interest rate and the market rate and increase the availability of credit to priority sectors. However, sectors requiring large subsidies should be accommodated in the fiscal budget rather than through credit allocation. The main point for governments to remember is that subsidies distort resource allocation and can disguise inefficiency. Whenever possible, subsidization should be avoided.

Macroeconomic Factors: Inflation, Interest Rates, and Exchange Rates

Internal financial market development and integration efforts are greatly determined by country policies and affected by macroeconomic variables and the policy framework. The literature identifies three macroeconomic factors that have an overwhelming influence on internal market development and the success of liberalizing reforms: inflation, interest rate and exchange rate policy. Many LDCs have experienced rampant inflation in the 1980's-double and even triple digit- although some have been far more effective than others in curbing inflationary trends and avoiding hyperinflation.

Bolivia had great difficulty curtailing hyperinflation, but drastic measures finally met with some success by 1987, three years after prices began their surge in 1984. After initial attempts to regain control of the economy through successive adjustment measures failed and price increases reached a monthly level of more than 100% early in 1985, central bank employees staged a strike in protest of adjustment measures; monetary increases were stopped for a short period and inflation subsequently decelerated to 11.8%; once post-strike monetary creation resumed, inflation rose to nearly 80% in June of 1985, representing an annual rate of 2,500%; a "shock treatment" was initiated by a new government in August 1985, including a severe reduction of fiscal deficits and tight money, tax reform, administrative restructuring, drastic staffing cuts at the central bank (from 1,200 to 200) and liberalization of trade, prices, interest rates and exchange rates; and the results were that the budget deficit fell and by 1987 the economy finally began to grow.[20]

Inflation has greatly hindered financial reform in numerous countries, but particularly in Latin America. Though reducing inflation and maintaining lower levels is one objective of reform programs, inability to swiftly reduce inflation jeopardizes the reform process. Brazil and Mexico, though successful in building financial systems with balanced and diversified institutional structures, have not enjoyed the deepening and integration which the financial infrastructure might otherwise allow because inflation remains high and largely uncontrollable. Prospects in Mexico seem more promising, however, as there has been progress in reducing inflation.

Reiterating the Shaw-McKinnon proposition, interest rate policy in developing countries has gained considerable attention in the literature over the last decade, with analysts suggesting a primary relationship between interest rate policy and financial deepening: to the extent that interest rates are controlled, there will be less financial deepening.

20 Chapters from forthcoming World Bank staff paper.

The experience of Korea in the 1980's challenges this proposition, however, since Korea maintained interest rate controls for banks and nonbank institutions and achieved financial deepening nonetheless. When interest rate ceilings are lower than the real rate, mobilization of savings is inhibited, and consequently investment. Long and Evenhouse suggest that in the developing country experience, "low or negative real interest rates discouraged the expansion of domestic deposits and gave borrowers a strong incentive to take on debt, an incentive reinforced in most countries by tax codes and by the lack of developed equity markets."[21] In periods of rampant inflation, frequently the controlled interest rate is actually a negative interest rate, since the adjustments have not compensated for inflation. Argentina liberalized domestic interest rates and most commodity prices in 1977 and they rose to a real rate of 10% initially, and turning to a negative real rate late in 1978, the end of the first phase of reform, until becoming positive again during 1981-1983.[22] Most experts attribute Argentina's negative real interest rates to surging inflation.

The interest rate situation in Chile during and after the reform period was quite different than in Argentina. Once reforms were implemented, nominal interest rates increased faster than the inflation rate, resulting in the first positive real interest rates the country had seen in years. Chile enjoyed positive real rates ranging from 1-17% on deposits until 1984. In fact, the interest rates after 1979 in Chile rose to mysteriously high levels, a situation which continues to elude explanation by experts. Possible explanations advanced by Yoo-Je Cho and Khatkhate include "imperfect substitution

[21] Millard Long and Eirik Evenhouse, "Restructuring Distressed Financial Systems," *Finance & Development*, September 1989, Volume 26, Number 3 (Washington D.C.: International Monetary Fund and The World Bank, 1989) p. 5.

[22] Vittorio Corbo and Jaime de Melo, "Lessons from the Southern Cone Policy Reforms," Research Observer Vol.2, No.2 (July 1987): 131; *World Development Report* 1989; and Yoon-Je Cho and Deena Khatkhate, "Lessons of Financial Liberalization in Asia," *World Bank Discussion Papers* No. 50 (Washington,D.C.: the International Bank for Reconstruction and Development, 1989), p. 89.

between domestic and foreign financial assets, costliness of arbitrage activity by banks, and market segmentation, but none provides a satisfactory answer for why parity conditions did not hold in Chile or why domestic interest rates rose so high."[23]

The Philippines offer additional evidence of the relationship between inflation and interest rates. Reforms were initiated in 1980 and though the nominal interest rates on loans and bank deposits decreased slightly, real interest rates became positive with declining inflation: "during the period 1984-1986, the market-determined interest rates were very high, higher than the real return on investment."[24]

In their analysis of conditions in several Asian countries, Yoon-Je Cho and Khatkhate conclude that "the growth of the financial sector has been rapid when the level of real interest rates is high and stable. Korea, Malaysia and, to some extent, Indonesia had quite stable inflation rates during 1982-86 and experienced rapid growth of the financial sector. The Philippines, which had highly fluctuating inflation during 1983-85, experienced contraction of the financial sector, although the average real interest rate was quite high during this period. However, the financial sector grew rapidly during 1980-83 when inflation was relatively stable. Sri Lanka's financial sector did not grow fast, presumably due to fluctuating and high inflation in the later stages of reform."[25]

When interest rates are kept artificially low, even below the real rate, investment decisions are distorted. The result is misallocation of resources in the economy. Many analysts call for a freeing of interest rates as a priority reform when financial market liberalization is the objective. In some cases, international integration may have a

[23] Yoon-Je Cho and Deena Khatkhate, p. 89.

[24] Ibid, pp. 66.

[25] Ibid, p. 67.

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desirable effect on domestic interest rates, which will gravitate toward equalization with international interest rates.

Removing interest rate ceilings in most instances is not a popular measure, but it is a necessary and crucial step to increase domestic savings and financial intermediation, which in turn results in lower capital flight and greater availability of financial resources for business investment. When ceilings are removed, interest rates may rise very high, especially if the inflation rate is also high. In this case, the lending rate becomes prohibitive in areas where funds are needed most, such as housing and consumer loans to the low income population. Banks may also become a casualty of interest rate liberalization if the yield of the loan portfolio they hold can not be adjusted above the rate demanded by depositors. Before and during the process of liberalization, many financial institutions in developing countries are or become insolvent. These institutions must be restructured, and some eliminated, for reforms to succeed. "Insolvent institutions allocate new resources inefficiently because their aim is to avoid immediate bankruptcy rather than to seek out customers with the best investment opportunities."[26] The viability of financial institutions is also affected by trade and industrial policy, so in the process of solving the problem of insolvency, these policies may require adjustment as well.

Consequently, there must be a mechanism to take care of this adverse short-term effect of interest rate reforms. For example, certain interest rate subsidies must be removed gradually and provisions must be made to assist banks in restructuring their portfolios.

In some countries, reforms were designed to take place gradually by establishing a range within which banks could fix their rates. In these cases, as liberalization progressed, the ranges were widened and eventually removed altogether.

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[26] *World Development Report* 1989, p. 129.

Exchange rate policy is also an important element in financial liberalization. However, in contrast with pure interest rate policies, the experience with free floating exchange rates has been different. While there is evidence that the complete liberalization of interest rates is essential to support a free market system, the same is not true with the exchange rate. A free floating exchange rate is not required to preserve a sound financial system. In developing countries in particular, a pegged rate is more desirable. The reason is that their hard currency reserves are not ample enough to perform open market operations and have the kind of "dirty float" that exists in industrial countries. Consequently, they must resort to an exchange rate pegged to one or several hard currencies.

A prime example of this strategy is Korea. Many attribute its economic success to a relatively stable exchange rate, which is now pegged to a basket of currencies after being pegged to the U.S. dollar in the 1960's and 1970's. Moderate movements in the exchange rate have been accompanied and facilitated by relatively low levels of inflation.

In contrast, the experience of the 1970's in the Southern Cone countries was disastrous. Instead of continuing to peg their exchange rate to one or several hard currencies, they adopted an exchange rate policy known as "tablita", a form of scheduled devaluations. These devaluations were based on some desired level of inflation. It was believed that in the free economy that they utilized at the time, high inflation persisted only because the deep erosion of the exchange rate was causing it. Based on this logic, they devalued the currency by small percentages, which they announced in advance hoping that the economy would reach a level of international equilibrium and inflation would increase only in the same proportion as the devaluation.

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The literature suggests that when countries can maintain macroeconomic stability, particularly in the areas of exchange and inflation rates, they are more likely to achieve financial deepening and may be more prepared to pursue international integration.

Credit Availability

Term finance, otherwise known as long-term credit, is scarce throughout the developing world generally because inflationary tendencies and fluctuations erode predictability in the system. High levels of inflation increase the risk of devaluation and increase uncertainty about the value of savings and investment. Consequently, those who invest in developing countries, whether domestically or from abroad, frequently have a bias towards short-term finance and investments. One response to the dilemma has been the introduction of compulsory pension funds, such as those instituted in Singapore and Chile. In Singapore, contributions by employees and employers, approximating 50% of salaries in 1984 before being reduced to 35% in 1986, are invested primarily in government bonds. Chile's pension system, restructured in 1981, features compulsory contributions of 10% of salaries, but contributions are privately managed by competing firms and chosen by employees: "two-thirds are invested in government bonds, one-quarter in mortgage bonds, and the rest in shares and other investments".[27]

Other policies which repress or promote financial market development and liberalization are tax and labor policy, directed credit or credit allocation programs, public ownership and privatization policy, and policies regarding the money supply. Promotive policies are those which increase the system's flexibility and which allow financial resources to flow towards activities where they will be used efficiently. Directed credit programs are usually considered repressive because resources flow not by choice but by directive. In Pakistan, for example, the government targeted 70 percent of new lending in 1986 by the

[27] Ibid, p. 107.

national banks, which are dominant in the financial sector.[28] Fortunately that portion was substantially reduced by 1988.

Often the industries and sectors enjoying the benefits of directed credit programs are ones that may not receive much investment if free market principles were in force. Considering the extent of government intervention which still characterizes LDC financial markets, ample evidence exists in the literature to categorize various government policies as repressive or promotive. Repressive policies are those which stymie internal market development through extensive government control over market entry and competition. Financial promotion, on the other hand, involves choosing policies designed to encourage financial deepening in the internal market.

Financial deepening is often measured as the expansion of financial assets held within the financial system, as a proportion of GDP. Countries in which M2 comprises a larger proportion of GDP are said to be financially deep. This means that the intermediation process is well developed and the largest possible amount of financial resources is available for investment. There is no single set of policies, no recipe, appropriate for every country. Rather, policies must be based on analysis of the country's macroeconomic situation, an understanding of the probable effects of various policies and, most importantly, coordination with a clear set of country objectives.

Informal Markets

Typically developing countries, particularly those characterized by financial repression, have a thriving informal financial sector, which serves the small business, agricultural and household sectors. The informal sector generally is not subject to the government monitoring and controls imposed on the formal financial sector. This dual system is less

[28] Ibid, p. 55.

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efficient than a well-developed formal financial market. For one reason, informal interest rates are generally higher than the real rate, yet they may be closer to the real rate than the controlled ceilings. Since informal markets do not have available a wide information network, financial resources flow only within a specific circle of intermediaries and users. This system is less efficient than a formal market, where all financial resources in the economy can be pooled together and allocated to the most productive units.

Family and friends are usually the most important source of credit in the informal sector, though pawnbrokers provide a substantial amount of credit to those with marketable collateral and money lenders extend credit to those without significant collateral. Merchants extend finance or credit to their customers and purchasing agents advance funds to their suppliers, creating a system of rotating savings and credit associations. The informal system serves clients that formal institutions determine pose unacceptably high costs and/or risks, and frequently the lending constitutes an efficient use of resources. The drawbacks of informal lending are that the "scale of lending is small, the range of services is limited, markets are fragmented, and interest rates are sometimes usurious."[29]

When reforms are contemplated, how to incorporate the informal sector becomes a salient issue. Several countries have recognized the value created by the informal sector and have established programs to link informal markets more closely with formal markets. Among experts there is a growing consensus, based on the lessons of successful programs, that programs should "take advantage of rather than suppress indigenous systems; encourage deposit mobilization as well as lending; gather the information that

[29] "Financial Systems and Development," p. 4.

formal lenders need to assess small borrowers' creditworthiness; and levy charges that cover costs."[30]

Capital Flight

Capital flight, a consequence of repressive domestic financial policies, can eliminate private domestic finance and has broad repercussions throughout the economy. There is a view that while countries suffer from having little or no domestic savings, private citizens continue to acquire foreign assets. If those assets could be repatriated, they could ease the shortage of external bank financing.[31] Countries experiencing capital flight have virtually no savings mobilization, so private investment finance is scarce at best. The difference between capital flight and foreign investment is mostly a matter of legal definition, because both mean domestic savings invested abroad. Although capital flight is detrimental to the economy as a whole, individuals engage in it when they perceive that the risk of investing domestically is greater than risks associated with investing in a foreign country. Some of the perceived domestic risks are: 1)expected depreciation of the domestic currency vis-a-vis stronger currencies; 2)depreciation of the currency due to hyperinflation; 3)lack of domestic investment alternatives, because of interest rate ceilings and overpriced real assets; and, 4)political instability resulting in low credibility of institutions. Furthermore, there is an exaggerated confidence in foreign financial institutions relative to the riskier domestic intermediaries, even when rates of return are higher in the developing countries.[32]

30 "Financial Systems and Development," p. 4; see also De Soto, *The Other Path*.

31 Mohsin S. Khan and Nadeem Ul Haque, "Capital Flight from Developing Countries," *Finance & Development* (March 1987) pp. 2-5.

32 Khan and Ul Haque, pp. 2-5.

Although the desire of individuals to move their capital abroad is understandable considering the repressive conditions described above, capital flight has reached alarming proportions, especially for Latin America in the past few years. An example cited by Urdaneta is that as of early 1986, as much as US$ 123 billion had fled Latin America.[33] Thus, the extent of capital flight has aggravated the position of Latin America as a net exporter of capital.

However, there is also the view that capital flight is not necessarily undesirable if it occurs simultaneously with capital inflows. As Cuddington puts it, "Long-term capital inflows offset by short-term capital outflows may reflect the fact that maturity transformation by financial intermediaries is occurring at the international level."[34] Consequently, the focus of financial policy does not have to be necessarily on the prohibition of capital outflows which find a way to circumvent legal restriction and leak out of the country, but rather to induce international investments into the country and create a positive balance of cash flows. Some developing countries, even those notorious for chronic capital flight problems have experienced periodic reversals. According to Cuddington, there is no supporting empirical evidence that capital flight cannot be reversed. It can be reversed when incentives for capital flight are reduced (or synonymously, when investment incentives are raised).[35]

While experiences in the developed countries are not necessarily applicable to developing countries, the U.S. experience is worth noting. The U.S. attempted controls

[33] Address by Enrique Urdaneta, President of the Inter-American Capital Markets to the 11th Annual Conference of the International Association of Securities Commissions and Similar Organizations held in Paris, July 1986. Also see Donald Lessard and John Williamson, eds., *Capital Flight and Third World Debt* (Washington D.C.: Institute for International Economics, 1987).

[34] John T. Cuddington, "Capital Flight: Estimates, Issues, and Explanations," unpublished World Bank staff paper, 1985.

[35] Cuddington, p. 16.

on capital flows in the early 1960's by limiting bank transfers and direct investments abroad, the country experienced a migration of banking activities and a large outflow of capital through investment devices to which regulations did not extend. Similar regulations in the U.K. were equally unsuccessful.[36]

International Integration vs. Isolation

Frequently, LDCs are unable or unwilling to attract domestic and international private investments. Although under certain circumstances developing countries may require the imposition of controls on capital flows, they must design these controls to ensure flexibility and balance. Otherwise they may discourage the inflow of external financial resources which are critically needed. Multilateral organizations report on the severe shortage of private capital flowing to developing nations, mainly because private bank lending has been curtailed. External official lending has filled some of the gap, but not to the extent of maintaining an adequate level of economic prosperity.

Several global trends are affecting the need for integration of LDCs into the international financial system and the rate at which integration must occur. As mature capital markets become increasingly interdependent and new capital markets are established in LDCs, the flow of capital among nations is becoming a major issue for policy makers and private investors. Developing countries need access to private finance, private finance needs markets and investment opportunities. The resulting capital movements are causing, in fact forcing, financial markets towards greater integration and openness.

[36] For an excellent historic analysis of capital controls in the U.S. and the U.K., see Sir Alec Cairncross, *Control of Long-Term International Capital Movements* (Washington, D.C.: The Brookings Institution, 1973).

Early in the century, under the gold-backed sterling standard, developing countries were fully integrated in the world economy and there were virtually no obstacles to capital flows. Since that time, however, developing countries have imposed increasing control on capital movements in support of national policies. In one view, the result has been the reverse of integration, financial isolation. This financial isolation attaches a risk premium to capital inflows. Once the risk premium surpasses the limit accepted by international investors, capital flows will stop. Conversely, a lower risk premium may induce the inflow of capital.[37]

External integration can have deleterious effects on economic development and growth in developing countries, however, primarily because the financial infrastructure in LDCs is frequently too weak to withstand the economic shock of changing from an inward-looking economy to an open economy. An analysis of reform measures pursued by the Southern Cone countries, namely Argentina, Chile and Uruguay, beginning in the mid-1970's presents an example of the difficulty of successfully integrating and how integration may even aggravate deficiencies existing within various sectors of the economy, producing a negative impact overall and a failure to achieve the proscribed objectives.

During the reform initiative, Argentina, Chile and Uruguay eliminated constraints on capital flows, decontrolled interest rates and relaxed many trade restrictions, each country in varying degrees. The programs called for simultaneous integration, liberalization, and stabilization efforts. While many observers consider the Southern Cone reform effort a failure on the whole, other analysts have suggested "that many of the microeconomic reforms were quite successful and that most of the problems were

[37] T.M. Rybczynski, "The Internationalization of the Financial System and the Developing Countries: The Evolving Relationship," *World Bank Working Papers*, 788, Series on International Capital and Economic Development No. 4 (Washington,D.C.: The International Bank for Reconstruction and Development, 1986).

caused by macroeconomic management during the transition to a more open economy," that unfavorable external shocks are to blame, and that the sequence in which reforms were implemented led to failure.[38]

Arguments for Controls

At times there is a need for controls because integration of financial markets can have undesired consequences. For example, a sudden flow of foreign capital into a country can be devastating to its balance of payments and may impair its general economic stability. This situation occurred in Chile during the reform process in the late 1970's.

Controls on international capital flows are justified also when there is lack of depth and breadth in emerging capital markets, especially with respect to equity securities. If excessive capital enters the market, the supply of equities may be short of demand and speculative stock volatility may result. This volatility must be avoided in the early stages when it is essential to establish public confidence in the equity market process.

An additional argument for controls is that one of the traditional roles of governments is to protect sovereignty. In some countries there is a strong nationalistic feeling against foreign intrusion.[39] This attitude, however, usually translates into restrictions that are politically expedient rather than fiscally prudent.

Some countries also argue for controls and resist the integration of their markets as a matter of cultural differences. Certain institutions succeed in some cultures but not in others. In many intercultural discussions the universality of certain economic principles

[38] Corbo and de Melo, p. 111.

[39] Cairncross, *Control of Long-Term International Capital Movements.*

is taken for granted, but in reality they are based on a financial, legislative and cultural system that is the product of the experience of a particular country.

When supervision, even to the point of interventionism, is applied in the proper measure and cultural environment, the results can be satisfactory, or even beneficial. One example is Korea, whose economy has been acclaimed as one of the most successful experiments in industrialization. In two decades its GNP quintupled due to drastic changes in the structure of industry.[40] This success was achieved despite the fact that, according to Yung-Chul Park, "...the country has been operating not in a free trade regime but in a highly interventionist atmosphere in which the government actively promotes exports and intervenes extensively in a number of markets, including financial and foreign exchange markets."[41] Other authors also marvel at the rigid control the Korean government has exercised over the country's economic resources.[42]

Based on the theory of "second best"[43] if a single country unilaterally lifts its barriers to investment, it may end up in a worse position than before and the other countries will reap the benefits. Black states that under these circumstances, "the benefits of free

[40] Yung-Chul Park, "Korea", Chapter 15 in Rudiger Dornbusch and F. Leslie C.H. Helmers, eds., *The Open Economy: Tools for Policy Makers in Developing Countries.*

[41] Park, p. 339.

[42] Park, p. 347, from M.D. Datta-Chaudhuri, "Industrialization and Foreign Trade: The Development Experiences of South Korea and the Philippines," in Eddy Lee, ed., *Export-led Industrialization and Development* (Geneva: International Labour Office, 1981).

[43] R. G. Lipsey and K. Lancaster, "The General Thoery of Second Best," Review of Economic Studies, Vol. 24(1):63, pp. 1956-7.

foreign investment into or out of a country are like the benefits of free trade - often illusory."[44]

Gradual International Integration

Several authors advocate integration but suggest a gradual approach. They recommend against sudden reforms that can be counterproductive in other areas of the economy: "Countries that attempted financial liberalization before undertaking other reforms suffered destabilizing capital flows, high interest rates, and corporate distress. Integration cannot succeed unless it is accompanied by the restructuring of insolvent banks and firms, and by adequate regulation and supervision.[45] They also recommend sequencing liberalization of the trade account and capital account depending on existing economic conditions.[46]

Recognizing the work of Fisher and Sachs on the issue of international integration, Corbo and de Melo suggest that "for countries with annual inflation of 25 percent or more, today's emerging consensus would therefore suggest that stabilization should precede liberalization.... The recommendation to start with a stabilization program also stems from the fact that successful liberalization depends on credibility and on having a

[44] Fischer Black, "The Ins and Outs of Foreign Investment", Financial Analysts Journal, (May-June 1978) p. 6

[45] "Financial Systems and Development," p. 4.

[46] Michael P. Dooley and Donald J. Mathieson, "Financial Liberalization in Developing Countries," *Finance & Development* (September 1987); P.J. Drake, "Securities Markets in Less Developed Countries," *Journal of Developmental Studies* 13 (January 1977), pp. 72-91; Edwards and van Wijnbergen (1986), pp. 141-148; and Sebastian Edwards, "Sequencing Economic Liberalization in Developing Countries," *Finance & Development* (Washington, D.C.: International Monetary Fund and The World Bank, March 1987), pp. 26-29.

stable and competitive real exchange rate.[47] Continuing with the inflation rate scale, Corbo and de Melo maintain than stabilization remains a high priority but that liberalization can be introduced simultaneously, though programs should "avoid measures that could jeopardize successful liberalization: the most obvious example is real exchange rate appreciation."[48] The authors offer additional guidance on reforms: initial country conditions concerning interest rates, the regulatory system, and capital flows must be recognized; reforms need realistic timetables, allowing time for adjustment; implement policies that can help speed up adjustment, when possible, to enhance credibility; institute a transition phase for financial deregulation, perhaps deregulating lending rates with deposit rates following gradually; deregulate domestic markets to ensure that resources are reallocated; implement external liberalizing reforms only after domestic market liberalization. Referring to the work of several authors (McKinnon 1982, Frenkel 1982 and 1983, Krueger 1984, Edwards 1985), Corbo and de Melo claim, "it is usually argued that the current account of the balance of payments should be liberalized first, then the capital account."[49]

The phasing or sequencing of financial reforms in relation to other economic, social, and political reforms is, therefore, an important, yet difficult policy question. Gelb and Honohan offer some additional guidance:

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

[47] Corbo and de Melo, pp. 116-117.

[48] Ibid, p. 118.

[49] Ibid, pp. 127-129.

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Abrupt financial sector liberalization can itself generate undesirable side-effects. For example, if interest rates are all deregulated at once, the(typically)shorter maturity of deposits than loans will imply a severe profitability squeeze for banks. This is especially acute for housing loans, because of their long maturity. Unless the low interest rates can be renegotiated, permanent increases in the level of interest rates may imply some form of state subvention if depositors are to be protected. Also, an easing of the fiscal burden on the financial system will generally result in pressure on the budget which may manifest itself in a distorting tax imposed elsewhere in the economy or inflation or explosive issue of public debt which further raises interest rates and contributes to financial instability.

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

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

In practice, the timing of financial reforms will probably follow "windows of opportunity" (as, for example, in Argentina), and the possible shocks which might arise in the course of other likely reforms must be factored in.[50]

In addition to gradualism, several authors suggest that integration, and internal liberalization as well, be supervised very closely. As pointed out by Edwards, "...according to the 'second best' theory, if existing restrictions are only relaxed sequentially, it is not possible to know *a priori* if, due to the partial liberalization, some

50 Gelb and Honohan, pp. 14-16.

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of the remaining distortions will be magnified."[51] This situation requires close supervision and adjustments as necessary. A poignant conclusion of one of the best accounts of the Southern Cone Fiasco, is that "closer supervision of financial activity is advisable when financial systems that have been tightly regulated for a long time are liberalized. In the Southern Cone, such supervision would have helped avert the crises..."[52]

Blejer and Sagari, among others, sustain that "external liberalization" or integration must take place only after internal liberalization has been established. "In general, relaxation of domestic regulation- internal liberalization- should precede the opening-up of the domestic financial market to external flows - external liberalization."[53]

> The main objectives of external and internal financial liberalization are the integration of the domestic financial market with the international market in order to improve the role of the financial markets in the allocation of resources. On the basis of the results of the recent liberalization experiences in developing countries, particularly in Latin America, it is frequently claimed that the financial liberalization measures adopted (e.g., the reduction of regulations on bank entry, the elimination of interest rate ceilings, or the relaxation of exchange controls), failed to attain those main objectives. It is also argued that this failure is reflected in the large spreads between foreign and domestic interest rates after adjusting for changes in exchange rates, and in the emergence of very high real interest rates.

51 Edwards (1987), p. 29; also R.G. Lipsey and K. Lancaster, "The General Theory of Second Best," *Review of Economic Studies* Vol.24(1): 63, pp. 1956-1957.

52 Vittorio Corbo, Jaime de Melo and James Tybout, "What Went Wrong with the Recent Reforms in the Southern Cone, *Economic Development and Cultural Change* Vol.3 (April 1986): p. 637.

53 Cuddington, pp. 94-95. The question of optimal sequence of liberalization between trade and financial markets has been discussed extensively in the literature. See Frenkel (1984), McKinnon (1982), and the discussion by G.Calvo, R. Dornbusch, and J. Williamson in Ardito Barletts et al.(1983).

> Internal and external financial liberalization are, undoubtedly, complementary processes. However, as the preceding analysis indicates, if a banking sector is characterized by very restrictive regulations, significant government participation, and a noncompetitive structure, external financial liberalization should be implemented only after internal financial liberalization is well under way.
>
> As a result of this sequencing, the adjustment costs and disruptive effects of opening up the capital account can be considerably reduced, and the benefits to the financial market, and to the economy in general, can be maximized.[54]

Data gathered by the World Bank for the *World Development Report* 1989 suggests that many developing countries will not be able to implement liberalization policies as extensively as some of the higher-income countries, particularly in the initial reform stages. The report includes a guarded generalization of the probable steps in moving from a regulated to a more liberal financial system. In turn, lasting international integration can not be achieved without a stable economy.

Issues in Regulation

Regulation is a complex issue, and distinctions must be drawn between the different types of regulation which may be adopted. There are administrative regulations, such as those regarding supervision of financial markets, and other types of regulations and controls that impose limits on activity; for example, limits on the number of branches a bank may have or limits, reserve requirements, and limits on the quantities of capital in flows and outflows.

Developing country governments have frequently adopted extensive financial controls to achieve specific goals. The problem is that governments generally are reluctant to terminate programs or reforms laws that are politically popular but economically

[54] Mario I. Blejer and Silvia B. Sagari, "Sequencing the Liberalization of Financial Markets," *Finance & Development* Vol.25, No.1 (March 1988), p. 20.

unreasonable. Authors suggest that the quest of governments must be to intervene in the marketplace to assure the achievement of national goals of economic stability, but they must also be prepared to relinquish controls that block the natural course of private enterprise. As van Agtmael states, "tax incentives cannot create a market. On the other hand, tax disincentives can be a major obstacle in market development. Thus, a first step in the analysis of the need for tax incentives should be a clear understanding of what tax distortions already exist."[55] Gelb and Honohan concur:

> No uniform approach has been adopted to the ideal regime of taxation of financial intermediation. Such taxes add to the wedge between borrowing and lending rates thereby contributing to inefficiency in the allocation of resources. It should be emphasized that, where inadequacy of capital is a major constraint to development, distortion of this type may be more severe than in capital rich countries. For this reason, a reduction in financial sector taxation is often a priority in financial sector reform. At the same time, it could happen that undue zeal in eliminating fiscal burdens on the sector might result in undue taxation elsewhere in the economy. A comparison of the amount of indirect tax collected with the value added of the financial sector gives some basis for comparing tax burdens across sectors. So far as tax design is concerned, it is desirable that the tax should not be linked to nominal interest receipts in inflation-prone countries, otherwise it may quickly grow in importance and contribute to a severe widening of interest rate spreads if inflation and nominal interest rates rise sharply.[56]

Although in some instances it may be necessary to enforce fiscal and monetary policy through controls in the interest of correcting some of the undesirable traits of the free market system and pursuing specific national goals, any government intervention must be planned carefully to maintain a regulatory balance.[57]

[55] Antoine W. van Agtmael, "Fiscal Policies in Securities Market Development," Presentation at the Capital Markets Seminar in Lisbon, Portugal, May 12-13, 1983.

[56] Gelb and Honohan, pp. 11-13.

[57] Regulatory balance here refers specifically to controls on capital flows, excluding administrative regulations such as the supervision of financial markets.

Government intervention may be required during the reform process. As mentioned previously, Argentina, Chile and Uruguay embarked on ambitious liberalization programs during the 1970's, including reforms and deregulation directed towards internal liberalization and international integration. Interest rate controls, directed credit programs and exchange controls were eliminated. The reforms proved difficult, however, and all three governments had to adjust their reforms to deal with such threats as rampant inflation and widespread bank failures. The Argentine government, for example, reintroduced several of the controls initially eliminated. After freeing interest rate controls, Turkey reintroduced controls two years later when real interest rates rose too far.[58] Some analysts suggest that "capital controls were instrumental in preventing capital flight from Korea in the early 1980's when the public's confidence in the Government's ability to manage the economy was very low, the political situation was volatile, and there was widespread distrust of the domestic banking system spawned by scandals and financial vulnerability. With free capital movement, Korea might have lost control over the deposit base of domestic financial intermediaries, as happened in other countries like the Philippines, Indonesia and the Southern Cone countries in Latin America."[59]

During the 1980's many developing countries have attempted reforms and financial sector restructuring, and in this process there has been wide-ranging government intervention. Examples include closing several financial intermediaries and withholding a small fraction of their total assets in Malaysia; closing and replacing nearly every bank in Guinea; generating inflation deliberately to reduce real debt burdens in Argentina; absorbing foreign exchange losses incurred by banks, as occurred in Costa Rica, Dominican Republic, Ecuador, and Yugoslavia; and commissioning external auditors to conduct independent audits of domestic banks to provide authorities with better

58 "Financial Systems and Development," p. 4.

59 Yoon-Je Cho and Khatkhate, p. 59.

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information about banks' portfolios, as occurred in several countries including Bolivia and Ghana.[60]

Freeing Up the Financial System

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

- increase in controlled interest rates to ensure that deposit rates are positive in real terms.
- removal of control on maximum deposit interest rates.
- removal of all interest rate controls.
- withdrawal of interest subsidies and cross-subsidies.
- reduction in the complexity of sectoral credit targets and the degree to which they differ from what would be the uncontrolled outcome.
- removal of bank-by-bank credit ceilings, or of overall credit ceilings in favor of broad instruments of monetary control.
- removal of prohibition on commercial banks from activities such as underwriting or investing in private corporate securities.
- ensuring that barriers to entry into banking are no more than is required for prudential reasons (though in some cases an increase in capital and other requirements is needed for precisely those reasons).
- reductions in fiscal or quasi-fiscal burdens on the financial sector such as those caused by low remuneration of heavy reserve requirements.
- liberalization of exchange controls.[61]

[60] Ibid, p. 59; and Long and Evenhouse, pp. 5-7.

[61] Alan Gelb and Patrick Honohan, "Financial Sector Reforms in Adjustment Programs," World Bank Working Papers (Washington, D.C.: International Bank for Reconstruction and Development, March 1989), p. 1.

> All of these measures have the general objective of improving the effectiveness of the financial sector's performance in mobilizing and allocating resources, by using broad market signals wherever possible....The timing of liberalization and its extent are sometimes debatable issues, especially when financial reforms interact with other reforms or macroeconomic imbalances. Also, the extent to which reliance on market signals in otherwise suboptimal environments is wholly adequate in meeting development needs for credit is still disputed (though it may be argued that the allocation of resources to desirable uses is better dealt with by fiscal means than by credit allocation). In practice, and for a variety of reasons, most countries choose to retain some degree of control over financial resource allocation and some degree of subsidy in their financial systems. Bank programs often focus on reducing the most egregious deviations from a market configuration, such as the prevalence of credit at negative real interest rates, or at rates below those available on deposits which encourages the substitution of borrowed for own funds.[62]

Some common effects of restructuring are sudden and extensive losses within the banking sector and even bank failures. Faced with this situation, a government must determine how to allocate losses and what action, if any, to take regarding ownership and management of these financial institutions. In Chile, the government protected foreign creditors even when government guarantees had not been offered for their lending. This helped Chile's international credit reputation, though taxpayers had to absorb the cost. Long and Evenhouse provide examples of actions taken concerning ownership and management:

> In Colombia and Spain, the law allowed Governments to write off the value of shares and issue new shares to other than former shareholders. In Thailand, existing shareholders were allowed to keep their shares but the issuance of many new shares greatly reduced their value. After restructuring insolvent banks, the

62 Gelb and Honohan, pp. 11-12.

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> Chilean Government provided cheap credit and generous tax incentives to new buyers of shares in the two biggest banks... Both the Chilean and Spanish Governments, for example, became the owners and operators of several restructured banks until suitable buyers were eventually found.[63]

Can developing countries offer attractive opportunities to international investors? If the return offered in one country does not compensate the risk taken, evidence shows that international investors quickly move their funds to countries which offer a better investment environment. The risk taken by investors in addition to financial risk, must include a premium for country risk and investment barriers imposed. Consequently, developing countries must adopt an optimal balance of fiscal and monetary regulations. Developing countries must open their economies to attract the external capital that they need to sustain economic growth. On the other hand, their systems for regulating capital flows must be carefully balanced to achieve economic stability.

Costs and Benefits of International Integration

While the trend toward financial globalization is well underway, consideration of the costs and benefits of integration deserves attention. In addressing the question theoretically and empirically, Subrahmanyam concluded that given certain utility assumptions, investors can increase their welfare through market integration[64]; and, most importantly, the welfare of individuals in the economies studied never declines and will generally improve.[65] However, an important prerequisite of this integration is the liberalization of markets and opening financial markets to free flow of capital. Recently

[63] Long and Evenhouse, p. 7.

[64] Marti G. Subrahmanyam, "On the Optimality of International Capital Market Integration," *Journal of Financial Economics*, (1978), p. 23.

[65] Subrahmanyam, pp. 3-28.

it has been found that international integration, particularly when attempted prematurely, can have a destabilizing effect on developing country economies.

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

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

More generally, the degree to which an efficient financial system can contribute to the process of economic growth is not precisely established. Certainly, a well-performing financial system is no substitute for policy weakness elsewhere in the economy. Nevertheless, when things go wrong in the financial system, such as with a hyperinflation or-more relevant in the present context-widespread bank failures, the impact on the economy can be sudden and dramatic and long-lived. Recent research on the 1930's depression in the US attaches considerable importance to the impact of bank failures on credit availability (independent of the deflationary effect of monetary contraction). Cause and effect have been difficult to disentangle in some of the developing country episodes of financial insolvency in that the insolvency of the banks became evident at a time of recession.[66]

[66] Gelb and Honohan, pp. 25-26.

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International integration may have severe costs. Financial market openness may not always produce the desired results in economic development and growth. Liberalization in developing countries may even have a detrimental effect in the short term. One reason is that the financial infrastructure of developing countries, when compared with mature economies, is too weak to withstand the economic shock of changing suddenly from an inward-looking economy to an open economy. Liberalization may even aggravate other deficiencies existing within various sectors of the economy, thus producing an overall negative impact and not achieving the desired outcomes.

As explained earlier, an example is the experience of Argentina, Chile and Uruguay, which pursued open market reforms starting in the mid-1970's. In varying degrees, they eliminated constraints on capital flows, decontrolled interest rates, and relaxed many trade restrictions. According to experts at the World Bank, "...initially some efficiency gains were made but these were ultimately overshadowed by problems with policy inconsistencies, implementation difficulties, and overlooked market frictions."[67] A main cause of the failure was the fact that, at the time reforms started, the three countries were experiencing severe macroeconomic imbalances, including foreign exchange shortages and high inflation. One of the contributing factors was the absence of basic regulatory constraints on financial activities.[68]

Integration can, however, bring many benefits. Despite the several shortcomings described above, developing countries need to become integrated into the world economy. There is ample evidence of critical shortages of long-term strategies to attract external sources of capital and to stop the outflow of domestic savings, both of which are urgently needed to sustain an acceptable level of economic growth. Under these circumstances, developing countries appear to have no choice but to become integrated

[67] Corbo, de Melo and Tybout, pp. 607-640.

[68] Ibid, pp. 607-640.

into the global economy. The central issue becomes then, how can developing countries enter the global economic mainstream by offering private investors opportunities that are more attractive than those available elsewhere in the world and at the same time maintain reasonable control over their own economies.[69]

There are more reasons for decontrolling capital flows then there are for controlling them. Justification for controls is usually based on economic instability, as described above. In addition, some countries have deep-seated nationalistic feelings and cultural differences which support investment barriers to keep foreigners from owning domestic companies and resources. Gill calls this "economic nationalism."[70]

The most powerful reason to decontrol capital flows is the severe need of developing countries for external financing and for tapping the vast resources of international investors. In addition they must reverse capital flight by improving domestic investment opportunities.[71]

[69] See for example Jack M. Guttentag and Richard Herring. "Commercial Bank Lending to Developing Countries" from "Overlending to Underlending to Structural Reform," *International Debt and the Developing Countries*, Gordon W. Smith and John T. Cuddington, eds., (Washington, D.C.: The World Bank, 1985), pp. 129-150. "Financial and External Debt of Developing Countries: 1986 Survey," Organization for Economic Cooperation and Development (Paris, 1987), pp. 8-12; "Geographical Distribution of Financial Flows to Developing Countries 1983-1986," Organization for Economic Cooperation and Development (Paris, 1988).

[70] Address by David Gill, Director, Capital Markets Department, International Finance Corporation, to the Ninth Annual Conference of the International Association of Securities Commissions and Similar Organizations, Toronto, August 1984.

[71] For an assessment of the volume of international capital flows see, "Factors Affecting the Trend Toward Internationalization of the Securities Markets," in *Internationalization of the Securities Markets*, Report of the Staff of the U.S. Securities and Exchange Commission to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce, Washington, D.C. (July 27, 1987), pp. 11-70. Also see Peter Pearson, "Foreign Investment Funds from an International Investor's Viewpoint: Commentator Remarks," *Capital Market Development in the Asia-Pacific Region*,

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The empirical evidence on the fluidity of international capital flows is somewhat ambiguous. In industrial countries Feldstein and Horioka observed a high correlation across countries in national savings and investment rates. This correlation would not be anticipated if the international capital flows always move to equate the marginal return on capital in all countries.[72]

Another study by Dooley, Frankel, and Mathieson looked at a sample of 50 developing countries. They found that the correlation between savings and investment was generally weaker for the developing countries. The central question is whether or not the foreign sectors are an efficient supplier of funds, if not, financial integration with the rest of the world may not have the desired effect of economic growth and stability. Honohan and Atiyas argue that domestic financial markets may not be very efficient at channelling savings in the economy. This may not become an obstacle if the foreign sector can close the financing gap for the business sector. However, if the foreign sector provides funds not in response to the needs of the domestic business sector, but rather in response to exogenous variables, then foreign capital will not flow smoothly into the country when it is needed.[73]

[72] Feldstein and Horioka (1980) quoted in Patrick Honohan and Izak Atiyas, "Intersectoral Financial Flows in Developing Countries," *World Bank Working Papers* (Washington, D.C.: The International Bank for Reconstruction and Development, March 1989).

[73] M.P. Dooley, J. Frankel and D. Mathieson, "International Capital Mobility", *IMF Staff Papers* Vol.34 (Washington, D.C.: International Monetary Fund, September 1987), pp. 503-30.

II. FINANCIAL TRENDS AND INNOVATIONS IN DEVELOPING COUNTRIES

There is a trend towards financial globalization, by choice and necessity. Communication and production technology are spreading quickly, causing national economies to become fused into a common system of commerce and finance. Although globalization offers many benefits to providers and users of financial resources, there are still many national systems of taxation and regulation that impede the free flow of capital. Many of these systems were created at a time when financial transactions did not have the global dimensions they have today.[74] It should be noted that the internationalization of securities markets is not new: U.S. securities were already actively traded in the London Stock Exchange in the early decades of the 19th century. What is novel about the current globalization is the speed with which it is spreading. As the trend toward globalization accelerates, the pressure to liberalize financial markets also increases.

The changes in financial market development that occurred during the 1980's has much to do with the acceleration of globalization. The debt crisis, the rationalization of the effectiveness of the public sector, the rapid increase in global trading and international competition, and the explosive growth in telecommunications and technology transfer all have played a vital role in defining the new order of international finance for the 1990's. Since many of the traditional sources of finance are no longer available, developing countries have had to utilize new innovations for obtaining finance to promote economic growth. Innovations that have increased financial flows to developing countries include privatization transactions, international capital market development, debt conversion schemes, and build-operate-transfer schemes. Each innovation, taken separately, will do little to promote a developing country's economic growth. Taken in aggregate, however, the innovations offer a comprehensive package that can give developing countries promising alternatives for attracting finance for economic development.

[74] *FRBNY Quarterly Review* Spring 1987, pp. 1-9.

Privatization

One of the most important financial trends in developing countries today that marks attempts to forge market-oriented economies is privatization. This trend gained impetus in the mid-1980's, when bilateral and multilateral lending institutions encouraged the process as a road to recovery for ailing and heavily indebted state-owned enterprises (SOEs). Governments created SOEs to foster industrialization and development of strategic industries, to preserve or increase employment opportunities, to maintain control of industries and sectors, and to prevent the entry of foreign-owned firms; SOEs, however, have frequently performed poorly, particularly in terms of financial rates of return. Comparative studies for Brazil, India and Israel have indicated that rates of return have generally been lower for SOEs than for the private sector. SOEs, owing to inefficient management and the negative consequences of price and other government controls, are a drain on public budgets and exacerbate external debt as illustrated in the following examples: "the net deficit of a sample of SOEs accounted for about 4 percent of Niger's GDP in 1982. For the seven largest Latin American economies, the combined deficit of SOEs rose from about 1 percent of GNP in the mid-1970s to about 4 percent in 1980-82."[75]

The poor performance of SOEs and their increasing burden on financial resources has spurred the trend toward privatization in which industrial and developing countries alike are divesting their ownership of SOEs in such sectors as telecommunications, steel, tourism, manufacturing, mining, and petrochemicals to improve efficiency and competition as well as to eliminate the drain on public budgets. The divestiture is occurring through liquidation, privatization of ownership, and management of contracts.

[75] *World Development Report* 1987, pp. 67.

The World Bank is heavily involved in privatization through its projects. Of 109 projects examined in a recent survey, 33 provided for divestiture, 21 contained components involving other forms of privatization (leasing, management contracts, concessions, etc.), and 30 provided for liquidation of state-owned enterprises.[76]

One illustration of the massive scope of this trend towards privatization and greater reliance on the private sector and market coordinates is the commitment of the World Bank and the establishment of new institutions to promote private sector activities.

> The World Bank Group has long emphasized the advantages of market discipline and private initiative in promoting efficient development. Over the past five years it has intensified its work in this regard through a number of new departures: the International Finance Corporation (IFC) has grown rapidly; the Foreign Investment Advisory Service was created by IFC in 1986; the Multilateral Investment Guarantee Agency was established in 1988; and the World Bank itself has increasingly emphasized the business environment in its adjustment lending. Development strategies have been changing during the 1980's, and the World Bank Group's approach has changed with them, as staff in all sectors and regions are increasingly working with member countries to seek in the private sector solutions to development problems.[77]

A Review Group, established by the World Bank to propose ways in which the World Bank could do more to help member countries strengthen the private sector's contribution to economic development, released a detailed report regarding the elements of private sector development and how the World Bank Group institutions might best assist in the process. The elements of private sector development are identified as:

- a supportive (or "enabling") business environment consisting of a stable macroeconomic setting, economic incentives that promote efficient

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[76] "Developing the Private Sector: A Challenge for the World Bank Group," International Bank for Reconstruction and Development (Washington, 1989), p. 13.

[77] Ibid.

resource allocation by the private sector, and laws and regulations that protect the public interest but do not unnecessarily interfere with private initiative;

- the services in infrastructure and human resource development necessary to permit private enterprises to function effectively; and
- a financial system that provides the incentives and institutions needed to mobilize and allocate financial resources efficiently.[78]

In its attempts to promote and assist private sector development in its member countries, the Review Group listed five possible approaches to be used in varying mixes in country-specific projects. The five approaches are: 1) the *incentives approach*, stressing the reduction of distorting incentives such as subsidies through reform of macroeconomic, trade, tax, and financial market policies; 2) he *deregulation approach*, emphasizing the reduction of unnecessary regulations, restrictions, and other public interventions in the private sector; 3) the *promotion approach*, encouraging private sector development through provision of credit, information, and advisory services; 4) the *development approach*, focusing on the creation of physical and human infrastructure required by private entrepreneurs; and 5) the *privatization approach*, transferring functions and enterprises from the public to the private sector through divestiture of state-owned enterprises, contracting out of leasing of activities or functions, and reducing public involvement in certain areas while permitting and promoting greater private sector initiative.[79]

Primary objectives of privatization are to increase profitability and efficiency. Reasons that some privatization attempts have failed are: 1) enterprises that government wants to sell are usually the least profitable ones that the private sector is not willing to buy at a

78 Ibid, p. 1.

79 Ibid, p. 6.

74.

price acceptable to government; 2) divestiture and privatization incite insecurity and opposition from employees who may lose their jobs, politicians who fear the consequences of unemployment, and bureaucrats who may lose patronage; and 3) relatively undeveloped capital markets sometimes make it difficult for governments to float shares and for buyers to finance large purchases.

Privatization within the financial sector has received a great deal of attention recently. The financial institutions in the greatest distress today, in many developing countries, are publicly owned and operated. Privatization offers prospects for improving efficiency and profitability of these institutions, but can only succeed if the quality of bank portfolios and regulatory framework improve. When privatization occurred in the Chilean banking sector, the ownership of public banks shifted from the government to large industrial groups, since they alone had the resources to acquire the banks, thereby increasing economic concentration and undermining sound banking. Guinea, a country with few banks and limited in its regulations and ability for supervision, has sought greater foreign participation in bank ownership and management.[80]

Chile has embarked on an ambitious and largely successful privatization program which has overcome many of the typical obstacles. As mentioned previously, Chile adopted a compulsory pension program throughout its economy. Privatization has provided pension funds with an expanded market for trading private securities and, thus, served as a dynamic vehicle for the expansion of securities markets.[81] Many countries have shown great interest in privatization, among them Bangladesh, Chile, Kenya, Malaysia, Mexico, the Philippines, Thailand, Togo, and Turkey, and substantial privatization has already occurred in Bangladesh and Chile.

80 *World Development Report* 1989, p. 129.

81 Chapters from forthcoming World Bank staff paper.

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The success of privatization depends upon the policy framework in which privatization is implemented and the extent to which price controls and subsidies are eliminated throughout the economy. For privatization to result in greater efficiency, there must be a competitive environment. Significant gains in efficiency can be made when there is a competitive marketplace and when ownership is transferred to the private sector. Experts stress that "the gains from privatization will be greater if the trade and domestic policy environment encourages competitive markets."[82]

International Capital Markets

The 1980's have been a trying time for developing countries because of the recognition of the debt crisis in 1982. Traditional methods of raising finance through commercial banks, utilized in the 1960's and 1970's, are no longer available to developing countries. This in itself poses a major problem for developing countries because without new and continuous financial inflows, economic growth will remain stagnate. Because of this problem, LDCs have had to examine alternate avenues from which to locate finance. The international capital markets, which have been experiencing tremendous globalization and integration during the 1980's, offers such possible sources of finance. Participation by LDCs in international capital markets previously has been extremely limited because of the "debt overhang" problem. Because of this, financial institutions have set strict pre-conditions and pre-requisites for developing countries that must be met before they are even considered for a new financing package. Some of the pre-requisites include:

- establish and maintain creditworthiness;
- bring about progressive integration of the domestic and international markets; and

[82] *World Development Report* 1987, p. 68.

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- promote competitive impulses and pressures for improving the effectiveness and efficiency of domestic financial markets in an environment of financial stability ensured through strategic and prudential regulation of the financial system.[83]

On most occasions, these pre-requisites have been difficult for developing countries to meet because of the enormous external debt and the traditional role of the government in "managing" the domestic financial markets. Some countries have, however, utilized the international capital markets to raise finance through innovative and creative techniques. These techniques include the Euromarkets, interest and currency swaps, the use of non-banking lending institutions, the development of country investment funds, and the development of equity markets. Although the literature shows that activities in each of these transactions has been relatively small to date, the literature also suggests the potential for utilizing these types of transactions in developing countries is promising.

Euromarkets

The euromarkets can provide numerous opportunities for developing countries because financial institutions and instruments are developed by circumventing burdensome country regulations, thus allowing for the opportunity to achieve more efficient allocation of financial resources. For example, the eurobond market is one of the more competitive and efficient capital markets utilized today. Hence, it is also the most innovative. The first major development in the eurobond market in the last decade has been the floating rate note. These notes have a variable rate which is set, usually semi-annually, at a margin over LIBOR. The floating rate notes usually come with warrants and convertibility rights, which is convenient for developing country usage.

[83] V.V. Bhatt, "On Participating in the International Capital Market," Economic Development Institute, The World Bank, p. 15.

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Developing countries, however, have had only a modest participation in international bond markets. Compared to industrial countries, placement of international bond issues by developing countries has been small.

(In billions of dollars)	1983	1988
Foreign and International Bonds		
Industrial Countries	78,401	229,135
Developing Countries	4,170	10,965
Eurobonds		
Industrial Countries	41,015	156,671
Developing Countries	2,382	5,525

Source: "International Capital Markets," International Monetary Fund, Washington, D.C., April, 1989, pp. 87 and 97.

As seen by the above table, the developing countries' share of all bonds issued by industrial and developing countries in foreign exchange and the euromarket was less than five percent. This is evidence that developing countries currently have minimal direct access to world bond markets. Most of their relationships with international markets is indirect, usually through foreign banking institutions which do business in those countries, through international banking lending, which is dwindling, or through an association with multinationals who themselves have access to external sources of capital. The only exception to traditional foreign funds sourcing through international banks and multinationals, are portfolio investments. Unfortunately, these investments can take place only where there is a reasonably active stock exchange where an abundant supply of local securities are traded.

unavailable for investment in developing countries are now becoming more available for developing country capital markets because of the need and desire to diversify investment portfolios. Hans Hurch writes:

> Securities market development tends to generate more diversified forms of risk capital through a wider choice of instrumentalities and thus contributes to desirable innovation not only in the financial sector but in economic activity in general. It provides for more diversified and competitive financial intermediation which should reflect positively upon intermediation cost reduction. By offering suppliers and users of resources a wider range of options, securities market development contributes to further deepening of the financial system and thus to the effectiveness of that system in the transition from stabilization to adjustment and, ultimately, return to sustained growth and development of the economy.[85]

Even though the opportunity is available for non-banking institutions to invest, the poor record of creditworthiness in aggregate of developing countries has kept many foreign investors away. Krishnan Saini writes: "Pension funds are the single largest source of funds--amounting to U.S.$653 billion at the end of 1980--for the United States capital markets, until recently they have not made any significant diversification into foreign securities, especially those of developing countries....The primary reason for this has been unfamiliarity with foreign markets; other concerns include the nature of liquidity in foreign securities and of course, exchange rates."[86]

[85] Hans Hurch, "Some Policy Issues for Securities Market Development," Economic Development Institute, Conference Paper, 1989.

[86] Krishnan G. Saini, "Capital Market Innovations and Financial Flows to Developing Countries," *World Bank Staff Paper No. 784*, 1986.

Country Investment Funds

One approach that has been relatively successful in attracting international investors, both institutional and individual, has been through the development of foreign mutual funds. These funds have been well received by institutional investors because they provide a vehicle to invest in a diversified basket of foreign securities. There were 21 such funds in 1983 with assets of $ 3.5 billion; the number grew to 59 funds in 1986 with assets of $ 15.9 billion.

Surprisingly, in the last several years emerging stock markets have outperformed the traditional New York, Tokyo, and London markets. An overview of selected stock markets compiled by the International Finance Corporation (IFC) as of December 1989 showed the following:

	12 month % change in IFC Price Index
Latin America	
Argentina	136.07
Brazil	39.31
Chile	35.40
Mexico	66.02
Asia	
Korea	-2.40
Philippines	57.48
Taiwan	95.35
Malaysia	39.43
Thailand	85.30
Europe/Middle East	
Greece	67.56
Turkey	300.07

Developed Countries

Japan	12.19
United Kingdom	21.09
United States	27.25

Clearly, there are investment opportunities in emerging markets. The strongest proponent of this kind of investments has been the IFC, who has cosponsored a number of national investment funds that are traded in the major exchanges. Successful funds have been started in at least 12 countries.

The best performer of all IFC funds has been the Emerging Markets Growth Fund (EMGF,Inc.) which started in May 1986 with a gross initial amount of $133 million dollars and as of December 1989 has a total market value of $310 million dollars, representing a compounded annual rate of return of 34.6%. The EMGF invests in securities of companies that are listed on the domestic markets and which can later be listed on the markets of major financial centers. By having EMGF "approve" of such securities (i.e., by purchasing them), their attractiveness to other foreign investors in foreign markets is enhanced and adds credibility to the securities.[87]

Equity Market Development

Several key elements must be present in the economic and regulatory environment of a developing country in order for an equity market to succeed. The environment must be ready to facilitate the operation of an equity market trough its economic, political, legal, institutional and regulatory infrastructure.[88]

87 Bhatt, p. 19.

88 For an excellent discussion, see Bryan Sudweeks, *Equity Market Development in Developing Countries* (New York: Praeger), 1989.

Once an equity market is operational, it must be allowed to flourish within a framework of mild, yet comprehensive regulations that preserve the integrity of the market. Equity markets, like all financial markets, are dynamic. They are constantly changing to meet differing patterns of savings, fiscal conditions, institutional arrangements and the supply and demand for funds. As opportunities and conditions change, that is, as the risk adjusted yield of instruments vary through time, investors accommodate to these developments by devising new strategies. Consequently, the regulatory system must be flexible, within certain limits, to be able to meet changing market conditions and the needs of market participants over time.
An equity market is the utmost expression of the free market system. Of all financial instruments, equity instruments are the ones where the full impact of risk and reward is shared by sellers and buyers. For this reason they also provide the most efficient allocation of resources, because buyers choose directly the level of desirable risk and return.

The macroeconomic benefits are increased efficiency in the financial system, such as, mobilization of savings, allocation of investment, repatriation of domestic capital, attraction of foreign portfolio investment, availability of vehicles for privatization and debt/equity swaps. The microeconomic benefits are a greater potential for growth through the availability of long term risk capital (both domestic and foreign), a broader risk diversification base among stockholders, and a lower cost of capital.

Equity markets also create costs. The early stages of developing equity markets are particularly volatile because they lack the breadth and depth to absorb domestic and international shocks. The market cycles can become unusually pronounced, a fact which undermines investor confidence and sends undue concern signals throughout the financial system. Another cost created by equity markets is the need for additional regulation which is alien to the existing regulatory system of countries most LDCs. This transition from specific banking regulations to a broad body of financial system regulations that must be designed to function effectively in a free market system, is one of the most critical steps toward the creation of equity markets.

A conservative investing public must be protected through disclosure rules from the possibility of speculation and dishonest activities that can take place in the equity market. But disclosure requirements are not enough to protect the public. The public itself must be educated to interpret and act upon the information that is being disclosed.

The most important prerequisite for the establishment and continued growth of an equity market is the propensity of the public and the private sector to accept the challenge of new ideas. Equity participation in private enterprises is an idea alien to many cultures. To embrace this idea first there must occur a change in attitude; therefore, the initiative and the commitment to establish an equity market must emanate from the country itself - from its government and its citizens. Otherwise, if the initiative is imposed by external influence, the commitment of the local authorities will be absent and the equity market will not develop.

Investors are seeking ways to distribute risks among investment project participants. To the extent that domestic parties are willing to accept some of the risks associated with investment projects, international investors may find developing country investment opportunities more attractive. There is also a trend toward investment project brokering where institutions such as the International Finance Corporation (IFC) of the World Bank help to piece together project finance. The IFC frequently participates as a small financier, but the organization also helps to assess projects and find funding for projects it has no financial stake in.

Debt Conversion

Since the beginning of the debt crisis in 1982, financial institutions and governments have been searching for innovative ways in which to deal with the international debts of developing country nations. Commercial banks for the past eight years have been forced to refinance on one loan package after another so as to keep billion dollar loans from being written off as losses. Many developing country governments have had to suspend interest payments at one time or another because of the poor performance earnings of the country and the inability to acquire adequate foreign exchange because of low export earnings.

To counteract these problems, one such innovation that has help to alleviate a small but not insignificant burden of the financial crisis is the debt conversion. Debt conversion, in its simplest form, is the selling of a loan note on the secondary market at a discount to a perspective buyer/investor who in turn purchases local currency (at the full value of the hard currency denominated loan note) from the Central Bank of the developing country to use for local investment purposes.

For example, a buyer purchases debt at a discount from a New York bank, paying in dollars (for example, a $100,000 loan note purchased for $50,000). The buyer (now investor) takes the $100,000 note to the Central Bank of the country where the loan originated and exchanges the note for $100,000 worth of local currency. The investor now takes the $100,000 worth of local currency and invests the money in the particular project he/she has been promoting or developing. Because of this transaction, the buyer/investor is able to make an investment at a significant lower cost and the Central Bank is allowed to cancel the full value of the original loan payable to the New York bank.

One of the most important aspects of debt conversion exchanges is that it is market driven and therefore "voluntary". Since it is voluntary, the motivation behind a conversion is the self-interest of all parties, including the creditor, the debtor, and the buyer/investor. The benefits of debt conversion, especially for developing countries are numerous. Conversion transactions can reduce the external debt and reduce debt service of the country. It can attract foreign investment, promote development, and increase exports which in turn can increase foreign exchange reserves. Debt conversion can also recapitalize the local private sector, finance privatization, and repatriate flight capital.[69]

Several debt conversions schemes have been successfully implemented by debtor countries. The largest conversions in 1988 were completed by Argentina, Brazil, Chile, Costa Rica and Mexico, as shown below in millions of dollars:

Debt Conversions (in Million of US $)-1988

Argentina	1,362
Brazil	1,964
Chile	2,606
Mexico	1,356

Source: Information provided by the respective Central Banks and reported in "International Capital Markets: Developments and Prospects", April 1989, IMF, Washington D.C., p. 37.

It is interesting to note that in Chile a substantial portion of bank debt converted and that the allocation of equity investments resulting from debt conversions have been largely determined by private investors.

Although the results of these conversions are mostly encouraging, the amount of debt converted is a very small percentage of total outstanding debt in LDCs. For example, total external and private debt as a percentage of GNP and long-term debt service as a

[69] "The Way Forward for Middle Income Countries," *The Institute for International Finance*, Inc. January, 1989, p. 21.

percentage of exports, for the same four countries is considerably higher in 1987 than it was in 1970, as shown below:

	Debt as % of GNP		Debt Service as % of Exports	
	1970	1987	1970	1987
Argentina	8.6	61.7	21.6	45.3
Brazil	8.2	29.1	12.5	26.7
Chile	32.1	103.6	24.5	26.4
Mexico	8.7	59.5	23.6	30.1

Source: "World Development Report 1989," World Bank, pp. 208-209.

Unless the external debt of LDCs is considerably reduced and financial resources flow into those countries in the form of domestic savings and risk equity capital, the expectations of sustained economic growth in LDCs will be pessimistic.

There are several "types" of debt conversion transactions that have been utilized over the last four years. They include debt for equity, debt for exports, debt for development, and debt for nature transactions. Of the four, debt for equity transactions have been the most utilized because the return on investment has been proven to be the most tangible for the investor. In the past year, however, other transactions, such as debt for development and debt for nature have become more frequently utilized due to the increased concern for both social welfare and environmental protection of developing countries. For example, in a debt for nature transaction, the monies collected from the transaction are sometimes used to purchase environmentally important resources (such as tropical forests) which are turned into protective habitats or national parks. Additional proceeds are usually put into a trust fund from which management of the lands can be financed.

As a means of financing projects and reducing debt obligations, debt conversion schemes will continue to be an integral part of a developing country's economic development policy. In today's market of tight credit policy, developing countries must use a variety of innovative methods to obtain financing for economic growth and development. Conversion transactions offer developing countries an additional avenue from which to finance development.

Build-Operate-Transfer

A unique financial trend which possibly has broad application in developing countries beyond project finance is the Build-Own-Operate (BOO) or Build-Operate-Transfer (BOT) model. The BOO and BOT project financing models are particular forms of project equity financing which have their origins as much in developed countries as in the developing countries.

The essential idea of BOO and BOT is that the private sector promoter and/or investor is responsible for arranging finance for a given project, building or constructing the project, and operating the project for a specified time period before transfering the project over to the government or a local private entity. During the life of the project (including construction and operation), the investor retains some or all rights of ownership to the project. The private investor or consortia is remunerated directly from the revenues earned from selling the output generated by the project. Often referred to as concession or limited recourse financing, BOO and BOT schemes call for the granting of the private sector entity a concession or license to operate a facility for a period of time sufficient to recover investment costs and an acceptable return on equity.

The principal feature of BOO and BOT schemes is that the private sector participants, foreign or domestic, share in the risks, responsibilities, and rewards of participating in the project. Because the onus is on the private sector entity to complete the project on time and within budget, the firm is in the position to maximize profit by controlling costs and minimizing inefficiency. For developing countries, these schemes would appear attractive for several reasons. First, sovereign limits on borrowing are not impacted because the private sector firm is generally responsible for arranging finance. Second, the financing terms and conditions for a project may be more flexible for the private entity than for a developing nation thus increasing the likelihood of a successful project. Third, suppliers, contractors, and often lenders, are held more accountable than previously now that they are owners rather than "contractors" to the project. Fourth, there is the distinct prospect of improved productivity, efficiency, and performance. Fifth, the developing country can anticipate benefits such as transfer of technology and managerial know how as well as an increased tax base. And sixth, at the conclusion of the concession, the rights and ownership of the project can be turned over to the government or to a local private entity at little or no cost.

It is argued that BOO and BOT have perhaps broader application in developing countries than just as a form of project finance. If designed properly, BOO and BOT schemes may be effective mechanisms to privatize government functions, reduce debt, attract new technology and capital, and develop equity markets.[90] Examples of BOO or BOT variations are found in the United Kingdom, Spain, Hong Kong, Pakistan, Singapore, Malaysia, Turkey, Thailand, Australia, and the United States.

As an example, in Pakistan eight power projects are being considered which together are worth approximately $2 billion and have a production capacity of 2,000 megawatts. All of the projects are to be joint ventures by consortia of domestic and foreign contractors, and the private sponsors are responsible for mobilizing the equity for each project. Of total financing, about 7 percent would come from the World Bank, 23 percent from

[90] Matthew L. Hensley, "New Forms of Project Financing: Utilizing Build-Operate-Transfer Schemes as a Financial Sector Development Mechanism." Unpublished Paper, 1989.

bilateral agencies, 25 percent from private equity holders, and 45 percent from private lenders. The government plans to institute measures that provide incentives to and reduce risks for lenders and investors, the elements of which include a rate of return that provides a reasonable yield to the private owners, provisions for repatriation of profits, and guaranteed purchase and price agreements between the power generators and the national utilities.[91]

Another example of BOT as a financial innovation is in Malaysia, where United Engineers Malaysia (UEM) a diversified construction and consulting engineering firm, was awarded the $1.3 billion BOT concession to build and operate 504 kilometers of the peninsula's 900 kilometer long north-south highway. UEM has a concession to collect tolls on its portion of the highway for twenty-five years, following which the ownership of the road can be transferred to the government if the government so desires. After receiving the concession (and thus "guaranteeing" a continuous revenue stream for twenty-five years) UEM has become one of the more actively traded stocks on the Kuala Lumpur Stock Exchange.

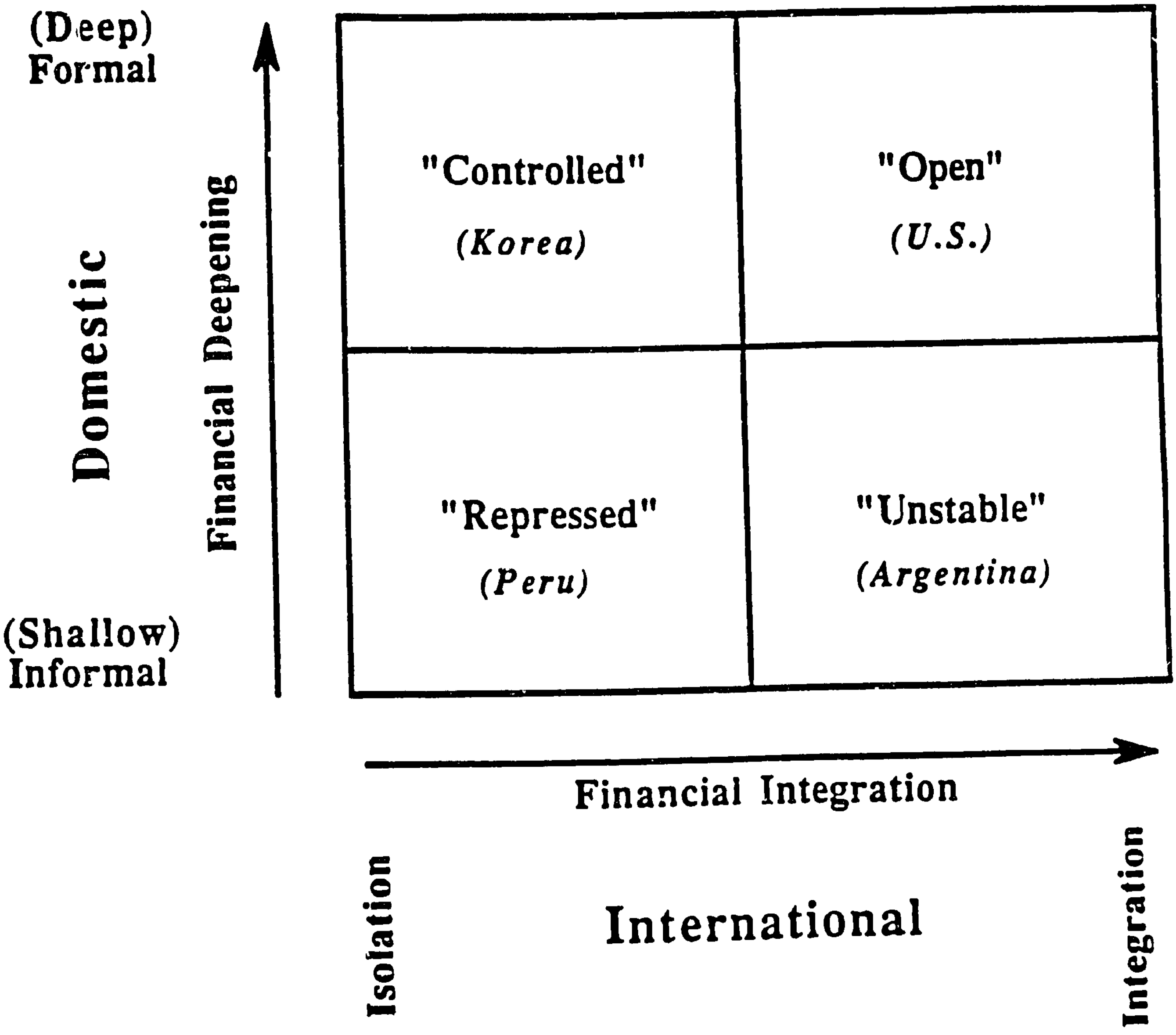
BOO and BOT schemes are just one of several ways in which equity involvement in developing country projects can be stimulated. Their use as a financial innovation with broad application and scope as a financial sector development instrument has exciting possibilities but remains to be demonstrated.[92]

[91] "Developing the Private Sector: A Challenge for the World Bank Group," p. 21.

[92] Hensley, Unpublished Paper.

III. FRAMEWORK: THE PROCESS OF FINANCIAL LIBERALIZATION

This framework attempts to explain the trajectory followed by countries as they move toward total liberalization, referred to as an "open" economy.[93]



[93] Cyhenart, Marta and Bryan Sudweeks, "The Process of Financial Liberalization and International Integration," forthcoming, 1990.

Integration Reform Experiences in Selected Developing Countries

The concept of this framework was deducted from the recent experiences of countries embarked on financial market reforms.[94]

Beginning in the 1970's and increasingly in the 1980's, developing countries have attempted reforms, with varying success, to achieve the liberalization and integration which is addressed in this paper. The experiences of these countries and their success or failure in the reform process have received great attention among international economists intent upon analyzing the reforms and their effects on the countries in question.

The reforms in the *Cono Sur* countries have received more attention than any other single group of countries in the literature and in analyses conducted thus far for several reasons. First, the reforms were instituted in the 1970's so there has been ample time to gather and analyze data pertaining to the effects of the measures throughout the economy. Many developing countries began implementing reforms only by the 1980's, and consequently there is not the wealth of data and analysis available for a comprehensive assessment of the reforms. In Korea, for example, reforms were initiated in the early 1980's yet substantial deregulation of interest rates only began in 1988, so a complete evaluation of the reforms cannot be conducted until all the measures have taken effect, the consequences observed and studied, and the complete data analyzed.

Other reasons why reform measures in the *Cono Sur* receive such emphasis in the literature is because the programs undertaken by each country were comprehensive and

[94] The country experiences cited in this section were drawn from the works of Yoon Je Cho and Deena Khatkhate, "Lessons of Financial Liberalization in Asia", The World Bank, Washington, D.C., April, 1989 and from the *World Development Report 1989*, which are the most recent and comprehensive compilation of liberalization efforts by developing countries.

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far-reaching, aiming at both liberalization and integration, the programs were well-documented, and took place during the same time period, making the three countries excellent subjects for comparison.

Yoon-Je Cho and Deena Khatkhate have assembled an excellent analysis of financial liberalization in Asia, specifically in Korea, Malaysia, the Philippines, Indonesia, and Sri Lanka, and the data allows a number of useful comparisons but there are some limitations to comparison since reforms may have taken place in different time periods and therefore were subject to varying international conditions. The experiences of some Asian countries, however, seem more successful and thus they provide further support for the processes underway throughout the world.

In summarizing the relative success of the countries they studied, Yoon-Je Cho and Khatkhate claim that financial liberalization has succeeded in Korea, where reforms were implemented in 1981-82; has succeeded to a lesser extent in Malaysia, and Sri Lanka, where reforms began in 1978 and 1977 respectively; has a mixed record in Indonesia, where reforms began in 1983; and has been largely unsuccessful in the Philippines, where reforms began in 1980.

Repressed Economy

A repressed economy, at the extreme, is one characterized by strong domestic controls, a shallow financial system, and an active informal financial market in which financial resources flow in a limited circle of intermediaries and users. Repression also exists in international operations, because of strong cultural ties and traditions, people are distrustful of foreign influence, they accept the domestic economic conditions of the country as a normal state of affairs, and they are reluctant to enter into foreign transactions.

There are several examples of countries which are striving to adopt financial reforms in order to start moving out of a repressed economy. Some examples are Indonesia, Sri Lanka, Malysia, Turkey and Pakistan.

Indonesia

When Indonesia embarked on financial reform in 1982, the financial system was already quite well developed, featuring considerable depth as well as breadth. The system was, however, characterized by an elaborate, rigid system of regulations which, in their effect, stifled domestic savings and therefore investment. The main impetus for reform was to mobilize domestic resources to finance investment. Indonesia devised a comprehensive reform program to be implemented in two stages: the first beginning in June 1983 included the elimination of ceilings on bank credits, the gradual narrowing of loan categories from access to Bank Indonesia liquidity credits, and deregulation of state banks' interest rates on most categories of deposits and on all loans except a few priority loans; and the second, in 1984, featuring the introduction of rediscount facilities and the BI certificates called Servifikats Bank Indonesia and the introduction of new money market instruments, designed to absorb the excess liquidity of banks which was being diverted to foreign assets.[95] Eliminating the credit ceilings facilitated a switch to indirect regulation of credit through reserve money management and by changing the functioning of the money market it oriented the banking system towards managing loan portfolios using cost-benefit criteria, thus allowing competitive forces to work.

The results of Indonesia's program are mixed. Inflation decreased from 12 percent in 1983 to 6 percent in 1986 which no doubt helped the country and the reform process. Other indicators, however, show fluctuations through the reform period. Initially, the

[95] Tomas F.T. Balino and V. Sundararajan, "Financial Reform in Indonesia: Causes, Consequences, and Prospects," in H.S. Cheng, ed., *Financial Policy and Reform in Pacific Basin Countries* (Lexington Books, 1986).

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GDP growth rate rose substantially in 1984 to 6.2 percent; unfortunately, there was a similarly sharp decline in 1985 when GDP growth was only 1.9 percent due to a devastating 15 percent decline in the terms of trade between 1983 and 1986. The country did manage to curb the fiscal deficit somewhat,but the level was still about 2.9 percent of GDP. The domestic savings and investment rates, both public and private, fell during the period of reform despite some increases soon after reforms were implemented. The major successes of the reform process in Indonesia were the increasing competitiveness of the banking system, growth in M3, and achieving positive real interest rates during most of the reform period.

Sri Lanka

In Sri Lanka the main focus of financial reform was on interest rate deregulation. The process began with the government raising the bank rate from 8.5 to 10 percent, complemented by a slight depreciation of the exchange rate, which was then allowed to float: actions designed to halt the illicit outflow of financial assets and thereby strengthen the domestic financial intermediation process. Yoon-Je Cho and Khatkhate summarize the reforms in Sri Lanka and their effects as follows:

> Two features of the financial reform in Sri Lanka stand out. First, the financial reform was much milder than might have been expected. Second, Government intervention did not evaporate, though the form and direction it had assumed in the past were market determined. What was important, therefore, was not the dimensions of the financial reform but the break it marked from the dirigistic traditions of previous Sri Lanka policy makers. The reforms of 1977 carried the interest rates to a level at which depositors found it rewarding to hold wealth in financial assets, and borrowers could use scarce capital resources to raise allocative efficiency of their investments. The reforms also permitted the financial system to operate in a more competitive environment, since more banks, particularly foreign banks and other deposit-taking nonbanks, could freely enter the field.[96]

[96] Cho and Khatkhate, pp. 20-21.

Ancillary components of the reform process in Sri Lanka included diluting exchange controls and some deregulating of prices and allocation of credit through interest rates. During the period of reform, economic indicators in Sri Lanka did not change drastically from 1975-77 levels. There was a slight increase in GDP growth rate to 7 percent in 1978, but the rate hovered at around 5.5 percent after that until 1985; inflation declined initially, but then increased to 14 percent which is the level the country had during 1975-77; the fiscal deficit remained unchanged until 1979, but then escalated sharply to 23 percent of GDP in 1980 and remained around 13 percent until 1985; and total investment during the period rose substantially, from 16 percent in 1977 to 28 percent during 1978-85, though domestic saving stayed at a level of about 15.5 percent during the period. The country did experience increases in both the M2 and M3 ratios to GDP, deposit and interest rates were positive through the period, except in 1980 and 1984, market considerations were given more weigh in determining interest rates despite continuing regulation, and there was enhanced competitiveness of banks due to an increase in the number of domestic and offshore banking units.[97]

Philippines

In the Philippines, liberalization efforts focused primarily on the banking sector and began with an amending of the banking laws in 1980 to permit the adoption of a universal banking system patterned on the German system. Implementation included relaxing and subsequently eliminating ceilings on certain categories of bank lending and deposit rates; establishing a new category of commercial banks called "unibanks" which were authorized, now for the first time, to expand their activities to include those typically associated with investment houses, leasing and finance companies; and allowing thrift banks, including savings and loans, mortgage banks and private development

[97] Ibid, pp. 32-33.

banks, to provide full domestic commercial banking services including accepting demand deposits. It is difficult to fully evaluate the reforms in the Philippines because there were so many macroeconomic changes during the reform period that had repercussions throughout the economy. During the initial years of financial liberalization, the financial sector did move towards realizing the goals of the reforms. However, highly fluctuating inflation during the period, rising from 19 percent in 1983 to 50 percent in 1984, combined with political turmoil and an inability to obtain foreign funds resulted in a loss of confidence, a large outflow of funds and capital flight which prompted the government to various actions which affected the reform process.

Malaysia

Reforms in Malaysia included a new interest rate regime in which commercial banks were allowed to determine their own interest rates on deposits and loans, though the prime rate was controlled by the monetary authority until 1981 and the Central Bank of Malaysia continued its ceiling on the lending rates for three categories of small-scale borrowers. At the time of reforms, Malaysia already had a thriving, competitive financial sector. Malaysia instituted reforms in 1978 and almost immediately afterwards suffered a sharp decline in the terms of trade: national income fell 4.5 percent in 1979 and a huge deficit in the current account emerged. The government responded by embarking on an aggressive expansion of public investment in both infrastructure and productive activities. The various programs and adjustments adopted by the government resulted in substantial increases in the fiscal deficit and reductions in the economic growth rate, which was a negative rate of -1.1 percent in 1985.

Despite a largely dismal macroeconomic situation, except for the fact that inflation had not posed a major problem, the financial sector in Malaysia developed rapidly during the reform program and sustained price stability. There was a modest, sustained rise in the deposit and lending rates; some integration of domestic interest rates, though the gap in lending rates charged be various financial institutions widened to some extent; small-sized banks could appropriate an expanding share of the credit market; and long-term funds became more ample and available than ever before.

Turkey

Turkey embarked on a stabilization and structural adjustment program in 1980 in which financial reforms included removing controls on interest rates and allowed banks to issue negotiable certificates of deposit. Financial reforms were curtailed after two years as the Central Bank faced financial difficulties, and deposit interest rate ceilings were reimposed. Turkey's experience during this reform period is quite interesting, however, because in many respects the reforms were successful and difficulties were due to reasons different than those experienced in the Southern Cone countries.

Between 1980 and 1982, the government deficit declined, controls were maintained on capital flows to prevent the complications experienced by the Southern Cone countries, the annual inflation rate declined from a figure of 100 percent in 1980 to 25 percent in 1982, real interest rates increased sharply, the domestic currency depreciated, and GNP growth became positive after two years of contraction. This macroeconomic situation seems quite favorable from the liberalization point of view, but the macroeconomic changes adversely affected corporate profits and businesses faced severe financial adjustment problems. The corporate sector's financial problems caused distress in the banking system in the form of nonperforming loans and distress borrowing. The authors of *World Development Report 1989* make the point that in the case of both the Philippines and Turkey, where liberalization focused heavily on interest rate reform, "weak prudential regulation and supervision allowed the capitalization of interest and a rapid deterioration of bank portfolios."[98]

[98] *World Development Report* 1989, pp. 124.

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Pakistan

One problem faced in Pakistan was that financial institutions suffered badly from excessive arrears due to slow enforcement of loan contracts. A reform designed to alleviate this problem was adopted in 1979 when the government established a system of special banking courts and enhanced in 1984 when a corresponding system was established to handle loan recovery for newly introduced Islamic financing instruments. Difficulties in implementing the new system and the inherent opportunity for challenging court rulings make this reform a limited success so far.

i. With continuously improving economic policies in the 1980's, coupled until recently with increased demand for goods and labor from the Middle East, Pakistan's overall economic performance has been strong relative to many other developing countries. Real GDP growth has averaged about 6.5 per annum since the beginning of FY84, the target set in the Sixth Five Year Plan (FY84-88). Growth performance in the key sectors has also been satisfactory. Since FY 84, the growth of agricultural value-added has averaged 3.7%, despite crop failures in FY84 and FY 87. Manufacturing value added has grown at a respectable 7.7 per annum over the same period, though this was below the Sixth Plan's ambitious target of 10%. The service sector has achieved an annual average growth rate of 7.1% since FY 84, while the construction and electricity-gas distribution sectors have grown at 9% annually. Inflation has been moderate, dropping to an annual average of 5% during the Sixth Plan period from 9.3 over the previous plan period.

ii. Consistent with the Government's policy of encouraging the private sector and increasing the role of markets in economic decisions, important policy changes have been taking place since the early 1980's. With the Sixth Plan's confirmation of the export-led growth and industrialization strategy, the pace of policy reforms has accelerated in many areas. Significant progress has been made in the areas of price decontrols, industrial deregulation (particularly investment sanctioning), reducing the extent of state monopoly in import activity, opening domestic trade in several major commodities to the private sector, and implementing a flexible exchange rate management. However, the pace of reform has been slower in trade liberalization until recently. Since 1980, the Government has been aligning procurement prices with border prices for most agricultural products, and has gradually dismantled subsidy programs for pesticides, seeds, nitrogenous fertilizers, and public mechanization services.

iii. In accordance with the Sixth Plan strategy, the government has been reasonably successful in redirecting public development expenditure toward priority sectors -energy, education, and health - although there have been shortfalls in targets. At the same time, expansion of public enterprises has been contained in favor of private initiative during this period. The private sector's share in total fixed investment rose from 38% in FY83 to 42% in FY88, and in the manufacturing sector its share in investment increased from 51% to 83% over the same period."[99]

Unstable Economy

An unstable economy, like the repressed economy, has a shallow financial system with strong financial barriers which do not allow financial resources to flow freely. The informal financial market is a black market of real and financial resources.

In an unstable economy, international integration is high by means of the black market which mobilizes capital in and out of the country. High inflation forces the economy to become "dollarized". Also a high external debt is restructured periodically and paid slowly through monetization which increases inflation. The government imposes strict controls on the trade account and international capital flows, but these controls are neutralized by an effective black market.

Culturally and educationally, people are more internationally-minded than people in typically repressed economies, and have a preference to make foreign investment and acquire foreign goods. Capital flight is perceived more as another financial strategy and less as an illegal activity.

[99] Internal documents of the World Bank.

An unstable economy is very sensitive to domestic and foreign economic shocks. Several countries experimented with external economic liberalization and failed. A dramatic example that took place during the 1970's was the attempt by Argentina, Chile and Uruguay to reinstate market mechanisms and lower barriers to international trade and capital movements. They followed closely the practices predicated by free-market advocates.[100] Trade restrictions were reduced, domestic capital markets were developed and barriers to international capital movements were eliminated. Within ten years, however, many evaluated the experiment as a failure: the banking systems in the three countries nearly collapsed and many banks had to be rescued by nationalization.[101] Experts do not agree on what caused the failure, but Corbo, for example, suggests that most of the problems were caused by the macroeconomic management employed during the transition to a more open economy.

Despite contradictory policies, inflation in the countries remained disturbingly rapid: Chile's inflation rate was around 50 percent in late 1977, Argentina's was 166 percent in 1978, and Uruguay's was roughly 50 percent in late 1978. The schedule of exchange rate devaluations, known as the *tablita*, turned out to be less than the difference between domestic and world inflation, so the countries found themselves in deep recession. The experiences of the Southern Cone countries, among others, leads to an argument which appears to have validity: the timing of reforms coincided with major stabilization programs to control inflation. Problems and the seeming failure that resulted from reforms may have been due to the economic conditions existing in each country rather

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100 These practices are proposed and reviewed in Ronald McKinnon, *Money and Capital in Economic Development*; Anne O. Krueger, *Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences* (Cambridge, Massachusetts: Ballinger, 1978); and Bela Belassa, *Development Strategies in Semi-Industrial Economies* (Oxford, England: Oxford University Press, 1982).

101 "Saneamiento de Bancos," a private report of Lanus de la Serna & Asociados (Buenos Aires, 1987).

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that to attempts at international integration. Their experiences with the *tablita* regime also lend validity to the view that real exchange rate appreciation to curb inflation should be avoided.[102]

Controlled Economy

A controlled economy can best be described as directed capitalism. It is directed in the sense that financial and goods markets are developed according to a national industrial plan dictated by government policy, usually long term. Rather than allowing purely free market forces to lead the market, specific industrial and financial plans stimulate markets to channel financial resources to industries that have been targeted for development. In a controlled economy, interest ceilings and resource allocation exist for preferential industries during the start up and the early growth period. They are removed as the industry is able to compete successfully in the domestic and international markets.

International financial integration, in the extreme, does not occur in a controlled economy. As this economy opens up, exports take precedence over imports and financial inflows are directed to specific uses.

102 Sebastian Edwards, "Stabilization with Liberalization: An Evaluation of Ten of Chile's Experience with Free Market Policies 1973-1983," *Economic Development and Cultural Change* 33 (January 1985): pp. 223-254; Rudiger Dornbusch and F. Leslie C.H. Helmers, eds., *The Open Economy: Tools for Policy Makers in Developing Countries* (Oxford: Oxford University Press, 1988); and Corbo and de Melo, pp. 118-138.

Culturally, people in a controlled economy tend to have a strong national pride and a sense of collective effort for the good of the country. They do not have a preference for foreign investments, other than by necessity.

An example of a controlled economy is Korea. It is interesting to note that Korea, similar to other Asian countries, has developed its own plan for success which does not necessarily follow the drastic liberalization measures advocated by Western economists, as noted by Yung-Chul Park.

Korea provides a compelling example of financial deepening and a successful transition from a heavily regulated economy to a more market-oriented one. During the 1960's and 1970's, Korea's economy and financial system were tightly controlled by the government, the financial sector serving as the key instrument in the nation's industrial policy. The regulations included tightly controlled low interest rates and direct credit programs. By the end of the 1970's there emerged a growing realization that the growth of the financial system had been inhibited and that slower economic growth was most likely attributable to inefficient resource allocation within the economy. In the early 1980's, Korea introduced several financial reforms, stabilization and adjustment programs including a number of measures designed to promote greater competition within the financial sector: eliminating preferential interest rates; privatization of many of the commercial banks; lowering entry barriers and largely deregulating nonbank institutions; refraining from additional directed credit programs; allowing foreign financial institutions and insurance companies to open branches; and allowing financial institutions to offer a wider range of services.

The government monitored the reform process closely and continued to supervise commercial loans. Complete controls were maintained on capital flows and, unlike many developing countries introducing financial reforms, the government continued to regulate the interest rates of bank and nonbank institutions, though interest rates were partially deregulated in the money and securities markets. By the mid 1980's Korea had achieved economic stability, having reined in the annual inflation rate to a 2-3 percent level and eliminating the fiscal and current account deficits. Through the first five years of the reform program, the country had experienced tremendous expansion in the financial sector, and this growth was reflected in the tremendous growth of M2 and M3 as a percentage of GNP which rose from 34.2 and 48.6,respectively, in 1980 to 41.3 and 94.4 in 1987.

Owing to the success of the program and strong economic growth rates, the government began a full liberalization of interest rates in late 1988 and announced plans for the opening of Korea's financial markets to further foreign participation. Korea has achieved financial deepening; however, the country has not yet undertaken measures aimed at achieving international integration.

The Road to an Open Economy

The repressed economy is ill-prepared to become integrated into international financial markets. Likewise, the unstable economy cannot open itself to the international shocks which will magnify its own domestic instability. The experience of the Cono Sur is clear evidence that drastic liberalization without the necessary financial and industrial infrastructure can be devastating to the economy. It appears that the path toward an open economy may reasonably go through some form of controlled economy, in order to build a sound infrastructure of formal financial markets and active trade markets. This position is supported by the work of Edwards on liberalization sequence and the work of Blejer and Sagari on the importance of a strong banking system as the basis for successful financial liberalization.

Financial reforms have been adopted in developing countries throughout the world. In Guinea, Ghana, Madagascar and Nigeria, for example, reforms have been adopted to

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restructure institutions, improve regulatory procedures and prepare for greater market orientation. Greece, Morocco, Portugal and Tunisia have adopted reforms aimed at reducing directed credit programs, liberalizing interest rates, and developing money and capital markets. The *Cono Sur* (Southern Cone) countries, Argentina, Chile, and Uruguay, adopted an array of reforms in the 1970's aimed both at financial liberalization and international integration. Countries in Southeast Asia, among them Indonesia, Malaysia and the Philippines, have also adopted financial reforms in the hopes of achieving higher levels of economic growth and more efficient resource allocation within their economies.

Developing countries are not alone in their financial liberalization efforts. During the past ten years, Australia, Japan, The United States and New Zealand have liberalized their interest rates. New Zealand, in fact, embarked on a broad liberalization program in 1984 to make the transition from a heavily regulated financial system to one which relies more heavily on market forces. The reform package includes trade liberalization, labor market reforms, measures to restore fiscal discipline, and reform of state-owned enterprises including privatization. Financial reforms included abolishing interest rate controls and credit directives, floating the exchange rate, introducing market-bases tenders for selling government securities, establishing a new system of monetary control, and measures to promote competitions among financial institutions.

Classification of Developing Countries

The first question is: Can a limited number of classifications be developed for LDC's reflecting their general macroeconomic conditions, domestic financial market conditions, and degree of integration with international markets?

The financial liberalization framework of the previous section provides a theoretical visualization of the process. This framework also offers the basis for a subjective classification of countries. Using a modified Delfi method by which a group of experts are asked to rank countries in the four categories shown on the framework, a preliminary classification can be determined.

A more objective classification can be obtained by using selected economic ratios, although there is some disagreement on which are the best variables to use. One of the ratios used by the World Bank is Net Financial Assets as Percentage of GNP. Traditional economic indicators include GNP per capita, growth of consumption and investment, percentage share of merchandise exports, and several balance of payments ratios.

Some interesting ratios are used by the "International Development Review" in its Credit Watch section. In particular one of the ratios could be useful to measure the degree of international integration of a country. It is the spread in basis points between the domestic interest rate and the rate of a comparable instrument in a strong currency such as the U.S. dollar or the German Mark. Countries are ranked numerically and those with the largest spreads are classified as the least integrated into the international markets. However, this ratio is questioned by Blejer and Sagari who maintain that large spreads between domestic and international interest rates do not necessarily imply an inefficient financial market, because they may reflect no more than differences in financial instruments.

Other objective indicators that have been suggested include foreign ownership of domestic assets, foreign borrowing as percentage of total invesments and the ratio of foreign bank assets and liabilities to toal assets and liabilities in the banking system. The best indicators are those that measure accurately the desired effect, as well as those that are supported by data that are readily available. The following are indicators that may fit those requirements:

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Foreign Assets. These are net foreign assets in a country, meaning the sum of foreign assets less the sum of foreign liabilities. This is the figure that appears on line "31n" of the Interntional Financial Statistics (IFS) published monthly by the IMF. This figure alone is evidence of capital inflows and outflows. It can also be shown as a percentage of GNP.

Interest Rate Differential. This is the domestic interest rate converted into a hard currency ($US, for example) less the interst rate of a similar instrument in the hard currency. For example the lending rate in line "60p" of the IFS divided by the exchange rate per $1.00 US in line "ag" less the lending rate of a similar instrument in $US. The smaller the difference the greater the international integration, provided that the exchange rate is not unresonably over- or under-valued.

Percentage Change in the Interest Spread. The domestic lending rate (line "60p") less the domestic deposit rate (line "60l") divided by the domestic lending rate. The direction and the magnitude of this proportion through time will give an indication of increasing or decreasing financial deepening.

Proportion of External Debt to Productivity. External borrowing (can be obtained from World Bank Debt Tables) as a proportion of industrial production (line "66" in the IFS) or exports (line "70" in the IFS). This ratio must be interpreted with greater care because, by itself, it does not reveal conclusive information. Rather, it is an alert sign if external debt increases disproportionately to productivity, or if both debt and productivity decline at the beginning of a period of stagnation. More favorable conditions would be signaled by a diminishing proportion of debt to industrial production or export.

It should be noted here that ratio analysis is only a basic form of looking at objective data. There are more powerful statisical analyses which, even in the exploratory stage,

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could disclose more complete information about a country. This study could have been enriched by that analysis, but the statistical portion was eliminated from the scope of work of this literature review.

A suggested two-stage approach to classifying developing countries according to financial deepening and international integration is as follows:

- Stage 1. Subjective preliminary classification using a modified Delfi method as described above.

- Stage 2. Objective classification by ranking countries according to the indicators selected.

The results must be carefully interpreted in the context of the country and any extraordinary events that may have an influence on the results.

The second question is whether such a typology of LDC countries can be useful in helping A.I.D. missions to formulate country strategies. The answer is affirmative. Such analysis can not only to help missions but also to give A.I.D. Washington an indication of the degree of financial development and international integration that exist in the universe of A.I.D. countries.

While it is true that other institutions have developed statistical economic indicators, most notably the World Bank, the IMF and OECD, the reality is that A.I.D. needs an accessible classification system that should be updated periodically, not only with the measures described above but also with information on the experience of the missions as the process of liberalization evolves. Furthermore, as the classifications are updated successes and failures will be highlighted. This exercise will serve to encourage the transfer among missions of good experiences worth replicating, as well as avoiding mistakes.

Suggestions for Case Studies

It appears from this preliminary literature research that the countries of interest to A.I.D. are those that fall into the categories of repressed and unstable economies. A.I.D. can make a significant contribution by helping those countries to restructure their domestic financial markets and sequence the liberalization process, in order to facilitate their development into an open economy.

Two countries that represent closely the characteristics of repressed and unstable economies, as described in the framework developed in this paper, are Pakistan and Chile. It would be most useful, therefore, to develop case studies on those two countries since they are representative of a large part of the universe of A.I.D. countries.

Conclusions

The major conclusions drawn from this literature, which have a direct application to A.I.D. assistance to developing countries are,

1) Reforms implemented in an unstable macroeconomic environment can exacerbate the instability; policy dialogues should focus on stabilization measures prior to liberalization reforms.

2) Internal economic liberalization should be sequenced next. An emphasis should be placed on building a strong financial infrastructure conducive to promote financial deepening.

3) Regulatory reforms must focus on a regulatory balance that supports liberalization with the appropriate degree of flexibility to adapt to changing circumstances. The regulatory framework must recognize that the driving economic force is private initiative. The objective of regulation is not to thwart that initiative but to encourage it within the parameters of national goals and social well being.

4) The adverse short-term effects of reforms must be anticipated and amiliorated through an economic and social infrastructure that can absorb industrial rehabilitation, labor training, and new business development, as well as assure solvency in the financial industry and sustain economic stability in the country.

5) Opening the financial sector to full international integration can be accomplished most successfully after the domestic economy and financial sector has been both stabilized and liberalized.

These preliminary conclusions will be further complemented by the in-depth case studies of two developing countries. These studies will further assist AID in formulating an effective financial sector reform program for developing countries.

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FORGING GREATER INTEGRATION AND INTERNATIONALIZATION OF FINANCIAL MARKETS: THE CASE OF PAKISTAN

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FORGING GREATER INTEGRATION AND INTERNATIONALIZATION OF FINANCIAL MARKETS: THE CASE OF PAKISTAN

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TABLE OF ABBREVIATIONS

BEL	=	Bank Equity Limited
BNFB	=	Bearer National Fund Bonds
CCI	=	Controller of Capital Issues
DFI	=	Development Finance Institution
FBC	=	Federal Bank for Cooperatives
FCB	=	Foreign Commercial Bank
FEBC	=	Foreign Exchange Bearer Certificate
GDP	=	Gross Domestic Product
HBFC	=	House Building Finance Corporation
HBL	=	Habib Bank Limited
ICP	=	Investment Corporation of Pakistan
IDBP	=	Industrial Development Bank of Pakistan
KSE	=	Karachi Stock Exchange
NBFI	=	Non-Bank Financial Intermediaries
NBP	=	National Bank of Pakistan
NCB	=	Nationalized Commercial Bank
NCCC	=	National Credit Consultative Committee
NDFC	=	National Development Finance Corporation
NDLC	=	National Development Leasing Corporation
NIT	=	National Investment Trust
NSS	=	National Savings Scheme
PBC	=	Pakistan Banking Council
PICIC	=	Pakistan Industrial Credit and Investment Corporation
PILC	=	Pakistan Industrial Leasing Company
PLS	=	Profit Loss Sharing

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PPCB	=	Punjab Provincial Cooperative Bank
PTC	=	Participation Term Certificate
SBFC	=	Small Business Finance Corporation
SBP	=	State Bank of Pakistan
SLIC	=	State Life Insurance Company
TFC	=	Term Finance Certificates
UBL	=	United Bank Limited

FORGING GREATER INTEGRATION AND INTERNATIONALIZATION OF FINANCIAL MARKETS: THE CASE OF PAKISTAN

1. Introduction

In the past several decades, both multilateral development institutions and developing countries have focused upon the development of official development finance institutions (DFIs) as the primary channels of external capital for economic development. Such focus was understandable in view of the fact that outside donor agencies needed centralized official channels in the host countries to facilitate the flows of international development capital. Additionally, the senior staff of the local DFIs were generally educated abroad or at least internationally oriented in their perspective and they proved to be the ideal local counterparts for many multilateral and bilateral development finance agencies.

In recent years, however, most official DFIs in developing countries have experienced financial difficulties as the result of accumulating bad debts and deteriorating asset quality. Loan recovery has been rather low in general and the steep depreciation of local currencies vis-a-vis the foreign currencies in which their external debts were denominated has led in many cases to severe erosion of the capital base. The fact that official DFIs have been by nature more susceptible to political pressures and manipulation in their investment decisions has undoubtedly accounted for the large share of non-performing and under-performing assets.

The world debt crisis of the 1980s has further highlighted the weakness as well as the limit of the traditional mode of channelling external development capital into LDCs through official DFIs of developing countries. Furthermore, the debt crisis has exposed the critical nature of debt service burden in foreign currencies for many developing countries. It is in this context that in recent years both international development agencies and developing countries have refocused their attention on the development of local financial markets that can facilitate the mobilization of indigenous savings and at the same time enhance the efficiency of savings allocation among productive uses.

Development of efficient financial markets in developing countries, however, has been severely constrained by the neglect of institution building in both private and public sectors. Efficient financial markets require a certain threshold in both the number and variety of market institutions that compose the market infrastructure. Lack of adequate government support and regulatory back-up has also hampered the growth of essential market institutions in developing countries. Even when some LDCs retain

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market institutions, the latter often suffer from lack of expertise, capital, and experienced staff. Perhaps it is understandable that institution building does not take place overnight, and that it requires a careful strategy and long-term commitment on the part of the government as well as the market participants.

In recent years, however, promoting the efficient functioning of financial institutions and markets has become a major policy goal for many developing countries. The process of financial development has two dimensions: domestic financial deepening and international financial integration. While both dimensions are important to economic growth, they may become the cause of either success or failure of an economic plan, depending on the sequence and intensity of their implementation.

Domestic financial deepening refers to the promotion of financial activity and capital formation that occurs in the domestic financial market through such measures as elimination of credit controls and credit rationing, interest rate ceilings, differential reserve requirements, and also to the elimination of discriminatory practices and capital requirements that curtail free entry of local participants into domestic financial markets. Financial deepening results from an increase in the level of competition in the domestic financial market.

International financial integration occurs when exchange controls are removed and the capital account is freed to allow financial resources to flow freely in and out of the country. Barriers to the entry into the local market by foreign financial institutions are removed and their access to various financial services and market activities is liberalized. As a result, the domestic economy acquires the characteristics of the international economy. The free market compensates for domestic inflation with adjustments in the exchange rate and domestic interest rates. In theory, the speed with which inflation, exchange and interest rates reach equilibrium is evidence of the degree of integration between the domestic financial system and international financial markets.

2. Financial Integration in Perspective

International financial markets have enjoyed a remarkably long period of linear expansion over the past four decades. The Eurodollar market, which stood at around $10 billion in the late 1950s, has ballooned to $5 trillion now.[1] The total international banking assets, which were barely noticeable until the mid 1960s,

[1]IMF, International Financial Statistics, May 1990.

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have grown to close to $6 trillion now. Cross-border international financial flows, including those related to Eurocurrency transactions and foreign exchange trading, are conservatively estimated at $1 trillion per every business day, or $200 trillion Oon an annual basis. The daily volume handled by the New York Clearing House Interbank Payments System (CHIPS), which clears mostly international financial transactions including Eurodollar and foreign exchange trading, averages about $1 trillion. In comparison, the Fed Wire network maintained by the U.S. Federal Reserve for domestic fund transfers handles a daily volume of about $700 billion on average. This large volume of cross-border financial flows may be compared to the total annual trading volume of goods and services, counting both exports and imports, of about $5 trillion on a worldwide basis. It appears, therefore, that the total cross-border financial flows are about 40 times that of cross-border flows in goods and services. International financial flows, which in the earlier days were largely influenced by international trade, have now turned the table. In the international market, the tail now wags the dog, not the other way around.

Financial integration on the international scale can be measured not just in its numerical magnitude, though almost astronomically large counting in the units of trillions of dollars, but also in terms of its diversity in both financial products and services. A real-time 24-hour trading in foreign exchanges is well established. The global, continuous 24-hour trading now extends to many debt and equity securities as well as their derivative products such as futures and options in interest rates, currencies and indexes. The existing linkages among major international futures and options exchanges are likely to be further strengthened by the soon-to-be operational Globex trading system. We can expect a continuing expansion in the volume of global trading in interest rate and currency swaps, zero-coupon bonds, FRNs, Eurosecurities, major government securities and their derivatives such as CATS, TIGRs, LIONs, ZEBRAs. If the sun indeed sets in today's British Empire unlike her former colonial days, nowadays the sun never sets on Citibank, Nomura, Merrill Lynch and Dai Ichi Kangyo of the world in a literal sense. These international financial institutions can no longer afford missing even one hour of trading on the 24-hour trading market due to both the high risk and the high opportunity cost involved.

However, financial market integration, even though impressive by itself in both volume and diversity, has to be viewed within the broader context of the overall economic integration now in progress around the world. Apart from the EC 1992 economic and monetary union, opening up of Eastern European countries' economies, closer economic policy coordination under the aegis of the G-7 as well as the IMF Interim Committee and the Committee of Twenty-Four, etc., it has been an inexorable historical trend over the past several decades that national economies have become more open and more

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integrated into a world economy. Thus, we can consider financial market integration as an integral part of the worldwide economic integration.

3. Economic Rationales for Financial Integration

After several decades of preoccupation with the dirigistic and interventionistic role of the government in promoting economic growth, an increasing number of developing countries are shifting their development focus to market signals guiding the allocation of resources in which the role of prices is being emphasized, profits are becoming a measure of economic success for enterprises and financial markets are being promoted to allocate resources to profitable activities within a competitive environment. Deregulation and liberalization in the financial system is encouraged to nurture competition among various financial institutions and markets and to enhance allocative efficiency in the economy. While the post-war economic development model was inward-oriented, relying upon government intervention to set pricing signals and promoting a strong participation of the state in the production of goods and services, the new approach is outward-oriented through a free market mechanism where the market prices play the dominant allocative role.[2] The role of the government in the new outward-oriented development model is to provide a level playing field for all financial institutions through deregulation and integration. Thus, financial integration becomes an integral part of the new development model. Here the existence of a substantial private sector is a necessary but not a sufficient condition for economic development, which also requires open competition free of oligopolistic and privileged practices perpetuated by protective barriers and subsidized credit.

Financial integration is also predicated upon the efficiency argument. By removing barriers to new entry and promoting competition, financial integration lowers both the cost of funds and the cost of financial services. Liberalized capital movements combined with market determined exchange rates pull down the domestic cost of funds to that of international level. Furthermore, the elimination of national barriers in financial services stimulates competition among the financial institutions, thus lowering the prices of financial services such as service fees

[2]Manual Hinds, "Introducing Competition in the Financial Sector," a paper presented at the Senior Policy Seminar on Financial Systems and Development in Africa, EDI-World Bank, 1990.

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and brokerage commissions.[3] While financial market integration may not mean equalization of financial service prices, price convergence toward the lowest denominator is one of its positive results. A study by Price Waterhouse demonstrates that financial subsectors that are already subject to international competition show the least price differentials, whereas the subsectors that have been protected from foreign competition show the widest price differences.[4]

Financial integration also enhances risk diversification for both borrowers and investors. Availability of a wider array of financing sources both domestically and internationally reduces not only the funding cost but also the fund availability risk for a borrower. If one financing source dries up, other sources can be tapped freely. Diversification of funding sources, available for the borrowers from industrialized countries, now becomes a feasible option for LDC borrowers through financial market integration. For international portfolio investors, availability of various investment securities in many capital markets including those of developing countries enhances the risk-return profile of their investment portfolio. A study by Bruno Solnik demonstrates that an active strategy of international portfolio diversification including certain Pacific Basin markets improves the portfolio performance. Especially, he noticed that inclusion of some Pacific Basic capital markets such as Korea, Taiwan and Thailand in the U.S. dollar-numeraire international portfolio significantly improves the risk-return profile.[5]

Financial market integration may also bring about the critical mass necessary for a market to enjoy the economies of scale and risk sharing. Modern financial markets require both sophisticated functional expertise and up-to-date market information. Such knowledge cannot be generated in a vacuum; it needs constant innovations and cross-fertilization of ideas among bankers and other finance professionals.[6] Individual national markets, if isolated from other active financial centers of the world, cannot benefit from new financial techniques and products and tend to be dominated by tradition-bound financial institutions that often

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[3]Susan Ulbaek and Michel Vaugeois, "EC Financial Integration: Potential Impact on EMENA Countries," World Bank, April 1990.

[4]Price Waterhouse, The Cost of Non-Europe in Financial Services, Bruxelles, 1988.

[5]Bruno Solnik, "Pacific Basin Stock Markets and International Diversification," a paper presented at the Second Annual Pacific Basin Finance Conference, Bangkok, Thailand, 1990.

[6]Yoon S. Park, "The Economics of Offshore Finance Centers," Columbia Journal of World Business, Winter, 1982.

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behave oligopolistically. Integration brings about the critical mass necessary for the financial intermediaries to experiment with new techniques and to stay competitive and innovative. The critical mass argument is particularly relevant for the financial markets of developing countries, which by themselves remain too small and too fragmented to engender the innovative and entrepreneurial spirit essential for modern financial market activities.

4. Economic Costs of Financial Market Integration

While financial market integration promotes competition and enhances market efficiency and financial innovations, it can also have a destabilizing effect on an economy, particularly when attempted prematurely. Developing countries are especially prone to this negative effect. One reason is that the financial infrastructure of developing countries, when compared with mature economies, is too weak to withstand the economic shock of changing suddenly from an inward-looking economy to an open economy. Liberalization may even aggravate other deficiencies existing within various sectors of the economy, thus producing an overall negative impact and not achieving the desired outcomes.

An example is the experience of Argentina, Chile and Uruguay, which pursued open market reforms starting in the mid-1970s. In varying degrees, they eliminated constraints on capital flows, decontrolled interest rates, and relaxed many trade restrictions. Initially some efficiency gains were made but these were ultimately overshadowed by problems with policy inconsistencies, implementation difficulties, and overlooked market frictions. A main cause of the failure was the fact that, at the time reforms started, the three countries were experiencing severe macroeconomic imbalances, including foreign exchange shortages and high inflation. Another contributing factor was the absence of adequate prudential regulatory constraints on financial activities. The adoption by the Southern Cone countries of tablita (pre-scheduled exchange rate devaluation table) initially induced capital inflows as domestic interest rates were higher than foreign rates even after the adjustment for exchange rate depreciation. Subsequently, however, tablita also raised domestic inflation due to both money supply expansion induced by capital inflows and driving up the prices of nontradeables.

There are many reasons for the high risk of failure of financial market integration, especially in developing countries. Despite recent progress in some developing countries, most LDC financial markets are still shallow and repressed with no required depth, liquidity and breath as in developed markets. LDC capital markets suffer from poor financial infrastructure. Licenses for new financial institutions are too strictly controlled by the

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governments, even though the proper role of a government in the securities market, which is quintessentially based upon the private initiatives, should be limited to that of a prudential regulator rather than a controller or interventionist. Such areas as proper accounting and auditing standards, legal rights of investors, and adequate disclosure rules and so on should be the main areas of concern to the government in promoting securities markets.

One of the major hurdles to development of well-functioning financial markets in developing countries is the infant stage of private institutional investors. Private pension funds and insurance companies are not yet any important investors in capital market instruments, mostly keeping the bulk of collected funds in time deposits with commercial banks or tax-exempt savings certificates issued by deficit-burdened governments. In many developing countries, mutual funds are predominantly government operated, and life insurance companies and unit trusts are also dominated by government institutions. Thus, the securities markets are often overwhelmed by government actions and policies, with little room for the private financial institutions to maneuver.

Furthermore, the financial markets of developing countries lack the balance. In almost all developing countries, commercial banks still play an overwhelmingly important role in the entire financial system. This condition has been the result of both an institutional inertia and the government policy orientation. Securities markets are essentially related to an advanced form of business finance, and as a consequence many developing countries find their securities markets at only an early stage of development. Both the volume as well as the institutional structure is inadequate compared to that of industrialized countries where securities markets have played a vital role in the overall allocative process of savings and investment funds. Not only the securities markets but also nonbank financial institutions (finance companies, development finance institutions, investment and merchant banks, insurance companies, pension funds, venture capital firms, and so on) consstitute a relatively small part of the financial system.

Instead, commercial banks play the dominant role in intermediating a nation's financial flows among various sectors of the economy. Commercial banks necessarily tend to view securities markets as their competition and have no incentive to encourage the latter's development. Such hostility on the part of commercial banks toward securities markets is shared equally among private as well as government-owned commercial banks. On the other hand, the dominant position of commercial banks in most LDCs stifles both innovation and competition in the financial system essential to the healthy growth of securities markets.

Underdeveloped securities markets deprive investors of the opportunities for investing in long-term financial investment instruments, while business firms are restricted in their ability to finance capital expansion through long-term debt or equity funds. The result is that a significant portion of financial activities are pushed underground into the informal sector beyond the realm of transparency and prudential regulation. Governments may initially have preferred to promote commercial banking due to the ease of control over the country's financial system with only a relatively limited number of commercial banks, but often the unexpected result has been to promote the growth of informal sector of finance in LDCs, making it even harder for the government to control the financial flows of a nation. It is no accident that the informal financial sector has been thriving in those developing countries where the formal financial sector is underdeveloped and distorted due to nationalized banking system, lack of non-bank financial institutions, and primitive securities markets.

The capital markets in LDCs are underdeveloped both from the supply side as well as the demand side. There are generally two basic reasons for this. On the supply side there is a low number of high grade securities in the market brought about by the limited number of listed companies. On the demand side there is a limited number of investors actively involved in the stock market. Most private sector corporations generate financing from short-term loan facilities with commercial banks. This excessive reliance on bank debt financing reduces the need for companies to raise funds through the securities market. In the Philippines, for example, there are over 140 companies listed on the stock exchange, 95 on the Big Board and the rest on the Small Board, of which only 63 are in the top 1,000 corporations of the Philippines.

Few people are willing to invest their money in the stock market. The number of individuals who are investors in the stock market is estimated to be less than one percent of the population in many LDCs. This compares with developed countries where the figure is around 10 percent. The limited amount of shares traded (or the float) leaves the market open to price manipulations. One of the main causes for lack of demand in the stock market is the lack of confidence by investors who perceive the market as highly speculative and open to insider trading abuses. Supply and demand are intrinsically linked together. The thinness of the market resulting from the small number of listed companies makes manipulation easier and prices more volatile, which in turn deters investors from participating in the market. Similarly, limited demand for stocks leads to depressed prices and increases the cost of raising funds from the securities market, providing little incentive for companies to offer their shares to the public. It is in a sense a vicious circle.

The limited supply of equity securities stems from several critical factors including: cheaper alternative sources of financing for corporations; reluctance of family-owned corporations to share control; hesitancy of disclosure of business operations

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to the outsiders; lack of listings of multinational companies; pre-emptive rights of shareholders; and government financing practices for state-owned enterprises.

Dependence on bank financing is probably the most prevalent institutionalized reason for so few securities issued in the market. Ease of financing and liquidity encouraged by the government and the commercial banks has enabled corporations to use bank financing for virtually all corporate financing needs. Tax policy has contributed to the corporate preference to use debt over equity financing since interest expenses are fully deductible from gross income while dividends are not.

Deeply rooted in the business community of many LDCs is the practice of maintaining tight control of enterprises by a small, generally related group. Reluctant to share power and concerned with privacy, these groups are resistant to the concept of offering shares publicly since it breaches the confidentiality long cultivated. Over years of development, earnings have been understated, taxes consequently underpaid, raising the possibility of penalties if the corporate revelations necessary for disclosure in public offerings are inconsistent with previous filings with the tax authorities.

Even where the private financial sector plays an increased role, the financial system is often dominated oligopolistic institutions. The anti-trust legislation in many developing countries is at an infant stage and large business groups, with privileged access to the government authorities, maintain close linkages with large banking and financial institutions. Thus, in many developing countries the small and medium-sized companies as well as new business ventures suffer from "double crowding-outs" by both the government and the big business groups.

As LDC financial markets are both shallow and oligopolistically controlled, financial market integration can sometimes be exploited by the privileged groups to enhance their oligopolistic control rather than promoting market competition and efficiency. Large business groups in developing countries are often the first to benefit from financial market integration, resulting in a greater degree of oligopclistic market control rather than enhancement of market efficiency through further competition. This risk is heightened in those developing countries where the real sector is not sufficiently integrated. Financial integration without concomitant real sector integration within the overall economy can often lead to further market disruptions instead of economic efficiency.

Furthermore, hasty financial market integration renders a developing country vulnerable to external financial disturbances. This "whipsaw" effect can be especially serious for smaller developing economies where the shallow domestic financial markets

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are ill-equipped to absorb the external financial shocks. The October 1987 stock market crash in the United States had a far more adverse effect on such relatively more integrated financial markets as Mexico, the Philippines, Thailand and Hong Kong, than Korea and Taiwan which maintained a strict control on foreign access to their securities markets. Transmission of financial market volatility is far speedier and more disruptive in integrated financial markets.

5. Types of Financial Market Integration

Financial policy in developing countries has increasingly focused on the objective of improving the efficiency of the financial system, without, however, neglecting the two other main objectives, namely to ensure the stability and soundness of the financial system and to maintain an adequate level of investor protection. Efforts towards modernizing national financial systems have gathered considerable momentum since the early 1980s under the impact of increasing internationalization of financial markets and intensifying competition within and between national financial systems. Competition policies have become a major, although not the only, policy tool for improving the efficiency of the national financial systems. In this context it needs to be stressed that competition is not seen as a goal in itself; the ultimate objective is efficiency.

In implementing policies towards improving the efficiency of national financial systems, a wide range of measures have been devised to stimulate competition and strengthen the role of market forces. These measures include the deregulation of interest rates and other financial service fees such as stock broker's commissions to promote price competition and the liberalization of various financial activities to enhance the role of market forces.

A most striking feature of developments on the supply side of the markets for financial services has been the trend towards diversification and decompartmentalization, or blurring of demarcation lines between formerly separated sectors of the financial system. The driving forces behind this trend have originated both from the market side and from the authorities' side. While financial institutions have used diversification strategies as a major weapon for competing vigorously in the rapidly growing and increasingly widening markets for financial services and products, the authorities have generally supported this trend also, often in connection with broader financial reforms designed to improve the efficiency and the functioning of their countries' financial systems.

The diversification and despecialization process has no doubt been one of the major factors contributing to intensified competition in the vast markets for financial services and products, although the speed and intensity of this development has varied from country to country depending on differences in historical and legal frameworks and tradition and on regulatory changes. In the process of regulatory reform designed to build more integrated financial systems, the authorities have often paid considerable attention to the question of competitive equality and have taken measures to ensure that the "players" in the market compete with equal weapons on a level playing field.

Financial market integration manifests itself in three major formats: functional, regional, and international. Functional integration has lessened the operational identities among those financial institutions with formerly distinct product lines, such as commercial versus investment banks, savings and loan associations, insurance companies, postal offices, and consumer credit companies. Policies towards despecialization and diversification of financial services and products which banks and other financial institutions are allowed to offer, were generally more important in countries with historically more segmented financial systems than in countries with more open and homogeneous systems. This applies in particular to savings institutions which in a number of countries traditionally acted as collectors and guardians of small savings that were to be channelled into narrowly defined uses such as housing finance or government securities. In most of these countries such savings institutions have gradually been allowed to become full-scale retail banking institutions and have thus been integrated with the banking system. In the United States, for example, the current S & L crisis has accelerated the trend towards transformation of S & Ls from traditional, narrowly-defined home financing services into broader full-service financial institutions.

In a similar way, the financial service powers of post office systems have sometimes been enhanced by the authorities with a view to making more efficient use in the distribution of financial services and products of the wide branch network that postal systems usually have at their disposal. A third trend within the broader development towards diversification and the blurring of demarcation lines within financial systems has been the process of integration of the banking sector with the securities markets and the specialized institutions operating in them. This process has in particular affected those countries in which the two sectors have historically been separated by law or tradition. Among the industrialized countries, the United States, Japan and Canada are the main examples where the separation between commercial and investment banking has been maintained rather strictly, whereas in the Continental Europe and other countries the role of banking institutions has been traditionally more widely interpreted and practiced, including both commercial and investment banking activities. In recent years, however, we are witnessing a growing trend toward broadening financial activities by banking institutions. Even the commercial banks of the United States and Japan can engage in investment banking activities outside their own home countries, while their domestic financial activities have been progressively liberalized and extended to include an increasing array of previously forbidden investment banking activities such as underwriting of certain corporate bonds, mortgage-backed securities and commercial paper.

Regional financial integration has been particularly noteworthy in commercial banking. In addition to providing more scope for price and product competition, the authorities have often taken measures designed to increase the number of competitors in the markets for financial services by the abolition of obstacles to territorial competition, i.e., by removing restrictions on the extension of domestic branch networks in the banking sector. In the United States, the McFadden Act of 1927 has effectively prohibited the development of inter-state or nationwide branch networks for U.S. commercial banks. The authorities now seem to believe that the ban on inter-state branch networks has negatively impacted the growth of the U.S. commercial banks in meeting the new international competitive challenges of large banking institutions from other industrialized countries such as Japan, Germany and the United Kingdom, where nationwide branching and/or universal banking (including the investment banking powers) has been freely allowed for a long time. Therefore, various measures have already been taken and others are on the way to dilute or even abolish the McFadden Act.

Regional financial integration has also been accelerated by the technological progress in the financial system. Widespread installation of automated teller machines (ATMs) provides a powerful weapon for commercial banks to overcome any barriers to interstate branching. Technological breakthroughs in computers and telecommunication make it possible for a financial institution to more easily gain access to the previously blocked market regions. Furthermore, the "regional branch networks" have been increasingly adopted in the United States whereby neighboring states collectively allow branching by each other's commercial banks on a reciprocal basis. Thus, banks in Virginia, Maryland and the District of Columbia can now establish banking establishments freely within the tri-state region. The same is true for the banks in the New England states as well as in the South Eastern states of Florida, Georgia, South and North Carolinas, etc. In some developing countries such as Indonesia and Pakistan, commercial banks are more freely allowed to open branches nationwide outside their traditional banking markets, thus accelerating the trend toward regional integration in financial services.

Perhaps the most significant financial integration, however, takes the form of internationalization or cross-border integration. In fact, among the most noteworthy financial market developments during the past ten years have been the trend toward

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internationalization, financial innovation, and securitization. While all these three developments interact among each other, internationalization has been instrumental in providing a fertile ground for financial innovation and securitization. The degree of international financial integration can be seen by various measures to facilitate a free flow of capital and financial services across national boundaries. This paper discusses the case of the Pakistani financial market, as the country attempts to develop its financial system through internationalization and integration of its financial markets.

6. Overview of the Economy in the 1980s

Pakistan experienced annual economic growth in excess of 6 percent in the 1980s, which compares favorably with many other developing countries. Despite this success, per capita income is still under US$400. While Pakistan benefitted from the prosperity of the Middle East region in the 1970s and early 1980s in terms of exports of goods and manpower, it has since been confronted with the problems of dealing with more than three million Afghan refugees and declining remittances from workers abroad. In spite of the high real growth in the economy in the past, the structure of production and exports has not diversified markedly in the last decade. Production and export still depend largely on agriculture and cotton-based industry, making the balance of payments vulnerable to external shocks.

In the early 1980s the Government began to move toward a more market-oriented economy. Until then, Pakistan had been a regulated economy with wide ranging subsidies and regulation of prices and investments, high tariff and non-tariff barriers, and government involvement in commercial activities. Interest rates had been controlled and monetary policy relied heavily on direct credit controls. While good progress had been made in liberalizing investment and price regulations and managing the exchange rate in a flexible manners, slower progress was recorded in trade liberalization and privatization of public enterprises. The system of direct credit control has been maintained. The introduction of Islamic banking laws in 1985, while helping to make the rates of return of financial investments more flexible, did not lead to a more efficient banking system. In recent years signs of disintermediation of funds in the banking sector became visible.

Between FY85 and FY87 (Pakistan's fiscal year extends from July 1 to June 30.), Pakistan was able to reduce the external current account deficit from 5 percent of GNP to 2.1 percent, because of rising prices for raw cotton and cotton manufactures. However, at the same time, it continued to record high overall fiscal deficits which implied that the private sector had to carry the burden of external adjustment. In FY88 an even more expansionary fiscal policy accompanied by an accommodating monetary policy resulted in a doubling of the current account deficit in terms of GNP, a drawdown of reserves and higher rates of inflation. The fiscal accounts recorded deficits of over 8 percent of GDP in FY87 and FY88, compared to around 5 percent of GDP in the early 1980s.

In spite of major political changes in the first half of FY89, massive civil unrest in the Karachi area and widespread flooding in Punjab, the economy continued to grow at over 5 percent and inflation abated by the end of FY89. Important program elements, such as the implementation of trade liberalization, tariff rationalization, and deregulation were broadly implemented as expected. Furthermore, the Government introduced revenue raising measures and pursued a flexible exchange rate policy. However, the overall results of the first year of the adjustment program were mixed in terms of putting the economy on a more solid footing. The budget deficit, although declining from 8.6 percent GDP in FY88 to 7.3 percent of GDP in FY89, fell short of target, mostly due to higher-than-planned subsidy outlays. While recurrent expenditure exceeded the target, development expenditures were below the projected level. The external current account deficit widened and the level of official reserves remained at three weeks of imports, primarily because of an adverse terms of trade shock of 8 percent in US$ terms equivalent to 1 percent of GDP.

In FY89 Pakistan's gross domestic product at market prices exceeded the target and grew by 5.6 percent. This was below the 1980s average of 6.3 percent and well below the FY88 growth rate of 7.4 percent. Agriculture was the major contributor to growth in FY89, after two years of sluggish performance, while industrial growth slowed, most significantly in the large-scale manufacturing sector. In the two previous years, it was the expansion in industry -- stimulated by an expansionary fiscal policy, terms of trade gains and large real exchange rate depreciations -- which was the driving force behind the growth in the economy. The favorable outcome in the agriculture sector in FY89 is attributed to the value added growth in major crops, although the production of such important commodities like rice and cotton was stagnant due to adverse weather conditions.

Pakistan's balance of payments has shown protracted weaknesses due to a narrow export base and dependence on workers' remittances. Due to lax demand management, and higher interest payments associated with increased (short-term) external indebtedness, the external current account deficit increased in terms of GNP from 2.1 percent in FY87 to 4.3 percent in FY88, while in FY88 gross official reserves fell to a level equivalent to only three weeks of imports.

The unexpected deterioration in the external current account was financed by faster disbursements of medium- and long-term loans from bilateral and multilateral sources, the latter of which consisted mostly of food and other commodity aid. Net

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disbursements under public and publicly guaranteed loans doubled to US$1,148 million in FY89. The repayment of a medium-term commercial loan in FY89 did not indicate a change in the government's debt strategy but was only a transitory effect of roll-over financing whose disbursement fell into the beginning of FY90. However, the Government actively pursued a policy of reducing short-term foreign commercial debt in FY89 and improving the external debt profile by starting to pay off a large short-term loan it contracted in FY88. The short-term capital inflow from foreign exchange bearer certificates, which are denominated in Pakistan Rupees and which can be converted into foreign exchange at the current exchange rate, fell from US$112 million in FY88 to US$28 million, probably due to higher expected rates of exchange rate depreciation.

In FY89 the Government continued its flexible exchange rate policy. It appropriately responded to the terms of trade loss by accelerating the rate of depreciation, as well as by tightening monetary policy. The depreciation in the real effective exchange rate amounted to 1.9 percent in FY89 over FY88. This year-on-year estimate, however, masks larger movements during the year. In September 1988, the Government began to accelerate the pace of nominal devaluations, thus reversing the real appreciation of the rupee observed since March 1988. The rate of devaluation was accelerated even further in April and May 1989 in response to the terms of trade deterioration. Subsequently, however, nominal adjustments in the exchange rate were slowed down to stabilize exchange rate expectations and avoid a reversal of the observed deceleration in the inflation rate.

As a result of the widening of the external current account deficit in FY89, external (civilian) debt increased from US$16.9 billion in FY88 to US$18.1 billion in FY89. This continues the trend since FY85 of rising external indebtedness to GNP due to large external current account deficits and associated financing. Large real depreciations of the rupee in FY85-86 also contributed to the increase in the external debt to GNP ratio.

The external debt service ratio declined only marginally, primarily because of lower than expected exports. The external debt service ratio, while high, reflects the concessional terms of most loans. However, the non-concessional share of foreign financing increased in FY88 resulting in an increase in the implicit interest rate from 5.1 percent in FY86 to 5.4 percent in FY88. In FY89 reduced recourse to short-term financing and larger availability of concessional financing lowered the average interest rate again to 5.1 percent.

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7. Overview of Financial Market Institutions

As of early 1990, the financial sector in Pakistan consists of five nationalized commercial banks (NCBs), twenty foreign commercial banks, four specialized commercial banks, nine development financial institutions (DFIs), two investment companies, one state-owned life insurance company, about 50 private non-life insurance companies, 13 public modarabahs (mutual funds), about ten leasing companies, a government housing finance corporation, one discount house, and two stock exchanges.

Pakistan's financial sector is a centrally controlled system of directed credit, dominated by government ownership of the commercial banks and many of the specialized development institutions. At its apex is the State Bank of Pakistan (SBP) which, along with considerable direct involvement of the Ministry of Finance, regulates the financial institutions. Also, as chair of the National Credit Consultative Committee (NCCC), the body charged with making recommendations on monetary and credit expansion and the sectoral distribution of credit, the SBP governor is instrumental in the division of credit among the government, public enterprises, and the private sector.

Deposit taking institutions are the most important type of financial organization in the financial sector and hold more than 50 per cent of the system's total assets. The nationalized commercial banks (NCBs), especially the three largest (Habib, National, and United) have the great majority of the deposit business. Together, the NCBs account for over 90 per cent of banking system deposits and 85 per cent of the advances. While foreign commercial banks are permitted to operate, private domestic commercial banking has been prohibited since banks were nationalized in 1974.

Government-owned specialized banks exist for financing agriculture, industry, and cooperatives. Although these banks are treated as deposit-taking institutions, they rely on central bank support for the majority of their funding. These and a number of development finance institutions (DFIs) are classified as non-bank financial intermediaries (NBFIs). The most important of these are the National Development Finance Corporation (NDFC), which is wholly government owned, and lends to public and private manufacturing enterprises; the House Building Finance Corporation (HBFC), which specializes in financing for home purchase and is funded almost entirely from the central bank; and the Pakistan Industrial Credit and Investment Corporation (PICIC), which has majority private ownership and provides long-term foreign currency financing to the private manufacturing sector. National Investment Trust (NIT) and Investment Corporation of Pakistan (ICP) are collective investment institutions, the former being an open-end mutual fund or unit trust; ICP manages a series of 18 closed-end mutual funds. Finally, there are two stock markets; the more

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important one is in Karachi, the other in Lahore). Although the market capitalization of listed companies has increased in recent years, it is still low by comparison with other developing countries in Asia.

This situation has concentrated market share in the NCBs and discouraged competitive and efficient operation of the financial system. Also, inadequacies in licensing and regulation contributed to two episodes of failure and scandals in private finance companies. Finally, savings and investment rates (now around 9 per cent and 16 per cent, respectively) are quite low. Below-market interest rate policies, designed to encourage investment in sectors such as industry and agriculture, may in fact have depressed savings propensities. Other reasons include weak capital markets and flows of curb market funds and remittances outside the formal intermediation system.

Despite the relatively low level of per capita income and low rate of national savings, the financial sector of Pakistan is quite large, dynamic and diverse when compared with other countries at similar levels of development. Although innovation and competition have been stifled by heavy and repressive government control and regulation, the financial sector has been far from stagnant. Institution building has been undertaken over a long period and has covered not only commercial banks and development finance institutions but also contractual savings as well as collective investment institutions such as insurance companies, provident funds and mutual funds (unit trusts). Organized markets for government and corporate securities are not, however, well developed although the equity market has experienced a considerable expansion in recent years. There is also a rudimentary market in interbank deposits and some bearer instruments.

Following the more liberal economic policies adopted by the Government since 1977, the number of foreign banks operating in Pakistan has increased considerably. With the Islamization of banking and finance, several new institutions engaged in leasing and other activities, compatible with Islamic modes of finance, have also been established, further enriching the institutional structure of the financial system. In fact, the number of financial institutions currently operating in Pakistan is deemed to be rather large, arguably causing a fragmentation of human and capital resources and a duplication of effort that may even result in increased costs of financial intermediation.

Tight regulation and control, while giving stability, have not succeeded in ensuring a sound financial situation in case of many individual financial institutions. The main reason for this is that financial regulations and control have discouraged competitive and efficient behavior in the system. And yet, the Government has neglected prudential regulations and regulations providing consumer, depositor and investor protection. While many financial institutions, especially commercial banks and some specialized institutions, have substantial non-performing assets, the stability of the financial sector as a whole has not been threatened, mainly because most financial institutions are state-owned and there is little fear of financial collapse. However, the impact of non-performing assets on the profitability and soundness of the most important financial institutions has caused considerable concern and the authorities have taken important, initial steps to assess the extent of the problem and to examine various ways for reforming the regulatory framework and improving the performance of individual institutions.

The neglect of institution building on the regulatory and supervisory front is also underlined by the experience of finance companies in the late 1970s. In response to large inflows of worker remittances, a large number of private finance companies were set up to collect deposits from the personal sector and utilize them in high-return, high-risk ventures. Most of these companies engaged in imprudent practices but they were allowed to operate with very little regulation and effective supervision. Not surprisingly, the outcome was a solvency and liquidity crisis that led to the closure of all these companies, wiping out substantial amounts of personal savings.

The neglect of regulatory and supervisory issues is also evident in the lack of effectiveness in the legal and judiciary system which has seriously undermined the loan recovery process of banks and other financial institutions. This issue will be discussed in more detail under a separate section in this report. As the financial services industry is highly dependent on the timely execution of financial contracts, reforming the legal and regulatory framework governing the provision of financial services is clearly a task of paramount importance for the well-being and future development of the financial sector.

Since the late 1970s, GOP has taken a series of measures to stimulate the growth of the financial system and enhance the efficiency of savings mobilization and resource allocation. One of the most important of these has been the active marketing of the National Savings Schemes (NSS), to cover growing government expenditures, offering high rates of interest. Another fundamental change has been the Islamization of the financial system which has had major implications for the functioning of financial institutions and for banking and financial practice. The impact of higher rates of return on national savings schemes and the adoption of profit and loss sharing (PLS) deposit accounts by scheduled banks are discussed later in greater detail.

In recent years, several new financial instruments have been introduced by government authorities striving to finance growing budget deficits. These have included the highly successful Khaas deposit certificates, and two types of tradable bearer instruments

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- the Bearer National Fund bonds (BNFB) and the foreign exchange bearer certificates (FEBCs); the BNFB is offered on a zero-coupon discount basis. These instruments were made available for one, two and three-year maturities and were open for subscription over specified periods covering between 4 and 8 weeks. The FEBCs, which on maturity are redeemable into foreign exchange at the going spot rate, are traded in the stock exchange at prices that reflect a small premium (8%) over the official exchange rate. This provides an indication that foreign currency is not very scarce and the exchange rate may be near its market value.

Innovation by individual institutions, especially the commercial banks, has been constrained by the restrictive regulatory environment but NBFIs have been able to introduce some interesting new products. NDFC, in particular, operates a deposit account that appears to work as an informal money market mutual fund, collecting deposits from investors for placement in Khaas certificates through NDFC. Investors earn a return that is closer to the rate obtainable on Khaas certificates but enjoy greater liquidity. Innovation by other types of institutions, such as insurance companies and mutual funds, has been less advanced but leasing companies as well as some Islamic types of companies (e.g. modarabas and musharikas) have been able to develop the leasing, venture capital and related concepts in the context of the Islamization of the financial system.

8. Commercial Banking System

A. Pakistani Commercial Banks

The commercial banking system in Pakistan predates the country's independence. The oldest Pakistan bank was set up in 1942 by the Habib business group. The Australasia Bank (now the Allied Bank) was established in Lahore in 1947. Most banking functions before independence, however, were carried out by numerous branches of foreign and Indian banks having their main offices in Bombay, Calcutta, or Delhi. Most of them closed their offices upon partition, so that Pakistan had to rebuild its banking system. In 1948, the State Bank of Pakistan (SBP) was established as the central bank of the country. One of its first functions was the issuance of currency to replace Indian currency notes in circulation as a transition measure. The second important function was the promotion of banking institutions.

A Banking Companies Act was passed in 1948, and the first new bank to be established, with government participation, was the National Bank of Pakistan (NBP) in 1949. The existing Pakistani banks also were encouraged to expand and the branches of foreign banks allowed to continue their activities undisturbed. In the 1950s, commercial banking expanded rapidly and important new private banking institutions, such as the National Commercial Bank in 1957 and the United Bank Ltd. (UBL) in 1959, were created. In the 1960s, two other important banks were established--Commerce Bank and Standard Bank. During this time SBP carried out its traditional central banking functions by inspecting banking institutions. It also contributed to the development of professional bankers through a centralized training scheme.

As banking grew, the country felt the need to review the effectiveness of banks in promoting economic development. During the 1960s, the Government sought to channel credit to targeted sectors mainly through specialized institutions and other schemes financed by SBP. It was felt that the banks were failing to play a developmental role. Together with banking reforms, SBP introduced more specialized credit schemes for small producers in agriculture and industry, enjoining greater commercial bank participation. These measures proved to be a prelude to the Nationalization of Banks Act of 1974, whereby the SBP and all the commercial banks incorporated in Pakistan were brought under direct government ownership. The Pakistan Banking Council (PBC) was established to coordinate the activities of the nationalized banks, which were merged to form five banks (NCBs). Since nationalization, the banking system has continued to expand its operations and geographical presence under more direct government control.

With total assets of Rs 500 billion, or about 80 per cent of the assets of the financial system as of early 1989 and a network of 7,000 branches, NCBs constitute the dominant part of the deposit-taking sector of the country. The deposit-taking sector consists of 5 NCBs, 19 foreign commercial banks, and 4 specialized banks which form together the group of scheduled banks. It also includes the national savings centers. There are no building societies or savings and loan associations in Pakistan nor any credit unions. However, there are several agricultural and rural credit cooperative societies for which one of the four specialized banks - the Federal Bank for Cooperatives (FBC) -functions as an apex bank. The other three specialized banks are the Agricultural Development Bank of Pakistan (ADBP), the Industrial Development Bank of Pakistan (IDBP) and the Small Business Finance Corporation (SBFC). The specialized banks are treated as deposit-taking institutions even though they rely on central bank support for the majority - in the case of ADBP, the vast majority - of their funding.

Within the commercial banking sector, the NCBs - and especially the three largest banks - Habib, National and United - have the lion's share of the business. The oligopolistic structure of the banking market is in line with the situation prevailing in most countries - developing as well as developed - that have an integrated banking structure, i.e. a structure that is not fragmented by geographical and other regulatory restrictions. There is some rivalry among the big banks but the degree of effective competition is limited by the extensive array of controls imposed on the operations of banks. The Pakistan Banking Council plays a coordinating role in the management and development of the NCBs. The NCBs are active in all segments of the market. They compete with foreign banks in the financing needs of large 'blue chip' private and public companies; except for this small segment, the lending markets in general are not very competitive. In the deposit market, they face competition from the national savings centers.

B. Foreign Banks in Pakistan

As of early 1990, there were 20 foreign commercial banks (FCBs) in Pakistan. Owing to their efficiency, overseas banks have been able to offer better rates of profits on deposits, compared to all banks' average. The differential ranges between 2.7 per cent in case of 7-day notice deposits to 5.9 per cent in case of one-year deposits for the year 1988. The average rate of return paid by foreign banks to its depositors is slightly above the inflation rate in Pakistan.

Foreign commercial banks form an important group, in the country's banking system. Up to June 30, 1989, there were only 19 foreign banks operating with 66 branches in Pakistan. The Dubai Bank has since been merged with the Union Bank of the Middle East after incurring heavy losses. By early 1990, the number of foreign banks increased to 20. These foreign banks have established high standards, in the country for financial products, investment banking, quality of service and technology. Besides, they serve as a bridge between Pakistan and international financial institutions, strengthening the ties of mutual co-operation. Still they are dwarfed by their counterpart, the five nationalized commercial banks of the country (NCBs) operating through 7,188 branches.

The total deposits of foreign banks operating in Pakistan maintained their upward trend having risen from Rs 13.8 billion in 1985 to Rs 26.3 billion in 1988 and further to Rs 34.7 billion in 1989. Their share in total deposits of the country increased from 10 percent in 1985 to 16 percent in 1989. While wide fluctuations are noticeable in the deposits base of the foreign banks operating in Pakistan, they still succeeded in attaining a significant growth rate in 1989 although at a somewhat slower pace than in 1987.

The reason for the substantial increase in the share of foreign commercial banks in deposits and advances is that they are in a position to pursue a relatively more aggressive lending policy, essentially because they succeeded in enlarging their credit ceiling base by bringing deposits from other countries in foreign exchange. Such a transfer also resulted in increasing their deposit base. Because of their policy of serving selected clientele, they are also in a position to provide a relatively better financial service as compared to the nationalized commercial banks. Foreign banks concentrate on market sectors that they know best and favor highly-focused modern market techniques. They are also moving away from the traditional concentration on trade and finance. The credit ceiling is fixed within the framework of the overall credit policy of the Government, which is decided in view of the legitimate needs of the economy. As a result, the loans advanced by all the FCBs at the end of June 1989 constituted 52 percent of their assets and liabilities.

As in the case of total deposits, the total advances of foreign banks operating in Pakistan grew by 7 percent in 1989, which was at a significantly lower growth than 22 percent in 1987. Despite this lower growth, their share in the total credit base of the banking industry in Pakistan increased from 11 percent in 1986 to 14 percent in 1989. However, the total credit base of the foreign banks in Pakistan is not too high and stood at Rs 22.7 billion as against Rs 13.6 billion in 1986.

Total assets/liabilities of foreign banks operating in Pakistan increased from Rs 52.3 billion in 1986 to Rs 105.1 billion in 1989, thus showing an increase of 25 percent per annum. Their share in relation to Pakistani banks increased from 15 percent in

1986 to 20 percent in 1989. The country's stock market being very small, the FCBs play an important role as institutional investors. By the end of June, 1989, about 93 percent of the total investments were held in Government securities. Total investment of foreign commercial banks increased from Rs 5.4 billion in 1986 to Rs 11.8 billion in 1989, thus showing an increase of 29 percent per annum.

In the process towards Islamisation of the financial system and the economy as a whole, FCBs were asked to provide interest-free banking facilities to its clients. In line with the nationalized commercial banks (NCBs), the FCBs have also ceased to accept interest-bearing deposits and switched over to financing on PLS basis to private business and individuals from April 1, 1985. Due to increased competition plus growing pressure on margin, following the switch-over to the PLS system, the profitability of these banks has been adversely affected. The funds deposited under the PLS do not bear interest and their use is restricted to non-interest bearing investment and PLS accounts provided less profits to the depositors than the interest-bearing depositors than the interest-bearing deposits with the same maturities for the last two years.

C. Modarabas

A modaraba is a business in which one party participates with his money and another with his efforts and skills, and a modaraba company is a company engaged in the business of floating and managing modarabas. Thus, a modaraba is basically an investment fund (mutual fund) for which resources are obtained through the sale of modaraba certificates by a modaraba company. Banks and financial institutions can register themselves as modaraba companies and in that capacity, provide risk capital to modarabas in the form of equity and credit with equity (PLS) features. An important advantage of a modaraba is that it enables project sponsors to mobilize funds directly from the public without recourse to financial intermediaries. In this way, funds raised through modarabas fall outside the credit ceilings imposed by SBP. Modaraba must be registered under Modaraba (Flotation & Control) Ordinance of 1980, and the modaraba business is governed by the Modaraba Companies and Modaraba Regulations of 1981. The partner who puts in managerial skill (the modaraba company) must have at least 10 per cent share in the modaraba, while the profit is shared in an agreed ratio, the modaraba company and shares being limited to a maximum of 10 per cent. Modaraba certificates are transferable and very popular instruments in stock exchanges.

Modarabas can be multi- or uni-purpose, and they may be perpetual or for a specified period. A company which is also engaged in businesses other than management of modarabas is eligible for registration as a modaraba company provided that it had paid-up capital of Rs 7.5 million, of which a minimum of Rs 2.5 million is allocated to its modaraba operations; or if it is solely engaged in modaraba activities paid-up capital of Rs 2.5 million. The income of modaraba company is tax exempt if at least 90 per cent of its annual profits are distributed as dividend. Dividends are taxable to individual recipients at 7.5 per cent (after a statutory exemption of Rs 15,000 of dividend income). Modarabas have been widely used and actively traded in stock exchanges. Given that modaraba can be designed to meet multiple needs, it is likely to grow in popularity. In recent years, modarabas have been actively promoted through stock exchanges. Many modaraba certificate issues, all of whom are listed on stock exchanges, have been highly successful. Some of these certificates, originally issued at par, have lately been trading at significant premiums.

9. Integration and Internationalization of the Banking System

A. Foreign Operations of Pakistan's Banks

The growth in Pakisstani banking between 1984-87 was about half of the growth between 1980-84, and of course much lower as compared to growth in the early years of post-nationalization period. Volume of bank credit which had risen from Rs51,290.5 million in 1980 to Rs100,464.2 million, and Rs130,747.1 million in 1987. Thus, there was a rise of about 96 percent in four years or about 24 percent per annum. Between 1984 and 1987, however, the volume of bank credit rose by only 30 percent in three years, or about 10 percent per annum. Growth of banking seems to have reached a plateau or a stage of flattening.

According to some, Pakistani banking in the 1980s, especially in the later years of the 1980s, is passing through a period of "consolidation" instead of "expansion" in terms of number of branches as well. The number, for example, decline from 7,122 in 1980 to 7,060 in 1983, and 6,560 in 1985. In the case of the largest bank (Habib), it decreased by 22 during the year 1985 reducing the number to 1,872 as against 1,922 in 1981. Even the smallest bank (ABL) closed 30 loss-incurring branches during 1985. Other banks followed the same pattern of consolidation and closing down the loss-incurring branches according to general policy of the Pakistan Banking Council. However, some banks opened additional branches abroad, which adds to profits. Need for consolidation arose because of liberal and enthusiastic expansion of banking operations in the early years of nationalization i.e. 1974-77.

Some Pakistani banks make good profit from their foreign operations or foreign deposits, because foreign profits when converted into Pakistan currency means good addition to total profitability as shown in the annual accounts. Although balance sheet shows foreign assets and liabilities as a distinct part of total, the Profit and Loss Account gives no such break-down. Between 1979 and 1983, major portion of profits of a couple of banks came from foreign operations, while domestic operations showed negligible or very limited profits. Some banks may still be making profits from foreign operations. Thus, profitability need not necessarily mean professional excellence alone. It is ironical that figures of foreign operations are published in Balance Sheets of individual banks, but not in Profit and Loss Accounts. Thus, educated guesses have to be made. In the year 1987, it is estimated that the total profits from foreign operations of all the five banks is estimated to be about Rs 420 million out of overall profits of Rs 1,656.7 million i.e., about 25 percent. The largest bank gets about 23 percent of their total profits from foreign operations. The two middle-sized banks get more about 40-42 percent of their total profits from their foreign operations.

Banks make shifts and adjustments between their loan portfolio and investments portfolio. Individual banks make such adjustments occasionally, partly as a matter of deliberate policy preferences, and partly because of the market situation wherein good opportunities of investments are available. However, an overall trend of a shift for all the banks from loans to investments is something else. This explains, at least partly, decline in profitability of the banks, because return on investments is generally lower than that on loans. However, in view of general shift from loans to investments another interesting but important point emerges. There seems to be a rather shrinking pattern or relative decline in good lending opportunities, or a relative dearth of good clients as compared to what the banks would like to have or what they used to have. This is hardly surprising in view of the kind of investment climate, and a relative slackness in the industrial sector.

It is interesting to look at the ratio of profit to bank funds. If we compare profits with deposits for the five nationalized banks, we find the ratio of 1.52 percent in 1974, which was the first year of nationalization and 0.79 percent, both in 1980 and 1983. It came down to 0.71 percent in 1985. The year 1985 was, therefore, not a very prosperous year for the banks as far as profitability was concerned. The fact that 1985 was not a very good year is also borne by the fact that the ratio of profit to deposit in case of the largest bank of the country which was 2.6 percent in 1974, the year of nationalization, declined slightly to 1.9 percent in 1977, 1.3 percent in 1984, and declined to 1.0 percent in 1985. It declined to 0.6 percent in 1988.

There are certain aspects which need a study as far as the structure of banking industry is concerned. There are five nationalized banks of varying sizes and historical background. The largest and oldest one of them has had one-third of more of the total deposits in the banking industry. Its market share in bank deposits was 32.6 percent for HBL in the year 1974, when the banks were nationalized. It rose to 34.4 percent in 1983, and 38.8 percent in 1985. It came down slightly to 35.8 percent in 1988. This meant that the remaining 60 - 65 percent was shared by the other four banks. Investments and loans also show the large share of the largest bank. This is a quasi monopolistic position. Even out of the remaining 60 - 65 percent of the bank deposits the two banks are almost equal. They have more or less equal market share in deposits i.e., more or less 23 -25 percent each. However, in more recent years, NBP seems to have snatched number two position from UBL. The market share of the two smallest banks put together would come to only about 13 - 15 percent. The pattern of distribution is very skewed.

B. Foreign Bank Activities in Pakistan

Nationalized commercial banks in Pakistan have faced certain important problems. One of them is the phenomenon of competition with foreign banks of different kind. In all, there are 20 foreign banks. Their number has increased recently. There are four American banks. Included among them are the two (Citibank and Chase) which generally avoid competing among themselves in a single foreign country. There are two British banks. One of them (Chartered) started its business in Pakistani areas first in 1863. The other (Grindlays) had started its business in Pakistani areas in 1883. The latter has 14 branches in Pakistan. Then, there are three other European banks. These, however, do not give a serious competition. There are two Bangladesh banks too. There are six Middle East banks. Two new Middle East banks (Faisal of Bahrain and Doha bank) have come up in 1988. One of these six banks (BCCI) is, technically speaking, not a Middle East bank, but it is an oil-based bank by origin. These Middle East banks have one advantage over other banks. Their top management consists of Pakistani bankers formerly working in leading Pakistani banks. Most of them left Pakistani banks after nationalization. These banks have with them the senior Pakistani bankers who are well-known to Pakistani clients. In this respect, they have an edge over other foreign banks operating in Pakistan. These foreign banks have given a touch of competition to nationalized commercial banks. Market share of foreign banks in the total banking business has increased during the 1980s as compared to the 1970s.

Most of these foreign banks have three branches each. Grindlays, the oldest bank, has 14 branches. Percentage share of salary bill in total expenditure is highest in case of Grindlays among the 20 foreign banks. Smaller banks had 20 percent of their total expenditure on salaries and allowances, while the ratio was around 15 percent in case of the largest bank. On the whole, the ratio of salary bill in total expenditure is lower than in the case of Pakistani banks. At the same time, it may be mentioned that the ratio of Profits to Deposits is higher in case of foreign banks than the ratio for Pakistani banks. Pakistani banks have to maintain a large number of branches. Each branch has to maintain at least 2 - 3 employees, irrespective of the volume of business in small places. Foreign banks have to maintain only a minimum staff in limited number of branches, usually three branches. The only exemption is Grindlays Bank which has historically inherited the branches since before Independence. Moreover, several banks of British origin were merged into it.

One source of profits for banks is income from services rendered, other than loans and investments made. There are various services like opening of LCs, bank guarantee, foreign exchange business remittances, etc. Banks earn fees or commissions on these services. These are known as NonFund Based Revenue (NFBR) because these sources of income are not based on deposits and borrowings from State Bank or other banks. The funds remain intact as far as these subsidiary services are concerned. Funds are employed for loans and investments which constitute bulk of the banking business. From business point of view, this is a very attractive revenue. Naturally, these revenue go straight to become a part of total profits, just like profits from foreign operations. Here again the foreign banks take away a good part of business, as compared to Pakistani banks.

Between 1982 and 1987, growth of Non-Fund Based Revenue was 113.8 percent for Pakistani banks. Growth in this field was 173.9 percent as far as foreign banks are concerned. Foreign banks capture more than 23 percent of total Non-Fund Based Revenue. Pakistani banks get only 76.5 percent. Foreign banks succeed in getting a more than proportionate share of business in Non-Fund Based Revenue. Market share of foreign banks are 9 percent of deposits, 13 percent of loans, 23.5 percent of Non-Fund Based Revenue, and 37 percent of profit after tax.

Foreign banks probably provide quicker and more prompt services than Pakistani banks as far as those subsidiary services are concerned. This is natural, because foreign banks deal with a smaller number of selected but big clients. There is no rush of work as far as volume of business is concerned. Their personnel is better paid, and a little more sophisticated in their behavior and dealings with clients. They attract more business. After all, historically speaking, foreign banks in South Asia specialized in these subsidiary services and were originally described as "Exchange Banks". Perhaps that specialization continues to help foreign banks. Anyway, this continues to be a cause of low profitability of Pakistani banks.

Occasionally, there are political demands for shifting the head offices of some banks from Karachi to Lahore or Islamabad. Perhaps, a more advisable course of action would be to leave the present system undisturbed, but to introduce a new kind of banks. Regional and Rural banks can be created in private sector under charter from provincial governments. These smaller provincial or regional banks can serve more intensively the rural areas in that region. Moreover, being in private sector, they may perhaps be more efficient, and certainly succeed in laundering the black money. The latter activity is more badly needed to mop up excess purchasing power which would control inflation, and promote savings which is imperative.

10. Pakistan's Informal Financial Market

The informal financial market in Pakistan (also referred to as the parallel financial market, un-official financial market or

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the black money market) is large and active. It has been in existence for a very long time in the past. Over the years it has substantially grown in volume and geographical coverage. Presently its activities not only cover whole of Pakistan but extend internationally as well. In Pakistan it extends all over the country. However, it is most active in large industrial and commercial towns, which include Karachi, Lahore, Faisalabad, and Peshawar. The market plays an important role in Pakistan's economy alongside the formal financial sector. Its mechanism is considered more efficient. A very large volume of industrial production and trading business are financed by the informal market.

The important sources of funds include the following: Un-accounted for business earnings; tax evasion; earnings of professionals, i.e. lawyers, doctors, consultants, accountants etc.; kick-backs from over-invoicing of equipment imports; kick-backs from over-invoicing of local equipment and services; drug trade; smuggling operations; corruption money paid to civil services, and employees of semi-Government organizations; and individual savings.

As in the formal structured economy, the informal financial market funds are also invested in every sphere of economic activity. Among some of the most popular investments of the funds are:

a) Fixed assets on long term basis;
b) Working capital assets; and
c) Trading activities.

Long term investments in productive fixed assets are made normally by the owners of funds themselves. Sponsors of closely held industrial projects invest their undeclared funds in fixed assets. Their assets have lot more value than recorded in the books. This was amply demonstrated in 1985 when the Government issued Special National Fund Bonds, providing a chance for whitening the un-declared wealth. As a result, over Rs.15 billion was declared, a large portion of which was written into the books in respect of un-declared money invested in fixed assets. Besides, a large number of small scale business and industrial units operate with un-official funds, mostly their own. Long term borrowing in the informal market for investment, however, is not common due to the high cost of such funds.

Besides direct investment in economic sectors, the informal market, also known as the Hundi system, performs some financial services which compete with the services performed by the regular financial sector institutions especially the commercial banks. The important of these are:

i) Remittance of funds within Pakistan and also internationally; and

ii) Lending services.

The informal market arranges remittance of large amounts of un-official funds through un-official channels with absolute confidentiality and utmost speed. For this purpose the dealers maintain very efficient net work throughout the country. The cost of such remittances is known to be less than the normal charges for money transfers through the banking channels. The un-official market remittances are mostly made on telephone.

The market also arranges remittance from Pakistan to destinations abroad in any convertible currency to most locations. It also arranges remittances from the Pakistani expatriates abroad to the beneficiaries in Pakistan. In the latter case, the market directly competes with the regular banking channels. Remittances to the families in Pakistan of expatriates abroad are delivered at their residences even in remote locations in much shorter period than the commercial banks. In fact the banks are unable to perform similar functions for administrative reasons.

For remittances to Pakistan, the Hundi system is in a position to offer better exchange rates and lower remittance charges than commercial banks. For remittances abroad from Pakistan, the conversion rate is less than the official rate offered by commercial banks. The foreign exchange operations of the informal market are mostly conducted through the Gulf countries. However, after the introduction of Foreign Exchange Bearer Certificates (FEBC) in 1986, it is also being used for foreign exchange remittances from aboard. The outstanding balance of FEBC as at end June 1989 was Rs.5.9 billion.

The informal market also offers facilities for borrowing of funds. The magnitude of lending operations however is not considered large and is estimated at 10 percent of the markets resources. The resources of lenders constitute mostly their own funds although the market also accepts deposits for relending. A market source estimates the number of lenders around 100 throughout the country. The lenders also maintain brokers who refer to them the potential borrowers. The brokers also include bank employees who refer to the informal market lenders their (banks) clients who are in urgent need of funds but cannot be accommodated by the banks due to credit ceiling constraints or for other reasons.

The duration of transactions in the informal market is short-term, i.e. 3 to 6 months. The investment in various stocks is expected to be turned over in this period. Similarly the duration of loans in the market is also short terms. Longer term credit however is allowed for sale of specific items i.e. goods and passenger transport vehicles, i.e. trucks, buses, mini busses, taxis etc. Cost of these vehicles is recovered in 18 months to two years.

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The interest rate is 2 1/2 to 3 percent per month for secured credit. On emergency loans for very short periods i.e. a few days, 4 to 5 percent per month is also charged. Interest on un-secured loans/credit is 3 to 4 percent per month for good risk clients. Interest is recovered monthly. First period interest is deducted from the loan principal at the time of disbursement. If repayment of principal is not made on due date the terms are re-negotiated if the lender agrees to with-hold recovery action. Even for a few days extension beyond the period agreed originally, interest is recovered for full one month.

Un-secured credit is difficult in the informal market. It is very security conscious. It is not much concerned about the purpose for which funds are required. Emphasis is on readily marketable security under complete control and discretion of the borrower for its disposal. In view of the clandestine nature of business, recourse to law is not possible for recovery. Bad debts do take place. Their number and volume is not considered large compared with the high rates of return available. Mafia type operations are not un-common for recoveries. It is said that the Pathan lenders from the tribal areas even remove the defaulters to their territory where Pakistan's laws are not enforceable.

The existence of informal financial market in Pakistan is very old. It dates back to pre-partition India to the early days of the British rule. Evasion of taxes then was considered to be legitimate and morally justified as a means of non-cooperation with foreign rulers. The earlier nationalistic feeling later matured into habit. In Pakistan the growth in market size has been aided by the imposition of direct controls to regulate in the economy. Imposition of controls and tariffs led t smuggling which increased with the influx of refugees from Afghanistan and the accompanying lucrative and flourishing drug trade.

The lack of standardization in Pakistan's tax system, vast discretionary powers of the income tax officials, and the fear of detailed scrutiny has also increased tax evasion. Besides persistent depreciation of Pakistan's currency, increasing budget deficits and political instability have led to a crisis of confidence and adversely affected to country's economic climate. For the past several years in the Government of Pakistan has introduced measures to mobilize black money for better economic uses. GOP had also offered various incentives for whitening of un-declared wealth. However, the measures and incentives have also acted as premium for mal-practices. Besides, most of the mobilization efforts are in fact recognition of the informal financial market and not to stop or curb its growth. It is therefore desirable to review and rationalizes the existing economic management policies, regulations and procedures under which the informal financial market has flourished and to effect structural changes to gradually attract the undeclared or hidden wealth as well as to reduce incentives for its continued growth.

11. Development Finance Institutions

In Pakistan, there is a large number of development oriented financial institutions classified as non-bank financial intermediaries (NBFIs); most of these are government owned. The most important of these are the Pakistan Industrial Credit and Investment Corporation (PICIC) and the National Development Finance Corporation (NDFC). PICIC has significant private ownership and provides long-term foreign currency financing to the private manufacturing sector. NDFC, which is wholly government owned, lends to both public and private manufacturing enterprises and funds itself both from foreign institutions and through issuing deposit certificates.

PICIC was established in 1957 as a privately-owned corporation, to provide medium- and long-term finance to private industry. It was also intended to play a key role in capital market development through the direct purchase and underwriting of shares and debentures. During the 1960s PICIC developed into a well-managed and experienced DFC and emerged as the major source of foreign exchange term finance for private industrial investment. However, the 1970s proved to be an exceptionally difficult period for PICIC. In the first half of the decade, separation of East Pakistan (now Bangladesh), devaluation of the rupee in 1972 by 130 per cent, the nationalization of some of the major private industries and speculation about possible nationalization of the textile industry (not implemented), all contributed to a drastic reduction in private industrial investment and led to a general disruption of the economy. The textile industry, which in the 1970s accounted for more than 40 per cent of PICIC's loan portfolio, was particularly adversely affected by reduced exports. Many PICIC borrowers did not repay their loans resulting in serious financial problems. Recently, the Government has extended the Foreign Exchange Risk Coverage Scheme to loans made prior to 1981, which will help in recovering old arrears of payment. PICIC has also taken remedial steps to safeguard against the impact of these arrears by making substantial provisions.

Given the present sources of financing, PICIC acts mainly as a conduit for on-lending of foreign currency loans obtained from multilateral and bilateral sources and does not have significant local resources of its own for on-lending. In 1983, PICIC decided to diversify operations in order to cope with increasing competition from new development financial institutions (DFIs) and commercial banks and has increased its rupee currency term and working capital loans. But progress has been slow in general mainly due to lack of management commitment. Equity investment (Rs 180 million as of December 31, 1987) and underwriting have become more important recently and should be expanded further. The rupee loan operations are conducted through funds mobilized from the inter-bank call money market backed by existing credit lines of Rs 1,585 million from SBP. PICIC also has a credit line of Rs 750 million for locally manufactured machinery from SBP. PICIC is a partner with the ADB in the equity of the Pakistan Industrial Leasing Company(PILC), a private sector company set up to provide equipment on lease for industrial development. PILC has an authorized capital of Rs 100 million, 40 per cent of which is owned by the Crescent Group and 20 per cent each by ADB, PICIC and the general public.

Because of the improvement in the investment climate and a more active role for the private sector envisaged under the Seventh Five-Year Plan, the business prospects for term lending institutions in Pakistan are good. PICIC should benefit from this trend provided that it can position itself to compete in the financial system which is becoming more competitive. Over the next few years PICIC will be concentrating its efforts in diversifying its operations in the area of export-import finance, working capital lending, merchant banking (leasing, underwriting) and portfolio management. Therefore, its traditional lending businesses are expected to grow at a more modest pace than during the 1982-87 period. In line with its policy of diversifying its operations PICIC has prepared an action program to implement its new business plan. PICIC plans to finance its new business through domestic resource mobilization in the form of short-term certificates of deposit.

NDFC was set up in 1973 as the bank for the public sector enterprises. However, with the basic change in government policy in 1977, NDFC's charter was amended in 1983 to enable it to provide financial services to both public and private sectors. In fifteen years since its inception, NDFC grew to be the largest development bank in Pakistan. It has over 30 branches. NDFC's operations are also the most diversified and include substantial working capital loans, underwriting, syndications, equity investments, foreign exchange services, and consultancy. NDFC has not relied on government funding but has been successful in raising resources from the market through various deposit schemes and bond/debenture issues. NDFC promoted the establishment of other non-bank financial institutions such as three leasing companies, a regional finance company, a training and development institute, and a management consultancy group. It is currently in the process of forming a private investment company with the participation of private and multilateral organizations.

NDFC has, so far, attained reasonable collection ratios and has kept its arrears to a manageable level. NDFC is targeting to maintain its arrears at about 11 per cent of outstanding portfolio and cash collection ratio of above 88 per cent as in 1987. Based on NDFC's statistics, there are some areas of concern which will require priority and close attention to ensure realization of its targets. First, there are 27 companies accounting for about 10 per cent of arrears which are operating profitably but are in arrears. These could be "wilful" defaulters and should be followed up intensively and, if necessary, NDFC should utilize stronger collection measures including suspending any working capital loans and "black-listing" with other financial institutions under the credit clearing system.

It is reported that the World bank has temporarily suspended takedowns by NDFC under present loan agreements because of its failure to achieve stipulated collection ratios. The matter is to be reviewed when 1989 financial statements become available.

In Pakistan, NDFC is the most experienced in terms of merchant banking operations and has successfully built up its deposit mobilization capabilities and organization. It has shown flexibility to adapt to changing situations and is active in doing subsector research for its project promotion and financial planning. NDFC can now provide complete financial packages to industrial enterprises. NDFC plans to expand on its non-fund operations and foreign exchange/export business. Its major objective is to improve the quality of its operations in view of the tighter competition in the system and projects a slower but adequate and diversified growth in business which is appropriate. NDFC recently established the National Development Leasing Corporation to engage in hire-purchase and leasing operations under the Islamic system as well as the Regional Development Finance Corporation to provide finance for projects undertaken by private entrepreneurs in less developed areas of the country. Other development finance institutions include the House Building Finance Corporation which specializes in providing finance for residential construction and home purchases. It is funded almost entirely from the State Bank of Pakistan and a number of entities that have been established jointly with governments from the oil producing Islamic countries such as Saudi Arabia, Kuwait and Libya.

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12. The Securities Markets

With continuously improving economic policies in the 1980s, coupled until recently with increased demand for goods and labor from the Middle East, Pakistan's overall economic performance has been strong relative to many other developing countries. Real GDP growth has averaged about 6.5 per cent per annum since the beginning of FY84, the target set in the Sixth Five Year Plan (FY84-88). Consistent with the Government's policy of encouraging the private sector and increasing the role of markets in economic decisions, important policy changes have been taking place since the early 1980s. With the Sixth Plan's confirmation of the export-led growth and industrialization strategy, the pace of policy reforms has accelerated in many areas. Significant progress has been made in the areas of price decontrols, industrial deregulation (particularly investment sanctioning), reducing the extent of state monopoly in import activity, opening domestic trade in several major commodities to the private sector, and implementing a flexible exchange rate management.

The development of an efficient securities market is important in Pakistan to enable mobilization of resources necessary to continue growth rates achieved over the last six or seven years. Such development implies a stimulation of savings on the one hand and development of sources of funding other than commercial banks on the other. By encouraging savings for the long-term funding needs of business, the economy can expand, thus creating jobs and increasing per capita income. Development of securities markets implies developing investor habits, borrowing practices, institutions and information systems. The markets need intermediaries with the necessary financial strength to develop secondary markets by providing liquidity in instruments, in addition to managing, distributing and underwriting securities issues.

A. Stock Exchange

There are stock exchanges in Karachi and Lahore, with the Karachi Exchange being the major center of activity. As of early 1990, there were 450 listed companies (as of May 1990) on the Karachi Stock Exchange (KSE), and about 250 on the Lahore Exchange (all of which are also listed on the Karachi exchange). Trading is principally in common shares of companies registered in Pakistan. There is hardly any trading in corporate debentures, preferred shares, and Government securities. Debentures are a little used source of corporate finance and have been nearly always privately placed, while government securities are predominantly held by banks to satisfy liquidity requirements.

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The regulatory framework for Pakistan's capital market has developed over time on a piecemeal basis. Stock exchange regulations consist of requirements imposed by legislation, and those imposed by the stock exchanges on their own members and on listed companies. The main regulations covering the capital markets are: the new Companies Ordinance (1984), the Securities and Exchange Ordinance (1969), the Capital Issues Act (1974), and the Monopolies and Restrictive Trade Practices Ordinances (1970). The Corporate Law Authority, effectively a branch of the Ministry of Finance, and the Registrar of Joint Stock Companies are responsible for ensuring compliance with these acts. New issues are governed by the requirements of the Monopolies and Restrictive Trade Practices Ordinance (1970) and the Capital Issues Act (1974). The latter gives full authority to approve all public issues to the Controller of Capital Issues (CCI) who is a Joint Secretary in the Ministry of Finance.

Listing on a stock exchange in Pakistan is, in general, not the outcome of an independent initiative by a company. Rather, it reflects the requirements of either regulatory authorities or financial institutions, which impose the requirement as a condition for the provision of credit. A "private" company is required to secure "public" status when its issued capital exceeds Rs 10 million (or Rs 5 million in the case of non-industrial companies). A public company is obliged to offer 50 per cent of its shares to the public. This requirement is relaxed in the case of subsidiaries of multinational companies, so that the sponsors can retain 60 per cent of the shares. All public companies require a minimum of 250 individual shareholders. It is not known to what extent nominees are used to circumvent this requirement.

KSE started in 1949 while the Lahore Stock Exchange was set up in 1970. Substantial private investment and rapid growth of private enterprise in the 1950s created buoyant conditions on the KSE as reflected in aggregate market capitalization and also in the number of new issues. However, lack of a proper regulatory framework resulted in substantial losses for some smaller investors. The Securities and Exchange Ordinance was enacted in 1969 to protect investors in corporate securities. Increased powers were thus acquired by the regulatory authorities over listed companies and KSE, especially with respect to disclosure of information relating to corporate affairs.

Constraints on private sector profitability in the late 1960s, followed by the loss of East Pakistan, the devaluation in 1972, and the Government's nationalization program depressed the stock market which continued to stagnate throughout the 1970s. As a result of the improved economic climate and government measures to encourage the private sector since 1977, the stock market has revived considerably. However, it remains a relatively marginal source of funds for private industrial investment. As of late 1988, the market valuation of all listed shares at KSE stood at Rs 42

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billion. Of that total, it is estimated that well over 50 per cent is in the hands of sponsoring families, close to 10 per cent is held by the National Investment Trust, and about 20 per cent by other financial institutions. Probably well under 10 per cent is held by the public, and this is reflected in very low turnover of shares.

In any event, investment in shares by individuals is modest. In the typical listed company shareholdings of individuals are very small; in a limited sampling of companies, two-thirds of all individual holders had holdings of less than 500 shares; in one case this portion of shareholders held an average of about 170 shares (with a value of Rs 4,800 or $240), in another the same portion held an average of about 100 shares (with a value of Rs 1,500 or $75). In this same sampling, the total number of company shareholders ranged from 270 to 4800.

B. Membership

Membership of the exchanges is on an individual or partnership basis with each partner a member in his own right, with the exception that a father may introduce his son. The KSE has a fixed membership of 200, of whom about 110 are currently active, but trading is dominated by about 30 members. The Lahore Stock Exchange has 120 members of which only a handful are active. Admission is controlled by the Board of each stock exchange within the framework of the 1971 Securities and Exchange Rules. Members must be citizens of Pakistan, and have some previous experience in the securities business. It has become a matter of practice that members of KSE should satisfy a minimum net worth criterion of Rs 500,000. The level of education of the typical stock exchange member is not high, and performance is not highly professional, nor reliably honest, in many instances. Single capacity for both jobbing and brokering prevails on both stock exchanges.

Outgoing members usually trade their membership. The going rate has appreciated in recent years and at present, is understood to be well above Rs 1.5 million. While the Securities and Exchange Ordinance provides the Federal Government with powers which could override the board of a stock exchange, the board carries responsibility for regulation and control of matters relating to dealing, registration and settlement in addition to admission, disciplining and suspension of members. Although the stock exchanges have requirements relating to disclosure, the regulations are not generally rigorously enforced. Commission rates are fixed according to a schedule set by the stock exchanges, varying inversely with the value of a transaction.

Because of the limited role of the stock exchange in the financing of industry, the KSE has been able to handle the volume of business without much difficulty. The capital requirement of the individual was not a constraint. However, if measures are taken to expand the role of the KSE in financing private industry, it will be important to expand the membership of KSE and increase the capital requirement of the members. Better capitalized and funded members would be able to operate more efficiently and accelerate the growth of the market. Corporate membership will also increase the range of services that would become available to both institutional and individual members. The existing brokers on the KSE could be encouraged to form partnerships or incorporated into specialized security houses.

C. The Secondary Market

It is essential that the liquidity of the equity markets be enhanced by permitting the development of a well capitalised institutional market-making capability. One way to develop this would be to encourage the formation of partnerships amongst the existing brokers on the Karachi Stock Exchange, which could lead to the formation and incorporation of specialized securities houses. Selected DFIs and other investment companies could be allowed to become new corporate members of the Karachi Stock Exchange. The illiquidity of the equity market in Pakistan may be to some degree explained by the absence of market-makers, i.e. member firms or corporate bodies committed to publishing a selling price and a buying price and to holding an inventory of shares. The dominant position of the ICP and NIT unit trusts amongst the institutional shareholders also mean that they have a strong influence on the price of quoted shares each time they enter the market. The development of private sector unit trusts, which is permitted by the Ordinance governing the finance houses, would seem to be desirable. Whilst ICP and NIT have been able to increase the dividend yield on their investment and compete with National Saving Schemes instruments and Khaas Deposits, it is likely that a more liquid market with other institutional players would enable unit trust managers to more readily realize capital gains on the investments.

Of the listed companies, shares of about 150 are regularly traded and there is an active daily market in only 30. Of these, most are blue chip companies, amongst which multinationals and selected engineering enterprises feature prominently. Reasons for the relatively thin market in shares is in large measure explained by the structure of share ownership. Since 1981, paid capital of listed companies has doubled and the market value has more than quadrupled. Although the market capitalization has increased substantially, its size is small in comparison to other developing countries such as India, Thailand, and Malaysia.

Institutions, consisting of the DFIs, government-sponsored mutual funds and private insurance companies, dominate the market, and often find it difficult to complete purchase orders because of the limited market and inadequate supply of securities.

The rapid increase in stock prices primarily reflects (1) some underlying improvements in important segments of industry (especially cotton textiles, which account for nearly one-third of the listed companies), (2) revival of basic business confidence, (3) recognition of political stability, and (4) clarification of the Government's policies in respect of the relative roles of the private and public sectors. Another material factor has been returning wealthy Pakistanis from the Middle East. Generally, most investors in Pakistan, both individual and institutional, tend to be income oriented. Cash dividend and high payout ratio weigh more heavily on their investment decisions than potential capital gains. Only half the listed companies declared dividends in 1988.

13. Conclusions

The process of financial integration and internationalization in Pakistan has been very uneven at best. The financial market in the country is composed of an emerging equity market but still no viable long-term bond market. Most long-term financing requirements have been met by specialized development finance institutions, most of whom are owned or controlled by the government. The overall financial performance in terms of the credit quality and profitability has been very dismal, typical of most DFIs in other developing countries. The equity market is composed of two stock exchanges located in Karachi and Lahore, and a third one is being started in Islamabad. Still, the equity market is at the early stage of development in terms of its contribution in resource mobilization for the corporate sector. The level of market activities is still very low, and many companies shy away from the equity market for funding their investment projects due to various institutional and legal impediments.

The public confidence in the stock market is also low, partly due to the widespread doubt about the published financial statements of the listed companies. Accounting and auditing standards need to be upgraded in order to raise confidence by potential investors in the financial statements of the listed companies. In Pakistan, there are no recognized profession-wide standards for auditing. The Institute of Chartered Accountants of Pakistan has been struggling to adopt international auditing guidelines in Pakistan but they are powerless in face of the opposition from many companies as well as many auditing firms themselves, which are only too willing to approve almost any financial statements in return for small fees. Many small accounting firms are too desperate for new business and fee income to insist on strict accounting standards.

In the absence of the industry-wide consensus, the strengthening of accounting standards can be made only by a change in laws to be administered by the Corporate Law Authority by making it mandatory for the audit report to insist that "the financial statements are prepared in compliance with the international accounting standards (IAS) and that the audit is conducted under the international auditing guidelines (IAG)." This new requirement must be made part of the laws. To ensure its compliance, the Corporate Law Authority should be strengthened by professionally qualified staff of accountants, lawyers and financial analysts a la the Securities and Exchange Commission in the United States. In fact, the Corporate Law Authority must be turned into an SEC.

At the current stage, financial integration with the international market is carried out through a very limited number of avenues in a tentative manner. The foremost among them is the primary dependence upon official bilateral and multilateral sources of foreign funds, borrowed by the government and government agencies. The access to foreign private sources of funds stays low at only $250 million in short-term funds and $500 million in long-term funds, as of early 1990. Even these private funding sources are primarily foreign banking institutions. Almost no international securities issues have been utilized to tap international markets.

On the other hand, foreign private banks have been reasonably successful in penetrating the local Pakistani market, with 20 foreign banks active in the country, as of early 1990. These banks can open up to three branches inside Pakistan on a reciprocal basis, except for the Grindlays Bank which has 17 branches due to the long historical ties. These foreign banks have been able to carve up an increasing share of the banking market in terms of deposits, loans and fee-based business. The fact that foreign banks are privately owned and operated allows them a greater degree of flexibility as compared to the government-owned five nationalized commercial banks. It is ironic, in fact, that the Government of Pakistan does not allow establishment of <u>local</u> Pakistani private commercial banks, while allowing foreign private commercial banks to operate freely in the country.

In recent years, there have been various movements to strengthen the process of integration and internationalization in the country. Licenses have been issued for private investment companies, which have foreign investment banks as joint venture partners with the local Pakistani sponsors. The much-discussed Pakistan Fund as well as the Overseas Pakistani Investors Fund may be launched soon to attract foreign portfolio investment funds into the country. A venture capital fund is being organized in Pakistan in partnership with foreign financial institutions.

In addition, the government should move toward allowing selected Pakistani companies, both private and state-owned, to issue long-term foreign and Eurobonds in international capital markets. This move can be followed by issuing convertible bonds by big Pakistani private companies, in order to familiarize foreign investors with the country's equity market. These and other measures toward integration of the Pakistan's financial system have to be undertaken under an overall strategy of financial market integration and internationalization to increase the competitiveness and efficiency of the market.

14. Policy Implications

In recent years, many developing countries have adopted financial sector reforms and market liberalization measures. In many of these countries, interest rates have been fully liberalized or managed more flexibly than before. Other countries have curtailed their directed credit programs though few have eliminated them entirely. Competition among financial institutions has been promoted by opening the domestic market to foreign banks and by authorizing charters for new banks and nonbank financial intermediaries. Access to local capital markets by both foreign portfolio investors and foreign financial institutions has been significantly liberalized. Several former centrally planned economies aim to stimulate competition through extensive restructuring of their banking and financial systems.

In some countries financial liberalization has been quite comprehensive. As mentioned earlier, Argentina, Chile and Uruguay carried out extensive reforms in the mid-1970s, including the elimination of interest rate controls, directed credit programs, and exchange controls. A number of Asian countries have also moved toward deregulation, but reforms were introduced more gradually and were less comprehensive with the possible exception of Indonesia. Financial liberalization has sometimes proved difficult. In the Southern Cone countries liberalization ended in disarray; the Government of Argentina had to reintroduce controls, and all three governments had to deal with widespread bank failures. The Turkish Government had to reintroduce interest rate controls when real rates rose too far. But in Asia, where macroeconomic conditions were more stable and reforms were implemented more gradually, there has been no need to reintroduce controls.[7]

Experience suggests that financial liberalization needs to

[7]Yoon Je Cho and Dinanath Khatkhate, Lessons from Financial Liberalization in Asia-A Comparative Study, World Bank, 1989.

be undertaken alongside macroeconomic reform. Countries that attempted financial liberalization before undertaking other needed economic reforms suffered destabilizing capital flows, high interest rates, and corporate distress. Financial liberalization cannot succeed unless it is accompanied by the restructuring of insolvent banks and firms, and by adequate regulation and supervision. Domestic financial markets need to be competitive in order to ensure that local financial intermediaries are efficiently run to meet the new competitive challenges from foreign financial institutions. And opening the capital account must be carefully done in order to avoid the destabilizing capital flows that proved so difficult to manage in a number of countries attempting deregulation. The "Big Bang" approach to financial integration, as demonstrated in the Southern Cone countries among others, accompanies a high degree of risk. It clearly demonstrates that a good policy such as financial market integration can have a bad result through poor implementation. It further demonstrates that financial market integration and liberalization, if not properly designed and implemented, can cause instability of the financial system, which in turn may magnify macroeconomic instability. Proper sequencing and speed is the key to successful financial integration, especially when the countries have shallow and oligopolistic financial markets.

It is too early to evaluate the impact of the recent financial reforms and deregulations. It takes time for investors to examine the merits and potential benefit of the new policies, and plan their investment strategy, especially in cases where large investments or investments by foreign institutions and individuals are involved. However, there are some signs that point to a degree of satisfaction and optimism and/or desire for more reform and deregulation, especially in the area of processes and procedures where the government is involved. The final outcome of recent moves toward financial market integration will depend upon not only the initial policy measures but also the patient follow-through in such areas as institution building and continuous regulatory reform.

Financial market integration has to be viewed within the broader context of economic and financial liberalization designed to remove structural rigidities in the economy that have impeded efficient resource allocation and factor use. Recent political and economic developments in the Eastern European countries clearly demonstrate that decentralized and privatized decision making is ultimately more successful at promoting economic development and growth. Financial market integration in its various functional and geographic forms reflects an important aspect of decentralized decision making in the environment of deregulation and liberalization, substituting market forces for government controls in global resource allocation. Financial market integration is a logical extension of McKinnon and Shaw's argument for financial deregulation to promote "financial deepening" both in the functional and geographical sense. But the critical issue here is not so much the direction of financial market integration but the speed and sequencing of integration. It is in this area that more study and research is needed.

ANNEX I

Institutional Structure and Total Assets in Pakistan's Financial Sector

SBP (State Bank of Pakistan)	141,137	30.7%
Commercial Banks	243,323	52.8%
Specialized Banks	27,658	6.0%
ADBP (Agricultural Development Bank of Pakistan)	16,193	
IDBP (Industrial Development Bank of Pakistan)	6,639	
FBC (Federal Bank for Cooperatives)	1,840	
Cooperative Banks	2,986	
Development Finance Institutions	31,482	6.8%
PICIC (Pakistan Industrial Credit and Investment Corporation)	6,596	
NDFC (National Development Finance Corporation)	12,849	
HBFC (House Building Finance Corporation of Pakistan)	8,900	
Pak-Kuwait	550	
Pak-Libya	1,460	
Saudi-Pak	722	
Other	405	
SLIC State Life Insurance Corporation	8,000	1.7%
Collective Investment Institutions	8,000	1.9%
ICP (Investment Corporation of Pakistan)	2,492	
NIT (National Investment Trust)	3,704	
BEL (Bankers Equity Limited)	2,714	
TOTAL	460,510	100.0%

Source: Pakistan Financial Sector Review, Volume II, December 11, 1987, The World Bank.

Gross Domestic and National Product
- At Constant 1980/81 Prices -
(Percentage change over previous period)

	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89 prel.	Average Growth 1985/89	Average Growth 1981/89
Consumption	5.0	5.7	6.9	8.4	0.4	5.0	11.0	4.6	5.8	5.8
Investment	13.9	6.2	4.5	9.9	4.6	3.7	-0.6	3.0	4.1	5.6
Gross Domestic Capital Formation	9.3	9.7	4.8	10.0	5.0	4.0	-0.4	2.4	4.1	5.5
Private Sector	3.2	11.2	9.8	11.4	4.2	1.0	4.5	10.3	6.2	6.9
Public Enterprises	7.4	14.1	-0.4	8.3	5.4	7.4	-9.1	-5.5	1.0	3.2
General Government 1/	26.6	0.5	3.2	9.4	6.3	5.7	3.4	-2.9	4.2	6.1
Change in Stocks	62.6	-19.1	1.6	9.2	0.0	0.[illegible]	-0.1	9.1	3.7	6.1
External Balance-										
Exports (g&nfs)	-6.0	24.6	-3.7	-0.4	32.8	12.3	-1.6	11.5	10.3	7.9
Imports (g&nfs)	-0.5	11.1	7.2	8.9	-2.5	2.0	8.1	2.9	3.8	4.6
GDP at Market Prices	6.5	6.8	5.0	7.5	5.6	6.4	7.4	5.6	6.5	6.3
Net Factor Income	0.8	44.2	-4.2	-8.9	8.6	-15.1	-54.1	-18.9	-20.7	-9.8
GNP at Market Prices	6.0	9.5	4.1	6.1	5.8	4.7	3.6	5.0	5.0	5.6
Indirect Taxes	-1.9	10.2	11.9	0.2	-1.4	5.4	18.3	9.2	6.1	6.3
Subsidies	-2.6	31.2	-1.9	9.1	30.5	-44.7	32.6	2.9	1.5	3.8
GNP at Factor Cost	6.9	9.7	3.1	6.9	7.2	3.4	2.3	4.3	4.8	5.5

Source: World Bank, Pakistan: Assessment of Economic Performance in FY89, March 15, 1990.

Balance of Payments,
(millions of US$)

	1985/86	1986/87	1987/88	1988/89 Program	1988/89 Prov.
Current Account Balance	(1,236)	(719)	(1,682)	(1,374)	(1,959)
Trade balance	(3,042)	(2,294)	(2,557)	(2,162)	(2,610)
Exports (f.o.b.)	2,942	3,498	4,362	4,921	4,594
Imports (f.o.b.)	(5,984)	(5,792)	(6,919)	(7,083)	(7,204)
Services (net)	(1,016)	(982)	(1,381)	(1,368)	(1,478)
of which:					
interest payments	(593)	(627)	(750)		(786)
Private transfers (net)	2,822	2,557	2,256	[illegible],156	2,129
of which:					
workers' remittances	2,596	2,278	2,013	1,900	1,897
Capital Account Balance	1,267	913	1,566	1,471	1,799
Official transfers (net)	468	383	511	598	568
(refugee assistance)	135	129	164		132
Medium- & long-term capital (net)	630	465	819	739	1,190
Public & publicly guaranteed	436	279	608	661	1,148
Official	328	212	481		1,011
disbursement	803	924	1,156		1,671
amortization 1/	(475)	(712)	(676)		(660)
Private	106	67	127		137
disbursement	270	93	156		160
amortization	(164)	(26)	(29)		(23)
Other public (net)	(4)	55	45	(61)	(135)
Commercial banks	20	25	10	0	(110)
disbursement	150	100	120	110	0
amortization	(130)	(75)	(110)	(110)	(110)
Other 2/	(24)	30	35	(61)	(25)
Private (net)	200	131	166	139	177
Foreign direct investments	165	130	162		167
Other	35	1	4		10
Short-term capital (net)	169	65	237	134	41
Official (net)	163	110	324	134	60
Commercial banks	0	0	250	15	(35)
disbursement	0	0	300		465
amortization	0	0	(50)		(500)
Foreign exch. bearer cert.	148	64	112	70	28
Other	15	46	(39)	49	67
Private (net)	6	(45)	(87)	0	(19)
Errors and Omissions	(24)	48	(32)	0	10
Overall Balance	7	242	(148)	97	(150)
Net Foreign Assets (- :increase)	7	(242)	148	(97)	150
State Bank of Pakistan	(379)	(391)	39	(129)	115
Gross reserves (- : increase)	(146)	46	451	(263)	7
IMF (net)	(250)	(350)	(322)	174	146
Other	17	(79)	(90)	(40)	(40)
Deposit Money Banks	386	149	109	32	35
Foreign currency deposits	496	403	155		201
Other bank deposits (net)	(110)	(254)	(46)		(166)
Memorandum items:					
Gross official reserves	915	864	465	720	458
Reserves in weeks of imports	7.5	6.2	3.1	4.7	3.0
Current account balance	(1,236)	(719)	(1,682)	(1,374)	(1,959)
(in percent of GNP)	-3.6	-2.1	-4.3	-3.4	-4.7

Sources: Ministry of Finance and IMF.

1/ Includes amortization of Trust Fund loans and debt relief
2/ Includes IDB
Note: Numbers in brackets indicate negative values

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Exchange Rate Development
(Period Averages)

	Rupee/US$ 1 period average	Rupee/US$ 1 change in % 1/	Real Effective Exchange Rate Index 1980=100 period average	Real Effective Exchange Rate Index 1980=100 change in % 1/
Q3 1983	13.34	-8.1	99.9	-1.1
Q4 1983	13.32	-4.5	102.7	3.6
Q1 1984	13.50	-4.6	101.8	4.5
Q2 1984	13.76	-5.9	100.6	0.6
Q3 1984	14.12	-5.6	103.4	3.5
Q4 1984	14.81	-10.1	102.1	-0.6
Q1 1985	15.74	-16.3	101.9	0.1
Q2 1985	15.96	-13.8	97.7	-2.9
Q3 1985	16.01	-11.8	93.3	-9.7
Q4 1985	16.00	-7.5	88.0	-13.8
Q1 1986	15.98	-1.5	84.9	-16.7
Q2 1986	16.54	-3.5	79.6	-18.6
Q3 1986	16.89	-5.2	75.3	-19.3
Q4 1986	17.19	-6.9	74.7	-15.2
Q1 1987	17.27	-7.5	71.3	-16.1
Q2 1987	17.32	-4.5	69.7	-12.4
Q3 1987	17.51	-3.6	70.2	-6.8
Q4 1987	17.50	-1.8	67.1	-10.2
Q1 1988	17.52	-1.4	66.2	-7.1
Q2 1988	17.69	-2.1	66.9	-4.1
Q3 1988	18.21	-3.8	70.0	-0.4
Q4 1988	18.60	-5.9	66.3	-1.2
Q1 1989	19.24	-8.9	65.6	-0.8
Q2 1989	20.61	-14.2	63.5	-5.1
Q3 1989	21.06	-13.5	61.9	-11.6

Source: International Monetary Fund

1/ Change over the same quarter of the previous year; a decline indicates a depreciation.

External and Domestic Debt and Debt Service 1/

	1985/86	1986/87	1987/88	1988/89
External Debt 1/				
Millions of US$	14,837	15,969	16,887	18,102
% of GNP	41.3	45.8	42.8	43.7
% Of External Current Account Receipts	220	225	222	234
External Debt Service 2/				
Millions of US$	1,825	2,176	2,329	2,363
of which:				
Interest (US$ million)	705	762	887	893
% Of External Current Account Receipts	27.1	30.7	30.7	30.5
Domestic Debt				
Billions of Rupees	198.4	243.4	284.5	328
% of GNP	36.3	40.6	41.1	41.3
Domestic Interest Payments				
Billions of Rupees	13.4	16.5	23.4	28.3
% of GNP	2.5	2.8	3.4	3.6
Memorandum items:				
Implicit domestic interest rate 3/	6.8	6.5	8.2	8.6
Implicit foreign interest rate 3/	4.0	3.8	4.3	4.3

Source: World Bank, Pakistan: Assessment of Economic Performance in FY89, March 15, 1990.

1/ non-military debt incl. IMF credit
2/ total external debt
3/ ratio between interest payments and stock of debt at the beginning of the period.

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DRAFT FINAL REPORT

CHILE

THE LESSONS

OF FINANCIAL LIBERALIZATION

Prepared for the
U.S. Agency for International Development

By

FMIRI, INC.
Washington, D.C.

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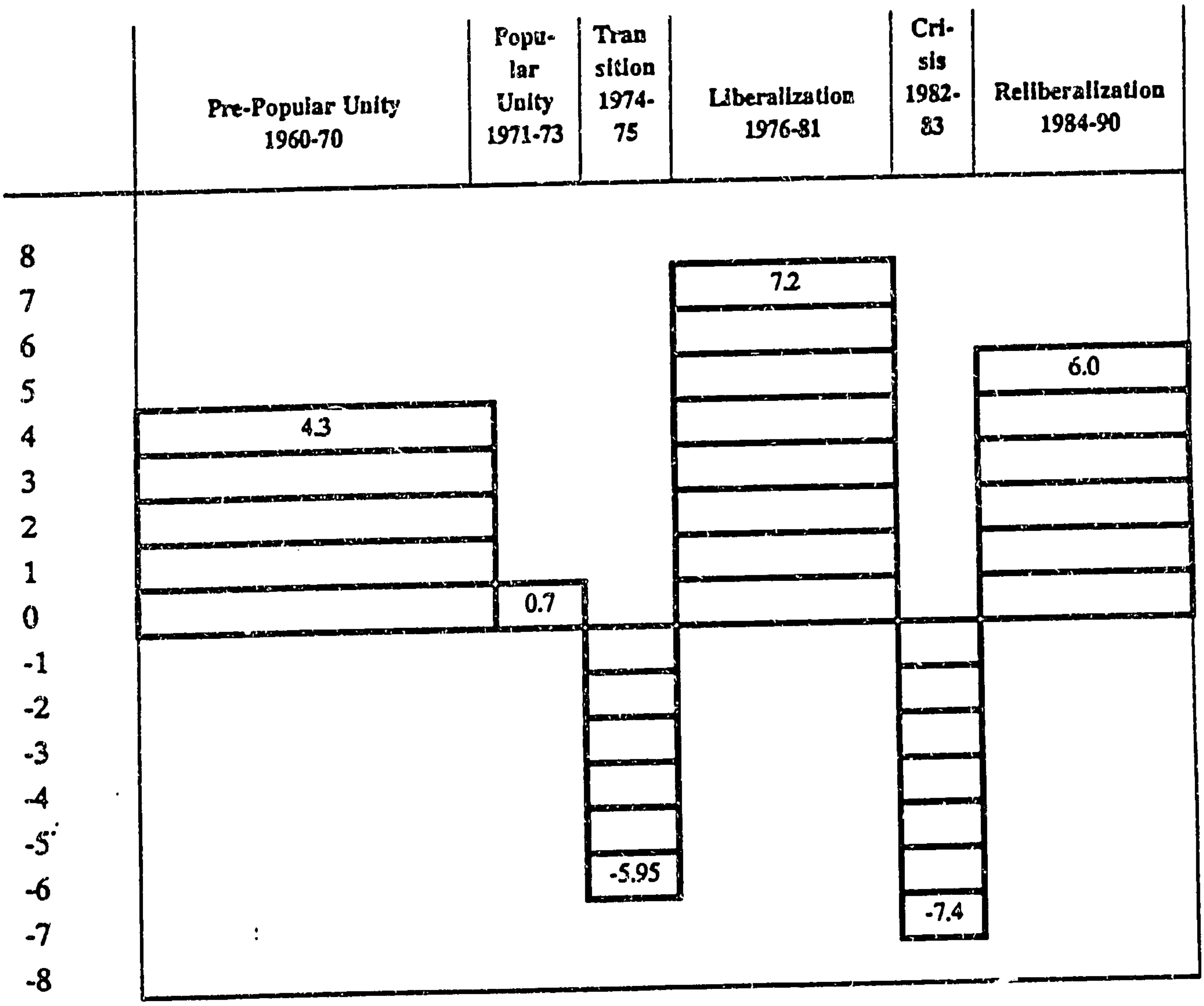
INTRODUCTION

Financial liberalization has been an important, if not paramount, element of Chilean economic policy for the last fifteen years. While the course of financial liberalization in Chile has not always been smooth, the recent experiences of the newly

Chart 1 - Average GNP Growth, 1960-90
(in percent)



industrialized economies in Asia reveal that mid-stream adjustments in any program of financial liberalization are necessary and, indeed, inevitable and constructive. Countries working to open their financial system to the healthy rigors of the market place must contend with changes in the world economy that require prudent responses while proceeding forcefully to introduce financial liberalization.

Since the fall of the government of Dr. Salvador Allende in 1973, Chile has pursued a bold course of financial liberalization. Its initial efforts at liberalization produced strong economic growth during the late 1970s. The correction in 1982 was caused in part by flaws in the strategy used to implement financial liberalization. But many of these flaws had their roots in the need to recover quickly from the economic morass created by the Allende government. They were also exacerbated by a poorly conceived policy towards inflation and by economic policies enacted in the developed countries.

Indeed, an analysis of GNP growth between 1960 and 1990 show that financial liberalization has materially benefited the Chilean economy (see chart 1). In the sixteen-year period before financial liberalization, the Chilean economy grew at an average rate of 2.3 percent. Even considering the effects of the crisis years of 1982-83, the Chilean economy averaged 4.6 percent growth in the years since financial liberalization was instituted, a 100 percent improvement over the preceding period.

This steady growth has had significant consequences for Chile. Recent research has shown the free market functions best when accompanied by democratic institutions. Strong growth extending over a a decade and a half is an accomplishment for any country. In Chile, it has created an environment that has made an orderly transition from a military regime to a democratically elected government possible. This steady growth, and the coherent and progressive regulatory institutions that have been established to monitor it, is an excellent indicator of future economic and social progress in Chile.

SECTION ONE

Chile stands out among the major countries of South America for its economic stability. The larger economies--Brazil, Argentina, Venezuela—are all in a period of churning economic turmoil. The success of efforts to restructure their economies—riddled as they are by inflation and hyperinflation—depends as much on the charisma of their leaders as it does on sound planning. In Colombia and Bolivia, economic problems are compounded by the drug trade, while in Peru, narcotics trafficking and the Shining Path guerillas have exacerbated the effects of poorly conceived economic policy.

This is not to imply that the Chilean economy has always exhibited the well-ordered calm that is so much in evidence these days. On the contrary, Chile has weathered a number of economic and political crises during the past twenty years. Yet recently, Chile has succeeded in creating a stable platform for future growth that can be shared by all members of society. The financial liberalization that began fifteen years ago has, with subsequent modification and refinement, yielded a powerful, durable engine for improving social welfare. The esteem with which the financial liberalization program is held by Chileans was underscored during the transfer of power from General Augusto Pinochet to Patricio Alywin. The program was for the most part retained by the new administration and many of Pinochet's economic appointees have retained their position in the government.

The new administration has inherited an open economy able to benefit from the export orientation and efficient import substitution of a dynamic private sector and a rehabilitated and efficient public sector that places relatively low demands on the overall economy. Since 1973, the Chilean public sector has shed approximately 530 nationalized and public sector enterprises and kept its budget roughly in balance.

Chile approached financial liberalization after the fall of the Allende government by deregulating a series of financial institutions simultaneously. While expedients that were introduced when this strategy was initially implemented upset the checks and balances necessary for a sound financial system, the experience of Chile over the long term, even considering the economic collapse of 1982 to 1983, underscores the benefits that attend from financial liberalization. The economic setbacks that Chile experienced in the early 1980s have less to do with liberalization itself and more to do with weaknesses in the regulatory structure and macroeconomic policy that allowed the banking sector to accumulate dangerous levels of questionable assets.

Setting the Stage for Deregulation

At the end of the 1950s, the Chilean economy was stagnant. An inward-looking pattern of economic development had produced increasingly disappointing results. The state had taken the lead in creating and managing new industries and placed a priority on import substitution, a policy predicated on import restrictions and an overvalued currency. At the same time, fiscal policy was often lax, leading to excessive money creation. Between 1955 and 1959, real gross national product grew at an average annual rate of 0.9 percent. During the 1950s, inflation averaged 36 percent annually, and Chile had the lowest savings and investment to GDP ratio in Latin America. The problem was compounded by unequal income distribution and high unemployment.

Both the Alessandri government (1958-64) and the Frei government (1965-70) employed a variety of strategies to rectify these problems, but neither attempted full-fledged financial deregulation. The Alessandri government made an early attempt at liberalization in an effort to stabilize inflation and stimulate economic growth, but its efforts failed because they were not carried out consistently. The government liberalized international trade by eliminating quantitative restrictions, reducing tariffs, and providing export incentives. It attacked inflation by unifying the exchange rate, following a 25 percent devaluation of the peso. Once this was accomplished, however, the exchange rate was fixed.

Initially, the program was successful, especially as the economy responded to expanded fiscal investment in public works and housing. By 1961, however, the Alessandri program was in disarray. Fiscal discipline was relaxed, imports accelerated, and the current account deficit grew. Because the exchange rate was fixed and inflation was rising, the currency became overvalued, producing a balance of payments crisis.

As the Alessandri administration drew to a close, the government changed tactics in a desperate attempt to shore up the economy. The government responded to the balance of payments crisis by dismantling its liberalization program. At the end of Alessandri's term in office, Chile was characterized by a highly protectionist trade regime.

Table 1 - Economic Indicators

Period Preceding the Popular Unity Government

	Growth of Real GNP (percent)	Inflation (percent)	Current Account (in U.S.$ million)	Fiscal Balance (percent of GNP)
1960-69	4.5	26.7	-126.8	-3.4
1970	2.1	34.9	-81.1	-2.7

When the Frei administration took over, it applied policies that mixed government intervention with the gradual liberalization. The government took control of foreign copper companies by buying shares in them and indexed wages to the previous year's inflation rate. At the same time, import controls were reduced. As with the case of the Alessandri government, the Frei administration's efforts initially yielded results. But by 1967, the economy was slowing down once again. National savings failed to increase, keeping investments low, and fostering dependence on foreign capital. As a result, Chile's external debt increased by one-third between 1966 and 1969. Wages rose higher than expected, since the wage adjustment of 100 percent of the previous year's inflation was treated as a minimum increase. Fortunately, the economy was propped up by copper prices, which reached an all-time high in the second half of the decade.

The 1960s were a period of sporadic economic growth and high inflation (see Table 1). Fundamental inequalities in the social structure grew more pronounced as the decade progressed, increasing support for the socialist solution that the Popular Unity Party advocated.

The Allende Government and the Socialist Experiment

Economic policies were radically changed when Dr. Salvador Allende's Popular Unity Party won the September 1970 elections. Assuming power in November 1970, the new government's goals were to reduce unequal income distribution and address chronic inflation and unemployment. To achieve these objectives, the Allende government instituted central planning and significantly expanded the role of the state in the economy. The government nationalized enterprises in mining, industry, agriculture, and banking and increased public sector wages at the expense of public sector investment.

The theory behind Allende's policies was that increased government spending would increase demand as well as public sector revenue. His economists postulated that such an expansion would not be inflationary since the manufacturing sector had significant unutilized capacity that reflected the preexisting pattern of consumption and income distribution. Initially, Allende's sweeping reforms seemed to produce favorable results. During 1971, real GDP rose by 9 percent, real wages and salaries rose by 17 percent, unemployment fell to below 4 percent, and inflation eased somewhat.

However, imbalances and distortions in the economy soon surfaced. Allende's policies boosted demand, but not revenue. Rising government expenditures yielded large public sector deficits that were financed primarily by printing currency. By 1973, public sector deficits reached 24.7 percent of GDP (see Table 2). The expansion of the money supply stimulated inflation despite price controls. The annualized rate of inflation reached 438.5 percent in August 1973. Official interest rates were sharply negative, and black markets flourished (see Chart 2). At the same time, Allende's efforts to stimulate demand were only too successful. Chile found itself in a balance of payments crisis.

Table 2 - Economic Indicators

The Popular Unity Government

	Growth of Real GNP (percent)	Inflation (percent)	Current Account (in U.S.$ million)	Fiscal Balance (percent of GNP)
1971	9.0	22.1	-188.8	-10.7
1972	-1.2	163.4	-386.6	-13.0
1973	-5.6	508.1	-294.6	-24.7

In response, the Allende government hastily imposed controls on foreign trade and credit, with quantitative restrictions on imports and exports, multiple exchange rates, and differentiated tariffs. This system was hardly coherent. Near the end of 1973, ad valorem tariff rates ranged from 0 to 750 percent, and the ratio between the highest and lowest official exchange rates was 52:1. Not surprisingly, these measures did little to halt the deterioration of the current account. International reserves, which in 1970 were approximately equivalent to six months of imports, declined to only two months of imports in the first quarter of 1973 and by the third quarter, net international reserves were negative.

The institutional reforms advocated by the Allende government also proved unsuccessful. Periods of labor unrest at manufacturing firms were often followed by government "interventions." Production in these newly expropriated firms suffered, and formally nationalized concerns fared no better. Output dropped, and the large losses that were generated had to be absorbed by the state. Expropriated agricultural land was organized into large state-owned farms. Here, too, production fell sharply. Confidence in the business climate deteriorated, and investment and savings declined sharply.

When the military overthrew the Allende government, the economy was again stagnant. Between 1971 and 1973, GDP growth averaged a meager 0.7 percent, and the fixed investment growth rate was negative 9.8 percent. Inflation averaged 230 percent during the period, fueled by large fiscal deficits. Price and exchange controls were pervasive, and the financial sector was heavily controlled. Multiple exchange rate practices prevailed with a pronounced bias toward import substitution. In the end, what had started as a visionary economic experiment ended in disarray and bloodshed.

The Military Regime and the Transition to Financial Liberalization

When the new government took over, it initiated economic policies aimed at freeing commodity markets and enforcing fiscal discipline. While increasing copper prices buffered some of the consequences of this change, the elimination of controls on wages and prices unleashed the tremendous latent inflationary pressure that had built up during the last year of the Allende regime (see Table 3).

Table 3 - Economic Indicators

The Transition to Liberalization

	Growth of Real GNP (percent)	Inflation (percent)	Current Account (in U.S.$ million)	Fiscal Balance (percent of GNP)
1974	1.0	375.9	--210.8	-10.5
1975	-12.9	340.7	-491.3	-2.6

In the face of these difficulties, the new government took the position that sweeping economic reforms were necessary. General Pinochet assembled a team educated at the University of Chicago to implement his free market policies. The "Chicago Boys" asserted the primacy of private enterprise, advocated openness to the world economy, and favored market determination of all prices (including interest rates, commodity prices, and exchange rates). Their goal was to induce the private and public sectors to become much more efficient, make production internationally competitive, and diversify the country's export base.

Financial liberalization was high on their agenda. The Central Bank was restructured to eliminate its role in sectoral and economic development, and its responsibilities were confined to monetary policy and financial markets. As a result, preferential credits from the Central Bank were drastically curtailed, and the refinancing rate on the remaining credit was raised to the market level. The banks were denationalized, and reserve requirements were scaled down over five to six years to 4 percent of savings and time deposits and 10 percent of demand deposits. All categories of financial institutions (banks, development banks, and other financial intermediaries) were permitted to compete for any type of business, and access to the financial sector was made progressively easy for new entrants, including foreigners. In 1974 nonbank financial intermediaries (*financieras*) were permitted to operate, and foreign banks, which had been expropriated under the Popular Unity government, were again permitted to establish branches and offices. Nonbanks were allowed to determine interest rates freely in May 1974 and banks from October 1975.

Financial liberalization was part of a comprehensive plan to open the Chilean economy. The government eliminated subsidies and price controls, and tariff and nontariff barriers to trade were reduced or removed. By 1979, the average tariff was scaled down from 90 percent to a uniform 10 percent on all goods except automobiles. The result was that industry and public sector companies cut costs and achieved significant gains in productivity.

The military government also began to privatize companies that had been taken over by the Allende government, which by 1973 controlled 488 firms (not counting banks). Over 250 of these firms had been held on the basis of interventions rather than formal privatization. Most of the intervened firms were returned to their owners during 1974 and all of them by 1978.

These measures were accompanied by the adoption of strong stabilization policies. The government's overriding concern was the elimination of inflation. The growth of monetary aggregates was restrained, and public sector expenditure was sharply reduced to balance the budget. The number of central government employees was cut by over a third, administrative procedures were simplified, and red tape was cut drastically to promote enterprise. In 1974, the government promulgated a major tax package that included a flat-rate value added tax of 2 percent, fully indexed the tax system, eliminated most exemptions, and integrated personal and business taxes. This tax reform succeeded in raising revenue, and the value added tax promoted investment by shifting the burden of taxes from production to consumption. The government also adjusted the nominal exchange rate to restore the balance of payments equilibrium. The multiple exchange rate was eliminated in 1976, and for the next two years a crawling peg was used to maintain a fairly stable real exchange rate.

While these efforts to reduce inflation met with some success, inflation still exceeded 60 percent at the end of 1977. The Chicago Boys then focused on adjusting the exchange rate as a means of bringing inflation under control. In early 1978, the government established the *tablita*, which scheduled a series of devaluations at a diminishing rates. By announcing exchange adjustments before they were enacted, the government hoped to diminish the expectations of inflation. In June 1979, the rate of devaluation was reduced to zero, and the exchange rate was fixed against the U.S. dollar.

Such a policy, while it may have seemed prudent at the end of the 1970s, proved otherwise in the early 1980s. Foreign exchange rates needed to be deregulated in conjunction with interest rates in order to avoid imbalances in the system.

Table 4 - Economic Indicators

The First Period of Liberalization

	Growth of Real GNP (percent)	Inflation (percent)	Current Account (in U.S.$ million)	Fiscal Balance (percent of GNP)
1976	3.5	174.3	147.9	-2.3
1977	9.9	63.5	-551.4	-1.8
1978	8.2	30.3	-1087.9	-0.8
1979	8.3	38.9	-1189.4	1.7
1980	7.8	31.2	1971.0	3.1
1981	5.5	9.5	-4733.0	1.7

The impact of these reforms, coming as they did during the first oil price shock and a slump in copper prices, was difficult to absorb, at least at first. Government revenues dropped, and public investment was brought to a halt. In 1975 GDP sank by close to 13 percent and unemployment soared to nearly 30 percent. But once this adjustment period was over, the economy grew rapidly, averaging over 7 percent between 1976 and 1981 (see Table 4). The ratio of total financial assets (which included paper issued by the banks, development banks, and financial intermediaries) to GNP more than doubled between 1975 and 1982. Even more important, financial assets other than M2 as a proportion of total financial assets expanded to 71 percent in 1982, from only 16 percent in 1975. The role of financial institutions in mobilizing and channeling savings increased and that of the government declined. Another result of reform was that the level of nominal interest rates increased faster than the rate of inflation, thereby ensuring positive real interest rates for the first time in years (see Chart 2). From 1974 to 1984, real interest rates ranged from 1 percent to 17 percent. Loan rates were substantially higher in both nominal and real terms.

Flaws in the System

Despite these improvements in the economy, several flaws in the financial policies enacted by the Chicago Boys soon became apparent. The effects of financial reform on the banking system were exaggerated by the inflow of foreign funds, which boosted the liabilities of banks. Until late 1977, restrictions on international capital movements were tighter than they had been under the Popular Unity government, and, apart from short-term trade financing, the capital account was, at least formally, virtually closed to the private sector. Because capital controls were in place during this period, real interest rates were higher than in the major capital markets. In September 1977, the government began to ease restrictions on capital inflows. However, domestic demand for capital kept interest rates high even after these controls were relaxed, resulting in a high demand for the peso. The government initially acted cautiously in dismantling capital controls because of fears that a massive and destabilizing inflow of outside capital induced by high interest rates would result. These fears were well founded, but government measures proved ineffective. Large amounts of foreign capital found their way into Chile despite these restrictions. Between 1977 and 1979, net capital inflow was estimated at US$8 billion, as Latin America became a haven for recycled petrodollars. Nonetheless, capital controls were liberalized again in 1979, although until late 1981 capital flows of less than two years were allowed only to finance foreign trade operations, and medium-term capital inflows were subject to reserve requirements. Capital flows increased again once these restrictions were removed. These capital flows were augmented by the overvalued peso.

Because a high proportion of financial assets in the banking system could rise or fall substantially according to external conditions, the financial system was extremely vulnerable to external shocks. A reversal could happen quickly, as the average maturity of financial instruments had shrivelled. Longer-term assets accounted for 54 percent of total assets in 1975 but only 37.2 percent in 1981.

Another problem was the high concentration of ownership of financially weak firms and banks. When the military government assumed power in 1973, it was eager to halt the drain to government finances caused by nationalized and intervened companies. While the military government moved rapidly to restore intervened firms to their original owners and sell publicly owned firms and banks, many of these firms required new investments to make them profitable. Only few buyers had the proper credentials and the financial standing to take them over. The result was a high degree of concentration of ownership in the hands of a small number of increasingly leveraged conglomerates. By 1979, ten conglomerates controlled 135 of the 250 largest private corporations.

The Chicago Boys also failed to institute systemic reforms of the banking sector. Although financial liberalization encouraged greater competition among banks, it did not alter the fundamental, oligopolistic nature of the banking system and the bank holding structure. At the end of 1974, the government passed a measure restricting bank ownership. No individual was permitted to own more than 1.5 percent of a bank, and companies were restricted to 3 percent. This law proved unworkable because of the dearth of qualified buyers. When the Pinochet government returned the banks to private hands after the military takeover, it sold them to whomever could afford them, allowing established economic groups to achieve highly leveraged buyouts of the banks.

The close relationship between the banks and their holding companies contributed to the staggering debt accumulated by the private sector. The ratio of banking system debt to GDP shot up from 5.0 percent in 1974 to 61.7 percent in 1982. Such sharp growth was fueled by optimistic expectations generated in the late 1970s when Chile achieved rapid growth. However, the debt soon acquired its own momentum, propelled by the relationships that joined the financial and manufacturing conglomerates. Banks lent to their owners' firms—some of which existed only on paper—and such loans, the so-called *créditos relacionados*, eventually constituted 20 percent of the banks' portfolios. The oligopolies also absorbed large portions of available credit resources, keeping upward pressure on interest rates. High interest rates and the overvalued peso, however, made their productive activities highly unremunerative and resulted in widespread bankruptcies. As a result, the banks' portfolios soured. Under usual circumstances the number of new loans issued should have declined, but instead it increased. New loans were used to roll over the old, essentially worthless, debt and to capitalize interest. By the end of 1982, these new loans constituted around 72 percent of outstanding peso loans. Loan default as a proportion of total financial assets soared to almost 19 percent.

The Superintendency of Banks and Financial Intermediaries (SBIF) was extremely lax in monitoring the banks, especially considering that the banks' controlling shareholders faced clear conflicts of interest. SBIF had ample authority to enforce the strict banking regulations that the government enacted, but it failed to do so. Prudential regulations were routinely avoided, primarily by the device of establishing new companies that formally complied with these laws. Through this means, the conglomerates effectively bypassed limits on exposure and concentration.

At the same time, the authorities' approach to depositor protection negated any possibility that monitoring of banks by depositors would provide this discipline. The government proclaimed reliance on free market principles and the discipline this implies, but in practice it implicitly provided free deposit insurance by rescuing all depositors as soon as problems arose. Its actions reinforced the general belief that depositors did not have to be concerned with the way bank management handled their money.

SECTION TWO

The Crisis of the Early 1980s

By the early 1980s, the Chilean banking system was supported by the flow of petrodollars drawn to Chile by high interest rates and the overvalued peso. But as we have seen, these two factors depressed investment in domestic industry and undermined exports. Imports of consumer goods trebled between 1979 and 1981, and the current account deficit jumped from $1.8 billion in 1980 to $4.7 billion in 1981 (see Table 4).

During 1981, U.S. efforts to control inflation began to take hold, and both the dollar and real world interest rates rose sharply. As real interest rates rose and the financial condition of many businesses deteriorated, the government's willingness to maintain the fixed interest rate was increasingly called into doubt. The capital inflows that had sustained the high level of domestic expenditure began to fall off, and unemployment began to rise. When the Mexican debt payment moratorium led to the cutoff of dollar loans to all of Latin America at the same time that copper prices fell drastically, the Chilean domestic credit system collapsed. The peso was devalued, finishing the year 88 percent lower against the dollar. While the devaluations improved international competitiveness, they further aggravated the financial position of companies that had taken on high levels of exchange rate exposure, and these problems led to further crises in the banking system. By the end of 1982 the Chilean banking system was in desperate condition: virtually all of the private Chilean banks were technically bankrupt. GNP declined 14.1 percent, and the current account deficit was worrisome (see Table 5).

The popular view is that Chile was led to this pass because financial liberalization was either excessive or carried out prematurely. However, some analysts have pointed out that Chile's economic crisis was caused because financial reform was partial and in many respects poorly implemented, while restrictions on international capital movements remained in place too long. They argue that the root cause of the crisis was a tentative and poorly designed approach to disinflation exacerbated by a fixed exchange rate rather than excessive liberalization.

Table 5 - Economic Indicators

The Crisis of the Early 1980s

	Growth of Real GNP (percent)	Inflation (percent)	Current Account (in U.S.$ million)	Fiscal Balance (percent of GNP)
1982	-14.1	20.7	-2304.0	-2.3
1983	-0.7	23.1	-1117.0	-3.8

Beginning in 1983, the government undertook a series of emergency measures that were to have a major impact in creating the stable economic climate that Chile now enjoys. As early as November 1981 the superintendent of banks had intervened in the affairs of the Sahli-Tassara group, forcing the sale of the Banco Español-Chile to the Banco de Santander and liquidating the Banco Regional de Linares. As the problems of the economy reached crisis proportions, the Chilean government took serious steps to revitalize the office of the superintendent of banks. In January 1983 the superintendency used its new powers to take control of the management of five banks (Banco de Concepción, Colocadora Nacional de Valores, Banco Internacional, Banco de Chile, and Banco de Santiago) and to liquidate two banks (Banco Hipotecario de Chile and Banco Unido de Fomento) and one finance company (CIGA). Other banks were forced to recapitalize to meet deposit insurance requirements, and new shares were sold to other Chilean groups and, in a number of cases, to foreign banks.

At the same time, government stepped in and took over the largest private sector conglomerates, which included the diversified empires built around Banco de Chile and Banco de Santiago. The Central Bank essentially bailed out the banks and voluntarily extended its sovereign guaranty to all private foreign debts contracted prior to 1985 (some $14.7 billion). As a result, foreign banks did not have to foreclose or write off bad debts. Chilean banks were also allowed to sell off part of their bad portfolios to the Central Bank. In total, this amounted to some $2.5 billion. The banks were required to repurchase their original obligations to the central banks along with accumulated interest out of future profits. (This obligation was modified in 1989 to treat the remaining debt as a bond with no expiration date.) Between June 1982 and June 1985, such financing as a ratio of the total commercial bank assets rose from 3 percent to 50 percent.

A series of devaluations after mid-1982 brought the exchange rate to a level that made Chilean exports competitive once again, but inflation and unemployment went up sharply and real wages collapsed. The Pinochet government responded by replacing the Chicago Boys by a more interventionist economic team, which instituted a series of protectionist measures. Import tariffs were increased to 35 percent, agricultural products received additional protection, and employment programs were established.

The Reliberalization

As soon as the economy began to recover, Pinochet brought back the Chicago Boys. They immediately set out to reliberalize the economy, but this time they made sure that government regulatory agencies were in place and that the market was transparent. Import tariffs were reduced once again during the period to 1988, as was the value added tax. At the same time, tax receipts increased with rising economic activity, and the public sector deficit was eliminated. Private sector investment increased dramatically between 1987 and 1989 as result of consistent and stable regulation and a favorable tax regime. GNP grew strongly between 1984 and 1990, averaging 6 percent while the fiscal deficit as a percent of GNP dropped below 1 percent in 1987 and has remained there (see Table 6).

Table 6 - Economic Indicators

The Reliberalization

	Growth of Real GNP (percent)	Inflation (percent)	Current Account (in U.S.$ billion)	Fiscal Balance (percent of GNP)
1984	6.3	23.0	-2.06	-4.4
1985	2.4	26.4	-1.33	-6.3
1986	5.7	17.3	-1.09	-1.9
1987	5.7	21.4	-0.75	-0.1
1988	7.4	12.7	-0.24	-0.0
1989	8.5	21.0	-0.81	-0.1
1990	6.0	28.0	-0.14	-0.5

Reliberalizing the Banking Sector

One of the Chicago Boys' first tasks was to reprivatize the five banks taken over by the superintendency of banks, this time insuring that ownership was not concentrated in the hands of an oligopolistic elite. Under a scheme promoted as "popular capitalism," individual investors and companies were given the chance to buy shares, putting up 5 and 10 percent of the purchase price of the shares with the rest being financed by the government in the form of an index-linked tax credit to a maximum value of the total tax paid over the previous three years. Companies could acquire stakes of no more than 5 percent. Old shareholders had first bidding rights, while new shareholders, including foreign interests, were allowed to assume a maximum of 50 percent ownership in all banks except the Banco de Chile. The process of reprivatizing the banks was completed in early 1987.

In September 1986 a new banking law was approved. This gave even wider powers to the superintendency, tightened up the rules regarding *créditos relacionados*, did away with some secrecy provisions, and required banks to pass a "whiteness" test at the end of each year. The test demonstrates that each bank has adequate capital provisions, and indeed since 1986 the banks have announced major increases in their provisions and capital base.

The remarkable pace of economic growth in the past few years has afforded the banks large profits. Consequently, those which have been returned to private ownership after state intervention have been able to repurchase their bad debts from the Central Bank at a much faster rate than had been expected. The repurchases totalled the equivalent of $383 million in 1989, reducing the debts in the hands of the Central Bank to less than $3 billion. Two banks were able to repurchase all of the outstanding balances during 1989, and most of the smaller banks should be able to do so over the next two or three years. However, the three largest banks (Banco de Chile, Banco de Santiago, and Banco Concepcion) which account for 76 percent of the outstanding debt, will require more time.

The banking sector presently includes the Central Bank (Banco Central), a state bank (Banco del Estado), forty-one national and foreign commercial banks, eighteen savings and loans associations, and several government organs, of which the Corporación de Fomento de la Producción (Corfo, the state-owned multi-purpose holding company) is the most important. The Banco Central, autonomous since December 1989, has all the functions of a normal central bank, including the exclusive right of note issue, rediscount, and reserve deposits for the commercial banks, and is the main institution controlling borrowing. It also determines the official exchange rate and regulates the financial system and foreign investment. The Banco del Estado acts as banking and financial agent for the government, but is also empowered to engage in all types of commercial activity. It provides loans with longer maturities than other commercial banks.

One problem that remains from the crisis years of 1982 to 1984 is that the Central Bank is highly leveraged. In addition to the $3.1 billion in bad private bank loans sold to the Central Bank, over $8.2 billion in treasury bonds were placed with the banks. This was done despite a 1980 constitutional prohibition against the Central Bank financing fiscal deficits. The banks' debt and treasury notes account for 45 percent of the Central Bank's assets of $23.1 billion. In 1987, the Chilean government began paying into the copper stabilization fund. One of the last acts of the Pinochet government was to use that money to repurchase some $1.1 billion of treasury bonds held by the Central Bank. The 1990 budget allocates about $625 million for the repayment of interest on the treasury notes. The government can divert part of this money to other projects and capitalize the remaining interest. The director of the budget announced that the government would capitalize $66 million of the interest during 1990. At the same time, the Central Bank is being squeezed on its operating balance because of the large amount of debt remaining. The bad loans sold to the Central Bank earn only inflation plus 5 percent, and the treasury notes earn Libor plus 0.5 percent. Many Central Bank obligations, however, carry higher rates of interest. As part of adjustment measures enacted in January 1990 to cool the economy, the Central Bank raised interest rates and locked in $2.36 billion of its paper in ten year notes at inflation plus 9.7 percent.

The Stock Market

The stock market has also enjoyed a resurgence. Although the first Chilean stock exchange was established in 1892 in Valparaíso, the Bolsa de Comercio de Santiago, created a year later, became the dominant exchange. (The Valparaíso stock exchange closed in 1982 and was reopened in 1989). The stock market collapsed during the Allende years, when most listed companies were nationalized or intervened, but it revived following the 1973 military coup, when the intervened companies were returned to the private sector and a major privatization program was launched. It dropped precipitously again during 1982-84; the market index fell by 40 percent in dollar terms.

Its strong recovery since 1986 was interrupted only briefly by the worldwide crash of 1987. At the end of 1989, the general share price index, which is calculated using the values of over 180 listed shares, posted a nominal 70.7 percent increase over its value at the end of 1988. The selected share price index (based on the 40 shares most actively traded) rose 65 percent. And total market capitalization reached $8.4 billion, up dramatically from the $7.0 billion registered at the close of 1988 (see Table 7). The stock market recovery was helped along by measures raising the threshold for payment of taxes on profits from sales of stocks and shares. Another important stimulus was the creation of privately run pension funds (AFPs). Investments by these funds must be handled by stockbrokers.

Table 7

Stock Market Statistics

	Market Cap ($US bil)	Annual Turnover ($US mil)	Market Cap/GDP	Turnover/ Market Cap	IPSA Index	Total Listed Companies	Market P/E
1984	2.106	51	14%	2%	67.1	208	15.7
1985	2.012	57	14%	3%	137.6	228	4.4
1986	4.625	298	26%	7%	385.6	231	5.4
1987	5.686	503	30%	9%	613.8	209	5.2
1988	7.079	614	35%	9%	938.5	203	3.6
1989	8.418	756	38%	9%	1,529.9	204	5.2

The entire pension fund system was privatized in 1981. Instead of one government-operated fund, several private funds competed for contributors. Employees can pay up to 15 percent of their wages to the fund of their choice. Contributors have their own accounts, with benefits tied to the scale of their contributions. The types of investments the funds could make were carefully controlled, with all operations strictly reviewed by the superintendent of funds. Initially, only paper issued by state agencies could be purchased. Later, mortgages and CDs were allowed. In 1984, the funds were permitted to invest up to

5 percent of their resources in certain domestic equities. These equities had to be alpha or beta stocks, had to show a record of being traded on most days, and had to have a relatively diluted shareholder distribution with no one shareholder owning more than 50 percent of the company. These restrictions limited the effective choice to about 20 stocks. In practice the AFPs took up most of their equity allocations through privatizations, during which a percentage of shares was usually set aside for them. Nevertheless, with the funds administering over $2.5 billion of contributions by mid-1987, a significant new element was added to a market where daily trading volumes had rarely exceeded $250,000 before 1986. Early in 1990, APFs were permitted to invest up to 7 percent of their resources in equities eligible under the old regulations, as well as an additional 1 percent in companies whose shareholder distribution is more concentrated. This creates another twenty to thirty new investment options for the AFPs. According to varying estimates, the latest liberalization measures will direct an additional $350 million to $530 million towards the stock market. The funds are expected to make a further $60 million of purchases per month in the coming months. With a daily stock market turnover presently in the range of $2 million, these purchases will represent a doubling in volumes by the end of 1990. Presently, the funds administer $4 billion of contributions, and the total is growing rapidly because of steep rises in employment and average earnings and because the funds have not yet made substantial payouts to pension-fund contributors.

Under the impetus of this growth, the Santiago market is rapidly modernizing. Reporting requirements are strict, and the operation of the market transparent. The market has been transformed by the advent of computerized trading and by new domestic competition from wealthy, sophisticated foreign banks. Bonds and money market instruments account for 97 percent of the activity on the Santiago exchange, and nearly all fixed-interest transactions are carried out through computerized trading. Of the four stockbrokers that generate the bulk of the Bolsa's business, two are recent arrivals in the exchange—InverChile (started with IFC, Swiss, and Chilean capital and developed further in association with the American Insurance Group and Midland Bank) and Security Pacific. A third, Tanner, recently took on a foreign partner, Continental Illinois. The newcomers tend to be more aggressive than the old guard, actively seeking out clients. The established members had attempted to block the entry of foreign firms on the grounds that members must remain independent of links with other financial institutions, but the Superintendencia de Valores y Seguros denied their petition to exclude foreigners.

A new entirely electronic exchange has been proposed for securities traders and the money desks of the banks, who already do double the business that the Santiago exchange handles. Already, they account for two-thirds of all the trading in fixed-income instruments on behalf of these institutions. The new exchange will offer options and futures, neither of which is available at the Santiago exchange and may develop other specializations.

Privatization

The stock market received an important boost from privatization. The first round of privatization in Chile occurred between 1973 and 1974, when the government privatized some 350 companies expropriated under the Allende government. During the next stage, from 1975 to 1982, 135 companies and sixteen banks held by Corfo went private. The third phase, begun in 1985, has led to the privatization of thirty-three companies. This round of privatization had an immediate effect on the stock exchange. In 1986, , volumes on the stock exchange quadrupled and real prices doubled. Privatization has created 170,000 new shareholders, tripled trading volumes, and added $1.5 billion to the total capitalization of the stock market. Among the largest privatizations to date include Compañía Teléfonos de Chile (CTC, now 51 percent owned by Australian investor Alan Bond), Entel (the $90 million telecommunications company, 75 percent privately controlled), Endesa (the state power company nearly half in private hands), and Soquimich (a nitrate company). These companies are among the most heavily traded on the market because their ownership is so broad. People's capitalism has given workers an average 18 percent share of thirty-three companies divested by the state since 1985. About 70,000 employees in mixed enterprises have become shareholders. These new shareholders have done well with their investments. The government estimates that in the last five years they have quadrupled their savings.

CONCLUSION

Chile is poised for significant growth, primarily on the strength of the far-sighted financial liberalization measures enacted in the last seven years. One sign of economic well being is the gradual, but sure emergence of the stock market. Most observers consider that the stock exchange is on the brink of substantial growth. As a source of funds for Chilean business, the markets are still too small to meet a major proportion of total need, but greater involvement by pension funds and foreign investors should change that. The continued liberalization of the AFPs' investment options promises further significant increases in the demand for stocks. According to the superintendent of funds, AFPs will be administering $9 billion of contributions by 1998 and $20 billion by 2015. The funds clearly are eager to make what investments they can in the stock market because of the higher returns available there. The fact that contributors may switch without penalty from one fund to another accentuates their need for high performing assets.

Privatization will also continue to fuel the stock market. At the height of the Allende regime, some 60 percent of Chile's properties were owned by the state. Now, after three rounds of privatization, only 40 percent is state-owned. Among the holdings kept by the government are the copper mines that remain Chile's biggest source of foreign exchange. According to the chief of privatization of Corfo, "A lot more could go."

The presence of foreign institutions among financial intermediaries in Santiago—a recent phenomenon—also reinforces the impression that the stock market is poised for impressive growth. Many other foreign institutions have come to Chile to service the burgeoning demand for equities and debt instruments. Bankers Trust, Santiago, for instance, has been active in the privatization of Pilmaiquen, a hydro-electric company. It bought into the company and, restructuring its debt, led issues of bonds and shares on the local market.

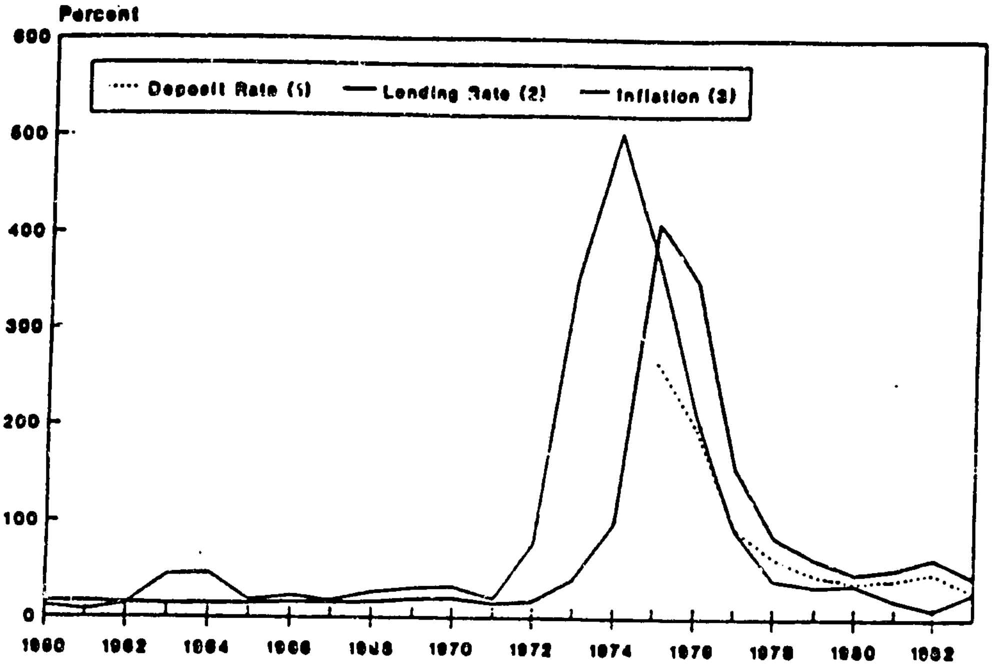
These are just a few signs among many that in the near future, Chile will see growing linkages with the international financial system. As we have seen, many international banks already are affiliated with members of the Santiago Stock Exchange, and there has been discussion about the creation of foreign investment funds in Chile. The International Finance Corporation pioneered the foreign investment fund field with a debt-equity conversion fund known as the Chile Investment Company. Opened in June 1988, the fund's value has increased by more than $10 million to $36 million. The IFC has begun a second fund, the International Investment Company of Chile SA. A $60 million Salomon Brothers fund was announced in April 1990 and sources at Citibank and Security Pacific confirmed that they are putting together a marketing strategy for a $30 million Chilean fund of their own. Both are fresh money funds, and as such represent new confidence in Chile's economy. The Salomon Brothers fund will be listed on the New York Stock Market, while Citibank and Security Pacific are targeting pension fund, mutual fund, and portfolio managers. There has also been a great deal of interest in Chile on the part of foreign investors, particularly Australians and New Zealanders. Carter Holt took a 34 percent interest in Copec, Fletcher Challenge bought a division of Cartones (forestry products), and the New Zealand dairy board bought Soprole (milk products). A sharp increase in foreign investment during the first quarter of 1990 indicates that Chile continues to be recognized as one of the healthiest economies in Latin America. The first quarter witnessed actual investments totaling $375.8 million, 203 percent increase over the same period in 1989, and an increase of 1,058 percent in foreign investment authorized.

The Chilean experience shows that financial liberalization, to be effective, must be followed through completely. You cannot, for instance, liberalize interest rates without deregulated foreign exchange. Liberalization cannot mean offering the rewards of a free market without the disciplines. Decentralizing credit allocation decisions is unlikely to be successful unless mechanisms are in place to favor financial institutions that accurately assess risk and expected return and find a prudent balance between them, while weeding out those that make decisions poorly or imprudently. After the fall of the Allende government, Chile neither created a healthy competitive environment in which market disciplines would do this, nor put effective supervisory arrangements in place to achieve the same effect. This failure was responsible for the banking collapse in the early 1980s and added greatly to the subsequent crisis.

Even considering these setbacks, Chile's decade and a half of financial liberalization has been beneficial for the Chilean economy and for Chilean society. It is important to consider that during the years since financial liberalization took hold in 1976, the Chilean economy grew 4.7 percent. This includes the 14.1 percent decline in the GNP in 1982. Without 1982, the GNP grew at 6 percent a year, a significant accomplishment when carried over fourteen years. Since 1984, the economy has grown at 5.7 percent, and other measures of economic imbalances, the current account deficit and the budget deficit, have shrunk within easily manageable limits. In reliberalizing the economy, the Chicago Boys have built on their experience in the late 1970s and early 1980s, rectified many of the omissions of the first round of liberalization, and created an environment conducive to economic growth, political stability, and social welfare.

Chart 2-Interest Rates and Inflation in Chile

1960-1982



* Deposit rates available to savers before 1975 are not readily available

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