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# Managing Financial Adjustment in Middle-Income Countries

Synthesis of a Policy Roundtable  
held in Istanbul  
July 6 -July 9, 1987

Alan Roe  
and  
Paul A. Popiel

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Alan Roe is chairman, Economics Department, University of Warwick. Paul A. Popiel is senior financial economist, Economic Development Institute, The World Bank.

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## Foreword

This document is one of a series reporting on policy seminars organized by the Economic Development Institute of the World Bank. Policy seminars provide a forum for an informal exchange of ideas and experiences among policy-makers from different countries, leading experts in development, and World Bank staff, with respect to major issues of development policy.

Policy Seminar Reports focus on issues raised during seminars that may be of interest to a wider audience. They are not intended to be comprehensive proceedings. However, they seek to convey the essence of the discussions that took place and to bring out any principal areas of agreement or disagreement that emerged amongst those participating.

Christopher R. Willoughby  
Director  
Economic Development Institute  
of The World Bank

21

## **Contents**

<b>Executive Summary</b>	<b>vii</b>
<b>1. Overview</b>	<b>1</b>
<b>2. The Influence of the Macroeconomic Environment on the Financial Sector</b>	<b>7</b>
Budgetary Deficits and Inflation	9
<i>The Impact of Public Deficits on Inflation</i>	9
<i>The Problems of Inflation for Financial Management</i>	10
<i>Noninflationary Financing and the Financial Sector</i>	11
The Appropriate Size for the Deficit	14
Interest Rate Policies	15
Conclusions	19
<b>3. Financial Sector Crisis</b>	<b>21</b>
Consequences of Financial Sector Crisis	22
Causes	23
Cures	26
Conclusions	32
<b>4. The Extension and Deepening of the Financial Sector</b>	<b>35</b>
Competition in Banking	36
The Development of Money and Capital Markets	39
Conclusions	44
<b>Annex A. List of Papers Presented at the Seminar</b>	<b>47</b>
<b>Annex B. List of Participants</b>	<b>49</b>

## **Executive Summary**

This paper synthesizes the discussions that took place at the Senior Policy Seminar on Managing Financial Adjustment in Countries of Europe, the Middle East, and North Africa held in Istanbul in July 1987. The seminar's aim was to consider the role financial policies and institutions play in the process of adjusting an economy to external shocks and structural changes in its operating environment. The discussions focused on the difficult problems of transition entailed by financial adjustment, that is, actual policy changes and implementation measures. The central topic was discussed under three main headings: (a) interdependences between general macroeconomic adjustment policies and specific financial adjustment policies; (b) causes and consequences of financial distress (sectorwide and among institutions); and (c) ways and means to extend and deepen financial systems, in particular, financial markets, in order to render them resilient to future external shocks and changes. Hence, this paper comprises three parts; namely,

- macroeconomic and financial policies,
- financial crisis and financial distress,
- the extension and deepening of the financial sector.

### **Macroeconomic and Financial Policies**

Discussions of macroeconomic and financial policies highlighted how prevalent, domestic structural distortions thwart the financial adjustment process. Many participants agreed that ultimately these distortions were attempts to preserve an unsustainable allocation pattern of real and financial resources. This pattern reflected a configuration of productive activities that was no longer viable under the new structure of relative prices that originated from the external shocks and structural changes of the 1970s and early 1980s. This situation was a major cause of disequilibrium in public finances, one of the greatest among hindrances to financial adjustment. Participants were unanimous in their view that managing financial adjustment in this context was a delicate task that involved balancing financial policy and institutional reform for the long term, with *ad hoc* interventions needed to limit financial distress and avoid a financial crisis in the short term, something that adjustment policies may well generate initially.

There was a consensus that in recent years the financing of public deficits has been a source of inflationary pressures because, in most cases, money creation resulting from credit to the public sector has increased the money supply faster than the rate at which the public was willing to absorb it. Participants unanimously felt that it is extremely difficult for a financial system to function efficiently when the annual rate of inflation exceeds 20 percent. By subjecting savers and investors to an inflation tax, high inflation causes disintermediation, and the resulting narrowing of the financial sector's base, together with other inflation-induced distortions, blunts the efficiency of mobilization and allocation of financial resources. This adverse effect is aggravated by administered interest rates, especially for longer-term intermediation operations.

But "noninflationary" financing of public deficits presented problems of its own, possibly leading to the crowding out of private borrowers from the credit markets. Budget financing instruments and mechanisms, such as cash reserve and other assets requirements, or selective and preferential credit programs usually carried below market interest rates. All these instruments and programs caused wide spreads in banks' intermediation operations and were reflected in expensive finance to nonprivileged borrowers. The general agreement was that with insufficiently developed money and capital markets, the consequences of large volumes of noninflationary financing of public deficits were directly reflected in interest rate levels, with the result that the price mechanism was largely responsible for crowding out the private sector.

Whichever way a country financed its deficit, the management of interest rates in a period of financial adjustment remained a very delicate task. Participants saw several problems in full liberalization of rates. First, with a rigid demand for credit and a low supply elasticity—a situation prevailing in most countries in the region—the freeing of interest rates would probably increase their levels substantially. Second, the absence of flexible and correct relative prices in other key markets of the economy would likewise drive rates up. Third, participants felt that financial institutions that have for a long time lived under regimes of administered interest rates lack the experience of operating in a free market environment. Too abrupt a transition might endanger the financial health of the weakest. Fourth, in the absence of a well developed and competitive nonbanking financial sector, liberalization of interest rates could lead to collusion among banks to fix interest rates, and thus ultimately to oligopoly situations.

## **Financial Crisis and Financial Distress**

All the participants felt that of the many problems a policymaker has to face, few are as difficult as those related to restoring a severely impaired financial sector to reasonable health. In several countries of the region, the shocks of the 1970s and 1980s, and their international and domestic repercussions have caused severe economic problems, a situation not unique to the region, but one seen in many developing and developed economies. Problems originating in the real sector of the economy spilled over to cause severe difficulties in the financial sectors, and were often compounded by inadequate initial policy responses at the national level.

Amongst the policy responses specifically related to the financial sector were attempts to maintain overvalued exchange rates, administer domestic interest rates at unrealistically low levels, and use selective and preferential credits. All these policies are related to unsustainable patterns of financial resource allocation as mentioned earlier. Adverse developments, both external and internal, sapped the financial strength and capability of a significant number of institutions—the number of banks and financial institutions that are insolvent today throughout the world is without precedent in the last 50 years. However, for most of the time this insolvency is not apparent, since financial institutions can function in a state of near bankruptcy as long as they have a positive cashflow.

Because of the political and economic implications of resolving financial crises, namely, bankruptcies, closures, and the consequent impact on the productive sector's output and on employment, the most common approach to the problem is one of benign neglect with occasional *ad hoc* interventions as manifestations of the problem become too pressing to be ignored. Nonetheless, participants generally agreed that the problem must be addressed as a matter of priority.

There are several adverse consequences when seriously impaired financial institutions continue to operate. First, the financial sector is weakened and prone to crises. Second, bailing out the institutions puts pressure on the authorities for support, subsidies, and restrictive practices, sometimes difficult to avoid in the short term. Third, the borrowing-lending spread is widened, thereby driving up the cost of nonpreferential credit. Fourth, resource mobilization and allocation are distorted in favor of nonperforming debtors at the expenses of productive enterprises. Moreover, the available evidence indicates that a delay in resolving the issue will merely aggravate the problem and make the solution that much more difficult and painful. As one participant remarked: "One of the major sins of a central banker, apart from that of printing too much money, is knowing

that a major proportion of the commercial banks are bankrupt and not doing anything about it.”

The best way to resolve a financial crisis is for the underlying growth of the economy to give individual enterprises and banks enough leeway to restructure their activities to re-establish a sound financial situation in financial and productive sector activities. An alternative but less desirable solution is to inflate out the debt problem. However, the roundtable agreed that while this inflationary approach can certainly write down the real value of the debts of financial institutions, it is scarcely a realistic way out because of the grave distortions that high inflation will cause and the damage it will inflict on the financial sector’s performance.

Hence, short of the best solution, policymakers must take a number of decisions to restore an impaired financial sector to health. The first and most difficult one is about how to distribute existing and potential losses. Once the crisis has occurred, its costs have been incurred and cannot be recouped. The best that can be achieved is a rational distribution of these costs between the various agents in the economy. The major advantage of the “growing out” solution is that it distributes the costs in a manner that is largely unaffected by the government, and hence, is detached from the political factor, although this does not have any implications for the equity of the outcome.

But short of this first best solution, policy decisions will thus be needed about how the losses will be distributed among shareholders, depositors, and taxpayers. There was broad agreement that any market-based economic system has to preserve correct incentives for banks, including the acceptance of full losses by the shareholders when things go wrong, as well as full accountability of the management. Participants also noted that irrespective of whether or not formal methods of deposit insurance are in place, protection to bank depositors must be provided. Since there is no crisis unless bank liabilities exceed their assets, this protection cannot be achieved merely by writing down the value of shareholder capital to zero. In addition, part of the burden of the losses will normally have to be transferred to the taxpayers.

There was a broad-based consensus that one of the causes of an imminent financial crisis is when banks lack the incentive to pursue their claims against nonperforming borrowers properly. However rational this behavior might be, it must be changed if the situation is to be turned around. This can be accomplished by putting pressure on the banks to write off debts that are clearly uncollectable and to pursue those that are collectable more aggressively. In this way, the first stage of the recovery



process concentrates the major part of the remaining losses in the banking system, thereby clearing the decks for a recapitalization designed to offset these losses and facilitate the restructuring of some of the companies that generated them.

The final point discussed concerned the resolution of the financial crisis by the direct physical and financial restructuring of distressed companies in the productive sectors. The reality of political economy makes it inevitable that governments will tend to intervene more or less directly in the very large enterprises of their economies that run into difficulties. While it may not make much economic sense to try to preserve output and employment levels in these enterprises on a scale beyond that which has longer-term viability, participants noted that it may make good political sense to do exactly that. From the narrow perspective of financial sector crisis and its eventual resolution, this may not matter too much provided the government makes every effort to preserve the transparency of what it is doing. Above all, this is an argument for explicit and visible subsidies as opposed to a diffused range of supports that can undermine the soundness of the financial institutions that serve as channels for these supports.

In cases where many small and medium sized companies are also a major part of generalized financial distress, the problems of a case by case approach to restructuring are more complex. A majority of participants felt that governments would probably be well advised to leave as much of the "portfolio review" as possible to banks and financial institutions that have the expertise to evaluate particular enterprises soundly. Other participants felt that if taxpayers' money was to be used to resolve problems of productive sector enterprises, then a government bureaucratic process was needed to determine who should and who should not obtain assistance.

Finally, participants emphasized that a critical part of the solution to a widespread financial sector crisis is a careful reappraisal of existing financial institutions and instruments in the economy, with a view to building more robust financial systems and introducing arrangements to encourage the writing down of nonperforming assets. Also, measures are required to deepen the financial system, and especially to provide savers and investors with far more options to suit differing requirements.

### **Extension and Deepening of the Financial Sector**

Turning to the future, all participants agreed that to respond to a world economic environment increasingly subject to rapid and unpredictable changes, financial systems must become deeper and more efficient and flexible. There was also a general sense that developing countries will need

new financial techniques and instruments that can facilitate a more rapid transfer of resources between different uses and provide enlarged opportunities for hedging and diversifying risks. These will be amongst the most important changes that government should pursue. Developing financial systems have potentially a great deal to gain from such innovations if they want to become more efficient and flexible.

The initial way to enhance the financial system's efficiency and flexibility is to instill more competition in it. Since the region's financial systems are dominated by banks, greater competition should first be fostered within the banking sector. Roundtable participants confirmed that in most of the region's countries, the degree of competition between financial institutions tends to be very weak, with the result that savers and borrowers have few choices about how to arrange financial portfolios and structure the financing of investments. Moreover, intermediation costs are high, and pressures for innovation are minimal. Three major reasons account for this lack of competition. First, government regulation often controls interest rates and banks' fees and commissions. Second, banks are usually arranged in cartels. Third, banks' ownership structures may limit competition among them, especially when most banks are publicly owned.

Introducing more competition into the banking sector is, however, a delicate task facing many pitfalls. Increased competition spurred by a wide opening of the banking sector to new entrants without enhanced regulation and supervision may lower banking standards, as occurred in Egypt. Alternatively, increasing competition by letting new banks in may convert an incipient financial crisis into an open one, since the condition of long established banks may be too poor to allow them to compete because of their unsound portfolios and overstaffing. In this case, the prerequisite for enhanced competition in the banking sector involves a systematic program to restructure any ailing established banks.

In those cases where competition is limited because specialized banking institutions monopolize certain types of financial operations, the obvious solution of moving rapidly to universal banking is itself subject to certain limitations. In particular, as participants pointed out, the need for specialized investment banks may be associated with the absence of efficient bond and equity markets. Thus, the establishment of financial markets may need to precede any major moves toward universal banking. At the same time, participants agreed that one of the most effective ways to enhance competition in the banking sector is to foster competition primarily from outside the sector rather than from within. All in all, they felt that a gradual approach in which each category of bank and other financial institution

makes marginal adjustments in the scope of its operations was preferable to any radical program to legislate away the existing specialization.

Most participants believed that the fostering of a deeper financial system by developing money and capital markets was an obvious way to strengthen the flexibility and resilience of economies for the future. The dominance of debt financing, a feature of most countries of the region, involves—at both the microeconomic and macroeconomic levels—well-known dangers related mainly to high exposure to volatile interest and exchange rates. Several participants suggested that the widespread incidence of financial distress in countries of the region has arisen largely because of the predominance of debt oriented financing.

Participants acknowledged that the practical steps needed to achieve this deepening of financial systems through the development of money and capital markets involved a complex agenda of reforms, many of which were difficult to implement. The main priorities discussed were the need for improved macroeconomic stability, especially low inflation; the removal of gross inequities in the fiscal treatment of different financial assets; the strengthening and diversification of financial institutions, particularly nonbank financial institutions; a substantial improvement in market mechanisms; and a better system of regulations and controls. An environment favorable to expanded use of capital market instruments needs improved legal requirements on accounting standards and information disclosure, as well as substantial changes in the incentives that companies have to disseminate relevant information to actual and potential investors.

# 1

## Overview

This paper synthesizes the discussions that took place at the Senior Policy Seminar on Managing Financial Adjustment held in Istanbul, Turkey from July 6-9, 1987. This roundtable provided the opportunity for an extended exchange of views between senior officials from countries of the Europe, Middle East, and North Africa Region (EMENA), senior staff of the World Bank, and a small number of international investment bankers. The EMENA countries represented were Egypt, Hungary, Jordan, Poland, Portugal, Tunisia, and Turkey. Although the participants from Morocco had to withdraw at the last moment, features of Morocco's experience were covered in the background papers prepared for the roundtable, and are also reflected in this synthesis. Dr. J. de Silva-Lopes, formerly Governor of the Bank of Portugal and Minister of Finance in the Portuguese government, moderated the seminar.

The purpose of the roundtable, the first of its type on this subject, was to consider the role that financial policies and institutions play in the process of adjusting an economy to radical changes in its operating environment—changes exemplified most obviously by the major movements in relative prices, incomes, and demands resulting from the increases in oil prices in the mid- and late-1970s, as well as by the economic and financial consequences of these developments. Although the seven countries that participated in the seminar differ from each other in many ways, they nonetheless share a considerable interest in this topic. Their financial systems are all characterized by the lack of importance of nonmonetary institutions; a factor that leaves them exposed to difficulties in economic and financial management. In addition, they have all had recent experiences of economic and financial adjustment, and have all followed paths of adjustment and financial reform, though to significantly different degrees.

The subject was discussed under three main headings.

- The nature of the interdependencies between macroeconomic adjustment policies and specific financial sector policies, such as, those concerned with interest rate determination—participants were

particularly concerned with the influence of large public sector deficits on limiting the scope of financial adjustment in general.

- The causes and consequences of financial sector crises as characterized by serious and widespread distress amongst both productive sectors and financial enterprises—since situations of this type have become far more common in EMENA and other developing countries in recent years, the seminar focused on appropriate strategies to manage such crises.
- The possibilities for, and advantages of, developing financial sectors so as to provide both savers and investors with more choices about how to handle their finances and manage risk—this topic involved the discussion of both the advantages and dangers of greater competition in the banking system, and the advantages and difficulties of developing nonbanking financial institutions and financial market instruments.

This paper comprises three chapters corresponding to the three major themes outlined above. They reflect both participants' contributions concerning their countries experiences and the issues papers prepared for and presented at the seminar that are listed in annex A. The contributions made it abundantly clear that, despite the organizational and institutional differences between the countries represented, they share many problems in formulating financial sector policies and managing financial adjustment. Consensus about possible solutions to these problems, however, was rather more difficult to establish. The paper identifies those solutions where the discussions indicated that the level of understanding about how best to proceed was reasonably well established. Equally, many areas of difficulty remain where both consensus and analytical understanding continue to be elusive, and others where the rift between solutions that participants accepted as analytically correct and those that they regarded as capable of implementation in practice is wide.

The discussions revealed clearly that most governments now recognize that a deep and efficient financial system is the most important determinant of how well and how fast an economy can respond to major external and other shocks. In the past, some countries have conducted financial sector policies that intensified the problems originating from external shocks and other causes. In the future, the assimilation of the experience gained from these difficulties should result in more attention being devoted to financial sector policies. In particular, if the world economic environment is to become increasingly subject to rapid and unpredictable change, improved financial sector policies and institutions to help absorb the changes with minimum disturbance are likely to become more important. Thus, as well

as benefiting from past experiences (chapter 3), countries need to deepen their financial sector institutions and adopt some longer-term reforms (chapter 4). This will certainly involve the absorption of information about the new financial instruments and practices that are dramatically changing the financial markets of the industrialized countries, and adoption of those that would help to build greater resilience in developing economies.

In relation to the interdependencies of macroeconomic adjustment policies and financial sector policies, there was considerable discussion of the connection between large public sector deficits and administered interest rate policies. Participants recognized that the developed economies have adopted generally liberal interest rate policies partly because the internationalization of finance has forced this on them, but also partly because their greater inflation stability has eliminated the dangers of extreme movements of interest rates. Opinions differed, however, about whether conventional policies focusing centrally on deficit reduction would give rise to predictable results in the form of lower inflation and in the potential for greater liberality in financial markets. Many participants referred to the practical difficulties of reducing large government deficits, especially in an environment of high inflation. However, most accepted that so long as such deficits existed, financing them entirely through inflationary mechanisms was likely to damage the economies' long-term prospects by generating serious distortions in relative prices, and so in the allocation of that economy's resources. This would include serious discouragement to longer-term instruments of investment financing and a general disabling of the financial sector's capacity to facilitate the efficient mobilization and allocation of resources.

In various ways, all the alternative noninflationary methods of financing the deficit result in a crowding out of private sector spending. A lengthy discussion about the wide variety of such methods of financing employed in the EMENA countries indicated that these can sometimes be arranged so as to limit the damage to the functioning of the financial sector that large deficits generally imply. Nonetheless, they will give rise to various degrees of inefficiency in the financial sector, including disabling the price mechanism as a serious basis for mobilizing and allocating financial resources. One comment that many participants supported was that in economies that have achieved a high degree of inflation-stability, the risks associated with the liberalization of interest rates are relatively limited. In other environments, by contrast, because countries perceive the potential dangers associated with such liberalization to be large, for governments to pursue such a course will be extremely difficult, even though they are aware of the theoretical benefits of so doing.

In relation to the issue of financial sector crises, the discussion amply confirmed the opinion expressed in the background paper that the incidence of such crises in the developing world was now greater than at any time in the past 50 years, and was a major cause of disappointingly low growth rates. The seminar focused on the causes, the consequences, and the possible escape routes from a state of financial crisis.

As regards causes, participants generally agreed that problems can originate from many different sources, including (a) major external shocks or conventional banking errors, such as excessively concentrated loan portfolios; (b) inappropriate macroeconomic policies; and (c) adverse developments in the productive sectors. A particularly difficult dilemma arises from the fact that many components of structural adjustment programs will necessarily exacerbate financial distress. While this is not a reason for aborting such programs, it will certainly make their acceptability more difficult in political terms.

As regards consequences, participants accepted that a set of financial institutions operating on the brink of crisis are likely to arrange their lending operations in ways that may be inimical to the longer-term performance of the economy. In particular, if they allow the extension of further loans to companies already in serious financial distress, the credit needs of sounder companies may not be met, both because the real price of credit may become extremely high, and because its availability after the needs of distress financing are met may be low. Thus the financial crisis may quickly generate an investment crisis. In addition, the high burden of non-performing loans on the balance sheets of the financial institutions will act somewhat like a tax on them and force an increase in the margin between deposit and lending rates of interest.

As regards solutions, participants recognized first, that there are few documented examples to indicate "best practice," and second, that the solutions are not restricted to actions in the financial sector alone. Indeed, since the problem can originate from many different sources, including persistent distortions in the allocation of real resources, the solutions involve the correction of these fundamental distortions as well as certain essential reforms in financial sector operations. The first point is an argument for not holding back from reforms in areas such as trade and price policies, even though the initial effect of such reforms may aggravate financial distress. In the financial sector itself, participants considered many components of necessary reform. Among the most important of these was the need to restore the incentive for the banking system to clean out its bad debts, so that after any necessary recapitalization, the banks would once again allocate loans in ways favoring productive potential rather than mere survival.

The discussion of competition in banking revealed that although the degree of competition amongst banks in developing countries is weak, many pitfalls are involved in trying to enhance competition. Problems can arise from a liberal approach to new entry where new entrants are confronted with a far laxer regulatory and control environment than are established banks. In these cases of increased competition being associated with unsound banking practices, it may be only a short-lived phenomenon. In other cases where the regulatory authorities restrict new entry because of their concern about the financial soundness of existing banks, the restoration of the health of these banks is likely to be a precondition for increased competition. Finally, on the subject of specialized versus universal banks, participants expressed many doubts about the speed at which countries could realistically expect to increase the competition in banking by breaking down the barriers between various specialized niches in their banking systems.

In relation to money and the development of capital markets, participants generally agreed that a deeper system of financial market institutions has the potential to moderate several of the difficulties of financial instability that many participating countries had experienced. The practical steps to achieve this deepening were, however, acknowledged to involve a complex agenda of reforms, many of which would be difficult to implement. Three main priority areas were discussed, namely, the need for improved macroeconomic stability, especially stable prices; the removal of gross inequities in the fiscal treatment of capital market instruments; and various measures, such as improved information systems, to provide the conditions conducive to a high degree of competition. The recent experiences of Portugal and Turkey suggest that significant progress can be made on the second of these issues if there is a commitment to doing so. The issue of competition and information, however, presents substantially more difficulties.



## **2**

### **The Influence of the Macroeconomic Environment on the Financial Sector**

Since 1974, the widespread macroeconomic instability of many countries has contrasted sharply with their relative stability of earlier years. The problems became particularly acute after the second oil price hike in 1979, when the nonoil exporting countries sustained the dual shock of significantly weaker terms of trade, and poorer export performance because of recession in the major industrial countries. For those countries that had built up substantial external debts in the period of expanding commercial bank lending after 1974, the effects of these developments were exacerbated by the sharp increase in real interest rates in world capital markets, and slightly later, by the virtual cessation of new international lending by commercial banks on a voluntary basis. This combination of adverse external circumstances required many countries, including several in the EMENA region, to undertake radical adjustment programs to achieve economic stabilization.

The relatively industrialized countries of Latin America and some EMENA countries, such as Turkey, were hit extremely hard by these adverse developments. During the 1970s, these countries had not only allowed their economies to overheat in the conventional sense of unrestrained excessive demand, but had aggravated the resulting problems by maintaining low real interest rates, by achieving only limited financial resource mobilization, and in other ways by encouraging greater dependence on external debt. When the funds to finance external deficits were no longer available, these countries were forced into draconian adjustments to achieve economic stability.

Although economists normally describe this sequence of events in macroeconomic terms, there was a wide consensus at the roundtable to also explain it in terms of resource allocation, in particular, in terms of the efforts of many countries in the late 1970s to use various macroeconomic measures to try to validate a pattern of resource allocation that was no longer sustainable after the relative price changes of the 1970s. Participants identified this as a broad-based problem that has resulted, among other

things, in the retention of unrealistic levels of productive capacity and employment in many industries in both industrialized and developing economies. They cited the ship building industry as a prime example. For a time, the measures appeared to work since the easy availability of external finance disguised the real costs of maintaining resources in activities that were no longer economic. Furthermore, to the extent that the subsidies and other devices to sustain a nonviable pattern of resource allocation led to enlarged public deficits, the financing of these was also relatively easy so long as some external funding was available. Thereafter, the efforts to preserve a nonsustainable pattern of resource allocation increasingly gave rise to inflation, as the possibility of increased external borrowing was drastically reduced, and to related problems, such as irresistible upward pressures on noncontrolled interest rates.

Seen in this way, financial adjustment is an important part of the solution to macroeconomic instability, insofar as it can improve the efficiency with which financial resources are mobilized and allocated. However, as several participants pointed out, policymakers may perceive it as part of the problem as well, since initially any reductions in the degree of support offered either to financial sector or productive sector enterprises will be likely to cause various degrees of financial distress, which may be politically and technically difficult to manage. Resistance to financial reform will also arise, quite legitimately, to the extent that the reforms proceed without parallel efforts being made to remove rigidities in wage, price, and other aspects of economic policy that also hinder the mobility of resources.

Thus, in most cases, the management of financial adjustment is a delicate task that involves balancing financial policy and institutional reforms designed for longer-term benefits, with *ad hoc* interventions needed to limit the financial distress and avoid the all out financial crisis that adjustment policies, with or without financial sector adjustment, may well generate initially. There are no textbook solutions available to help policymakers find their way through the complex interactions between macroeconomic instability, an unsustainable pattern of resource allocation, and the benefits and costs of a financial sector adjustment. At the roundtable, participants discussed two main aspects of this problem.. First, how do large public sector deficits affect inflation, and in turn, how do inflationary and noninflationary approaches to financing the deficit compromise the efficient management and adjustment of the financial sector? Second, in what ways does interest rate policy impact upon efficient adjustment and, in particular, what are the consequences of maintaining interest rates at unrealistically low levels in real terms, and subsequently, of trying to move to various degrees of rate liberalization?

## **Budgetary Deficits and Inflation**

The interactions between budgetary deficits and financial adjustment as considered at the seminar are discussed here in three stages as follows:

- In what ways and to what extent are public sector deficits a prime factor in rapid inflation?
- What are the main problems that high inflation causes for the management and adjustment of the financial sector?
- What are the main ways in which public sector deficits give rise to problems for the management and adjustment of the financial sector independently of their effects on inflation?

*The Impact of Public Deficits on Inflation.* Two facts are relevant to this discussion. First, in recent years most EMENA countries have had rather large public sector deficits. The average overall deficit is equivalent to approximately 10 percent of the GDP in Jordan, Morocco, Portugal, and Tunisia, and as high as 20 percent in Egypt. In Hungary and Turkey the deficits, while on the increase in recent years, are still markedly lower, at about 3.5 percent of the GDP. In many cases, the figures would be substantially higher if they were to be adjusted to include the deficits of the public enterprises. Second, where domestic bank lending to the government causes the money supply to increase more rapidly than the demand to hold it, then inflationary pressures result. The money-creating effects of deficits will in turn be felt either when the central bank lends to the government (with no offsetting monetary actions), or when commercial banks lend to the government and, at the same time, are enabled to maintain their credits to the private sector at an unchanged level.

Participants pointed out that in at least four countries in the EMENA region, namely, Egypt, Morocco, Portugal, and Turkey, the financing of public deficits has been a significant factor in monetary expansion, in recent years, accounting arithmetically for about 50 percent, 40 percent, 60 percent, and 35 percent of the increase in these four countries, respectively. The second fact above suggests that, in the absence of a significant increase in the demand to hold money balances relative to nominal income, the deficits alone would be responsible for inflation at rates equal to the product of these percentages and the prevailing rates of monetary expansion, which have been about 23 percent, 15 percent, 28 percent, and 55 percent, respectively. In reality, the calculation is more complicated because some countries, notably Portugal and Morocco, have experienced significant increases in the demand to hold money and so inflation has not responded so directly to the monetary stimulus.

The interrelation between public deficit and inflation is blurred by the widespread perception, actively reflected in the seminar, that higher inflation

has itself been a major cause of high public sector deficits, and not merely a possible consequence. The evidence for this view relies mainly on the fact that so many developing countries coincidentally experienced rising deficits only when inflation rates themselves began to attain high levels at the end of the 1970s. Participants suggested many possible explanations for this phenomenon, but the two that came up most often were the inflation elasticity of tax revenues and the adjustment of administered prices to increased costs. More fundamentally, participants suggested that attempts to maintain a pattern of real resource allocation when it was no longer viable are likely at some point to give rise to demands for increased subsidies, increased financing, or other support from the government, and so to a further enlargement of deficits. In any event, the consequences and policy implications are far from straightforward.

If public sector deficits are significantly endogenous, a conventional expenditure cutting exercise is unlikely to succeed. In addition, complementary reforms involving improvements in tax systems and more expeditious adjustments of administered prices are called for. Acceptance of the more fundamental suggestion just referred to also implies policies that would systematically encourage the adjustment of the real productive system and the enterprises within it to correct the misallocation of resources as a parallel, or even a prior, step to seeking correction of the public deficit. This in turn raises the issue of the extent to which the freeing of prices is likely to be sufficient of itself to encourage the adjustment to a correct resource allocation structure. Depending on the extent of the previous misallocation, the additional support that this price mechanism process may require could result in an initial increase in the size of the public sector deficit. It also evokes the question of what is to be done when some prices cannot be increased because the country concerned is a price taker in international markets and world prices are depressed.

*The Problems of Inflation for Financial Management.* Participants generally acknowledged that it is extremely difficult for a financial system to function efficiently when inflation rates move significantly beyond 20 percent per annum and stay there for a considerable period of time. There are a number of explanations for this. First, high inflation is likely to increase the chances of real interest rates on monetary balances becoming negative. Even in those countries that seek to keep interest rates in line with inflation (for example, Turkey since 1980 and Portugal), these efforts rarely give depositors full insulation from the inflation tax, and virtually no country pays inflation-adjusted rates on currency balances and sight deposits. In countries attempting to hold nominal interest rates at low levels despite high inflation, the inflation tax rate is even more penal, and the overall distortion of the tax system in the direction of saving rather than

consumption is even more severe. The natural and well-documented reaction of depositors to a high inflation tax rate is to avoid it by shifting their savings away from domestic monetary assets toward real and foreign currency denominated assets. However, the resulting financial disintermediation and consequent narrowing of the financial sector base make it more difficult for this sector to mobilize and allocate financial resources efficiently.

Second, participants noted that where high inflation is allowed to give rise to high nominal rates of interest, the high interest rates comprise two conceptually distinct components. The first is an inflation premium that merely protects the real value of the assets against inflation, and the second is the real interest rate itself. The failure of all the countries in the EMENA region to separate these two components for taxation purposes has resulted in highly negative after-tax yields on financial investments, even where nominal interest rates have been operated with some flexibility relative to inflation. This distortion operates in high-inflation countries to encourage borrowing by making it very cheap, while at the same time discouraging lending by making it very unremunerative. In this way, high inflation contributes further to the repression and narrowing of financial sector activity.

Third, in economies where interest rates are charged on a nonfloating basis, high inflation leads to a shortening of financial assets and maturities and discourages longer-term lending and borrowing. Lenders will be concerned about the risks of negative returns on their assets if they make longer term commitments. In contrast, borrowers will be concerned about positive real rates on borrowing if inflation were to fall. The most common policy response in this situation is to accept passively the decline of the longer-term financial markets as a consequence of inflation. The alternative is to introduce floating interest rates, which is the practice Portugal has adopted for several years. This solution, however, has its own problems since it will impose an enhanced need for liquidity even on sound and profitable companies. This is because a higher nominal interest rate when inflation is high implies a premature and involuntary amortization of debt that would not arise with the same real rate of interest when prices are stable. Thus, for countries that adopt the floating interest rate, ensuring an adequate supply of additional credit to ensure the full refinancing of this element of premature amortization where the borrower requires it is equally important. Quantifying the required amounts of such additional credit is technically difficult, and in the view of seminar participants, it is rare for the matter to receive the proper attention in stabilization programs.

*Noninflationary Financing and the Financial Sector.* Whenever the authorities seek to finance large deficits without recourse to inflationary

methods of finance, they tend to reduce the availability of credit to the private sector and so crowd out more or less that sector's investment and other spending. Participants discussed a variety of methods of noninflationary finance as practiced in the EMENA countries. The mechanisms through which the crowding out effects are achieved can be classified under four main headings. The first and most common involves the use of compulsory and often high reserve requirements on the commercial banks. In Turkey, for example, the reserve requirement on certain classes of deposits has been as high as 45 percent in recent years. Since the banks typically receive a zero or very low interest rate on their required reserves, they are in effect taxed at a rate approximately equal to the average cost of funds on this proportion of their total deposits. The preservation of bank profitability in this situation requires the establishment of high margins between deposit and lending interest rates. In Turkey in the early 1980s, this margin was as high as 15 points, which is the main reason why the public sector was able to borrow at very low interest rates while many nonpreferential borrowers in the private sector were having to pay as much as 35 to 40 percent in real terms. More recently, even though reserve requirements in Turkey have been reduced, the same crowding out result has been achieved through a somewhat different mechanism. Specifically, the weekly auctioning of treasury bills has resulted in generally high interest rates on these bills, and has influenced both the quantities of, and the interest rates on, the loans that the banks have been prepared to offer to private sector clients. They are also said to have influenced the authorities' thinking about the appropriate levels at which to administer deposit rates of interest.

The second major mechanism of noninflationary financing is the imposition of compulsory holding of treasury securities or other government paper on the commercial banks; a method used in Morocco and Tunisia, where the proportion of deposits that the banks had to use in this way was set at 30 percent and 20 percent, respectively. Since the interest rates offered have normally been substantially below market rates, this device also increases the margin necessary between bank deposit and lending rates, and reduces the availability of credit to the private sector.

The third mechanism, which has been important in the past in both Portugal and Morocco, is the informal mechanism of accumulating arrears. Since this forces the government's creditors to seek additional credit (formal and informal), it results in some part of credit resources being tied up in ways that do not serve any productive purpose in the private sector.

The fourth mechanism, which has been used for many years in Portugal, Morocco, and Tunisia, is the device of ceilings on the expansion of bank credits to the private sector. To the extent that these ceilings are binding,

they leave the banks with an accumulation of liquid funds that they cannot use for normal credit purposes (assuming that they have no mechanisms for turning away bank deposits). In Portugal, the authorities have made available specialized treasury bonds and bills to the banks to absorb the liquidity, but only at low interest rates. Crowding out in this case occurs both directly, through the quantitative restraint of the credit ceilings, and indirectly, as the banks seek to preserve profitability by charging higher spreads on the credit permitted.

Developing countries' widespread use of these methods of noninflationary finance contrasts sharply with the situation in many industrialized countries. There, the authorities tend to rely on their relatively well-developed money and capital markets to sell their bonds and other paper extensively to outside organizations and individuals, as well as to the banks. The consequence is that large volumes of noninflationary financing of public deficits will reflect directly on general levels of interest rates, with the result that the crowding out will occur largely through a price mechanism. As several participants noted, in countries with weak capital markets, moderate sales of government securities to individuals and institutions other than banks may contribute to the development of capital markets. However, such purchases ought to be voluntary. Monetary authorities often refuse to accept the interest rate consequences of even modest sales of this type and attempt instead to achieve the sale through various degrees of compulsion. This is the case, for example, as regards purchases of such assets by pension funds and insurance companies in countries such as Portugal, Morocco, and Tunisia. It is recognized, however, that these practices may merely retard the sound development of nonbank financial institutions, and so restrict the longer-term demand for capital market instruments to which these institutions might contribute significantly.

The difficulties inherent in cutting public deficits to eliminate their burden on the financial and the productive sectors are compounded by the difficulties surrounding the crowding out arguments. Participants pointed out that although policymakers may be well aware of the potential burden their financing methods impose elsewhere in the economy, the quantitative magnitude of that burden is extremely difficult to assess. They can rarely be certain that cuts in public spending to reduce the risks of crowding out will result in corresponding increases in private sector investment rather than in a general decline in economic activity. This is especially true where the demoralization of private sector activity is multifaceted and not merely a function of the unfavorable terms on which it needs to seek its finance. Furthermore, examples from the Southern Cone economies indicate that when the starting conditions involve a chronic misallocation of resources,

then private speculative activity rather than private productive activity may be the first and overwhelming result of a more liberalized environment.

Participants agreed that for the authorities to end crowding out practices is not easy, even when they are fully cognizant of the arguments in favor of doing so. If they have real difficulties in reducing public deficits, then some use of the crowding out instruments is better than an excessive use of inflationary financing, which can easily take an economy past the point where financial sectors operate with any real effectiveness. But, even where deficits can potentially be brought under control, the authorities have to take some risks that the private sector will make good use of the extra resources thereby made available to them. They are unlikely to do so merely because of a financial liberalization if other aspects of the climate for private sector investment, including expectations about the longevity of liberal policies, are insufficiently encouraging. Countries such as Argentina, where there have been many false dawns as regards the introduction of economic liberalization, have serious credibility problems.

### **The Appropriate Size for the Deficit**

Although the discussion in the seminar indicated that many false trials and twists lurk on the path that apparently connects a large public deficit to inflation and the repression of the financial system, it is clear that large deficits are one aspect of these problems. Participants therefore agreed that some guidance that could be offered to the authorities to enable them to assess the size at which the deficit ceased to be "acceptable" would be extremely useful. However, an economy that is able to achieve a consistently high aggregate savings rate may be able to live with a higher level of public sector investment. Italy and Japan are cases in point. Furthermore, while the analysis presented in the preceding paragraphs indicated a variety of ways in which large public deficits may discourage savings through financial channels, no real evidence exists about a corresponding effect on aggregate savings rates. Thus, although the aggregate savings rate is unlikely to be fully independent of the way in which the government manages its economy and public sector, it may nonetheless be a helpful indicator from the point of view of assessing how much the authorities can get away with in determining their own expenditures and borrowing.

Another useful guideline suggested would involve comparison of the public sector deficit relative to the GDP, and the size of the financial system (such as, total financial assets held) relative to the GDP. If the deficit is equivalent to 5 percent of the GDP, for example, and the financial system is equivalent to 20 percent of the GDP, then the financing of the deficit from domestic sources requires the financial system to grow by about 25 percent



per annum to avoid increased crowding out. Large-scale inflationary financing will almost certainly reduce the size of the financial system in time, relative to the GDP, as savers seek to avoid the inflation tax. If the authorities therefore decide to employ alternative financing methods, they should monitor the effect of these on the size of the financial sector to see whether they are indeed progressively increasing the extent of crowding out.

Authorities encounter far more difficulties when judgments about the relative merits from a social and productive point of view of public and private expenditures are involved. Much public expenditure will be socially and productively desirable, while much private expenditure may be socially trivial or even undesirable. Hence, large deficits and correspondingly large volumes of crowding out cannot be condemned automatically. However, low-saving economies that are known to have energetic and productive private sectors are unlikely to be able to sustain large public deficits for long without seriously harming their productive potential.

### **Interest Rate Policies**

The second main issue discussed under the broad heading of macroeconomic policy and finance was interest rate policy. This topic is of considerable current importance to the EMENA countries since many of them have now acknowledged the dangers of administered interest rates, and are beginning to introduce various degrees of flexibility into interest rate management. Interest rates have traditionally been subject to administrative controls in all the countries in the EMENA region, with the result that rates have often remained negative in real terms for substantial periods. The consequences of this were the familiar ones of an excessive demand for credit; the associated need to ration credit; an inevitable leakage of some portion of scarce credit supplies to low productivity investments; the flight of capital into gold, land, or foreign currencies; and the general repression of financial sector development.

Turkey in the late 1970s offered a striking example of this syndrome. Real interest rates on time deposits fell as low as minus 50 percent at times, and the ratio of broad money to GNP fell from 24 percent in 1978 to only 15 percent in 1980. Borrowers achieved extremely favorable terms on their debts, which were rapidly eroded by inflation, but being starved of new credits, had increasingly to resort to the nonregulated bond markets where effective rates of borrowing were considerably higher.

Some of the dangers of a high degree of centralized administration, both of general interest rates and those on preferential credits, are also illustrated by Egypt's experience. There, the highly negative real rates of interest have

encouraged the widespread holding of wealth in the form of dollars. By encouraging borrowing, they have produced large distortions of debt to equity ratios and serious undercapitalization of productive enterprises; and by offering inadequate returns to savers have encouraged the large-scale switching of funds to new Islamic banks that, by claiming not to be deposit-takers and so avoiding cash and other assets requirements, were able to pay very high rates to savers. Many of these banks are unregulated and possibly financially shaky. Furthermore, this problem is to some extent "locked in" since a major increase in real interest rates would spell disaster for many highly leveraged firms, especially if price controls were not simultaneously liberalized.

As regards selective interest rates and rate ceilings, governments' efforts to establish lower interest rates both for agricultural and other preferred lending, as well as for longer maturity loans, have resulted in commercial bank allocations of credit moving in exactly the opposite direction. The lesson that was drawn by the Egyptian participants is that where the demand for credit exceeds the supply, the banks should retain control of the direction of credit and not the borrowers.

All the EMENA countries, including the East European countries, have made some moves in the routinely prescribed direction of liberalizing interest rates, but the seminar discussion confirmed that none of them are even close to full liberalization. Four major problems can explain the difficulties inherent in full liberalization, as demonstrated by those countries in Latin America and elsewhere that have attempted this undertaking. The first and most straightforward of these is that if the demand for credit is rigid, as it is likely to be in many countries, and supply elasticities are also low, then the freeing of interest rates will lead to substantial increases in their level, especially when interest rate targeting is replaced by monetary targeting and is accompanied by a lower rate of money supply expansion. Thus, the policymaker who is swayed by this line of argument can readily defend continued controls on interest rates, since with low supply and demand elasticities for credit, the magnitude of the excess demand at the controlled rates and the economic distortions introduced by this will both be small.

In the same context, several participants noted that the developed countries have adopted generally liberal interest rate policies partly because this has been forced on them by the internationalization of finance; but partly because their greater inflation stability has eliminated dangers of extreme movements in rates as the result of interest liberalization; and partly because they have relied on large exchange rate adjustments to mitigate the effects of instability on interest rates (that is, the United States and Japan). Thus, a developing country with moderately stable inflation, a degree of continued

control of interest rates should not be a major problem since equilibrium is unlikely to be far away. This is now the situation in many of the EMENA countries with the notable exception of Yugoslavia. In countries suffering high inflation and instability, however, it is far from clear that the costs imposed on the economy by managing interest rates at below their equilibrium level will be small and acceptable. The only general conclusion that can be sustained is that it is pointless to liberalize interest rates, and financial markets more generally, while most other markets remain subject to wide-ranging controls. By contrast, in the context of general liberalization, for governments to set interest rates correctly will be extremely difficult, and some role for market forces will probably be helpful.

This in turn leads to the second major reservation about a full liberalization of interest rates, namely, that in the absence of flexibility and correct relative prices in other key markets, such a liberalization is likely to drive real interest rates to very high levels. This concern is most vividly illustrated by the deregulation of financial markets in the Southern Cone economies: Chile, where real interest rates rose to levels in excess of 40 percent, and Argentina and Uruguay, where they exceeded 15 percent. The attempt to maintain exchange rates at uncompetitive levels in these countries is part of the explanation, to the extent that high real interest rates were sought to obtain protection from exchange risks. More generally, the freeing of formerly controlled commodity prices gave rise to capital gains and a speculative euphoria, which wrongly projected into the future generated an inflated speculative demand for credit. Even when capital losses were sustained as part of the adjustment process, these were assumed to be temporary and firms were able to borrow to see themselves through the supposedly transitory difficulties. Later on, many highly indebted firms were able to obtain distress financing, in many cases from banks in the same conglomerate to which they themselves belonged, and with bankruptcy approaching attempted to borrow more and more as interest rates, and their own finance charges, rose ever higher. The lessons from these experiences clearly indicate the need for certain preconditions for interest rate liberalization if wholly unrealistic short-term credit demands and interest rates are to be avoided (some of these are discussed further in the next chapter).

Banks who have lived for long periods under regimes of managed or administered interest rates lack the experience of operating in a free market environment. Too abrupt a transition from one regime to another may cause problems in the management of assets and liabilities and ultimately endanger the financial health of the least well-managed institutions. In this context, systemic inefficiencies may lead to financial disruption or crisis.

The fourth possible reason for not enthusiastically espousing full interest rate liberalization is that where banking systems are uncompetitive, the control of interest rates through cartels or gentlemen's agreements amongst the banks may replace government control. Where governments have political or administrative difficulties in combating these tendencies, they may quite reasonably prefer direct controls of their own even though they fully appreciate the inefficiencies to which these can give rise.

As already noted, in recent years many of the countries in the EMENA region have moved to liberalize interest rates to some extent. In Turkey, for example, rates were completely freed for a time in the early stages of its stabilization program in 1980, but are now monitored so as to achieve substantially positive rates. Participants explained that their adequacy in this regard is reviewed from the viewpoint of the overall monetary policy at least once every three months. The substantially positive rates since 1981 resulted, among other things, in a very rapid growth in deposits in the banking sector. In July 1987, the banks were given the freedom to set interest rates on deposits of more than one year maturity, which has already resulted in substantial variations in rates between larger and smaller banks. Portugal has also moved in a similar direction with controls now applied only to a limited set of rates.

In 1985, Tunisia raised the interest rates on both deposits and credits to positive real levels and simplified the structure of lending rates. Since early 1987, banks have been given considerable freedom in fixing their conditions of lending except in the case of priority loans. In Poland, one of the intentions of the economic reform program is to allow interest rate levels to be set by reference to the supply of and demand for monetary assets, and to establish positive real interest rates on credits and longer-term bank deposits.

In a few cases, these reforms have been encouraged by a subset of the same international pressures that are largely responsible for the high degree of freedom of interest rates in developed economies. In Portugal and Turkey, for example, participants pointed out that the high degree of interest and exchange rate sensitivity of emigrants' remittances contribute significantly to the partial integration of the domestic financial markets of these economies into the international market. However, most countries attempt to insulate themselves to some degree from the influences of international capital markets by maintaining controls on capital movements, even though it is generally accepted that the leakages through these controls will be large if interest rate differentials adjusted for expected changes in exchange rates are themselves large. Egypt, Turkey, and Yugoslavia try to achieve this insulation by devices such as foreign currency deposits in

domestic banks and other arrangements favorable to emigrants' deposits. However, they also recognize the dangers involved. In particular, such deposits may make shifts of funds into foreign currency easier rather than more difficult, encourage the segmentation of financial markets, and give rise to serious risks of illiquidity for commercial banks as a consequence of their high foreign currency liabilities.

### **Conclusions**

Clearly the two topics discussed in this first chapter are intimately connected. Governments with large deficits will be amongst the major borrowers in an economy, and for this reason alone may be tempted to keep interest rates low. In addition, when deficits are high, their books may look slightly healthier if subsidies to priority sectors are provided through the banking system as preferential credits rather than more transparently as fiscal transfers. In any event, there are serious constraints on interest rate policy so long as large deficits persist. In countries where these are financed predominantly through money creation, the resulting inflation will easily get out of control as the tax base for the inflation tax progressively contracts as the demand to hold monetary assets itself contracts. In these cases, the eventual adjustment of the economy will be complicated not only by the increased magnitude of the deficit if, as is likely, this does respond to higher inflation, but also by the need for transitionally very high real interest rates to restore some faith in the wisdom of holding monetary assets. In countries that make greater use of noninflationary financing of deficits, it is unlikely, unless the aggregate savings rate is very high, that the authorities will be able to contemplate financing methods that crowd out mainly through price, as in many of the industrial countries, until deficits are reduced to a reasonable size.

### 3

## **Financial Sector Crisis**

In some countries, the authorities have managed to adjust to the relative price and other external shocks of the 1970s and early 1980s without apparent crisis either in their productive or in their financial sectors. Various types of crises have more often been a characteristic of the adjustment process. In countries such as Mexico, and Brazil, the crisis has manifested itself, among other things, in an inability to meet servicing obligations on large external debts. But in many countries, including most of the EMENA countries, that have still managed to avoid severe external debt problems, financial sectors have encountered acute difficulties. Even the Republic of Korea, widely referred to as the model of sound adjustment to the problems of that period, is known to have a banking sector characterized by problem assets, and several banks have already had to call on government support. Nor is the problem confined to developing economies. In 1986, no fewer than 150 U.S. banks had to be financially restructured and 2 out of 14 major Canadian banks failed.

Participants pointed out that incipient crisis in domestic banking sectors is extremely hard to spot without a substantial amount of inside information. The normally available statistics about actual bank failures, and even about the magnitude of the banks' bad debts, typically represent only the tip of a very large iceberg. The reason is that neither banks nor governments have anything to gain by revealing the true size of their bad debt situation. However, work in a variety of countries by the World Bank suggests that the number of banks and other financial institutions that are currently insolvent is without precedent in the last 50 years, and that as a rule of thumb, the banks true nonperforming loans may be as much as eight times the level actually shown in their balance sheets. Banks in a wide variety of developing countries are of course in difficulties because many of their borrowers cannot service their loans, which in turn indicates deep problems in the underlying productive sectors of these economies.

The significance of this situation for policy making in the future lies in two factors. First, policymakers need to understand the causes of widespread difficulties of financial sectors so that they can attempt to avoid the repetition of the causal factors in the future. Second, they need to be interested in possible remedies. Prior to discussion of these two concerns, however, participants considered major consequences of a bankrupt or near bankrupt financial sector from the viewpoint of the effectiveness with which it can discharge its intermediation functions of mobilizing and allocating resources.

### **Consequences of Financial Sector Crisis**

In most developing countries, banks that have failed to the point where they have to be closed down are the exception rather than the rule. But many banks that are mildly to seriously financially impaired by the level of their bad debts relative to capital stay alive. Such a situation is worrying first and foremost because it may take very little to turn the incipient crisis into an actual crisis involving bank failures, the complete collapse of associated productive enterprises, and an uncontrolled change in certain macroeconomic aggregates. Confronted as they are every working day with a financially impaired banking sector, many treasury or central bank officials come to feel that their economy's future lies more with fate than it does with their sound economic management.

Second, even if a country can avoid large-scale collapse, the impaired state of the banking sector will inevitably distort one or more aspects of economic management. Most probably, the authorities will need to provide direct or *ad hoc* subsidies to keep a bank or one of its productive sector clients alive for a little longer. The authorities may also have to support the banks by administratively restricting competition from new entrants, knowing that such competition would deprive the existing banks of their better clients and so further weaken their overall balance sheets. For example, this may account for the Portuguese authorities' ambivalence toward the entry of new foreign banks in the recent past. By the same type of reasoning, the authorities may connive in the maintenance of unrealistically high margins between deposit and lending interest rates in order to provide the banks with some means of covering losses. This is currently the situation in Turkey. Through all of these *ad hoc* ways, the authorities will enable banks and productive enterprises to survive, but only at the expense of retarding the development of more efficient financial institutions and practices for the future.

Third, and most serious, the perpetuation of a severely impaired banking system has grave consequences for the efficient mobilization and allocation of scarce financial resources. Banks preoccupied with survival will make

different portfolio decisions from those preoccupied with making profits. They are likely, for example, to allocate funds disproportionately to nonperforming debtors to prevent their bankruptcy. Furthermore, this approach is likely to be self-perpetuating. Borrowers in the productive sector who are nearly or completely bankrupt (that is, are nearing or below zero equity), have nothing to lose by increasing their borrowing however high the costs. If the banks are operating to keep major clients alive, then the borrowers may indeed obtain this additional distress borrowing, even though it can achieve little more than delaying their eventual demise. While this is happening, viable firms may be crowded out from access to funds in a very direct sense. If the cost of funds moves very high because of the weight of distress financing, the viable firms may choose in any case to sit on the sidelines and delay their investment plans until both the price and the availability of credit returns to normal. Thus, the financial crisis readily becomes an investment crisis, with the resulting sluggish performance of the real economy rendering it unlikely that the economy can grow its way out of the problem in the way that Portugal, for example, seems to have managed to do in the past three years. The situation is made worse and can go on longer if there are expectations that, in time, the government will bail out major debtors in both the financial and productive sectors.

The situation is above all one in which banks are “taxed” by the bad debts in their portfolios, with many of the same consequences that stem from taxation through reserve requirements and other restrictions on bank portfolios. The consequences include a shortage of credit to viable projects and unnecessarily high interest rates on borrowing for those who do manage to obtain credit. The main difference is that whereas the proceeds from the reserve requirement tax go to support public sector expenditures, those from the “tax” associated with bad debts go largely to preserve jobs and incomes in productive sector enterprises. Regrettably, the workings of the financial markets in this type of situation are unlikely to ensure efficient discrimination between those nonperforming investments that can ultimately be successful, and those that can never hope to be. Participants generally agreed that the nature of financial sector crisis is such that some additional methods besides those of the market need to be brought to bear to help the banks make this sort of distinction.

### **Causes**

Many factors can propel a country’s financial sector to the state of impairment just described. However, several participants pointed out that often this results from many separate actions by public and private



decisionmakers, none of which can be independently faulted. Thus, financial sector crisis may not even have the redeeming feature, in puritanical terms, of involving an independent or evil force on which to heap the blame. A situation that arose in Egypt amply illustrates this point. When the authorities rightly made the decision to float the Egyptian pound in 1985, the resulting depreciation gave rise to immediate foreign exchange losses for those productive enterprises that had borrowed in foreign currencies. Even amongst well-managed companies, many were confronted with serious financial difficulties, as a consequence. The Egyptian banks knew that they did not have the capacity to handle widespread bankruptcy, and also knew that the legal procedures for bankruptcy were unsatisfactory, not only in terms of the duration of legal proceedings required, but also in terms of the minimal residual assets likely to be available to nonpreferred creditors. Hence, their management decision, supported no doubt by shareholders, was to provide additional credit facilities to keep distressed companies alive, even though this would obviously weaken balance sheets by increasing the weight of nonperforming loans. There were no obvious villains in this sequence of events, but the outcome was a substantially weaker financial sector.

Moving to more general explanations, the seminar noted that an obvious distinction can be drawn between problems that originate in the real or productive sectors of the economy and those that originate in the financial sector. Because all real economic activities need to be financed, major errors about real investment and production will inevitably rapidly spill over to cause problems in the financial sector, at least where the errors are systemic and not confined to a mere handful of agents. In the 1970s and early 1980s, when the economic pattern of resource allocation was changing rapidly for most economies, many of the wrong decisions in the productive sectors were indeed systemic and were encouraged in many cases by ill-conceived macroeconomic policies. With the benefit of hindsight, the major errors included the use of exchange rate and other trade policies that over-emphasized production for domestic markets; too optimistic expectations about the pace at which the world economy would expand; the attempts to use expansionary macropolicies to maintain living standards and growth rates in the face of large terms-of-trade losses and sluggish international growth; the use of overvalued exchange rates to keep inflation rates down; and, of course, excessive and inefficient use of external borrowing. These policies encouraged a configuration of production capacity in many economies that could only be profitable if previous patterns of relative prices and growth rates of international demand could be restored. In the event this did not happen, the international economy experienced a recession in 1983-84 worse than anything seen since the 1930s, and considerable

financial distress at the microeconomic level was one inevitable consequence.

In the financial sector itself, two main factors contributed to the problems described. First, the attempts to administer domestic interest rates at unrealistically low levels in the face of rising inflation in the late 1970s resulted not only in an inadequate rate of mobilization of financial resources, but also in widespread official or unofficial credit rationing, the outcome of which was to allocate funds in ways that could favor the sounder long-term projects only by chance. The increased investment in real assets such as land, which is one of the more obvious manifestations of financial repression, was only one aspect of this situation.

Second, and partly as a consequence of the problems created by low interest rates, governments routinely intervened to direct credit to favored regions or sectors, such as agriculture and housing, with only secondary consideration given to the longer-term profitability of these preferred activities. Favorable access to lending for publicly-owned enterprises was a very common aspect of this general interventionism with credit allocation. In addition, in countries where banks and productive enterprises shared a common ownership, the banks themselves failed to observe the arms-length approach to determining the relative merits of alternative potential borrowers. In many countries at present, a high proportion of the nonperforming debts in banks' portfolios are found in the categories of these directed credits. The substantial arrears of the Portuguese public enterprises to the banks is a clear example.

Finally, participants noted that a third set of causes exists that, while originating in the financial sector, can be regarded as conventional banking mistakes rather than mistakes induced by policy intervention. As in the United States and other industrialized countries, many banks in the developing countries have run into difficulties because of excessive concentrations of loans to particular economic activities or clients. Some, lacking experience of flexible exchange rate regimes, have lost money by being overexposed in foreign currency liabilities. Inefficiency resulting in high margins between deposit and lending rates is another problem that has been exacerbated when management has seen the opening of new and expensive branches as a realistic alternative to competing via interest rate differences. Some banks have lacked good internal management procedures, and several participants had had the same problem as the Egyptian bankers in being unable to resist the pressures to roll over facilities to larger or influential clients when these clients first manifested an inability to repay credits. They noted that the instrument of bankruptcy has rarely served the banking systems of EMENA and other countries well. This is partly because the legal procedures involved are far too cumbersome and

drawn out, for example in Portugal, Turkey, and Egypt. But mainly it is because bankruptcy as an institution works best when an economy is close to equilibrium and financial difficulties afflict only a small minority of firms. It is not well equipped to handle the problems of widespread financial failure and crisis.

### Cures

Participants widely agreed that amongst the many problems policymakers have to face, few are as difficult as those involved in pulling a severely impaired financial sector from the brink of disaster. Few governments, even those whose political strength is close to unassailable, can seriously contemplate the bankruptcy and closure of a large part of their domestic banking sector and the associated widespread collapse of productive sector employment and jobs. Thus, the most common approach to the problem is one of benign neglect interrupted by occasional *ad hoc* interventions as various manifestations of the problem become too pressing to be ignored. One participant suggested that a possible approach is to concede the near permanence of the problem and settle in to the long-term subsidization of distressed firms as the “least bad” solution. The handling of the problem is also frequently characterized by a high degree of secrecy. Korea treats the size of the bad debts in the banking system as a state secret, and few governments reveal the true magnitude of the problem they face. Portugal can claim to be relatively unusual in this regard. Thus, the first difficulty in finding a solution is to persuade the authorities to address the problem.

If this can be achieved, should they be encouraged to address the problem as a matter of priority? Clearly the answer is yes. Quite apart from the distortions in financial resources allocation and mobilization that will arise from long-standing financial impairment, the bulk of the available evidence suggests that delay will merely worsen the problem and make its ultimate solution that much more difficult and painful. As one commentator at the seminar remarked: “One of the major sins of a central banker, apart from that of printing too much money, is knowing that a major proportion of commercial banks are bankrupt and not doing anything about it.” Clearly, the numerous decisions about the fate of individual firms will be difficult to make and will give rise to some degree of political embarrassment. Equally, the conventionally secretive and *ad hoc* approach might be regarded as one most likely to avoid major capital flight and to retain the public’s confidence in the banks.

The easiest solution to the problem is the one most policymakers hope for, namely, that the underlying growth of the economy will give individual enterprises and banks enough leeway to restructure their activities to re-establish a sound financial situation in most financial and productive sector

activities. Participants argued that the evolution of the Portuguese economy since 1983-84, when a large proportion of productive enterprises and banks were in serious financial difficulties came close to exemplifying this "growing out of the problems" solution. However, even in this case, the authorities had to make a variety of policy interventions to generate the present improved financial situation amongst enterprises. In particular, the government had to provide substantial equity injections into the banking sector, and to arrange the restructuring and the write-off of large debts of several major publicly owned enterprises. Furthermore, there is still room for discussion about whether the fundamental problems in Portugal have yet been fully resolved.

An alternative to the growing out solution is to "inflate out" the debt problem. In many cases, a much higher rate of inflation is the unavoidable consequence of a substantially passive approach to financial sector crisis that involves the occasional *ad hoc* injection of funds to paper over the more obvious manifestations of such crisis. While this inflationary approach can certainly write down the real value of the debts of the productive sector enterprises to manageable levels, participants agreed that it is scarcely a realistic way out of the problem. High rates of inflation cause many distortions and damage the performance of the financial sector. Assuming then that the inflation route is unacceptable, the growing out solution cannot be relied upon, and more interventionist strategies are called for. Although models from around the world to guide actions remain extremely limited, participants pointed out that certain general principles of good practice are beginning to emerge, not least from the major early victims of severe financial distress such as Chile.

The first point in analyzing these experiences goes back to the earlier discussion about the widespread causes of the problem. It is evident from this that solutions cannot be found only at the level of the financial sector. The crisis is unlikely to be resolved merely by recapitalizing the banks. Indeed, a solution almost certainly needs to begin in the productive sectors.

Second, if macroeconomic policies have encouraged a pattern of resource allocation that is almost certainly unsustainable, then changes in macropolicies to encourage structural adjustment are inevitably called for. Without these, restructuring efforts at the level of the individual firm will fail in the longer term because the same erroneous signals that caused errors in the first place are likely to cause them to be repeated. Admittedly, some aspects of structural adjustment and the associated liberalization will initially exacerbate the financial sector's problems. The reduction of trade restrictions, for example, will propel more firms into situations of financial difficulty. Similarly, interest rate reforms in high inflation economies have normally resulted in extremely high nominal interest rates, and so led to

serious liquidity problems for many productive sector firms. However, holding back from reform of a structural adjustment type is only logical if the prevailing resource allocation and the associated stance of macroeconomic policy are sustainable on a longer term basis. Otherwise, delays will aggravate the problems the financial sector faces. Such reform in any case cannot be the fundamental cause for the crisis: the cause lies in the erroneous policies that the reform is designed to change.

Third, once a government has made the mistakes that led to crisis, the costs of these mistakes cannot be recouped. All that the solution strategies can hope to achieve is a rational distribution of these costs between the various agents in the economy. The major advantage of the “growing-out” solution is that it distributes the costs in a manner that is largely unaffected by government, and so is detached from political pressures, although this does not imply anything about the fairness or the equity of the outcome. Portugal’s relatively successful experience in this area, for example, was possible only by virtue of a high degree of flexibility in real wages. However, this has meant that the recovery of profits needed to restore the financial soundness of a reasonable part of both the productive and the financial sectors imposed a far higher immediate burden on salaried workers and employees than it did on shareholders and taxpayers. A similar bias also applies to attempted solutions to financial sector crisis that involve the effective writing down of debts via inflation. Such an approach loads most of the initial costs onto holders of fixed price credits, but the instability in the economy that it can also introduce is likely to diffuse the costs in other and unpredictable ways.

More generally, the authorities will have to take policy decisions about how to distribute the costs, and a number of institutional and political pressures will affect the nature of the outcome. Participants noted, for example, that in the days before central banking was widely established, the losses associated with the failure of a bank would certainly have involved major losses for that bank’s depositors as well as for its owners. Now, and largely irrespective of whether formal methods of deposit insurance are in place, governments tend to protect bank depositors. However, since there is no crisis unless bank liabilities exceed assets, the government cannot achieve this protection merely by writing down the value of shareholder capital to zero. In addition, part of the burden of losses will normally be transferred to the taxpayer community in general. The methods chosen to handle important bank failures in the United States, such as that of Continental Illinois, are a major example of this tendency. However, protecting the position of bank depositors, who are not responsible for their bank’s portfolio errors, is one thing. Protecting the bank’s management and shareholders is something altogether different. Participants broadly

accepted that any market based economic system has to preserve correct incentives for banks, and this has to include the acceptance of full losses by shareholders when things go wrong. Any other way of sharing losses would be an open invitation to bank managements to approach their fundamental task of making decisions involving risks in a reckless fashion with far too little attention to the consequences of error. Outright dishonesty by managers in handling bank affairs clearly ought to result in substantial jail sentences for those concerned, as has been the case in Chile. However, managers who are not dishonest, but nevertheless make serious errors, should lose their jobs if the proper incentives for the bank's future conduct are to be preserved. Such managers tend to conceal losses, indulge in high-risk lending, and so on, which cannot readily be eliminated if they remain in their posts. Fortunately, their replacement is straightforward since typically, relatively few banks fail and the necessary skills are normally fairly easily transferable from other banks.

Fourth, participants argued that the authorities should recognize that the perpetuation and intensification of imminent financial crises is due in part to the loss of incentives to pursue their claims against nonperforming borrowers properly. The reasons for such behavior have been described earlier and they are perfectly defensible in their own terms, but this behavior pattern and the incentives that motivate it have to be changed if the situation is to be turned around. The Chilean approach to this problem during the past two years is an interesting one and provides lessons that others might benefit from, although the severity of Chile's financial crisis is certainly unusual. The core of this approach was the cutting back of government resources to support banks and lame duck companies, not in an across-the-board manner, but in a manner that favored the well-managed banks. The basic idea was to force the banks to push for the restructuring of their clients to save themselves. The government achieved the ability to distinguish between well-managed and poorly managed banks by a major intensification of the bank supervision process. This in turn put the banks under effective pressure to write off debts that were clearly uncollectable and to pursue those that were more aggressively. Thus, the taking of unavoidable losses, the selling of bad debtors' assets, and the collecting of some debts meant that banks' balance sheets began to provide a more realistic picture of their real financial health. Many of Chile's banks were restructured with this approach, although their shareholders' investments were lost in part or in full, as were those of the shareholders in many productive sector enterprises.

This first part of the recovery process resulted in concentrating the major part of remaining losses in the banking system. It thereby cleared the decks for a recapitalization of the banks designed to offset these losses and

facilitate the eventual restructuring of some of the companies that had generated them. This was achieved by the government purchasing these debts by issuing to the banks long-term government bonds at market interest rates. The annual interest cost of this to the government was estimated at about 1.5 to 2.0 percent of GDP. However, the resulting restoration of confidence in both the banks and the domestic currency so far seems to have had extremely salutary consequences for economic management. In particular, the increased willingness to hold financial assets, especially the increased ratio of holdings of broad money to GDP, has substantially increased the seignorage revenues that the government is able to collect from issuing the domestic currency. According to some estimates, the increased revenues from this source are sufficient to cover most of the interest costs of the long term bonds provided to the banks. If this is indeed the case, a major financial restructuring operation has been achieved at a very limited cost to the taxpayer.

Fifth, participants discussed the role played in resolving financial crises by the direct physical and financial restructuring of distressed companies in the productive sectors. The reality of political economy makes it inevitable that all governments will attempt to intervene more or less directly in the restructuring of the very large enterprises in their economy that run into difficulties. While it may not make much economic sense to try to preserve output and employment levels in these enterprises on a scale beyond that which has longer-term viability, participants noted that it may make good political sense to do just that. From the narrow perspective of financial sector crisis and its eventual resolution, this may not matter too much provided that every effort is made to preserve transparency in what is being done. Above all this is an argument for explicit and visible subsidies as opposed to a diffused range of supports that can undermine the financial soundness of banks, central banks, and any other institutions that serve as channels for these supports. Regrettably, the incentive system that government officials face often points in the direction of concealment rather than revelation in these areas. Although they may be expected to provide government support to particular major enterprises in the production system, participants noted that they are probably also expected to spend minimum government money in doing so!

In cases where many small and medium companies are also a major part of generalized financial distress, the problems of a case-by-case approach to restructuring are more complex. One view expressed was that if taxpayers' money is to be used to resolve the problems of productive sector enterprises, then a government bureaucratic process is needed to determine who should and who should not obtain assistance. A complementary point is that the case-by-case approach should ensure the economical use of any

public funds that are made available to support the process. But participants also noted that few governments are likely to be able to muster the appropriate technical expertise to do the job well. Governments have usually become involved in microlevel interventions in the productive system when they have been pursuing some well-defined sectoral objective (such as the Spanish government preparing its large productive sector for the country's entry into the European Community). Here the evidence about the success of intervention is mixed and examples of both failure and success abound. The successful cases generally seem to have involved in-depth diagnosis by independent consultants of the future potential for activities of various types. In the more general case, several participants felt that governments would probably be well advised to leave as much of the portfolio review as possible to banks and the financial institutions that have the expertise to evaluate particular enterprises soundly. However, this delegation of the task should not be contemplated without ensuring that banks have proper incentives to do the task properly, especially given that further injections of government money may be involved, as in the Chilean case. Pushing more government money through the banking system, in the absence of the change, will achieve nothing.

Clearly the problem of government intervention at the microeconomic level is fundamentally about selectivity: whom to help and how. One approach, sometimes practiced but probably to be avoided, is to charge selectively preferential interest rates to enterprises in difficulties. As with the automatic bailing out of shareholders of failing banks, such an approach seems likely to produce the wrong incentives and to reward failure. Participants argued that a better approach, certainly from the viewpoint of correct incentives, was that recently adopted in the new Polish special law of bankruptcy. Productive sector enterprises are now required to propose special recovery programs that, if accepted by the banks, qualify the enterprise concerned to receive further credit conditional on implementing the program.

Finally, participants emphasized several times that a vital part of the solution to a widespread financial sector crisis is careful reappraisal of the existing financial institutions and instruments in the economy, with a view to building more robust arrangements for the future. In most cases, this is likely to involve the introduction of better accounting, auditing, and supervision of the banking system to provide for earlier identification and correction of impending problems. It may involve a reform of bankruptcy arrangements and associated tax rules to encourage the writing down of nonperforming assets. Above all, it will require measures to deepen the financial system, and especially to provide both savers and investors with far more permutations of risk and return to suit differing requirements.



Clearly this is not an independent part of the solution since the broadening of financial markets will not occur if, for example, the macroeconomy is not reasonably stable and if the tax system is stacked against nondebt instruments. These and other important prerequisites for the emergence and growth of capital markets are considered further in the next chapter.

## Conclusions

The seminar confirmed that financial sector crisis has been a feature of many financial systems in recent years and is often a major issue to be addressed in handling economic adjustment. Its successful resolution presents policymakers with a formidable array of difficulties, and it is not surprising that a combination of benign neglect and *ad hoc* reactions to its more visible manifestations appear as the most common approaches to dealing with it. However, the consequences of failing to address the problem head-on are serious. Even if these do not always involve an escalation of the problem, they will certainly result in chronic inefficiencies in the use of financial resources, especially in a shortage of financing for viable projects and in unreasonably high interest rates charged to those borrowers who are able to gain access to financing. In either event, the financial crisis is likely to result in an investment crisis as well. Since the margins between bank lending and deposit rates of interest will also rise as the banks attempt to protect their profitability against the heavy weight of nonperforming loans, the general efficiency of the process whereby loanable funds are mobilized and reallocated will be impaired.

Participants recognized that the causes of financial sector crises were numerous, including problems in the real productive sectors of the economy (some precipitated by inappropriate macroeconomic policies) and financial sector policies, as well as conventional banking misjudgments, such as excessive concentration of loan portfolios. Although a conventional program of macroeconomic and structural adjustment will often exacerbate the symptoms of financial malaise, several participants argued that it would be a fundamental mistake to hold back from such reforms merely because of this difficulty in implementing them. To do so would involve a failure to recognize that an unsustainable pattern of resource allocation and the macropolicies that help support it, must eventually weaken the financial health both of the productive enterprises that have the direct control over resources, and of the financial institutions that provide their funding. While accepting this, several participants, aware of the practical difficulties, referred to the possible need to accept a degree of long-term subsidy of financially troubled institutions merely because the alternative of a major reform program was too difficult to implement.

The resolution of a situation of financial crisis is certainly not straightforward and no ready-made formulae to guide the policymaker exist. In isolated cases, a favorable conjuncture of external events may enable an economy to achieve a growth of real output sufficiently rapid to build up profitability and restore balance sheet positions, and so avert the need to put in place special programs of financial restructuring. Up to a point, this has been the experience of the Portuguese participants. More commonly, the *ad hoc* approaches to resolving the problem may merely result in a reduction of indebtedness through an inflationary process, but with all the distortionary consequences that inflation entails. In both these cases, the distribution of the costs of the mistakes leading to financial crisis will be removed from the control of the policymakers, but will not necessarily be handled in a manner that is equitable or otherwise desirable. In all other cases, policy decisions about how to resolve the crisis are required as, by implication, are decisions about how to share the costs of the adjustment. Although case histories to guide future decision making in this area remain extremely scarce, certainly amongst the EMENA countries, they are beginning to emerge, not least from some of the earliest sufferers of more extreme financial crisis in Latin America. A vital part of adjustment in this area would appear to be the re-establishment of proper incentives for the banks to pursue their bad debtors, and thereafter to allocate their future loans more by reference to sound commercial criteria and less by reference to the need to protect their own capital by sending good money after bad. In the slightly longer term, participants recognized the importance of building more diversified and robust financial sector arrangements for the future.

## 4

### **The Extension and Deepening of the Financial Sector**

It is inevitable, given the difficult economic circumstances of the past few years, that the foremost financial sector issues in the policy debate in EMENA countries and elsewhere, have been those raised in the previous two chapters. They have been issues relating to the role of the financial sector in economic stabilization and to the management of and escape from economic crisis. In the future, as these difficult matters are resolved, as indeed they have been to some extent in several of the EMENA countries, longer-term issues about the appropriate size, structure, and nature of the financial sector will play an increasingly important role.

The seminar exhibited a general sense that most countries in the region had really only begun to scratch the surface of the possibilities in the area of financial sector innovation, and that all countries had potentially a great deal to gain from such innovation. Indeed, several participants argued that to the extent that the world economic environment is subject to increasingly rapid and unpredictable change, new financial techniques and instruments that can facilitate a more rapid transfer of resources between different uses, and provide greater opportunities for hedging and diversifying risk, will be amongst the most important changes that the developing countries need to pursue. The rapid expansion of new financial instruments in the markets of the industrialized countries, especially those involving options and futures trading, are likely to offer some models from which the developing countries can learn. However, off-the-peg replication of the methods and instruments emerging in the United States, the United Kingdom, and Japan is unlikely to provide much scope, and a great deal of attention has to be given to the preconditions that will make financial innovation successful. In the past, governments have generally approached this matter in a half-hearted way, contradicting nominal commitments to the deepening of financial and capital markets by a variety of policy interventions that rendered such development unlikely. Thus, for example, there has been less than a full appreciation of the importance of those preconditions involving the resolution of the macrolinked impediments to financial sector development.

As in the seminar, this chapter presents the discussion of the advantages and difficulties of financial sector expansion and deepening under two main heads. It focuses first on the relatively narrow issue of competition in banking, and second, on the role of, and impediments to, the more rapid development of money and capital markets.

### **Competition in Banking**

Seminar participants confirmed that, in most EMENA countries, the degree of competition between financial institutions is weak, with the result that savers and borrowers have few choices about how to arrange financial portfolios and structure the financing of investments, that intermediation costs are high, and that pressures for innovation are minimal. Three major reasons account for this lack of competition.

The first is government regulations, which in most EMENA countries cause at least some of the following constraints to the functioning of financial sector: limitations on interest rates and commissions that banks can offer and charge; forced investment in specified treasury securities and preferred credits; imposition of uniform rates of expansion on credits from all the banks; and protection of agricultural, housing, and other specialized banking organizations from competition with the other banks. In Hungary, there is even segmented banking activity between households and companies. Second, in most EMENA countries, the narrowness of the financial sector means that it is dominated by a relatively small number of larger banks that commonly establish cartel or other collusive arrangements to limit competition. The "generations agreement" amongst the Turkish banks to fix interest rates when these were freed from government control is a well-known example. But, in Tunisia and Morocco, the widespread cofinancing of most large loans implies a high degree of collaboration rather than competition between the banks. Third, the ownership structure of banks may limit competition, especially where most banks are publicly owned, as is usual.

In response to these three factors restricting competition, many countries' liberalization programs have, in recent years, included measures to loosen regulations affecting financial institutions, to install new banks, and to move toward despecialized (that is, multipurpose) financial institutions. Many of the issues concerned with interest rate deregulation have already been discussed and do not need much expansion. Suffice it to say that such a step is insufficient in itself to produce competitive banking, as the example of Turkey and the collusion between the banks there indicates. The Turkish banks also continue to have high operating costs (estimated at 5 percent of total assets in 1983 as against 6 percent in 1978), and similar inefficiencies are evident in Portugal despite some freeing of interest rates.

A potentially more immediate spur to increased competition and greater banking efficiency can come from the entry of new banks, as shown by the experience in Portugal when the lifting of previous prohibitions in 1984 gave rise to a flood of new foreign and domestic banking activity. Participants pointed out that the new banks are radically more efficient than the old ones. In particular, their staff to asset ratios are only a fraction of those found in the established banks. But having clean balance sheets in a generally impaired financial sector, they are also a threat to the survival of the established banks. Mainly for this reason, the government has felt the need to discourage too rapid a pace of new entry and has done this mainly through the use of effectively very high capital requirements on the newcomers. The Hungarian participants noted that four new banks have been created to remove the former monopoly status of the National Bank of Hungary in domestic banking operations, but here too, the competition that has been unleashed is far from being unqualified: in this case it is restricted by the continued segmentation of household and corporate banking.

Attention was drawn to two main problems that have emerged in connection with the attempted entry of new banks. First, the established banks have strong reasons for resisting such entry, especially when their ratio of nonperforming loans is high and their profitability is held down by past mistakes that may not have been entirely of their own making, and that do not encumber their new competitors. Since their political influence is considerable and they may receive strong support from labor unions, especially when banks are seriously overmanned, they appear to have succeeded in at least limiting the progress of new entry. The implication is that new entry is likely to be resisted less if it can be preceded by an exercise to clean the balance sheets of the existing banks as described earlier.

The second problem with new entry has been that new entrants have often enjoyed highly privileged operating conditions, at least in terms of the regulatory requirements, compared to established banks, which has led to unfortunate consequences and even threatened financial stability. Participants referred to Egypt as a prime example of this, although Jordan manifests many of the same symptoms. In Egypt, the number of banks went from 10 in 1975 to 100 in 1985, with most of the new banks claiming to operate according to Islamic principles. By claiming not to be deposit takers, they were able to achieve much greater freedom in setting their terms of lending and borrowing than could the established banks, and so they were very successful at luring business away from these banks. However, their rapid expansion could not match either the availability of qualified staff or the ability of the Central Bank to provide adequate supervision. Their competitive position as regards interest rates was achieved in part by a visible decline in banking standards, including extending a variety of

doubtful loans and failing to make proper provisions. Hence, while some competition has been achieved, it cannot probably be claimed to have improved the longer-term efficiency of the Egyptian banking sector. Perhaps the regulatory and supervisory framework did not keep pace with the emergence of the new financial institutions.

The third area of reform that has received attention in recent years is that of reducing the degree of administered specialization of various financial institutions. Participants pointed out that this very much mirrors the trend in the United States, for example, where banks are increasingly finding the margins in lending operations to be too small, and so are seeking diversification into insurance, real estate, and even retail shopping outlets. In the developing countries, the steps in the direction of despecialization will remain far less dramatic than this, but the authorities are beginning to question the traditional separations between, for example, agricultural and nonagricultural banks. However, participants expressed considerable caution about too precipitate a move toward universal banking. Their reservations were due in part to the existing gaps in financial instruments. Thus, for example, they argued that specialized development banks are partly needed to fund major investment projects because the countries concerned lack well-functioning equity markets. Even though their specialization in both the use and the sourcing of funds can create problems (for example, excessive concentration of portfolios on certain classes of longer-term loans), this can be regarded as an inevitable consequence and cost of poorly developed capital markets. They also noted that the realization of the possible benefits of scale economies and risk diversification available to less specialized institutions, implies the need for more sophisticated regulatory and supervisory arrangements of banks than is currently found in most EMENA countries to ensure that each type of banking activity is carried out on a sound basis. The supervisory requirements of specialized banking are far less onerous than those of universal banking. This benefit of specialization has to be weighed against its numerous disadvantages.

Participants argued that in the shorter term, a gradual merging and overlapping of a few of the functions of specialized institutions with those of the general banks is both feasible and acceptable. In Jordan, this would involve general banks being allowed into areas such as housing and agricultural finance. In Portugal, the specialized banks would be allowed into activities such as shorter-term credits. However, while this evolutionary and cautious approach is understandable, participants also argued that there is a need for clearer recognition of the hidden subsidies that may be involved in perpetuating the existence of narrowly specialized institutions. Even ignoring the inefficiencies encouraged by their monopoly

positions, these institutions may not have sufficient volumes of business to cover their costs. One participant suggested that the authorities might seriously consider the possibility of injecting more competition while retaining some level of subsidy through the banking system to assist clearly identified activities that might otherwise suffer a deficiency of credit. This could be done by allowing all banks to compete for the loans to these activities, and then allocating them subsidies in proportion to the loans actually granted.

### **The Development of Money and Capital Markets**

The banks dominate the financial sectors of all the EMENA countries, monetary assets are the most important domestic assets in the portfolios of savers, and bank credit is the major source of investment financing apart from self-financing, and for a limited subset of companies, external loans. The dominance of debt finance involves well-known dangers at the microeconomic level of the individual enterprise since a high debt to equity ratio leaves the enterprise that has to operate in a volatile market with a high degree of exposure to down-side risk. Furthermore, these problems extend into the macroeconomic sphere whenever economywide shocks simultaneously affect the performance of a substantial number of enterprises. Several participants suggested that the widespread incidence of financial distress in the EMENA countries has arisen, in no small measure, from the predominance of debt-oriented financing. These points are now well established and they produced a broad-based general agreement that the fostering of a deeper financial system through development of money and capital markets is an obvious way to strengthen the economies' resilience for the future.

In counterpoint to this general position, there was some discussion of certain extremely successful economies, notably Japan, that have achieved outstanding performance on the basis of a similarly credit-based and highly leveraged financial system to that found in many developing countries. However, since so many different factors, such as a low and stable inflation rate and certain cultural features, together account for Japan's success with credit-based financing, it is unlikely that many developing countries would be able to replicate these as an alternative to making serious efforts to develop money and capital markets. Thus, the majority of the EMENA countries are likely to benefit from serious efforts devoted to this matter even though the guidelines to help this effort are limited.

In the past, many countries have acknowledged the benefits of broader money and capital markets, but progress in achieving these has been negligible. The capital markets in Tunisia and Jordan, for example, have operated for 12 and 17 years, respectively, but are still shallow and

relatively inactive. Until quite recently, similar comments could have been made about both Portugal and Turkey. The background paper pointed out that primary markets for publicly listed new equities are active only in Portugal, Jordan, Turkey, and Egypt and, except in Jordan, these markets are small both in terms of the numbers of companies listed and total market capitalization. Secondary markets for equities are limited and typically involve high intermediation costs as well as very large spreads between buying and selling prices (10 percent to 15 percent is not uncommon). Most shares trade on low price-to-earnings ratios, which reflects the narrowness of markets, but obviously discourages active interest in new floatations. The importance of corporate bond issues and markets is somewhat greater in countries such as Portugal that have tried to improve the taxation position of such bonds relative to that of those issued by the government.

Many explanations of this apparent rift between aspirations and achievement exist, and the seminar discussion referred to a number of items. They include the following:

- a limited supply of securities caused, among other things, by the unwillingness of family owned companies to go public, the predominance of state owned enterprises, the high incidence of unprofitable companies, the high costs of issuing and trading, and a general reluctance to disclose information to tax officials and potential competitors;
- a limited demand for securities arising from lack of confidence in the issuer or the regulatory authority, an uneven tax treatment of risk securities, and a concern that in thin markets, the price volatility of securities may be too high and too influenced by insider trading;
- a generally unstable macroeconomic and possibly political climate, producing a category of risks for most business activities additional to those found in more stable economies where capital markets are deep and active;
- inadequacies in accounting and auditing procedures and in information dissemination more generally, that taken together, hinder the establishment of investor confidence and the authorities' ability to protect investors from malpractice.

This list of impediments implies a substantial menu of possible reforms, any of which might be addressed in an effort to speed up the evolution of capital markets. However, most of the discussion in the seminar focused on three main areas of priority. The first is to establish a reasonable degree of macroeconomic stability, especially some stability and predictability about rates of inflation. For reasons explained earlier, financial systems of



whatever type are unlikely to function well when inflation is high, especially if it is also volatile. The arbitrariness of relative price changes in such a situation will discourage the issue of longer-term debt instruments and will certainly discourage the holding of risk securities. Thus, the deeper and longer end of the spectrum of financial instruments will be particularly badly affected by instability and high inflation.

The second priority, which has received substantial attention in both Turkey and Portugal in the past two years, is the removal of the historical inequity in the treatment of different types of financial instruments and institutions as regards taxation and general regulation. It is not uncommon for incomes from investments in corporations to be taxed three times over: through the corporation tax, through a withholding tax on dividends, and then through personal income tax. In Portugal in 1982, for example, economists estimated that a private company would need a pre-tax rate of profit of 81 percent if its equity issues were to compete in terms of post-tax return with treasury bonds, which at that time were yielding 20 percent tax free. This type of fiscal inequity clearly encourages debt and credit relative to equity financing, as indeed does the widespread practice of treating debt interest, but not dividends, as an allowable deduction for the purposes of corporation tax. Paradoxically, efforts to reduce the monetary financing of public deficits and force the government to borrow at closer to market rates of interest has often exacerbated this problem by giving government bond issues tax-exempt yields to get them established. Participants noted that while this practice has certainly deepened financial markets in one way, the distortions against private sector bond and equity issues that it has also introduced nullify many of the benefits normally associated with such a deepening.

By contrast, the nontax aspects of the regulatory environment do not always dispense their biases in the same uniform direction against private capital-market instruments. Participants noted, for example, that reserve requirements normally impinge only on banks and so give some competitive advantage to nonbanks. Similarly, preferential credit systems will raise the cost of credit for the nonpreferred borrowers relative to what they might obtain from nonbank sources. Differential capitalization requirements and credit ceilings may also work in the direction of favoring nonbanks, but deposit insurance will normally work in the opposite direction.

None of these interventions have been introduced intentionally to deter the development of capital markets. They represent a variety of *ad hoc* measures designed to achieve various objectives. But since their incidental impact is for the most part unfavorable to capital markets, policymakers must give priority to ways of scaling down the extent of the inequity to which they give rise. They have usually done this by reducing the fiscal

bias already referred to, and then by providing positive incentives to both issue and hold capital market securities. In the new Turkish arrangements introduced in March 1987, for example, publicly listed companies can qualify for reductions in corporation tax in amounts proportional to the shares held by smaller shareholders. In addition, dividends are now taxed only once, namely, through the corporation tax, and the intermediation costs of new issues have been reduced by lower stamp duties on underwriting agreements. Together with the July 1987 freeing of interest rates on one-year deposits, which compete with corporate bond issues, the freedom of security markets is significantly improved. Similar institutional reforms have taken place in Portugal within the past year and the volume of new issue activity, at least in corporate bonds, has increased significantly as a consequence.

The third priority area concerns the steps necessary to turn the well-defined theoretical advantages of greater competition in financial markets into practical institutional reality. This in turn can be discussed by reference to the three well-established theoretical advantages of competitive markets, namely, freedom of entry and exit, a large number of buyers and sellers, and perfect knowledge and information. These conditions are unlikely to exist in their theoretical purity in any real world market, especially in a developing country, but they do provide a benchmark against which to assess actual performance.

The issues of freedom of entry and exit are intimately connected. If the authorities can easily accept the demise of existing financial institutions, then they can also adopt a very open attitude toward new entry. The reality is very different. For exactly the same reasons in the United States, Turkey, Portugal, and elsewhere, the authorities will almost certainly prevent the failure of a large bank. But whereas a large, diversified banking system with 140,000 banks, such as in the United States, can accept complete freedom of new entry without increasing the dangers to existing banks, this is not possible in smaller countries, such as Turkey and Portugal, with highly concentrated banking systems. Thus, in these countries, the practical step required to allow freedom of entry without the ambivalence it experienced in Portugal is to clean the balance sheets of the existing banks to ensure that they can survive in reasonably open competition with newcomers. This requires recourse to some of the measures already described. The only alternative to this is to allow free entry, but then fetter the competition. Clearly this would negate many of the supposed benefits of greater competition.

As far as the numbers of buyers and sellers in the market is concerned, the experiences of Egypt and Jordan cited earlier suggest that a large number of participants in the market is no guarantee of the market's orderliness and

stability. Instead, it may be better to settle for a situation in which no singular participant or colluding group of participants could affect the market. The present situation in Turkey, where one shareholder controls 70 percent of the shares of 44 out of 164 publicly listed companies, hardly represents an acceptable competitive market for the remaining 30 percent shareholding in these companies. Participants argued that the practical steps needed to redress this and similar situations involve at least two types of measures. The first would be the fiscal measures already described to encourage greater holdings of capital market instruments, and the second is the improvement in accounting, regulatory, and supervisory frameworks to provide better protection to minority shareholders. There may, however, be an inherent contradiction in trying to promote larger numbers of participants in the banking sector where operational policy and scale economies will inevitably tip practice toward fewer and larger units. Thus greater competition as evidenced by larger numbers of participants may be a temporary, disequilibrium phenomenon to be replaced inevitably by a substantially increased concentration. The longer-term situation in the Egyptian banking sector seems likely to head in this direction. By implication, practical measures to actively promote competition ought to focus on nonbank financial activities where the longer-term equilibrium may be characterized by a greater number of participants than now exist.

The final condition pertaining to the degree of competition is that concerned with information. Participants noted that at present, the dissemination of information about company performance to both existing and potential investors in these companies is generally extremely poor in the EMENA countries compared with the position in the major Western capital markets. They suggested that at least two types of action are needed to change this. First, the legal requirements on accounting standards, and the disclosure of relevant information in share prospectuses and company reports and the associated penalties, must be significantly tightened. Second, and probably as a prior step to the first, serious attention needs to be given to incentives to disseminate relevant information. If, for example, profits are taxed at far too high a rate or the tax rules give insufficient attention to the need to revalue assets before calculating depreciation charges, then many otherwise honest and sound companies will understate their profits. Similarly, if being a public company is likely to mean in practice, if not in law, that tax liabilities will be higher, then many companies will refrain from going public. In most countries, these issues of the incentives to give out information do not command nearly enough attention. A final and more difficult problem to solve arises from the fact that there may be economies of scale in information dissemination. Participants noted, for example, that in well-functioning stock markets,

much of the best information comes not directly from the listed companies themselves, but from brokers and advisors, whose efforts to assemble this information are justified by the large number of clients to whom they can distribute it. Similarly, specialized investment newspapers and magazines can exist because they have thousands or even millions of subscribers. It may follow from this that new and embryonic securities markets such as those in the EMENA countries will not attain great depth and reliability of information, despite the two reforms proposed, until they realize the critical size at which these economies of scale can be to be attained.

### **Conclusions**

Although the degree of competition amongst banks in developing countries is weak, many pitfalls are involved in trying to enhance competition. In countries that allow a reasonable freedom of entry of new banks, for example, Egypt, there is some evidence that if the regulatory and other constraints on the new entrants are relatively lax, then increased competition may be achieved at the expense of a significant decline in banking standards. In these cases, the increased competition associated with an enlarged number of participants may be a short term disequilibrium phenomenon to be replaced by a subsequent lessening of competition as unsound banks eventually collapse. In other cases where certain limitations on the freedom of entry are maintained, the explanation may lie in the unsound condition of established banks and the authorities' concern that increased competition will merely convert an incipient crisis into an open financial crisis as some of these banks collapse. In these cases, the precondition for enhanced competition in the banking sector will involve a systematic program to restructure the financial situations of the existing banks and their clients.

Where the limitation on competition is associated with the existence of specialized banking institutions with monopoly positions in certain classes of business, the obvious solution of moving rapidly to universal banking is itself subject to certain limitations. In particular, the need for specialized investment banks may be associated with the absence of well-functioning equity and bond markets. Thus, the establishment of these markets may need to precede any major moves toward universal banking. Such moves are also constrained by the substantially more sophisticated arrangements needed to regulate universal banks. In general, therefore, participants felt that a gradualist approach in which each category of bank makes marginal adjustments in the scope of its operations was preferable to any radical program to legislate away existing specializations.

In relation to the second issue discussed in this chapter, most participants agreed that strong money and capital markets have the potential to deepen

the financial system and dampen financial instability, which many participating countries had experienced in the past. The practical steps to achieve this deepening were, however, acknowledged to involve a complex agenda of reforms, many of which would be difficult to implement. The three main priority areas were the need for improved macroeconomic stability, especially for low inflation; the removal of gross inequities in the fiscal treatment of capital market instruments; and various measures, such as improved information systems, to provide the conditions conducive to a high degree of competition. The recent experiences of both Portugal and Turkey suggest that significant progress can be made on the second of these issues if the government is committed to doing so. The issue of competition and information, however, presents substantially more difficulties. An environment favorable to expanded use of capital market instruments requires improved legal requirements on accounting standards and information disclosure more generally, and substantial changes in the incentives that companies have to disseminate relevant information to potential and actual investors. Most difficult of all, it may require a certain minimum scale of operations before the richness of the information provided comes anywhere near to matching that found in those developed economies where capital markets operate successfully.

## Annex A

### List of Papers Presented at the Seminar

*Most of these papers are available as informal Working Papers published by the Institute.*

Professor W. Baka, President, National Bank of Poland, *Poland Economic and Banking Reform*, Istanbul, Turkey, July 7, 1987

Millard Long, Division Chief, Industry Department, Financial Development Division, World Bank, *Crisis in the Financial Sector*, May 1987, Washington

Paul A. Popiel, Senior Financial Economist, Economic Development Institute of the World Bank, *Development of Money and Capital Markets*, May 1987, Washington

Dr. Rusdu Saracoglu, Deputy Governor, Central Bank of the Republic of Turkey, *Economic Stabilization and Structural Adjustment, the Case of Turkey*, February 1987

Dr. Mohammed Skhiri, Governor, Central Bank of Tunisia, *Internal and External Imbalances and Adjustment Policies, the Case of Tunisia*, Istanbul, Turkey, July 7, 1987

Dr. J. da Silva Lopes, *Reform of the Financial Sector Policies in the Countries of Europe, Middle East and North Africa*, Lisbon, June 10, 1987

Professor Dr. Ismail Turk, Chairman, Capital Market Board of Turkey, *Comment on Mr. Paul A. Popiel's Paper*, Istanbul, Turkey, June 1987

Professor Robert Vogel, *Issues for Financial Institutions*, Miami, USA, May 1987

## **Annex B**

### **List of Participants**

#### **Egypt**

Mr. Mamdouh Moussa Habsa  
Deputy Manager  
Research Department

Mr. Al-Motaz Mansour  
Managing Director  
Misr-Iran Development Bank

#### **Hungary**

Ms. Edene Bako  
General Manager  
Economics Department  
National Bank of Hungary

Mr. Istvan Kollarik  
General Manager  
Ministry of Finance

#### **Jordan**

Mr. Ziyad Annab  
General Manager  
Industrial Development Bank of  
Jordan

#### **Poland**

Mr. W. Baka  
World Bank Governor and President  
National Bank of Poland

Mr. Andrzej Dorosz  
Deputy Minister  
Ministry of Finance

Mr. Grzegorz Wojtowicz  
Director, Foreign Department  
National Bank of Poland

#### **Portugal**

Ms. Theodora Cardoso  
Director, Foreign Department  
National Bank of Poland

Mr. Jose Cardoso da Silva  
Member of Managing Board  
Banco Pinto e Sotto Mayor

#### **Tunisia**

Mr. Chekib Nouira  
Directeur General  
Banque de Développement  
Economique

Mr. Mohamed Skhiri  
Gouverneur  
Banque Centrale de Tunisie

Mr. Rachid El Hakim  
Director of Studies  
Banque Centrale de Tunisie

#### **Turkey**

Mr. Yavuz Canevi  
Undersecretary of Treasury  
and Foreign Trade

Mr. Ozhan Eroguz  
General Manager  
Industrial Bank of Turkey

**Mr. Zeki Kiy**  
Undersecretariat of Treasury  
and Foreign Trade

**Mr. Ali Kocaturk**  
Director General of Banking  
and Foreign Exchange  
Undersecretariat for Treasury  
and Foreign Trade

**Mr. Unal Korukcu**  
Executive General Manager  
Turkiye Is Bankasi, A.S.

**Mr. Rusdu Saracoglu**  
Deputy Governor  
Central Bank of Turkey

**Dr. Ismail Turk**  
Chairman  
Capital Market Board  
of Turkey

#### **Observers from Turkey**

**Mr. Yasar Akgun**  
Treasury Controller  
Undersecretariat of Treasury  
and Foreign Trade

**Mr. Hayati Ecer**  
Sworn Bank Auditor  
Undersecretariat of Treasury

**Mr. Melek Kayacan**  
Assistant Expert  
Undersecretariat of Treasury  
and Foreign Trade

**Mr. Levent Tekin**  
Expert  
Undersecretariat of Treasury  
and Foreign Trade

#### **International Investment Bankers**

**Dr. Eric Hayden**  
Managing Director  
Bank of Boston

**Mr. Hani Findakly**  
Senior Vice President  
Drexel Burnham Lambert

**Mr. Sykes Wilford**  
Drexel Burnham Lambert

#### **Observer**

**Mr. Alan Roe**  
Department of Economics  
University of Warwick

#### **Moderator**

**Mr. J. da Silva Lopes**  
Financial Consultant  
Caixa Geral de Depositos

#### **World Bank**

**Mr. Jacques Coudol**  
Deputy Division Chief,  
Industrial Development and  
Finance Division

**Mr. James A. Hanson**  
Senior Economist

**Mr. Parvez Hasan**  
Chief Economist

**Mr. Manuel E. Hinds**  
Senior Financial Economist

**Mr. Millard F. Long**  
Chief, Financial Policy and  
Systems Division



Mr. George C. Zaidan  
Project Advisor, Office  
of the Director  
Country Department IV

**EDI**

Mr. Sidney E. Chernick  
Adviser, Senior Policy Seminars

Mr. Paul A. Popiel  
Senior Financial Economist

Mr. Gerrit B.H. Renger  
Chief, Finance, Industry and  
Energy Division

Mr. Jayanta Roy  
Principal Training Officer

Policy Seminar Reports numbers 1 through 7 are available from the Economic Development Institute of the World Bank, 1818 H Street, N.W., Washington, D.C. 20433, attention: Ms. Edith A. Pena.

- 1 *Transport Policies in Francophone Sub-Saharan Africa: Issues and Options*. Hernán Levy. EDI Catalog no. 705/016.
- 1F *Les politiques de transport en Afrique francophone au sud du Sahara: Problèmes et choix*. Hernán Levy. EDI Catalog no. 705/016.
- 2 *Food Policy Seminar*. J. Price Gittinger. EDI Catalog no. 505/003.
- 3 *Agricultural Policy and Its Relationship to Food Policy in Sub-Saharan Africa*. Sakwa Bunyasi. EDI Catalog no. 070/001.
- 3F *La politique agricole et ses rapports avec la politique alimentaire en Afrique subsaharienne*. Sakwa Bunyasi. EDI Catalog no. 070/001.
- 4 *Development Policy Analysis*. David G. Davies. EDI Catalog no. 420/043.
- 5 *Management Training and Research for African Development*. J. Price Gittinger. EDI Catalog no. 430/008.

5F *La formation et la recherche en gestion pour le développement de l'Afrique*. J. Price Gittinger. EDI Catalog no. 430/008.

6 *Land and Water Resources Management*. Jacques J. Kozub, Norman Meyers, and Emmanuel D'Silva. EDI Catalog no. 070/003.

7 *Export Policies and Administration*. Randi B. Greenblatt with Joaquin A. Cottani and Domingo F. Cavallo. EDI Catalog no. 400/047.

The following titles may be purchased from the Publications Sales Unit, World Bank, 1818 H Street, N.W., Washington, D.C. 20433.

8 *The Political Economy of Reform in Sub-Saharan Africa*. Ravi Gulhati.

9 *Transport Policy Issues in Sub-Saharan Africa*. Hernán Levy and Patrick O. Malone.

10 *Políticas de Transporte en América Latina*. Hernán Levy.





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EDI Policy Seminar Reports make available summaries of EDI policy seminars that are of particular interest and importance to readers concerned with public affairs. The reports seek to convey the essence of the discussions and to bring out the principal areas of agreement or disagreement among the participants, who represent a wide range of governmental, academic, and professional backgrounds.

#### WORLD BANK PUBLICATIONS OF RELATED INTEREST

**The Alleviation of Poverty under Structural Adjustment.**

Lionel Demery and Tony Addison. In English and German.

**Public Expenditure in Latin America: Effects on Poverty.**

Guy P. Pfeffermann. World Bank Discussion Paper 5.

**Macroeconomic Policies and Adjustment in Yugoslavia: Some Counterfactual Simulations.**

Fahrettin Yagci and Steven Kamin. World Bank Discussion Paper 16.

**International Financial Flows to Brazil since the Late 1960s: Analysis of Debt Expansion and Payments Problems.**

Paulo Nogueira Batista, Jr. World Bank Discussion Paper 7.

**Macroeconomic Policies, Debt Accumulation, and Adjustment in Brazil, 1965-84.**

Celso Martone. World Bank Discussion Paper 8.

**Structural Adjustment in Lowinca: A Case Exercise in Economic Policy Analysis.**

Paul G. Clark and others. EDI Development Policy Case Series, Teaching Case 1.

**International Debt and the Developing Countries.**

Gordon W. Smith and John T. Cuddington, editors.

**Poland: Reform, Adjustment, and Growth.**

Volume 1: The Main Report, The Economic System.

Volume 2: Reports on the Principal Sectors.

**Structural Change and Development Policy.**

Hollis Chenery. Oxford University Press. In English, French, and Spanish.

**The Open Economy: Tools for Policymakers in Developing Countries.**

Rudiger Dornbusch and F. Leslie C. H. Helmers, editors. Oxford University Press.