ECONOMIC AND SOCIAL COMMISSION FOR WESTERN ASIA

DEVELOPMENT AND INSTITUTIONAL REFORM OF FINANCIAL MARKETS: ISSUES AND POLICY OPTIONS FOR THE ESCWA REGION

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ABBREVIATIONS AND EXPLANATORY NOTES

CAR	capital adequacy ratio
FDI	foreign direct investment
ICT	information and communications technology
IMF	International Monetary Fund
GCC	Gulf Cooperation Council
GDP	gross domestic product
GNP	gross national product
MDEs	more diversified economies
MPI	macroprudential indicators
NPL	non-performing loans
OECD	Organization for Economic Cooperation and Development
ROA	return on assets
ROE	return on equity
WTO	World Trade Organization
¥	yen

Two dots (..) indicate that data are not available or are not separately reported.

References to dollars ($) indicate United States dollars, unless otherwise stated.

I. INTRODUCTION

In recent years, the vital link between the strength of financial markets and economic growth has received increasing attention. Numerous theoretical and empirical studies provide ample evidence to support the important role of financial markets in economic growth. Efficient financial markets mobilize domestic and foreign resources, and allocate them to productive and profitable investment projects and programmes. In this regard, the more productive the investment is the higher the rate of economic growth. Efficient financial markets also contribute to economic growth by pooling risks, improving corporate governance by enforcing market discipline, and facilitating transactions.

It is only in recent years that the importance of money and finance with regard to economic growth has gained serious recognition. During the heydays of the Keynesian forced-saving school in the 1950s and 1960s,[1] the crucial role of these factors in facilitating economic growth was largely overlooked.[2] During this period, the majority of developing countries pursued a policy of financial repression that was characterized by low nominal interest rates and high inflation, resulting in very low or negative real interest rates, which have been cited as the major cause of financial underdevelopment. In the 1970s, particularly through the influence of two seminal works, the dominance of the financial repression school started to recede;[3] since then, the primacy of financial liberalization and financial sector reforms as a means of spurring economic growth has attracted an increasing amount of attention from both economists and policy makers.

More importantly, financial liberalization, accompanied by phenomenal advances in information and communications technology (ICT) over the past two decades, has accelerated the integration of global financial markets, intensified competition, and markedly enhanced the efficiency of the global financial system. However, the global financial system has become increasingly fragile and unstable, and at the same time developing countries have become increasingly vulnerable to external shocks emanating from global financial instability. For example, the rapid succession of recent financial crises, including Black Monday, 19 October 1987, which saw a worldwide stock market plummet; the Mexican Peso or Tequila crisis in 1994-1995; the Asian currency and financial meltdowns in 1997, which sent shock waves through Latin America and the Russian Federation; and the decade-long banking crisis and economic stagnation in Japan are still vivid today. Each financial crisis, prompted by global financial integration, buffeted various economic agents, particularly banks and enterprises, and their financing mechanisms. Numerous banks and firms have closed, and many others have been forced to restructure to survive. In conclusion, in the present highly unstable and uncertain global financial environment, building sound and efficient financial markets and institutions that are buttressed by a solid regulatory and supervisory mechanism is generally considered as a sine qua non for forestalling financial instability and economic crisis, and sustaining economic growth.

A. The ESCWA region as a small open economy

The primary objective of this study is to analyse conceptual and practical issues related to developing sound and efficient financial markets and institutions in the Economic and Social Commission for Western Asia (ESCWA) region as an integral component of overall economic development, and to articulate policy options for developing and strengthening the financial sector in the region. This study is based on the assumption that the ESCWA region is a small open economy. In conventional economic analysis, the term ‘small open economy’ refers to an economy whose foreign trade—that is, exports and imports of goods and services including financial services—accounts for an insignificant portion of total world income, and also to the fact that changes in imports and exports do not have any appreciable effect on total world expenditure. Therefore, imports are considered as leakage, while exports are exogenously given on the premise that they depend on events that occur in the rest of the world. This can be contrasted with the example of a large open

[1] Forced savings are the result of a situation in which finance enables investments to be greater than savings; and where subsequently, both investment and consumption have the potential to exceed actual output.

[2] Anand Chandavarkar, “Of finance and development: neglected and unsettled questions”, *World Development*, Vol. 20, No. 1, (Great Britain, Pergamon Press, 1992), pp. 133-142.

[3] Ronald I. McKinnon, *Money and Capital in Economic Development*, (Washington D.C., Brookings Institution, 1973) and Edward S. Shaw, *Financial Deepening in Economic Development*, (New York, Oxford University Press, 1973).

economy, where foreign trade claims a considerable share of world income, and where it is necessary to consider economic repercussion or interdependence in terms of the rest of the world, therefore necessitating a more complicated analysis. For example, economic changes, including an investment boom, recession or a sharp rise in oil prices stemming from energy shortages in a large economy are bound to influence the economies of other regions, including the ESCWA region. However, similar changes in the economic activities of a small open economy, including those of countries in the ESCWA region are likely to have an insignificant effect on other economies.

The assumption of a small open economy means that it is possible to disregard the external foreign income repercussion of a change in domestic economic activity, which simplifies economic analysis. Such an assumption with regard to the ESCWA region seems to be justified on the basis that the shares of the region of world totals for most variables, are negligible. The region's world share of selected real economic variables, including gross domestic product (GDP), population, labour force, imports and exports all amounted to equal to or less than 3 per cent of world totals. The shares of the region in terms of financial variables were equally insignificant, reflecting the general underdevelopment of local financial markets and institutions. Indeed, the region's world shares of bank assets, stock-market capitalization and market values of bonds in 2000 were all estimated at less than 2.5 per cent. In particular, foreign direct investment (FDI) flows into the ESCWA region registered a tiny world share of approximately 0.04 per cent (see table 1).

The strikingly small shares of the region of global production, trade and finance, imply that the economies in the ESCWA region, as a whole, have not been integrated into the global economic system (see table 1). Indeed, they have been sidelined, and operate as a bystander, rather than a major active participant in global economic integration. This means that economic changes in the region are likely to have little effect on the rest of the world, while at the same time, local economies are highly sensitive and vulnerable to external shocks from outside the region, for example, a sharp rise in oil prices or a sudden massive inflow of short-term speculative capitals or global recession. The major thrust of this study is that the development of sound and efficient financial markets and institutions, particularly the banking sector, is an indispensable strategy for economic survival and is a means of sustaining economic growth in the present turbulent and unstable global financial environment, which has resulted from the rapid liberalization and integration of global financial and capital markets in recent decades.

Table 1. Selected economic indicators for the ESCWA region and the World economy, 2000

Variable	ESCWA	World	ESCWA/World (per cent)
GDP (billions of US dollars)[a]	382	31 492	1.21
Population (millions)[a]	159	6 057	2.63
Labour force (millions)[a]	54	2 943	1.86
Exports (millions of US dollars)[b]	179 541	6 338 198	3
Imports (millions of US dollars)[b]	119 862	6 510 806	2
Foreign direct investment inflows (millions of US dollars)[c]	666	1 491 134	0.04
Savings (billions of US dollars)[d]	104	31 350	0.03
Bank assets (trillions of US dollars)[e]	0.5	20	2.5
Market capitalization (trillions of US dollars)[e]	0.18	10	1.8
Market value of bonds (trillions of US dollars)[e]	0.12	10	1.2

Source: Compiled by ESCWA from various sources.

a/ World Bank, World Development Indicators 2002. Available at: http://www.worldbank.org/data/wdi2002/.

b/ United Nations Conference on Trade and Development (UNCTAD), *UNCTAD Handbook of Statistics 2002* (TD/STAT/27).

c/ UNCTAD, *World Investment Report 2002*, (UNCTAD/WIR/2002).

d/ ESCWA estimates.

e/ International Monetary Fund and Bank for International Settlements.

B. GLOBAL PERSPECTIVES ON THE DEVELOPMENT OF FINANCIAL MARKETS AND LESSONS OF THE 1997-1998 ASIAN FINANCIAL CRISIS

This section provides cogent reasons as to why the developing countries, in general, and those in the ESCWA region, in particular, must develop and strengthen sound and efficient financial markets and institutions in the present highly volatile and unstable global financial system, and highlights lessons from the recent Asian financial crisis. Rapid integration of global financial markets during the past two decades has been spurred by the twin liberalization of financial and capital markets coupled with dramatic advances in ICT. Extensive deregulation of domestic financial markets and liberalization of financial services has resulted in the intensification of competition and a substantial reduction in the profitability of financial intermediaries, particularly banks. As a result, many banking failures and crises have occurred in a number of countries over the past decades.

However, technological advances in communications and information systems in recent years have significantly enhanced the capacity of financial intermediaries, and enabled them to take advantage of the greater opportunities offered by more liberalized environments, blurred demarcation lines between different types of financial services in different countries, and lowered official barriers to international capital flows. Phenomenal advances in ICT have reduced the costs of international financial transactions and at the same time accelerated the speed and quantity of cross-border transactions. The globalization of financial markets is deemed to be a major factor in the enormous increase of global financial flows, which grew from approximately $300 billion per day in the early 1990s to over $3.5 trillion per day in 1999. In fact, the volume of international finance and capital movements has far outpaced world output and international trade. For example, more than $1.5 trillion worth of foreign exchanges were traded every day in 1997, which can be compared to the daily world output in that year, which was estimated at some $82 billion, and daily world exports of $16 billion.[4]

The globalization of financial markets has opened a new window of opportunity and also generated new risks for many developing countries, including those in the ESCWA region. The integration of global financial markets has permitted certain developing countries, particularly those in East Asia, to mobilize resources unencumbered by domestic saving constraints from external sources, to accelerate their investments and economic growth. In other words, the globalization of financial markets has created a more efficient mechanism for generating savings and allocating investments on a global scale. It must also be noted, however, that financial globalization has also given rise to tremendous risks of financial instability and economic crisis, which are often primarily caused by footloose volatile movements of enormous sums of international capital, particularly short-term speculative capital flows. The magnitude of short-term capital flows actually overwhelms the capacity of national monetary and fiscal policies to mitigate the adverse effects of such capital flows. Under such circumstances, many developing countries with inefficient financial markets and weak financial institutions are left in the lurch, pushed to the brink of a financial meltdown and subsequent economic collapse in the wake of a relentless onslaught of international capital flows. The financial calamity caused by short-term international capital movements was evident in the 1997-1998 Asian financial crisis,[5] which can be used as an example to help forestall the occurrence of a similar crisis in the ESCWA region.

In July 1997, the Asian currency crisis and financial turmoil of catastrophic proportions erupted in Thailand and rapidly spread to neighbouring countries, namely, Indonesia, Malaysia, the Philippines and the Republic of South Korea, and into other emerging markets like Brazil and the Russian Federation. As a result, the currency and stock markets in these Asian economies plummeted by some 30-50 per cent in the short span of six months, from July to December 1997. All of these countries suffered unprecedented sharp falls during this period, which can be compared to decades of remarkable economic growth, and which

[4] Nayyar Deepak, “Globalization and development strategies”, a paper prepared for the United Nations Conference on Trade and Development High-level Round Table on Trade and Development: Directions for the Twenty-first Century, held in Bangkok, 12 February 2000, (1999), (TD(X)/RT.1/4).

[5] For a comprehensive bibliography on this topic, see the references in Morris Goldstein, *The Asian Financial Crisis; Causes, Cures and Systemic Implications*, (Washington D.C., Institute for International Economics, 1998).

ended in a deep freeze with negative growth rates of 5-10 per cent.[6] This was an abrupt reversal, and it destroyed the much-touted Asian economic miracle. It is also worth noting that these Asian countries had not only sustained a decade of enviable and rapid economic growth, they had also maintained sound and strong economic fundamentals, as highlighted by macroeconomic indicators related to inflation, unemployment and government deficits, despite the fact that in most cases, shallow financial markets and fragile financial institutions were in place. This implies that a strong macroeconomic environment alone, without the buttress of a strong financial sector, cannot shield an economy from a financial crisis triggered by deregulated free international capital flows.

In fact, as in any economic crisis, the Asian crisis was not dominated by a few isolated factors, but was rather characterized by interrelated multiple origins. In this context, contributing factors can be roughly classified as having domestic and foreign origins. The domestic factors leading to the crisis included misaligned real exchange rates and in particular, the pegging of exchange rates to the United States dollar; corruption and cronyism; excessive investments, often in unproductive and speculative sectors, for example, real estate and stock markets; inordinate investment projects under explicit or implicit Government guarantees and subsidies leading to unsustainably high levels of current account imbalances; lack of transparency in business and financial transactions; inadequate regulatory and supervisory infrastructure for financial intermediaries; and inordinate borrowing from foreign sources, and the consequent rapid accumulation of foreign debt, particularly bank-related unhedged short-term foreign debt.

The major foreign factors included tremendous external pressures on the capital account convertibility coupled with financial liberalization in Asia and Latin America during the 1990s; the reckless behaviour of international banks, which had extended huge amounts of funds to these regions; lengthy economic stagnation in Japan since the beginning of the 1990s up to the present, which contributed to the export slowdowns of Asian countries to Japan; the sharp appreciation of the dollar against the yen and the euro since the second half of 1995, which eroded the export competitiveness of the dollar-pegged Asian countries; and finally the so-called China factor, namely the rapidly growing share of China in terms of FDI, production and total exports from Asia.

In addition to the internal and external factors cited above, there is a growing consensus that massive short-term capital inflows and the consequent excessive build-up of short-term liabilities relative to international reserves rendered these economies extremely vulnerable to sudden capital outflows. For example, net private capital inflows into five Asian countries, namely, Indonesia, Malaysia, the Philippines, Republic of Korea and Thailand in 1996 amounted to $93 billion. Only one year later, these economies suffered a sharp reversal of a net outflow of $12.1 billion, with an astonishing gross outflow in a single year of $105 billion, which is comparable to more than 10 per cent of the combined GDP of the five countries.[7] As a result, three of these economies, namely Indonesia, Republic of Korea and Thailand, went into a tailspin, suffering financial meltdowns and deep economic recession. Thus, volatile and sudden gigantic short-term capital flows in and out of these emerging markets were dominant causes of the recent crisis.[8] Developing countries have become increasingly vulnerable to these short-term capital flows as a result of weak and fragile banking sectors and financial markets. In most cases, financial liberalization has failed to achieve the objective of building a sound and efficient financial sector. What is even worse is that financial markets have become extremely fragile and fragmented, owing to the fact that the twin liberalization of capital and financial markets preceded the necessary regulatory and supervisory infrastructure for financial intermediaries, which should have been put into place and strengthened before liberalization.

[6] See, for example, Se-Hark Park, “Conceptual and practical issues in banking regulation and supervision in developing countries with special reference to Asia”, *Economia*, Vol. 52, No. 1, (May 2001), pp. 9-37.

[7] Morris Goldstein, *The Asian Financial Crisis; Causes, Cures and Systemic Implications*, (Washington D.C., Institute for International Economics, 1998).

[8] Sebastian Edwards, “How effective are capital controls?”, *Journal of Economic Perspectives*, Vol. 13, No. 4, (Autumn 1999), pp. 65-84.

The fundamental weaknesses of the financial structure in developing countries manifest themselves in many different forms, and include the absence of prudential supervision; primitive regulatory structures for financial intermediaries, and even outright corrupt lending practices; inadequate bank capital; acute shortages of regulatory expertise; and non-market criteria for project selection and credit allocation, including Government and policy-directed lending, and the absence of sound deposit insurance schemes, all of which contribute to the rapid accumulation of non-performing loans (NPLs) or bad loans and the resultant banking crises in these countries.

In recent years, research has focused on various ways of reducing financial instability in developing countries, including controlling short-term capital flows at the national level,[9] and a grandiose scheme to build a new international financial architecture.[10] Developing and strengthening sound and efficient financial sectors whilst ensuring that effective regulatory and prudential supervision machinery is in place is undoubtedly an effective means of enhancing financial stability, and a necessary survival strategy in the present unstable global financial system.

C. A STYLIZED EXPLANATION OF A BOOM-BUST CYCLE OF SHORT-TERM CAPITAL FLOWS INTO DEVELOPING COUNTRIES

This section provides a stylized explanation of how sudden large capital flows into a developing country, particularly into a small open economy, have the ability to cause a financial and economic crisis. The simple model presented below has the potential to explain, reasonably well, what happened in the 1997 Asian financial crises, underscoring the risk related to liberalizing capital markets when a prerequisite institutional framework for effective regulation and prudential supervision of financial intermediaries has not been firmly established. More importantly, the model also provides a useful conceptual framework for analyzing and even predicting potential scenarios in the ESCWA region in the event that it is faced with a similar threat of massive speculative short-term capital flows. In addition, it suggests preventive policy measures to forestall a possible financial crisis prompted by inappropriate financial sector reforms.

In the context of fully liberalized financial and capital markets, appreciable return differentials, net of risk premiums between domestic interest rates (i^d) and foreign interest rates (i^f) induce, all things being equal, large-scale capital inflows, where the size of capital flows is defined relative to the gross national product (GNP). In the absence of central bank intervention, for example, sterilization, such capital inflows increase money supply, lower domestic interest rates, and therefore expand credit creation in the banking sector, by widening excess liquidity. Excess liquidity, in turn, stimulates private investment, particularly speculative investment, in such sectors as property and stock markets, thereby widening the private investment and domestic savings gap. Moreover, excess speculative investments often lead to asset and property price escalation, namely, a bubble economy. At the same time, the widening private investment-savings gap becomes an important cause of worsening current account deficits. It must also be noted that sudden massive capital inflows result in the appreciation of the real exchange rate of the domestic currency and erode the export competitiveness of the recipient economy. A consequent decline in exports, coupled with increasing imports, also contributes to the deterioration of the trade account deficit, which, other things being equal, could pull the current account in the same direction. This is a typical case of ‘Dutch disease’.[11]

Eventually, worsening current account deficits reach a critical point where foreign investors push a panic button and massive capital outflows ensue. The consequences of the reversal of capital flows are usually catastrophic in proportion, as was the case in the recent Asian crisis. The currency meltdown in the form of a sharp depreciation of the domestic currency follows abrupt capital outflows and this in turn leads to the insolvency and bankruptcy of enterprises that borrowed heavily in foreign currencies through the intermediation of the domestic banking sector, for example, the Bangkok International Banking Facility. The failure of domestic enterprises sees a sharp increase in the non-performing assets of banks, namely, bad

[9] Ibid.

[10] Dani Rodrick, “Who needs capital-account convertibility?”, *Essay in International Finance*, Peter Kenen (ed.), (1998).

[11] This is when the discovery of natural resources deindustrializes the economy of a country, and where the rising value of a country’s currency decreases exports, increases imports and reduces productivity.

loans, which means that banks are then saddled with heavy foreign currency-denominated debts. The banking crisis then leads to a generalized economic crisis, and to widespread unemployment and deepening recession. This is a typical scenario of a boom-and-bust cycle.

With the objective of maintaining a stable exchange rate and thus preventing this boom-and-bust cycle, monetary authorities often intervene in the money market, through the process of sterilization, to offset the increase in money supply induced by capital inflows through a number of monetary instruments, including sales of government securities in open market operation. This assumes, of course, the existence of a fairly sophisticated capital market for government securities. However, such a sterilization operation could raise domestic interest rates steeply, thus attracting continuous capital inflows, while greatly depressing domestic investments and spending. In short, this is a no-win situation (see figure).

Figure. Boom-bust cycle of short-term capital flows in developing countries

1. Assuming a pegged exchange rate, free financial and capital markets, and without sterilization:

$\Delta(i^d - i^f)\uparrow\rightarrow$ capital inflows $\uparrow\rightarrow$ $M^s\uparrow\rightarrow$ $i^d\downarrow\rightarrow$ bank lending (excess liquidity) $\uparrow\rightarrow$ $\Delta(I-S)\downarrow\rightarrow$ speculative $I\uparrow\rightarrow$ bubble
$\downarrow\rightarrow$ real exchange rates $\downarrow\rightarrow$ exports $\downarrow\rightarrow$ current account deficits $\downarrow\rightarrow$
capital outflows $\uparrow\rightarrow$ exchange rates $\downarrow\rightarrow$ business debt burden $\uparrow\rightarrow$ business bankruptcy $\uparrow\rightarrow$
banks' bad debts $\uparrow\rightarrow$ generalized financial and economic crisis

2. The same conditions as above, with sterilization:

$\Delta(i^d - i^f)\uparrow\rightarrow$ capital inflows $\uparrow\rightarrow$ sterilization (e.g. sales of government securities) $\rightarrow$ i^d $\uparrow\rightarrow$ capital inflows $\uparrow$
$\downarrow$
investment and output $\downarrow\rightarrow$ recession

i^d : domestic interest rates
i^f : foreign interest rates
M^s : money supply
I : investment
S : savings

D. PROBLEMS INHERENT IN THE FINANCIAL SECTOR: INFORMATION ASYMMETRY, ADVERSE SELECTION AND MORAL HAZARD

The risky nature of banking is discussed in this section. However, given that this problem is equally relevant to other financial areas, including insurance, investment trust, and bond and equity markets, the example of the banking sector can be used to illustrate the particular problems facing financial markets in general.

In this context, a bank accepts deposits that it has to pay back on demand any time, and lends the deposits to enterprises or individuals over a fixed-time frame, namely, borrowing short and lending long with a high risk of a run on the bank. The fragility of banking and consequent financial market instability as characterized by asymmetric information, adverse selection and moral hazard has been extensively discussed in a number of studies.[12]

For the purposes of this study, it has been assumed that there are no financial market distortions, for example, financial repression and direct government interventions with regard to credit allocation, which were commonly practiced in many developing countries, and even in Japan during its post-war rapid economic growth period in the 1950s and 1960s. Non-performing loan problems and consequent financial instability can occur even in such a distortion-free market as a result of problems inherent in financial transactions, namely, asymmetric information, adverse selection and moral hazard. The asymmetric information problem arises because banks or lenders have less accurate information than borrowers regarding the potential returns and risks related to the projects of borrowers. Another asymmetric information problem can occur when depositors lack information concerning the quality of bank assets, which may become a cause for bank panics.

The first type of asymmetric information can lead to adverse selection, which is a situation where in the absence of adequate information about a borrower, a lower quality borrower with a higher credit risk is the one finally selected for a loan. Moreover, this adverse selection can give rise to what is called moral hazard on the part of the borrower. Borrowers are inclined to engage in highly risky activities. When a project succeeds, the borrower gains significant profits. When it fails, a bank bears most of the loss, thus creating a non-performing asset. Therefore, lenders must monitor and supervise the activities of borrowers to minimize the moral hazard problem. However, to prevent a run on a bank resulting from the second type of asymmetric information, namely, the lack of information on the part of the depositor concerning the activities of a bank, a government safety net, for example, a deposit insurance scheme is usually set up. Nevertheless, such a safety net may lead to another type of moral hazard. In the presence of a safety net, depositors are protected when a bank fails, and hence they lose incentives to impose market discipline on banks, by means of threatening deposit withdrawals when banks are suspected of risky activities. Furthermore, when a government safety net is in place, a bank is more likely to take greater risks than in other cases. Even in some developed economies, with relatively sophisticated financial institutions, which is the case in Japan, the disclosure of information regarding firms and banks is severely limited, and is further compounded by a financial structure that is distorted by a long history of interventionist government policies. In such a case, asymmetric information and moral hazard problems magnify the risk of financial instability. Needless to say, the task of designing and implementing effective regulation and prudential supervision of the financial sector to mitigate such problems must be considered as urgent and made a high priority.

[12] Pioneering theoretical works on this subject include Joseph E. Stiglitz and Andrew Weiss, “Credit rationing in markets with imperfect information”, *American Economic Review*, Vol. 71, (1981), pp. 393-410 and “Assymetric information in credit markets and its implications for macro-economics”, *Oxford Economic Papers*, No. 44, (1992), pp. 694-724; and Frederic S. Mishkin, “Prudential supervision: Why is it important and what are the issues?”, NBER working paper series, working paper 7926, (Cambridge, Massachusetts, National Bureau of Economic Research, September 2000). Available at: http://www.nber.org/papers/w7926.

II. FINANCE AND ECONOMIC GROWTH

A. THE FINANCIAL SYSTEM AND FINANCIAL MARKETS

This chapter attempts to define the relationships among various activities in the financial sector to provide a better understanding of the roles of financial markets and institutions in economic growth. Financial sector policy—for example, a policy of financial liberalization versus a policy of financial repression—determines financial structure, which is a combination of two factors: financial institutions, namely, banks, including investment banks, insurance companies, pension funds and mutual funds; and financial markets, for example, money markets, equity markets, bond markets and capital markets. In turn, the kind of financial structure that is developed affects the nature and magnitude of the financial services or financial functions that are offered, including the mobilization of domestic savings, the facilitation of transactions, and the management of risk. In other words, financial intermediaries and markets must be viewed as vehicles for providing financial services. Finally, financial functions or services can affect long-run economic growth by influencing the mobilization of domestic and external resources for investments, while at the same time influencing the optimal allocation of these investment resources. These linkages can be summarized graphically as follows:

Financial policy → financial structure (institutions and markets) → financial functions (financial services) → economic growth

This graphical representation shows that different linkages can be defined at different stages of development; for example, there is a link between financial policy and financial structure, one between financial structure and financial functions or services, and one between financial functions and economic growth. It is important, therefore, to underscore that links between the financial system and economic growth must be examined in the context of the intermediate linkages defined above. For example, if a country pursues a policy of financial repression for development expediency, that policy is likely to contribute to the development of a financial structure characterized by shallow financial markets. Moreover, when financial markets are thin and narrow with the virtual non-existence of capital markets, credit allocation through indirect finance, namely, bank financing as opposed to equity financing of investment projects, becomes the most important financing mechanism, and hence in this case, banks play the predominant role in financial markets. When the role of financial markets in economic growth is analysed, the issue of financial markets in the broader context of the overall working of a financial system can be addressed.

Financial markets are a set of institutional arrangements that provide various growth-enhancing financial services, including facilitating the transfer of funds from those with an excess supply of funds, namely, savers, to those with excess demand for funds, namely, investors. More specifically, financial markets are where claims on financial assets of various types and maturities originate and are traded. In general, financial markets deal with four product types and each of these product types can be further classified into various financial instruments. These are detailed below.[13]

(a) *Equities*

(i) Common stock;
(ii) Preferred stock;
(iii) Warrant.

(b) *Fixed-income securities*

(i) Certain preferred stock;
(ii) Debt obligations, which include the following:

[13] This classification system is based on Thomas H. McInish, *Capital Markets; A Global Perspec*tive, (Blackwell Publishing, 2000).

a. Bonds;
b. Money market instruments.

(c) *Derivatives*

(i) Options;
(ii) Futures;
(iii) Forwards;
(v) Warrants.

(d) *Money*

(i) Currency and money;
(ii) Deposits.

Equities represent capital contributed to a firm that in a legal context, does not have to be repaid, and also limited liabilities: investors lose the amount of investment only. Equities include all types of stock issued by a firm. Shares of common stock represent ownership interest in a firm, and the owners of stock or shareholders are the owners of that firm. By contrast, preferred stock has a higher claim priority than common stock in terms of earnings; however, this priority comes after the other obligations of the firm. A warrant is a security issued by a firm that allows stock to be obtained in that firm or sometimes in another firm, at a specified price for a specified period. Warrants are usually considered to be equities and therefore, the funds raised from the sale of warrants are regarded as part of the capital of the firm.

Fixed-income securities are debt obligations that prescribe the payment of a predetermined sum at a predetermined date. They include a bond, which is a debt instrument issued by firms and various governmental bodies ranging from local Governments and federal Governments to international organizations, for example, the World Bank. A money market instrument is a debt obligation with an initial maturity date of less than one year. In contrast, capital market instruments are financial instruments with an initial maturity of one year or longer. Money market instruments are traded in the money market, whereas bonds, equities and warrants are traded in the capital market.

A derivative is a contractual arrangement that legally binds one party to the contract to transfer the assets, including cash, to the other party during the specified contract period. The derivative contract can entail the transfer of a wide variety of items, including cash payments, financial assets and real commodities, namely, precious metals, agricultural products and industrial commodities. An option is a contractual arrangement for a prescribed period during which one party to the contract acquires the right to receive something for the payment of a fee, for example, the right to purchase common stock at a predetermined price. A future is a contractual arrangement whereby one party to the contract is obligated to deliver a predetermined type and quantity of an asset at a predetermined future date at a predetermined price. A swap is a financial arrangement that permits two parties to exchange one or more periodic payments based on the value or change in the value of the items specified in the contract, for example, interest rates and exchange rates. A forward is the setting of a price, which then remains fixed, for forward dealing, and this occurs when a contract is being established.

Theoretically, money is defined as anything that can be used as a medium of exchange. In practice, money consists of coins and paper currency printed by Governments, and demand deposits or cheques, which are liabilities of the banking sector, and are commonly accepted as a medium of exchange. The trading of money between countries is executed on the foreign exchange market; foreign money that is traded is foreign exchange.

It must also be noted that a wide variety of financial instruments, including stocks, bonds and warrants are initially sold in primary markets, where investment bankers assist in the initial sale of securities. Thereafter, any trading of these securities after the initial sale is regarded as a secondary market transaction. In conclusion, many types of financial institutions operate in a variety of financial markets, and are specialized in the creation and trade of different financial instruments. For example, commercial banks and investment banks engage in the initial offer of stocks and bonds. The banking sector and Governments create money, and affect money supply. Various organized secondary trading arrangements, including foreign exchange markets, facilitate the further circulation of these financial assets, thereby permitting investors to sell their investment. Financial institutions, namely, insurance companies, pension funds and mutual funds, and also banks, facilitate the transfer of financial resources from savers to investors. When financial markets are capable of greater efficiency in mobilizing financial resources and in allocating them to the most productive investments, then economic growth is greater. Therefore, sound financial policy shapes the kind of financial system or financial institutions and financial markets that are conducive to economic growth.

B. THE IMPORTANCE OF A FINANCIAL SYSTEM FOR ECONOMIC GROWTH[14]

The crucial link between finance and economic growth is reviewed in this section; and more specifically, an explanation for why a well-functioning financial system is essential to economic growth is provided. Various characteristics of a well-functioning financial system are also identified. As highlighted above, the type of financial policy affects the kind of financial structure, and the type of financial functions or services that financial intermediaries and financial markets provide affect economic growth. An efficient financial system provides the following essential financial functions or services to firms, households and Governments:

1. An efficient mobilization of savings with liquidity and risk diversification;

2. An efficient allocation of investment resources with a close monitoring of the investment activities of firms and sound corporate governance;

3. Payments and other transaction-facilitating services.

These functions or services are essential to long-run economic growth, based on the fact that they are capable of significantly influencing the propensities of savings and affecting investment activities.

The endemic nature of market failures in financial sectors encumbered by information asymmetry, adverse selection and moral hazard, and the fact that these market failures give rise to high costs of monitoring and transferring information, is highlighted above. When such market imperfections are not removed or mitigated, smooth savings flows and efficient investment allocation are greatly impeded and economic growth is affected adversely. The financial intermediaries and the markets that they support, namely, inter-bank, money, bond, equity and insurance markets, provide exactly the kind of services that overcome or at least alleviate the adverse effects of market failures that are inherent in the financial sector. Savers face great difficulties and risks when they try to lend money directly without financial intermediation. First, they incur the high search costs of potential borrowers. Indeed, even when they succeed in finding potential clients, they face the problem of asymmetric information, whereby savers have insufficient information concerning clients and how likely they are to repay loans, while in many cases, borrowers or investors tend to have access to more information. As a result, savers are often very reluctant to part with liquid money, and potential savings and productive investments will not necessarily materialize. It is at this point that financial intermediaries step in and help to solve the problems associated with information asymmetry, for both savers and investors. Financial intermediaries, for example, banks, provide savers with a wide array of savings instruments that have varying risks and liquidity, ranging from demand deposits to time deposits with varying maturities and returns, and which are dovetailed to the risk and liquidity preferences of savers. In this case, liquidity can be defined as the degree of ease with which one asset is traded for other assets. Liquidity risk is the risk associated with selling an asset. The availability of a wide range of saving instruments considerably reduces this type of risk. However, there is another type of risk facing investors, namely, firm- or industry-specific risks. For example, there is the risk associated with a

[14] The information presented in this section is largely based on the following: Ross Levine, "Financial functions, institutions and growth", *Sequencing? Financial Strategies for Developing Countries*, Alison Harwood and Bruce L.R. Smith (eds.), (Washington D.C., Brookings Institution Press, 1997).

given firm going under, an industry being depressed, or a country in deep recession. Financial systems provide mechanisms for pooling, diversifying and trading risky assets, including options and future contracts to hedge and trade interest rate and exchange rate risks. Well-developed equity markets permit claims on investments to be traded easily. As a result of the trading of risk and the pooling of resources, transaction costs of both savings and investments are reduced. Moreover, financial intermediaries help markets to extend the range of feasible investment projects by pooling resources, particularly those with a large potential for economies of scale, which nevertheless require large capital inputs.

It is now possible to consider investment allocation. Efficient financial intermediaries play an equally important role in directing investment flows to the most productive and profitable projects. It must be noted that it is costly and difficult for individual savers to monitor the investment activities of their borrowers, namely, firms. Even if they are capable of doing so, they may not have the time or the resources to collect, process or analyse a wide range of information concerning investment returns, enterprise management, markets and economic conditions. Efficient financial intermediaries are able to remedy this type of market failure. In most cases, financial intermediaries and banks collect and evaluate a whole host of information regarding enterprises that are soliciting loans and other borrowers. Such information includes previous business performance, expected future costs and revenue flows and profitability, management quality and business strategy, and other pertinent information. Based on these assessments, intermediaries select the most profitable projects for capital allocation. Whenever capital is allocated in the most efficient manner to the most productive investment projects through a rigorous selection process, economic growth is greater.

One of the most important functions that financial intermediaries provide in conjunction with the vetting process of investment allocation is the improvement of corporate governance. Financial intermediaries correct or alleviate the adverse effects of another form of market failure, namely, the principal-agent problem. The principal agent problem arises from the divergence of motivation between the agent, which in this case includes the managers of the firm, and the principal, which includes the owners and other claim holders of the firm. The primary duties of managers are to serve the interest of owners and other claim holders by maximizing the profit and capital valuation of the firm. Still, managers can advance their own personal interests, rather than the interests of shareholders and debt-holders, and allocate firm resources accordingly. Of course, equity-holders need to monitor and evaluate the performance of managers; however, small, outside owners often have limited resources in this regard, and cannot do this without assistance, which creates demand for financial intermediaries, who are better prepared to carry out this task. Financial intermediaries, therefore, are in a better position to implement the supervisory function of compelling firm managers to act in accordance with the best interest of shareholders, debt holders and other claim holders. Different financial intermediaries have different means of disciplining firm managers. For example, banks can exert the pressure of sound corporate governance by threatening not to renew loans. Banks also use liquid equity markets, which reveal the market valuation of the performance of a firm, as a means of disciplining managers; in cases where the value of a firm is too low, managers face dismissal or a firm can be taken over. Such direct intervention improves corporate governance.

It is evident that in the absence of corporate governance enforced by financial intermediaries and other claimholders, the abuse of corporate power by management to further its own interests is likely to occur. This can result in less efficient resource allocation and slower economic growth. Moreover, savers become less inclined to invest in big corporations. This reluctance can reduce the overall size of savings or redirect savings flows to smaller enterprises that can be more easily monitored even though in economic terms, these may be less efficient. In conclusion, therefore, efficient financial systems promote long-run economic growth through the encouragement of good corporate governance.

It is important, however, to recognize that there is an equally, if not more serious problem related to corporate governance, which is endemic to the financial intermediaries themselves, particularly banks, and an associated principal-agent problem that arises in the context of prudential regulation and supervision, which improves the corporate governance of the financial sector. For example, the motivation of an agent, namely, a financial regulator or supervisor, often diverges from that of the principal, namely, the taxpayer he serves. Regulatory forbearance is an example of this problem. Undoubtedly, this issue is of critical importance to the development of sound and efficient institutions and markets, and is reviewed in greater detail below.

The role of finance in facilitating transactions, through the provision of means of payments and clearance, the unit of account and the store of value functions, is always taken for granted. Just as the value of air or water is felt when they are limited, the immeasurable value of the role of finance in executing payments and clearance smoothly, thereby realizing the huge quantity of daily business transactions, is deeply appreciated only when these functions are severely impaired, for example, in cases of hyperinflation, in early barter economies without finance, or even the recent experiences of the command economies of Eastern Europe as they make the transition to a market economy. In short, money as a medium of exchange removes the need to barter and increases gains from trade by encouraging specialization. Payment and clearance mechanisms simplify an extremely large volume of economic interactions. The absence of an effective payment and clearance system, therefore, hinders economic transactions and impedes economic growth.

These ideas illustrate that a sound and efficient financial system is a prerequisite to long-run economic growth. Still, empirical evidence must also be presented to support the theoretically critical link between finance and economic growth. It has been argued that a sound and efficient financial system is a significant factor in economic growth; therefore, such a successful financial system must be clearly characterized. Unfortunately, however, given that a unique or ideal financial system does not seem to exist, this is difficult to do. Despite some notable convergences of different systems in recent years, financial systems have evolved in different ways in different parts of the world. For example, the evolution of financial systems in certain countries, namely, Germany and Japan, has been dominated by the banking sector, while systems in other countries, namely, the United Kingdom of Great Britain and Northern Ireland and the United States of America have placed greater emphasis on capital markets.[15]

Despite marked differences between financial systems, it is possible to glean some factors that are common to all relatively successful financial systems in various countries. These include sound economic fundamentals as measured by various macroeconomic indicators, a fairly well developed legal framework, a high standard of accounting and auditing that is commensurate with global standards, adequate availability of skilled manpower, including the necessary manpower for the development of the financial sector, limited Government intervention in credit allocation, an infrastructure for sound regulation and prudential supervision of financial intermediaries and the widespread application of information technology in the financial sector.

One pioneering empirical work attempts to provide plausible empirical evidence of the crucial links between finance and growth, and articulates the structure of a successful financial system that had been examined in an empirical context. The study uses cross-country data pertaining to 80 cases and covers the period between 1960 and 1989. According to the study, real per capita GDP growth is positively correlated with the following five variables:[16]

(a) The overall size of financial system measured by the depth variable, which is defined as the currency held outside financial institutions plus demand deposits and interest-bearing liabilities of banks and non-bank financial institutions, or M3 money supply, divided by GDP. Non-bank assets include insurance companies, pension funds, mutual funds, brokerage houses and investment banks;

(b) The importance of banks relative to the central bank in allocating credit, as measured by bank credit divided by bank credit plus central bank credit;

(c) The relative importance of private sector credit as opposed to public sector credit as measured by the variable representing credit issued to private sector firms divided by total credit;

[15] Gerard Caprio and Stijn Claessens, “The importance of the financial system for development: Implications for Egypt”, a paper presented as part of the Distinguished Lecture Series 6, (Cairo, The Egyptian Center for Economic Studies, 1997).

[16] Robert G. King and Ross Levine, “Finance, entrepreneurship and growth: Theory and evidence”, *Journal of Monetary Economics*, No. 32, (1993), pp. 513-542.

(d) The quantitative importance of non-bank financial institutions as measured by the ratio of non-bank assets over GDP;

(e) The level of stock market development measured by a composite measure of various variables reflecting the liquidity of the market and the degree of its integration with world capital markets.

These empirical results characterize a distinct pattern of successful financial sector development, which is capable of augmenting the process of economic growth. As the per capita income of a country increases, financial systems expand. Private banks become more important relative to the central bank in allocating credit; the greater share of total credit is allocated to the private sector; non-bank financial institutions grow in importance; and stock markets also become more important and sophisticated. It must be noted, however, that these results are subject to the data limitations that are common to most empirical investigations, and hence they are less conclusive than they might at first appear.

In addition, given that the results indicate a statistical association between financial structure and economic growth, there is a serious problem of ascertaining the direction of causation. For example, it is not clear whether financial deepening is a cause or a result of rapid economic growth. The results do not suggest that the transformation of a financial structure in a particular way will somehow lead to rising per capita incomes. However, empirical results not only help to describe the common characteristics of successful financial systems, they also lend themselves to certain policy interpretations. For example, the pattern of financial sector development that is highlighted in the aforementioned study suggests that developing countries in the early stages of development must focus on the development of their banking sectors, while middle-income developing countries must adopt policies that facilitate stock market development.

C. HISTORICAL OVERVIEW OF FINANCIAL POLICIES IN DEVELOPING COUNTRIES

This section presents an historical overview of financial policies in developing countries beginning during the period of financial repression in the 1950s and 1960s. In this context, it is useful to highlight the manner in which government intervention came about at this juncture. During this period, the shortage of capital was considered to be a critical constraint on economic growth in developing countries. The basic motivation for government intervention was to correct market failures in financial markets to generate sufficient capital for economic development. Financial markets in developing countries were considered to be too underdeveloped to mobilize socially optimal levels of capital for economic development. Moreover, the prevailing view at the time was that Governments were not only capable of remedying such market failures, they were also the only catalysts for economic growth that were capable of mobilizing a huge amount of capital for infrastructure and social programmes during the early stages of development. Thus, Governments actively intervened in domestic financial markets to provide subsidized credit to strategic sectors selected by the overall development plan. Intervention followed intervention and soon financial markets were directly controlled by government policy directives in terms of credit pricing and allocation.

Unfortunately, like most interventions, government control of domestic financial markets coupled with weak administrative capacity bred corruption, rent-seeking activities, distortions, and inefficiencies in all aspects of the financial sector. In the context of financial repression, subsidized interest rates were determined by Governments, negative or very low real interest rates were set, and privileged firms with access to cheap loans appropriated rents from depositors. Commercial banks were increasingly dominated by Governments in terms of lending and securing bank credit. Governments directed credit allocation, thereby creating a highly leveraged industrial base and large firms, which dominated the aggregate economies of these countries, continued to rely on subsidized bank credit for their financial requirements. Over time, large firms forged close customer relationships with banks, providing business and financial information to the banks, thereby alleviating the problem of asymmetric information, which reinforced the direction of credit. Meanwhile, banks neglected small- and medium-sized firms. The combination of the asymmetric information problem of banks and the excessive reliance of large firms on bank credit created dangerously high debt-equity levels.

The disastrous consequence of fragility in a banking sector that is marked by a very high debt-equity ratio is the extreme vulnerability of both firms and banks to external shocks, which takes the form of a sharp rise in the servicing costs of domestic and foreign currency-denominated debts, which is as a result of the reversal of capital flows and subsequent deep currency depreciation. Firms experiencing a sharp increase in interest costs on an outstanding debt must borrow more to survive or to avoid bankruptcy. Banks are drawn into a moral hazard game, whereby their loan portfolios are highly exposed to such firms, and where even their own survival is threatened by the failure of such firms. Banks often continue to lend to these firms even when they are aware that these debts will never be repaid, which is a case of 'evergreening', which can also be defined as the practice of offering companies new loans to cover old ones.

The underdevelopment and fundamental weakness of a financial structure formed under conditions of financial repression is manifested in various forms of structural rigidities. One of many important structural flaws in developing countries is inadequate capacity for credit risk assessment of the banking sector. Financial intermediaries tend to have insufficient technical skills or the sophistication to evaluate and monitor credit risks.

When domestic financial deregulation and capital market liberalization is introduced in a distorted institutional setting that has been nurtured under a lengthy financial repression policy, greater freedom for financial intermediaries in creating and allocating credit results in greater freedom to finance speculative, risky and unproductive projects.[17] Such a liberalized climate of finance plants the seeds for the emergence of large systemic risks and debt overhangs in the absence of prudential banking regulation and supervision. When there is a lack of market information, banks follow their herd instincts and concentrate activities on a few risky ventures, for example, speculating in property markets, and hence become extremely vulnerable to adverse shocks, namely, sudden massive outflows of foreign capital. Once battered by such adverse shocks, a vicious cycle of debt deflation resulting from the currency meltdown ensues, which is what happened in the Asian financial crisis.

Since the early 1970s, the views of the financial repression school have been seriously challenged and discredited by those in the financial liberalization school.[18] The financial liberalization school argues that financial repression, namely, Government administered low or negative real deposit rates, is largely responsible for the underdevelopment of the financial sector. As a result, financial repression gives rise to a number of growth-inhibiting effects. Firstly, low or negative real deposit rates encourage current consumption and induce people to hold savings in real rather than financial assets, on the basis that real assets, namely, real estate, gold and other precious metals are a better hedge against inflation. This impedes the development of the financial sector as a result of an insufficient demand for financial assets. The shallow financial sector in turn adversely affects saving rates owing to a lack of alternative savings instruments. Reduced flows of savings mean less financial resources for investment. Secondly, low or negative real deposit rate ceilings that are set well below market-clearing levels generate excess demand for loanable funds, which necessitates some form of government credit-allocation, and encourages rent-seeking and directly unproductive activities, while Governments attempt to pick winners or favour policy-targeted sectors for investment allocation. As one government intervention follows another, this process breeds corruption and stunts the sound development of the financial structure, thus making the financial sector excessively dependent on government directives. Thirdly, low capital costs encourage an inefficient use of scarce capital and induce a capital-intensive industrial structure, which is inconsistent with the resource endowments of most developing countries.

[17] In the Republic of Korea, capital account liberalization was undertaken in the first half of the 1990s. Overseas issuance of foreign currency-denominated bonds by domestic firms was allowed in 1991. Korean stock markets were opened for the first time to foreign investors in 1992, and foreign borrowing by domestic firms was permitted in 1995. As a result of capital account convertibility, the Government allowed banks to borrow from foreign creditors, with very few quantitative restrictions on both short-term and long-term debt; the Government, however, imposed some restrictions on stock market transactions. As a result, the major bulk of external debt during the three years preceding the currency crisis in 1997 involved the banking sector, whose share of total external debt during that period amounted to 70 per cent, while the remaining 30 per cent was attributed to trade and finance in the corporate sector. See Michael P. Dooley and Inseok Shin, "Private inflows when crises are anticipated: A case study of Korea", NBER working paper series, working paper 7992, (Cambridge, Massachusetts, National Bureau of Economic Research, November 2000). Available at: http://www.nber.org/papers/w7992.

[18] See Ronald I. McKinnon, *Money and Capital in Economic Development*, (Washington D.C., Brookings Institution, 1973) and Edward S. Shaw, *Financial Deepening in Economic Development*, (New York, Oxford University Press, 1973).

A well-functioning financial system provides three growth-promoting functions. Firstly, by offering greater liquidity and pooling risks, such a system mobilizes savings efficiently. Secondly, through prudent selection and monitoring of investment projects, this type of system promotes efficient investment allocation and also capital accumulation. Thirdly, by providing payments and other transaction-facilitating services, such a system promotes trade and specialization. The financial liberalization school argues that financial repression is the main culprit in terms of impeding the development of a growth-promoting financial system. In other words, financial repression produces government failure and the solution to this problem is simply to remove government intervention in the financial sector, and in particular, to remove ceilings on deposit interest rates. A rise in deposit rates is conducive to financial deepening on the basis that it not only encourages a greater amount of savings, it also encourages more savings to be held in financial rather than real assets, and promotes the development of a wide range of savings instruments with varying liquidity and risk exposure.

What is equally important is that a rise in the real interest rate encourages a more efficient use of capital, which is a major determinant of economic growth. In many developing countries, it is not always the lack of capital, rather the inefficiency of capital utilization that hinders economic growth. It is evident that at low or negative real interest rates, there is little incentive to economize capital; however, such an incentive rises with the rise in capital costs reflected in rising real interest costs. In short, financial liberalization advocates argue that a rise in real interest rates as part of financial liberalization is expected to raise both the volume and quality of investment.

It must be cautioned at this juncture that the links between a rise in deposit rates and savings, and the links between savings and investment have not been sufficiently supported by empirical evidence. The primacy of savings and the importance of removing interest rate ceilings or a repressed financial market condition have been underscored by some economists.[19] Once such actions are carried out, savings increase, and an increased flow of savings can be channelled into productive investments, thereby stimulating economic growth. However, the link between savings and investment through market-clearing real interest rate adjustments must be theoretically justified, and must also be substantiated empirically. Moreover, financial liberalization entails the deregulation of interest rates, and also the liberalization of a wide range of repressed financial conditions. Issues related to a comprehensive financial liberalization programme are reviewed below.

Nevertheless, the doctrine of financial liberalization has been challenged on both conceptual and empirical grounds. Perhaps the policy of financial repression can be better understood in the context of the historical evolution of the financial structures associated with the stages of economic development in developing countries. In this context, there are two different ways of financing business projects: (a) indirect finance based on the intermediation of the banks; and (b) direct finance that relies on securities transactions in capital markets. It has been observed that over time, the development of capital markets usually becomes evident at relatively advanced stages of economic development, as is the case in developed countries, where there are complex and sophisticated structural, institutional and technological requirements for building capital markets. It is relatively less time-consuming, technically easier and less costly to establish a bank than to build a complex network of capital markets to finance both private and public investment projects and also government deficits. Therefore, it is no surprise that the banking sector evolved during the early stages of development in every country without exception, and it seems obvious that the financial systems in developing countries are dominated by bank-financed credit mechanisms or bank intermediation. In other words, banks collect savings and channel them into private investment and public infrastructure projects and government deficits, which means that private and public investments are financed through bank intermediation.

More importantly, the banking sector readily lends itself to government intervention and control. Given that capital markets are weak or almost non-existent in most developing countries, banks become the main suppliers of credit and firms become highly dependent on bank credit. When Governments intervene directly in credit allocation, for example, they direct scarce financial resources at subsidized costs, for example, low or negative real interest costs through nominal interest rate ceilings, to the most strategic

[19] Including, for example, Ronald McKinnon and Edward Shaw.

sectors favoured by the government plan or industrial policy to accelerate economic growth, both banks and firms are at the mercy of policy-directed credit allocation. Government-directed industrialization drives based on policy-guided credit allocation were carried out in many East Asian countries, including Malaysia, the Republic of Korea, Singapore and Thailand, and even in Japan during the post-war rapid economic growth period in the 1950s and 1960s. In such an institutional setting, financial repression in terms of policy-directed credit allocation, either through the interest rate ceiling or direct quantitative allocation, has certain merits.[20] Firstly, at the very early stages of development, characterized by the shallowness of the banking sector and financial markets, the Government is the only agent capable of mobilizing huge resources for large-scale infrastructure and social projects, and hence prompting the process of economic growth. Secondly, policy-directed credit allocation permits various productive investments to materialize faster than through retained profits or through the slow development of securities markets. Moreover, productive investment that is financed in this way is likely to be immune to the boom-bust cycles of speculative stock markets. Thirdly, policy-directed credit allocation through banks focuses on long-term growth factors, as opposed to the preoccupation of stock market finance, which focuses on short-term profit maximization. Finally, Governments have the political power to direct private sector activities in line with their industrial strategies.

Other arguments support financial repression at the early stages of economic development.[21] Financial repression based on the low deposit rate ceiling, coupled with high inflation resulting in low or negative real interest rates may facilitate resource transfers from the household sector to the corporate sector. In this case, when the marginal propensity to save is greater in the corporate sector than in the household sector, aggregate savings increase. Secondly, low or negative real interest rates remove the problem of adverse selection described above; however, whether or not the quality of borrowers improves depends on the capacity of Governments to select productive investments. Moreover, given that the cost of capital becomes cheaper, financial repression provides the incentive to increase the equity capital of a firm, which in turn reduces the likelihood of business failure, and at the same time motivates the firm to select profitable projects based on the fact that greater capital is at stake. Finally financial repression is a useful policy tool in selecting productive investments. This is based on the fact that cheap subsidized capital creates an excess demand for loanable funds, and Governments can allocate limited resources in accordance with certain measurable performance results, for example, exports or foreign exchange earnings growth.

These arguments, which support financial repression appear to contain some truth, can be seriously faulted on conceptual grounds. The crux of the problem is government failure. The basic reason for government intervention in the financial sector is to remedy the market failure that is endemic to financial intermediaries. However, it remains highly uncertain as to whether government failure makes a situation worse than market failure. In other words, government intervention can aggravate the disease that it intends to cure. It is a little far-fetched to presume that a Government knows better than the market. Even an efficient, transparent Government, with a superior bureaucracy that is capable of correcting or at least mitigating certain failures of financial markets, still encounters many practical problems. One of these is that it is often difficult to pinpoint the type of market failure. Even when the kind of market failure can be identified, the seriousness of the problem is difficult to ascertain. Another concern is that even when the extent of a particular problem can be gauged, there is a lack of uncertainty regarding what sort of remedial measures must be applied to solve that problem, how effective these will be, and what the most feasible solution is. In short, there is a high likelihood that Governments will remedy market failure imperfectly, which can be attributed to the fact that some interventions are likely to be influenced by various factors, including the pressure of special interest groups or corruption.

The fundamental issue is not whether to choose government-directed financial repression or financial liberalization. Rather, policy choice must be considered in the broad context of the various stages of development in which a country finds itself. As discussed above, at the very early stages of economic

[20] Robert Wade, "The role of the Government in overcoming market failure: Taiwan, Republic of Korea and Japan", *Achieving Industrialization in East Asia*, Helen Hughes (ed.), (Cambridge, Cambridge University Press, 1988).

[21] Joseph E. Stiglitz, "The role of the State in financial markets", *Proceedings of the World Bank Annual Conference on Development Economics 1993*, (The International Bank for Reconstruction and Development/World Bank, 1994), pp. 19-62.

development, when there is an underdeveloped financial sector, a Government is often the only catalyst for economic growth, and must take the initiative in starting the process of economic growth by creating and nurturing financial markets through active interventionist policies within a broad framework of industrial policy. Quite simply, there seems to be no alternative to financial repression. However, at relatively advanced stages of development, when economic growth starts and accelerates, the financial structure becomes increasingly complex and sophisticated. Market forces must then be harnessed to replace government interventions. At this juncture, financial liberalization and reforms must be promoted to develop a well-functioning and efficient financial system that includes the development of capital markets. It must be underscored, however, that financial liberalization and reforms must be enforced only after an effective mechanism for prudential regulation and supervision of the financial sector is firmly in place, otherwise, financial liberalization and reform programmes are highly likely to fail.

The next section addresses the issue of what constitutes the major elements of financial liberalization and reform, and considers reasons for their implementation within the institutional context of prudential regulation and supervision of the financial system.

III. FINANCIAL SECTOR REFORMS

A. MAJOR ELEMENTS OF THE FINANCIAL SECTOR REFORMS

Broadly speaking, reform of the financial sector in developing countries entails the liberalization of financial markets that have been distorted by financial repression and the removal of capital controls. The liberalization of financial markets includes removing foreign exchange controls, lifting interest rate restrictions, developing non-bank financial markets and lowering entry barriers to the banking sector.[22] At a practical level, various aspects of financial market reforms introduced in Indonesia, Malaysia, the Republic of Korea and the Philippines from the late 1970s to the early 1990s have been described in a study.[23] These include the removal of interest rate and credit ceilings, rationalization or abolition of access of priority loans to rediscount facilities, introduction of new financial instruments, privatization of commercial banks and the introduction of changes in ownership structures and the lifting of credit controls.

One of the major conclusions of this study was that strikingly similar results could be seen in all these Asian economies, including the fact that financial liberalization was undertaken at a high cost, and the bulk of reform elements, particularly the liberalization of interest rates, could not be sustained because of these high costs. Moreover, the high costs of liberalization were witnessed in the form of a sharp increase in non-performing loans as a result of market interest rate escalation, which forced many firms into a position where their payment obligations exceeded their expected receipts.

One important capital account convertibility measure that facilitates short-term capital flows into developing countries, is the provision that guarantees the rights of non-residents to withdraw their investments freely, and eases restrictions on foreign investments and the holding of foreign assets by nationals. Known as Article 8 of the Articles of Agreement of the International Monetary Fund (IMF), this stipulates currency convertibility for current account transactions.[24] The IMF is also aiming to regulate banking practices in developing countries. In addition to IMF policy orientation, developed countries are applying a great deal of pressure, particularly the United States, to open money and capital markets, and remove foreign exchange controls in developing countries. In fact, the rapid liberalization and integration of global financial markets in the past decade has rendered any attempt by individual countries to control capital movements ineffective, and therefore, the liberalization of capital markets has become a fait accompli.[25] Finally, capital account convertibility is often required as a prerequisite to membership of certain international organizations, for example, it influenced the membership of the Republic of Korea in the Organization for Economic Cooperation and Development (OECD) and the admission of China to the World Trade Organization (WTO).

[22] For example, as a result of easing entry restrictions, the number of banks in Indonesia sharply increased from 111 in 1988 to 240 in 1994. See Anwar Naustion, "The banking system and monetary aggregates following financial sector reforms: Lessons from Indonesia", Research for Action Series No. 27, (United Nations University World Institute for Development Economics Research, September 1996).

[23] Trevor M. Sikorski, *Financial Liberalization in Developing Countries*, (Cheltenham, United Kingdom, Edward Elgar Publishing, 1996), table 7.1.

[24] Indonesia and the Republic of Korea acquired IMF Article 8 status in 1988, Thailand in 1990, the Philippines in 1995, and China in 1996. Hong Kong, Japan, Malaysia and Singapore were accorded the same status in the 1960s.

[25] For example, a number of Asian economies established offshore markets as a means of developing domestic financial markets and facilitating overseas borrowing, including Hong Kong and Singapore; the Labuan market of Malaysia was established in 1990 and the Bangkok International Banking Facility was established in Thailand in 1993. More recently, similar offshore markets have been planned in Taipei and Shanghai. In general, Asian offshore markets tend to be more lax in terms of regulating interest rates, reserve requirements, withholding taxes on interest income and foreign exchange control than their onshore counterparts. It is extremely difficult to plug leakages of capital flight through offshore banking facilities. See C.H Kwan, Donna Vandenbrink and Chia Siow Yue, *Coping with Capital Flows in East Asia*, (Tokyo and Singapore, Nomura Research Institute and Institute of Southeast Asian Studies, 1998).

The potential benefits of capital account convertibility, as analogous to current account convertibility, have been hotly debated.[26] While it is beyond the scope of this study to evaluate the controversies surrounding this issue, it is possible to summarize some salient points, which have some relevance here. The proponents of capital account liberalization as a logical extension of current account convertibility emphasize that freeing capital controls raises economic efficiency and enhances growth potential as a result of lowering interest rates through arbitrages between domestic and foreign interest rates. In other words, capital convertibility permits an optimal allocation of global financial capital whereby financial resources are mobilized at the lowest costs and channelled into the most productive uses. Moreover, free capital flows tend to promote competition and hence raise productivity in financial markets in developing countries.

The general belief, however, is that any premature capital account convertibility during economic reform can result in macroeconomic instability and destabilizing capital flows. It has been suggested that the liberalization of capital accounts can cause large destabilizing capital outflows when domestic capital markets are repressed and interest rates are set at low levels.[27]

The benefits of financial openness must also be assessed against the costs of establishing and maintaining an insurance mechanism to cope with the risks of financial openness. These costs are the economic losses associated with the costs of establishing and maintaining government safety nets and minimizing the negative redistributive impacts of financial instability resulting from financial liberalization. More importantly, the opponents of capital account liberalization in developing countries focus on the fundamental differences in the characteristics of the two markets. In comparison with international trade in goods and services, financial markets are inherently more prone to market failures arising from asymmetric information, a type of insurance-scheme adverse selection and moral hazard problems, as highlighted above. These problems, which are endemic to financial intermediaries, can give rise to excessively risky lending; and a mismatch between short-term liabilities and the long-term assets of banks, which expose banks to the risk of a bank run, financial panic and herd behaviour leading to exuberance and contagion effects. Indeed, these are just a few major theoretical points against the wisdom of blanket adoption of capital account liberalization.

B. Financial reform sequencing

The objectives and benefits of financial sector reform with a view to developing a market-based well-functioning financial system do not require further elaboration. Financial liberalization is commonly accepted as the main pillar of financial sector reform, based on the fact that reform is aimed at rehabilitating an ailing system ravaged by financial repression, and the best way to remove financial repression is to deregulate or liberalize financial markets. However, the question of how best to move from financial repression to a market-oriented financial system remains highly uncertain and controversial. In general, based on the high risks associated with financial liberalization, conventional wisdom places financial sector reform in the later phase of an overall reform programme, and favours a gradualist approach to implementing the reform programme. The commonly accepted view in the overall reform sequence is to deregulate and reform the product market first, particularly the labour market, and then to liberalize external trade after the productive, particularly the manufacturing capacity, of a given country has been upgraded to internationally competitive levels. The next step is the liberalization of domestic financial markets, either in conjunction with or after, the development of a reasonably well-functioning system of prudential regulation and supervision of financial intermediaries and an adequate legal framework for the efficient functioning of a financial system. The free convertibility of the capital account of the balance of payments is usually planned at the last stage of the overall reform programme. However, there are many divergent arguments with regard to different overall reform sequences, and there is the even greater diversity of options regarding the proper sequencing of the numerous subprogrammes within a reform programme of a given sector. The salient features of the conceptual and empirical issues involved in the sequence and the speed of reform

[26] Dani Rodrik, “Who needs capital-account convertibility?”, *Essay in International Finance*, Peter Kenen (ed.), (1998).

[27] Ronald I. McKinnon, *Money and Capital in Economic Development*, (Washington D.C., Brookings Institution, 1973) and “The order of economic liberalization: Lessons from Chile and Argentina”, Carnegie-Rochester Conference Series on Public Policy, No. 17, (1982), pp. 159-186.

programmes are reviewed below, with the aim of highlighting policy implications for financial sector reform in the ESCWA region.

The conventional view based on experiences in implementing financial reforms in various developing countries over the past two or three decades is that financial liberalization works only when financial reform is carried out after a number of preconditions have been met. Macroeconomic stability emerges as the most important precondition for successful reform. Macroeconomic instability, characterized by runaway inflation and massive unemployment, weakens domestic financial markets and renders them extremely vulnerable to a financial meltdown triggered by large-scale reform measures. It has been pointed out that high inflation reduces the information content of prices and therefore, makes resource allocation decisions difficult.[28] High inflation is often caused by large monetized budget deficits. It has been suggested, therefore, that budget control must precede financial liberalization.[29] When budget deficits are the cause of inflation, control of inflation requires a cut in government spending. It follows therefore, that in most cases the major burden of macroeconomic stabilization is placed on fiscal policy in the form of drastic cuts in government spending programmes. Such drastic expenditure cuts tend to target programmes that engender the least political resistance, for example, health, welfare and education programmes. As a result, the weakest and most marginalized groups of society, namely, the poor, women, children and the aged, suffer most from such inequitable fiscal austerity.

In addition to the unfair burden sharing of macroeconomic stabilization programmes, the Asian financial crisis offers another important lesson, and that is that macroeconomic stability alone is not a sufficient condition for successful financial reform. Prior to the crisis, East Asian countries enjoyed relatively stable macroeconomic environments as measured in terms of government deficits, inflation, unemployment and growth rates, which highlights that macroeconomic stability, in itself, was not strong enough to repel the speculative attacks of international capital, and that what was needed in this case, was the development of a sound and efficient financial sector buttressed by an effective financial regulation and a prudential supervision system. The reasons for this are outlined below.

The theoretical question concerning the optimal sequencing of financial sector reforms has been investigated by a number of economists.[30] In addition, other economists have presented a plausible programme for sequencing detailed elements of financial sector reform, and this is outlined below:

(a) Eliminating direct credit and interest rate controls and developing monetary controls based on the indirect monetary instruments, which include such open market operations as auctions of government treasury bills, central bank refinance credits, or certificates of deposit to control money market liquidity;

(b) Developing money and inter-bank markets supported by indirect monetary instruments auctioned in open market operations;

(c) Developing and improving prudential regulation and supervision of financial intermediaries;

(d) Developing an effective mechanism for the disposal of bad loans and the restructuring of insolvent financial institutions;

(e) Introducing various market deregulations, including increasing competition between banks, lowering or eliminating barriers to market entry and privatizing Government-owned banks;

[28] Hans Genberg, “On the sequencing of reforms in Eastern Europe”, IMF Working Paper Series, No. 91/13, (Washington D.C., 1991).

[29] Ronald I. McKinnon The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy, (Baltimore and London, John Hopkins University Press, 1991).

[30] See Mario Blejer and Silvia Sagari, “The structure of the banking sector and the sequence of financial liberalization”, *Economic Reform and Stabilization in Latin America*, M. Connolly and C. Gonzalez-Vega (eds.), (New York, Praeger Publishers, 1986), pp. 93-107; and Ronald I. McKinnon, “The order of economic liberalization: Lessons from Chile and Argentina”, Carnegie-Rochester Conference Series on Public Policy, No. 17, (1982), pp. 159-186.

(f) Reducing and eventually eliminating direct credit controls;

(g) Promoting the development of long-term capital markets by issuing long-term government securities and improving securities regulation;

(h) Increasing the efficiency of the clearance and settlements system for payments;

(i) Improving the efficiency of foreign exchange markets by removing foreign exchange controls and enforcing capital account convertibility.

It is generally accepted that the use of indirect monetary instruments tends to be more effective in controlling monetary aggregates than the use of direct credit interest rate controls in financial repression, which has some associated distortions, for example, rent-seeking activities and corruption. Furthermore, open-market type operations associated with the use of indirect monetary instruments can also stimulate the development of domestic financial markets. This means, therefore, that these instruments must be developed at the very early stages of financial sector reforms. It must also be noted that there are strong policy and functional linkages between money markets and markets for short-term instruments, for example, government treasury bills. This calls for the simultaneous development of both markets in practice, contrary to the desirable sequence suggested above. In general, most developing countries tend to assign priority to reforming the banking sector, which is based on the fact that it is usually the most dominant form of finance at the early stages of development. It is highly unlikely that developing countries possess the technical and institutional capacities to develop money markets and indirect monetary instruments at the same time at the very early stages of development, despite the importance of money supply controls based on market-based indirect instruments.

There are many other strong functional linkages among the various elements of financial reforms that are sequenced above, and therefore, simultaneous action on several fronts is perhaps imperative, rather than sequential implementation. For example, the task of disposing of bad loans and restructuring insolvent banks (see (d) above) can be closely affected by the outcome of removing direct credit controls (see (f) above), and also strongly influenced by prudential regulation and supervision of the financial sector (see (c) above). Moreover, the relative importance of various elements of financial reform, which is reflected in the order of their implementation, varies from country to country, depending upon the initial conditions and diverse characteristics of the country in question. For example, for the majority of least-developed countries, improving the clearing and settlements system is a matter of extreme urgency, and must therefore be introduced at the very early stages of a financial reform programme rather in the latter stages of that programme, as is the case above. A banking system that is incapable of speedy and reliable fund transfers raises transaction costs and is not likely to benefit from improved money markets.

C. The speed of financial liberalization

Closely related to the issue of reform sequence is the question of a choice between rapid and gradual liberalization. There are risks and costs to both approaches. Bearing in mind the fact that financial repression entails the costs of inefficient saving mobilization and poor investment allocation, many developing countries cannot afford to pursue a gradual reform policy. It has been noted that the gradual approach to reform has been pursued among countries with relatively high domestic saving rates, namely, China, Japan and the Republic of Korea.[31] Countries with high ratios of savings can perhaps afford to be cautious and prudent in implementing reform programmes, on the basis that they can achieve high growth rates with sufficient domestic resources. However, countries with low saving ratios cannot afford to continue economic stagnation with inefficient savings mobilization and poor investment allocation. More importantly, rapid reform gives great credibility to the resolve of Governments to carry out reforms, and deprives various anti-reform groups of the time to mobilize to block the reform programme. Indeed, anti-reform interests are formidable stumbling blocks to reform, and these include recipients of subsidized credits, for example, well-connected enterprises and state-enterprises; pressure groups clamouring for

[31] R. Barry Johnston, “Aspects of the design of financial programs with the adoption of indirect monetary controls”, IMF Paper on Policy Analysis and Assessment, No. 93/16, (1993).

protection from foreign competition, for example, banking, securities and insurance industries; and many other rent-seeking groups. By moving quickly, Governments can deflate the pressure applied by anti-reform groups. For example, tightening budget allocation and accelerating a privatization programme is a means of eliminating inefficient zombie firms that largely depend on subsidized credit for survival.

The early advocates of financial liberalization recommended a big-bang approach of "doing everything at once".[32] However, when this policy recommendation was actually implemented in the Southern Cone of Latin America in the late 1970s, the experiment was terminated as a significant failure. This failure was followed by a number of adverse effects that were related to financial liberalization, in other developing countries, which led to new ways of thinking about reform sequencing.[33] A financial reform programme calls for careful planning and it must be sequenced with other reforms. It must not be rapidly pushed before ensuring that requisite institutional arrangements are firmly in place. A gradual and time-phased approach is perhaps what is needed for countries that face great difficulties in effecting financial and monetary discipline. It is a particularly time-consuming and challenging task to create the prerequisite conditions for financial liberalization, namely, prudential regulation and supervision of the financial sector, which requires enormous institution-building and a significant development of human skills to counter the pervasive moral hazards and adverse selection associated with very high interest rates in liberalized financial markets.

Aside from macroeconomic stabilization as a precondition for financial liberalization, extreme care must be taken in opening capital markets to avoid destabilizing capital flows. In fact, such action must be delayed until the liberalization of domestic financial markets is completed. In addition, financial liberalization does not always engender competition in financial markets, which can be attributed to the fact that financial systems in a number of developing countries are characterized by uncompetitive and oligopolistic market structures that have been nurtured by long periods of financial repression.[34] Therefore, competition policy must complement financial liberalization.

It is evident that financial reform raises many complex questions related to the contents, sequence, speed, risks and costs of such reform. Moreover, the results of both theoretical and empirical studies are inconclusive and further research must be carried out on a broad range of financial reform issues. However, one important consensus view that is emerging from numerous studies is that financial liberalization in developing countries must be preceded or accompanied by the development of effective machinery for prudential regulation and supervision of financial markets. Prudential regulation and supervision is necessary not only to deter moral hazards resulting from financial market deregulation, but also as an effective defensive strategy against the adverse effects of destabilizing capital movements in financial markets. This raises the question of why prudential regulation and supervision is not pursued in conjunction with financial liberalization more often. The response is that building prudential regulation and supervision is expensive, time-consuming and complex, while liberalizing measures are inexpensive, and can be swiftly and easily implemented. The important issue of banking regulation and supervision in developing countries is reviewed below.

D. Development of a legal framework for financial sector reforms[35]

The development of a legal framework to support financial sector reform is as important as financial liberalization; however the importance of this issue is often overlooked. Such development covers two

[32] These include, for example, Ronald I. McKinnon and Edward Shaw, *Financial Deepening in Economic Development,* (New York, Oxford University Press, (1973), p. 251.

[33] Trevor M. Sikorski, *Financial Liberalization in Developing Countries*, (Cheltenham, United Kingdom, Edward Elgar Publishing, 1996).

[34] M. J. Fry, "Financial repression and economic growth", a paper prepared as part of the *Papers* series of the International Financial Group, University of Birmingham, No. 93-07, (1993).

[35] This section is largely based on: Philip A. Wellons, "Sequencing legal developments to support financial sector reforms", *Sequencing? Financial Strategies for Developing Countries*, Alison Harwood and Bruce L. R. Smith (eds.), (Washington D.C., Brookings Institution Press, 1997).

major areas: the contents of financial and commercial law; and the legal process. In both cases, the sequencing problem must be taken into consideration. The contents of financial law refer to banks, securities markets and institutional investors. Commercial laws are quite extensive, and include company law, property rights, and bankruptcy and trust laws. In addition, the legal process entails legislative drafting, implementation and enforcement.

The theory of legal development offers little guide with regard to sequencing various elements of such development. Given that there is no prototype financial sequence, there is no prototype sequence of legal development. Each country develops in a unique way reflecting different social, political and economic conditions, and therefore, each country develops according to a different sequence.

Some common patterns have emerged, however, from current practices in transition economies. First, policy makers concerned with financial sector reform tend to emphasize financial laws initially, and commercial laws subsequently. Moreover, those involved in legal development often fail to coordinate development of both financial and commercial law. Poor coordination usually results in a chaotic situation whereby different Ministries, agencies and monetary authorities are responsible for different laws and different legal processes. A desirable alternative to this is to focus on a predetermined set of financial activities first, and then develop related financial and commercial laws accordingly, for example, the choice between direct or indirect finance systems.

In this context, focusing on direct finance encourages the promotion of money and capital markets rather than the banking sector. There is then a need to develop financial laws governing securities, stock exchanges and institutional investors, for example, pension funds, insurance companies and mutual funds. In the context of commercial laws, there is a need to deal with a negotiable instruments law for the smooth transfer of rights in securities, protection of property rights, company laws that specify the rights and obligations of shareholders, contract laws, and laws governing fiduciaries, for example, brokers.

The usual pattern of sequencing the legal process can be described as the draft, implement, and enforce sequence, whereby legislation is first drafted, then implemented and finally enforced. The crux of the problem is that Governments often have limited or no capacity to carry out the legal mandate in terms of budgetary funding or trained manpower. For example, judges may not be familiar with financial markets and the essence of new laws, and are too few in number to handle a caseload, which means that a new law cannot be enforced and it loses credibility. One solution to this problem is to adopt a focused approach, as discussed above. Such an approach provides a sequence to the content of the law and also directs efforts in developing the legal process. For example, a direct finance strategy highlights the importance of developing prudential regulation and disclosure rules, and also manpower training, to implement those laws, and to formulate administrative procedures for the legal process.

Finally, the initial conditions of a given country are very important for a legal development strategy. In particular, the initial conditions of the financial system dictate the major thrust of legal reform. For example, when a financial system is slightly developed, as is the case in many least developed countries, legal reform starts with the basics. When the financial system of a country is fairly sophisticated, as is the case in some middle-income countries, the sequence must be different. In this context, it is worth noting that the prevailing legal system in a country, for example, British common law or European code law, influences the sequence of legal development. Common law builds on the precedent of judicial decisions about individual cases, while code law states general principles framed by statute. A country with a code system must develop a new law, for example, a trust law, which is something that the common law country does not need to do. Code requirements dictate the sequence of legal development, which has been the case in Eastern European countries.

IV. SHORT-TERM CAPITAL FLOWS AND BANKING CRISES IN DEVELOPING COUNTRIES

Studies of recent currency and financial crises in developing countries have focused an increasing amount of attention on financial sector weakness, which led to the overextension of bank and non-bank private credit to corporations. In these cases, the bulk of private capital was raised overseas in the form of short-term maturities and foreign currency-denominated. For example, short-term debt owed by developing countries to foreign banks increased sharply from $176 billion to $454 billion between 1990 and 1997.[36] Furthermore, this private capital was mostly directed towards speculative investment, including investments in property and stock markets, thus creating a bubble economy, industries with a looming overcapacity and low expected returns, or fiscally unsustainable ambitious infrastructure projects and a state monopoly sector. Moreover, at the end of 1997, many Asian banks were heavily exposed to the property sector, with the share of property loans in total bank loans ranging from 25 to 40 per cent in Indonesia, Malaysia, Singapore and Thailand, and even more in Hong Kong.[37] The combination of short-term, foreign currency-denominated over-borrowing and unproductive investments of these funds made these economies extremely exposed to speculative attacks and to the currency shocks of sudden massive capital outflows. In this context, currency and financial crises are more directly influenced by the composition of external borrowing than by the overall external debt burden, whether the size of short-term external debt is measured against GDP, exports, or external reserves as an indicator of liquidity and currency mismatches.[38] For example, short term debt as a percentage of total debt as of June 1997 stood as high as 60 per cents in the Republic of Korea, 46 per cent in Thailand, 39 per cent in Malaysia, 24 per cent in Indonesia and 19 per cent in the Philippines, while the ratio of short-term debt to international reserves was 3 for the Republic of Korea, 1.6 for Indonesia, 1.1 for Thailand, 0.7 for the Philippines and 0.6 for Malaysia.[39]

Given the extreme volatility and risks of short-term foreign debt, why do developing countries then tap short-term capital rather than the relatively safer long-term loans or foreign direct investment? In answering this question, it is important to recognize, above all, that a bank or a banking system largely finances illiquid investments that produce revenue flows after a long gestation and hence, is less likely to generate cash flows in short run or ready secondary market values, namely, liquidity mismatches.[40] In this case, the quality of investments that are being financed and the health of financial markets is of critical importance in determining how much a bank or a banking system can raise in terms of long-or medium-term capital rather than short-term loans to finance domestic projects. When projects are sufficiently credit-worthy to gain the confidence of foreign investors in terms of recovering their loans, long-or medium-term capital may be forthcoming. However, when the quality of projects that are being financed deteriorates and the banking sector becomes weaker and less transparent with the result that the enforcement of debt repayment becomes more difficult, the sources of long-term capital rapidly dry up and the banking sector must turn to short-term capital markets. Nevertheless, there is a critical limit to short-term capital financing for any given country, namely, the debt capacity, which is determined by the quality of projects being financed and the soundness of the financial institutions that enable investors to recover their loans. As a country exhausts this debt capacity by building up short-term debt, the likelihood of a financial crisis increases accordingly. In this

[36] Uri Dadush, Dipak Dasgupta and Dilip Ratha, "The role of short-term debt in recent crises", *Finance and Development*, (December 2000), pp. 54-57.

[37] Morris Goldstein, *The Asian Financial Crisis; Causes, Cures and Systemic Implications*, (Washington D.C., Institute for International Economics, 1998), p. 2, table 4B.

[38] See, for example, Steven Radelet and Jeffrey Sachs, "The onset of the East Asian financial crisis", NBER working paper series, working paper 6680, (Cambridge, Massachusetts, National Bureau of Economic Research, August 1998). Available at: http://www.nber.org/papers/w6680; and Morris Goldstein and John Hawkins, "The origin of the Asian financial turmoil", Research discussion paper 9805, (Reserve Bank of Australia, May 1998).

[39] Morris Goldstein, *The Asian Financial Crisis; Causes, Cures and Systemic Implications*, (Washington D.C., Institute for International Economics, 1998), table 6.

[40] Douglas W. Diamond and Raghuram Rajan, "Banks, short-term debt and financial crises: Theory, policy implications and applications", NBER working paper series, working paper 7764, (Cambridge, Massachusetts, National Bureau of Economic Research, June 2000). Available at: http://www.nber.org/papers/w7764.

regard, it is of paramount importance to recognize that the restructuring of the banking sector and financial markets by improving prudential regulation and supervision directly contributes to raising the debt capacity of a country so that investors become increasingly confident with regard to financing projects with extended gestation periods.

Moreover, given these currency and liquidity mismatches and the investment misallocation in many developing economies, it is not surprising to find that a banking crisis is characterized by heavy volumes of bad debts. Reliable estimates of non-performing bank loans in developing economies are hard to ascertain and vary according to different studies. For example, one recent estimate puts total bad debts of the four worst hit Asian economies at $130 billion with a cost range of 20-55 per cent of GDP.[41] Another estimate puts the share of non-performing to total bank loans in the 15-35 per cent range in Indonesia, Republic of Korea and Thailand; and points out that the banking sector in Malaysia is perhaps also in equally bad shape.[42] Needless to say, many bank failures and the fragility of the financial market in developing economies are the result of the rapid accumulation of non-performing bank assets.

[41] Angus Armstrong and Michael Spencer, "Will the Asian phoenix rise again?", *Global Emerging Markets,* Vol. 1, No. 33, (1998), pp. 1-26.

[42] Morris Goldstein, *The Asian Financial Crisis; Causes, Cures and Systemic Implications*, (Washington D.C., Institute for International Economics, 1998), p. 4, table 5.

V. PRACTICAL ISSUES RELATED TO BANKING REGULATION AND SUPERVISION IN DEVELOPING COUNTRIES

This section reviews crucial issues related to prudential regulation and supervision of financial intermediaries, focusing in particular on the banking sector, based on the fact that the problems that are endemic to the banking industry are also almost identical in nature to those observed in other financial sectors. One of many divergent views regarding the fundamental causes of the financial crisis in developing countries is the thesis of crony capitalism. This school of thought advances the argument that the uncontrolled corporate investment spree in developing countries, particularly in certain Asian countries, namely, Indonesia, Republic of Korea and Thailand was at the core of the recent Asian crisis. Excessive corporate investments in fixed assets, particularly in property markets, led to poor profitability, which was reflected in a low return on equity and on capital employed. Moreover, these corporate investment excesses were made possible by financial excesses, which violated prudential financial practices and eventually led to the banking sector crisis. A number of factors are deeply entangled in this process of financial distress, and they include bad government policies that intervened extensively in banking decisions pertaining to credit allocation, magnified moral hazard problems with explicit or implicit government guarantees, and neglected prudential banking supervision. Indeed, this type of crisis could have been avoided by ensuring that effective machinery for prudential supervision of the financial system was put in place, thereby preventing such investment and financial excesses.

Even in the absence of such financial market distortions as financial repression, which is common in developing countries, it is possible that even a relatively sound banking sector in developed countries may suffer some form of financial instability as a result of the problems of asymmetric information, adverse selection and moral hazard that are inherent in financial intermediation, as has been witnessed in the banking crisis in Japan. In developing countries, the difficulty associated with acquiring information concerning firms and banks, compounded by a financial structure weakened by a long history of bad government policies, distortions and even corruption, renders asymmetric information and moral hazard problems far more severe than they would be in other countries, and makes the task of designing and implementing prudential supervision considerably more difficult. Moreover, these difficulties are further compounded by the realities of pervasive political interference in the financial market and the intractable problem of enforcing prudential banking regulation in the face of political interventions, even when reasonably sound rules and regulations are put in place.

In the present highly liberalized global financial and capital market, few people would dispute the catastrophic consequences of a fragile domestic financial system coupled with an inadequate system of financial regulation and supervision. Reliable costs of failed financial systems in developing countries are very difficult to estimate; however one study put the total cost of 59 banking failures in these countries in the 1976-1996 period, prior to the 1997 Asian crisis at $250 billion, at an average of over 9 per cent of GDP.[43] Moreover, one recent estimate of the banking crashes in the worst hit countries in the 1997 Asian crisis, namely, Indonesia, the Philippines, Republic of Korea and Thailand, amounted to some $130 billion, approximately 20-55 per cent of GDP.[44] This can be compared with 10 banking failures in developed countries, where the average cost was estimated at approximately 4 per cent of GDP over the same period.

This highlights that strengthening the banking structure through prudential regulation and supervision is one essential step to restore financial stability in developing economies. There are many different ways to provide prudential banking supervision, including restrictions on asset holdings and activities; separation of banking and other financial industries, for example, securities, insurance, or real estate; capital requirements; disclosure requirements; and bank examination. This study reviews two important issues for prudential supervision, namely, capital adequacy requirements and restrictions on banking activities, with the aim of

[43] Gerard Caprio and Daniela Klingebiel, “Bank insolvency: Bad luck, bad policy, or bad banking?”, a paper prepared for the Annual World Bank Conference on Development Economics 1996, (The International Bank for Reconstruction and Development/World Bank, 1997).

[44] Angus Armstrong and Michael Spencer, “Will the Asian phoenix rise again?”, *Global Emerging Markets*, Vol. 1, No. 33, 1998, pp. 1-26.

highlighting how difficult or feasible it is to implement these measures in the face of existing institutional rigidities and political obstacles in developing economies.

A. Capital adequacy requirements

Ensuring sufficient capital for the assets of banks is one means of inducing banks to accept less risky investments, based on the fact that the more equity capital there is, the greater the losses of the bank are in the event that it fails. In 1988, the Basel Committee on Banking Supervision of the Bank for International Settlements established the minimum capital requirement in relation to its risks as an international banking standard, known as the Basel Accord I. This requirement took the form of a leverage ratio, and can be explained as the amount of capital divided by the risk-weighted total assets of the bank, with the minimum ratio set at 8 per cent of the risk-weighted assets of the bank. Given the numerous shortcomings of the current one-size-fits-all approach, a capital standard for banks, namely, the Basel Accord II, or Core Principles for Effective Banking Supervision was formulated in 1997 to remedy known defects in existing rules. While the new approach is far more comprehensive, it is still considered to be inadequate, and it is highly unlikely that it will be implemented before 2006, despite the fact that it was originally planned for 2004.[45] The following section on capital adequacy ratio (CAR) is based on the Basel Accord I.

There are many technical and practical difficulties involved in implementing capital adequacy requirements. With regard to defining CAR there is a serious problem of how to measure capital in the numerator and risk-weighted assets in the denominator of the ratio. The risk-weighted assets and off-balance sheets[46] of the bank defined by the Basel Accord are classified into the following four categories, each with a different risk weight:

(a) The first category carries a zero weight and includes default-free assets, for example, reserves and government securities (United States treasury bills) in developed countries;

(b) The second category receives a 20 per cent weight and includes claims on banks in OECD countries;

(c) The third category has a 50 per cent weight and includes municipal bonds and residential mortgages;

(d) The fourth category has a maximum weight of a 100 per cent, and includes personal and commercial loans.

One problem arising from this risk asset classification is regulatory (capital) arbitrage, whereby banks have incentives to substitute more risky assets for safer assets in their portfolios.[47] This occurs because this scheme does not differentiate the risk between a safe loan to an AAA-rated corporation and a highly risky loan to a CCC-rated firm, which both receive the same risk weight of 100 per cent. However, a further finer differentiation of the credit risks of corporate loans, according to their credit rating, is impracticable in most developing countries where such a credit rating system of corporations is virtually non-existent or remains at an embryonic stage.

[45] For a full description of the Basel Accord II, see the Basel Committee on Banking Supervision, “A new capital adequacy framework”, (Basel, June 1999) and “The Basel Committee on Banking Supervision”. Available at: http://www.bis.org/bcbs/aboutbcbs.htm. For a critical review of the proposed Basel Accord II, see *The Economist*, (23 February - 1 March 2002).

[46] Off-balance sheet activities of the bank refers to the activities of the bank, which do not appear on its balance sheet, namely, trading financial instruments, including loan commitments, letters of credit, interest-rate swaps and trading positions in futures and options, and generating incomes from fees. These off-balance sheet activities are believed to expose banks to risk, which is why they were included as part of the risk-weighted assets in the capital requirements established in 1988.

[47] Frederic S. Mishkin, “Prudential supervision: Why is it important and what are the issues?”, NBER working paper series, working paper 7926, (Cambridge, Massachusetts, National Bureau of Economic Research, September 2000). Available at: http://www.nber.org/papers/w7926.

The problem of estimating capital in the numerator and assets in the denominator of the adequacy ratio poses a number of serious difficulties. First, accounting capital is defined as the residual difference between the assets and liabilities of a bank, and hence capital valuation is directly affected by how the assets of the bank are valued. A natural yardstick for valuing assets is fair market value, and this approach does not pose serious problems when the assets of the bank are predominantly composed of marketable securities. However, banks hold a considerable part of their assets in the form of real estate, and the market value of property is very difficult to estimate, particularly during a boom-and burst cycle, which many Asian economies and Japan have experienced in recent years.

A realistic valuation of a bank's loans, which comprise the major portion of its assets, poses even greater problems. Severe asymmetric information problems run counter to the realistic market valuation of loans. Using inside information, a bank is likely to retain worthy loans while it attempts to sell through deep discount, bad loans with little likelihood of repayment. In this case, bank regulators cannot rely on the market price of loans to assess the loan value. Moreover, this information asymmetry leads to further difficulties for bank regulators. Ideally, bank regulators prefer to have their own fair valuation of the assets of a bank classified by different types of risk. In practice, however, bank supervisors do not have access to inside information or the resources to dispute the bank's assessment of its loans. The problem is further aggravated by the general tendency of banks to overvalue their loans and underestimate reserve requirements against bad loans. Furthermore, a bank can continue its operations and postpone its closure even in a state of insolvency with its liabilities exceeding its assets (or a negative net worth), as long as the net deposit flows and the interest income from performing assets are sufficient to pay its operating expenses and interest on deposit.

During an insolvency crisis, banks are even more tempted to overvalue their assets simply to delay their demise; the situation deteriorates further when bank supervisors are under political pressure not to pursue the investigation of problem loans that have been made to politically powerful persons, their families or other politically motivated loans. The worst situation is when bank officials help themselves to resources through self-lending or outright fraud, and engage in concealment activities against bank regulators through account riggings or other fraudulent manipulations. These types of fraudulent activities are not uncommon in many developing countries and even in developed countries, including Japan and the United States, where banking scandals have occurred.

More transparent and stricter accounting standards would make it easier for bank regulators to examine banks. For example, in most countries when the interest payment on a loan remains in arrears for more than three months, the loan is classified as non-performing, and the interest on it is not counted as the accrued income. However, loan classification based on the length of delayed interest payment varies considerably in developing countries. In Thailand, for example, interest accrual on non-performing loans was permitted for up to one year in 1997. However, in times of widespread financial crisis, as was the case in the recent Asian crisis, even the best accounting standards could not prevent banks from hiding bad debts, in other words, banks engaged in 'evergreening', or the refinancing of loans to cover interest repayments. This is particularly likely when a bank is overexposed to a small number of big enterprises on the verge of bankruptcy, and the failure of these firms is likely to endanger the solvency of the bank itself. The situation becomes more acute when this problem loan involves a large corporation, which accounts for a dominant output share of the economy. Moreover, when it is linked to a politically elite group, political pressure is often exerted both on a bank and regulators to keep the weakened enterprise alive.

Measuring the level of capital is one big problem, and measuring the risk of bank assets is another matter. Aside from the numerous conceptual and practical difficulties involved in measuring bank capital, minimizing the risk of a bank failure rather than value maximization is a primary concern in bank supervision. It is quite natural, therefore, that high-risk situations call for high capital standards. However, there are many different ways for a bank to thwart the higher capital adequacy requirements that are demanded by highly risky environments. A bank can respond to the higher capital requirements simply by raising the risk of its loan portfolio, using a technique like capital arbitrage. The rules governing risk classification of bank assets are rather arbitrary and subjective, and hence there is plenty of room for a bank to amplify risk.

The problem is further compounded by the rapid development of new financial instruments and financial derivatives, where the potential for the bank to magnify its risky portfolio is greatest. In this context, there is a glaring paucity of technical expertise to deal with new financial market developments in developing countries. More importantly, the risk caused by the transaction of new financial instruments and derivatives, spreads at a faster rate than the occurrence of annual or even quarterly bank examinations. Given that the continuous electronic monitoring of banking operations is not yet feasible, there is no alternative but to rely on the internal risk management systems of banks in this new market.

One way to remedy this problem is to employ the expert services of a private credit rating agency to assess the credit risk of different bank assets in developing countries. This means, however, that there is no domestic technical capacity to develop a private credit rating system. However, the use of a foreign credit agency is often costly, and the track record of such foreign agencies in assessing both country risks and corporate risks in developing countries has been at most, mediocre. Even for a world-class risk-rating firm, this type of task is extremely difficult in countries where financial markets are dominated by a complex network of assets and ownership cemented by political connections, close family ties and personal relations. In such an opaque and secretive environment, banks can dilute the quality of bank capital by responding to the higher capital standards in many different ways. The shareholders of a bank can borrow from other banks to purchase bank shares, which is what actually happened in Chile in the early 1980s and in Mexico in 1994;[48] they can egregiously borrow from their own bank; or a number of banks buy each other's shares in the form of cross-share holding, which is an activity that is widely practiced in Japan. Obviously this type of capital quality dilution provides less incentives for prudent management and is very difficult for outsiders to detect, not to mention prevent.

One important method for strengthening the capital adequacy position of a bank is issuance of the subordinated debt. Subordinated debt is the most inferior debt that is paid off, after all other claims are settled in the case of a bank failure, and is counted as part of Tier 2 capital in computing CAR. As a result of high non-payment risks associated with subordinated debt, holders of this debt are supposed to have strong incentives to monitor the banking operation. Moreover, issuing banks must disclose information thoroughly to gain market credibility before they can sell subordinated debts. As a result, the market-determined price and interest rate of a subordinated debt reflects a market assessment of the financial health of the issuing bank, and such information is often a useful input to prudential bank supervision. In fact, this scheme is widely used in developed countries and has even been initiated in some developing countries, namely, Argentina in 1997. One major benefit of the subordinated debt requirement, for example in Argentina, is that it makes it extremely difficult for bank supervisors to ignore the market signal pertaining to the financial health of a given bank, which is revealed by such a requirement, and hence bank regulators are compelled to take proper action to close down a weak bank or to rebuild it. In other words, they are deprived of any excuse for regulatory forbearance.

However, there are some practical difficulties with regard to implementing this debt scheme. First of all, holders of subordinated debts must be entities that are sufficiently distanced from the interests of a bank, or shareholders, and should preferably be foreign investors. More realistically, there are few banks in developing countries that are willing to make a full disclosure of information and raise bank capital at relatively high costs. It must also be noted that there are many abuses of this scheme, including rigging the capital ratio. Such account rigging to raise the capital ratio has actually occurred in the form of cross-holding of subordinated debts between banks and major life insurance companies in Japan. To be more specific, as of the end of March 2000, major Japanese banks had purchased a total of 2.2 trillion yen (¥) or approximately $18 billion worth of subordinated debts from 14 major domestic insurance companies, and in return the insurance companies bought back ¥777 billion worth of bank shares, and ¥670 billion worth of subordinated debts of banks.[49] The transactions were undertaken to raise both the capital ratios of banks and the solvency ratios of insurance companies above the required 200 per cent level. In the case of the dissolution of the Long-term Credit Bank of Japan, now the Shinsei Bank, the subordinated debts of

[48] Gerard Caprio and Patrick Honohan, "Restoring banking stability: Beyond supervised capital requirements", *Journal of Economic Perspectives*, Vol. 13, No. 4, (Autumn 1999), pp. 43-64.

[49] *Nihon Keizai Shinbun* (15 November 2000) (in Japanese).

insurance companies held by the bank were fully protected and in the case of Yamaichi Securities, which declared bankruptcy, an out-of-court settlement was reached to repay half of the amount of subordinated debts. These kinds of abuses are even more likely in developing countries where a greater concentration of economic and political power is much more common and interlocking corporate ownerships among family members and elite groups are more prevalent than in developed countries. As a result, such institutional shortcomings considerably diminish the usefulness of the very promising role of subordinated debts in subjecting the bank to the discipline of private creditor monitoring and in creating incentives for the private production and disclosure of bank information.

B. Restrictions on banking activities

To minimize risk-taking by banks, banking activities can be restricted in two areas: asset holdings and the types of business that are allowed. With regard to the former, it is obvious that a bank is naturally inclined to hold risky assets, on the grounds that the return on risky assets is higher than on safe assets, and the pay-off for the bank is accordingly higher in the event that the project succeeds, while depositors must bear the cost in the event that it fails. In this case, even in the absence of a government safety net, for example, deposit insurance, the bank will not engage in risky activities when depositors have sufficient information concerning the activities of the bank, that is, when there is no asymmetrical information problem. Therefore, in this type of situation, when a bank holds too many risky assets, depositors will withdraw their deposits; however, the asymmetric problem always exists in reality. Unfortunately, in the presence of a government safety net to protect depositors, a bank has an even greater incentive to engage in risky activities, which is a moral hazard problem. There is, therefore, a compelling case for Governments to impose restrictions on banks that hold risky assets, including common stocks or property. Bank regulations can also restrict the exposure of banks to a small number of borrowers or businesses.

Such banking regulations that limit the range of bank asset holdings seem to take on an extra significance in developing countries that are plagued by non-performing property loans, overexposure to a small number of large corporate borrowers, and severe asymmetric information problems. However, the enactment of adequate banking regulations is one thing and the enforcement of such regulations is another. Information disclosure stands in the way of the effective enforcement of bank regulation and this disclosure requirement poses an especially serious problem in developing countries. More specifically, bank regulators must insist that banks use certain common accounting standards and make public disclosure of a wide range of information regarding their activities so that depositors, creditors, shareholders and markets are capable of assessing and monitoring the risk quality of their asset portfolios and therefore enforcing a degree of constraint on banks with regard to undertaking overly risky activities. The New Zealand disclosure system is notable in this context, in that it requires: (a) the public disclosure of a comprehensive quarterly financial statement of each bank; (b) bank directors to validate such a statement; and (c) that they be made subject to unlimited liabilities in the case of the failure of a bank.[50] However, such a disclosure requirement seems to be a long way off in most developing countries, given the institutional realities characterized by severe information asymmetry problems, which exist between regulators and banks, and depositors and banks, and which often result in shady concealments and scandals; a complex network of politically connected insiders; and pervasive political interferences in financial markets.

Another way to reduce the risk level of banking activities is to restrict banks from engaging in commercial activities that lie outside the core business of banking. One well-known historical example is the Glass-Steagall Act of 1933, which enforced the separation of the banking and securities businesses in the United States until it was repealed by the enactment of the Gramm-Leach-Bliley Financial Services Modernization Act of 1999. In addition, commercial banking activities in Japan were strictly separated from other financial industries, for example, trust and investment banking, insurance, real estate and other financial services in the post-war period until very recently.

[50] Frederic S. Mishkin, “Prudential supervision: Why is it important and what are the issues?”, NBER working paper series, working paper 7926, (Cambridge, Massachusetts, National Bureau of Economic Research, September 2000). Available at: http://www.nber.org/papers/w7926.

The central question here is whether restricting the activities of banks in certain business domains increases or reduces the safety and stability of the financial system. Proponents of separation argue that certain business domains, namely, investment banking and real estate tend to be risky and hence the risk of a bank failure may increase when the bank undertakes such activities. A particularly thorny problem in this context is the underwriting of securities by banks. Banks can sell the unsold new issues of securities to trust funds, other non-bank entities they manage, or even to the bank itself. Given a complex network of business ownership by a handful of politically powerful families and other elite groups, coupled with the non-transparency of a legal framework governing financial transactions in most developing countries, such grave concerns over conflict of interest leading to underwriting abuses are often justified. Moreover, the extended coverage of the safety net to other non-banking activities reduces market discipline and encourages risk-taking in these industries. However, proponents of removing banks' entry barriers to other financial industries claim that bank entry into other industries promotes competition, and therefore enhances market efficiency in these industries. Furthermore, the creation of a universal bank offering a wide range of financial services, including securities, insurance and real estate, in addition to commercial banking, will allow banks to diversify their products, thereby increasing the safety of banks and the financial system.

The question of whether the separation of commercial banking from other non-bank businesses increases or decreases the stability of the financial system must be answered empirically. While not conclusive, proponents of restricting commercial banking are not empirically supported by that many relevant studies.[51] In other words, there are no reliable statistical relationships between restrictive regulations on banking activities, the level of financial development and the stability of the financial system.

More importantly, as a component of effective measures to reform and rebuild the weak domestic banking sector, the opening of domestic banking markets to foreign participation has been seriously considered in many countries. In fact, foreign banks recently owned approximately 40 per cent of domestic bank assets in Argentina. Moreover, Thailand is deregulating policies that govern foreign ownership, and other developing countries are also moving in this direction.[52] The apparent advantage here is that foreign participation, particularly from globally competitive banks, enhances the stability of the financial system by making domestic banks safer and more diversified in asset holdings; enabling them to learn sound and prudential banking practices; and providing them with the opportunity to expand their banking business beyond small local and national markets, which is a matter of crucial importance to small economies constrained by the limited size of their domestic markets. Of course, there are some disadvantages associated with opening domestic markets to foreign participation, for example, neglect of small domestic borrowers, including small- and medium-enterprises. Regardless of the merits and demerits of foreign participation, regulatory restrictions on domestic banks thwart the introduction of such a scheme. Given that most big foreign banks that are active in global markets are free from such regulatory restrictions, and offer multi-faceted banking and other financial services, they have an unfair competitive edge over their domestic counterparts when they are permitted to establish a branch bank. Moreover, such regulatory restrictions on domestic banks hinder them from forming a joint venture or merging with foreign banks.

[51] For example, Douglas W. Diamond and Raghuram Rajan, "Banks, short-term debt and financial crises: Theory, policy implications and applications", NBER working paper series, working paper 7764, (Cambridge, Massachusetts, National Bureau of Economic Research, June 2000). Available at: http://www.nber.org/papers/w7764.

[52] Gerard Caprio and Patrick Honohan, "Restoring banking stability: Beyond supervised capital requirements", *Journal of Economic Perspectives*, Vol. 13, No. 4, (Autumn 1999), pp. 43-64.

VI. SELECTED PRACTICAL ISSUES IN THE ENFORCEMENT OF PRUDENTIAL SUPERVISION

A. PRINCIPAL-AGENT PROBLEMS

One critical issue in the implementation of bank supervision is the principal-agent problem. This is a serious issue, even in many industrialized countries, including the United States, where adequate banking rules and legal frameworks have been firmly established, and satisfactory solutions have yet to be found. Undoubtedly, this issue is much more intractable in developing countries, where there are weaker legal and institutional foundations for the financial system.

The principal-agent problem arises from the divergence of motivation between the agent, a regulator or supervisor, and the principal, the taxpayer. The primary duties of bank supervisors are to serve the interests of the taxpayer by promoting the safety and stability of the financial system. They perform various functions to achieve this end, including curbing the risky activities of banks, requiring sufficient capital and closing down insolvent banks. In practice, however, bank regulators and supervisors are often motivated to engage in what is known as regulatory forbearance against the interest of the taxpayer. There are a number of plausible explanations for this sort of antisocial behaviour. First, when excessive bank failures are attributed to poor performance on the part of a regulatory agency, regulators may be inclined to avoid blame by relaxing regulatory standards, for example, capital adequacy requirements, and to conceal the insolvency problem of a bank, in the hope that the situation will improve, which is what happened in the savings and loans crisis in the United States in the early 1980s.[53] Second, the primary concern of regulators is often to protect their career, and they often find it difficult to resist pressure from those who strongly influence that career. This problem is perhaps particularly acute in developing countries where government employment is highly prized and is often obtained through personal connections with powerful politicians or other politically influential groups. Third, rapidly changing economic conditions may force regulators to yield to political pressures and engage in regulatory forbearance. For example, in times of deepening recession and credit crunch, politicians usually put tremendous pressure on bank regulators to relax regulatory standards, and such pressure is hard to resist.

Some notable proposals are being advanced to alleviate the principal-agent problem, namely, to reduce the incentives of bank regulators to engage in regulatory forbearance. One interesting solution to this problem is to enforce a mandatory requirement that financial supervisors must produce and make public disclosure of reports on their actions regarding insolvent banks. Such information disclosure and accountability requirements discourage bank supervisors from engaging in regulatory lapses and make it more difficult for politicians to put pressure on bank supervisors. In this regard, it is also important to recognize the important role of the subordinated debt requirement (see above), in monitoring the behaviour of bank supervisors. More specifically, when a weak bank fails to comply with the subordinated debt requirement, this sends out a clear market signal concerning the weak position of that bank, and bank regulators must take appropriate actions. However, as described above, there are numerous institutional and practical difficulties regarding the implementation of a subordinated debt system in developing countries, and hence bank monitoring with the aid of such a mechanism may not be feasible for some time to come for many developing countries.

In addition to the principal-agent problem, a number of equally important practical issues must be highlighted. First, there is the problem of a serious wage gap between bank supervisors and other professions in financial markets; this gap appears to be rapidly widening in emerging markets where foreign participation in the banking sector, which is encouraged through attractive pay packages, is common. Bank supervisors tend to be considerably less well paid than other comparable professions, namely, bankers, accountants, auditors and financial analysts in private financial institutions. This glaring wage gap reduces the incentive to work on the part of the bank regulator and increases the susceptibility to engage in regulatory abuses and even corruption; for example, a regulator might relax supervision in return for the promise of future employment promises in the institution that is being supervised or might even accept outright bribery. Moreover, it is very hard to retain skilled supervisors in a tight job market for skilled manpower. An obvious

[53] Edward J. Kane. *The S & L Insurance Mess: How Did It Happen?*, (Washington D.C., The Urban Institute Press, 1990).

solution to this problem is to raise the salary scales of bank supervisors; however, this runs into budgetary constraints. Still, one way of solving revolving-door type employment, is to ban future employment of bank supervisors in the financial intermediaries under their supervision. However, such a plan is impracticable, unless it is accompanied by a high pay scheme for bank supervisors, on the basis that otherwise it would be difficult to recruit and retain competent supervisors in the first place.

Another concern is the daunting problem of training and upgrading the technical skills of bank supervisors in the face of rapidly changing financial markets with increasingly complex new financial instruments. Basically, neither adequate technical competencies nor sufficient training capacities are available to upgrade technical skills in most developing countries.

In addition, another problem in performing regulatory functions is the real danger that bank regulators will face personal lawsuits for their actions against a failing bank or one that has broken the law. Legal protection for bank regulators in the performance of their duties has not been well established in developing countries, and therefore, regulators are often vulnerable to liability suits brought by politically powerful groups. Obviously, bank regulation cannot function in such a risky legal environment for regulators. In this case, raising public awareness of regulatory forbearance, and increasing public intolerance of such regulatory negligence, minimizes political interference and the legal threats that impede regulatory performance. However, the catch is that effective machinery for facilitating information disclosure and hence raising the level of public awareness does not yet exist in most developing countries.

B. TOOLS FOR MONITORING THE STABILITY AND SOUNDNESS OF A FINANCIAL SYSTEM

The availability of quantitative and qualitative tools for monitoring and assessing the soundness and stability of a financial system undoubtedly facilitates the task of prudential banking regulation and supervision. Moreover, these tools can be used as an early warning system against potential financial disasters. In recent years, many national and international institutions have initiated and intensified their efforts to develop such systems.

One of the tools most commonly used by bank examiners for monitoring the health of individual institutions is the CAMELS rating system, which was developed in the United States in the early 1990s and has been adopted in many other countries in variant forms. The acronym is based on the following factors: capital adequacy, asset quality, management, earnings, liquidity and sensitivity to market risk. Based on a composite indicator derived from information concerning these six areas, which are related to the activities of bank, bank regulators are able to take appropriate actions to alter the behaviour of a bank or close down its operations in the event that the rating is too low. However, there are many practical difficulties in implementing this system in developing countries. These include the major problems associated with capital adequacy, and in particular, monitoring the quality of bank assets, which are reviewed above. Moreover, sound management is obviously essential to bank performance; however, management is a qualitative variable and difficult to measure. Evidently, profitability is related to the solvency of a bank, but this is difficult to interpret. For example, unusually high profits can be attributed to excessive risk-taking. The level of liquidity is affected by a number of different factors, including funding sources, maturity mismatches and poor management of short-term liquidity. This can be cogently demonstrated through the example of the collapse of Barings Bank in 1995, which illustrates that a bank that is healthy and liquid at one point of time can be rapidly driven into insolvency and bankruptcy by the fraud and mismanagement of one or two people. Lastly, measuring sensitivity to market risk poses many problems, based on the fact that the operations of banks are becoming increasingly diversified in such areas as interest rate swaps, foreign exchange transactions, stock and commodity market transactions, and even real estate, with each of these operations generating a varying degree of risk, which is very difficult to measure.

Another notable monitoring framework is the BASIC system of banking supervision, which was developed by Argentina in the aftermath of the Tequila or Peso crisis in Mexico in 1994-1995. The acronym stands for bonds, auditing, supervision, information and credit rating. One particular feature of this system is the heavy emphasis on the disclosure of information concerning all loans in the financial system, and the creation of a credit bureau to make such information public. Of course, the problem in this case is that the usefulness of information disclosure depends on the accuracy and reliability of information. Another key feature is credit rating, which banks are required to obtain and publicize. Furthermore, banks are compelled to issue subordinated debts, which subjects them to market discipline.

A rather more comprehensive and ambitious monitoring system, the Macroprudential Indicators (MPI) of Financial System Soundness, is being developed as part of a joint World Bank-IMF Financial Sector Assessment Programme.[54] Basically, MPI combines the CAMELS framework with macro-indicators. Using the CAMELS framework, aggregated indicators of the soundness of individual institutions are calculated and known as microprudential indicators. Macroeconomic indicators cover major macroeconomic variables, including economic growth, balance of payments, inflation, interest and exchange rates, lending and asset price booms and contagion effects. Indeed, MPI is based on the conceptual underpinning that both types of micro and macro indicators, namely, the financial weakness of individual institutions and macroeconomic shocks, are useful with regard to pinpointing a financial crisis. This MPI system is still in the early stages of development and requires a number of improvements before becoming operational. In this regard, there is a need for a better conceptual clarification of the determinants of the soundness and stability of the financial system and their interrelationships, and the identification of various early warning signals, which policy makers must heed to prevent financial crises. The most formidable problems are encountered, however, in the areas of statistical data. In this context, the usefulness of the MPI system is severely limited by the extreme diversity and heterogeneity of national accounting and statistical standards; moreover, the absence of a common international standard hinders international comparisons. In addition, there are a number of thorny issues related to poor or incomplete data or to the paucity of data concerning asset quality and other aspects of bank operations, including ownership, sectoral concentration of credit, bad debt provision and write-offs. The inadequate data problem is indeed a formidable challenge in developing countries, and is also a matter of serious concern in developed countries, as was forcefully revealed in a series of recent financial scandals in Japan. Furthermore, as emphasized above, rapid financial innovations, for example, financial derivatives and off-balance sheet positions pose special problems with regard to assessing the health of financial institutions, based on extreme volatility, the lack of reporting of positions and potentially large positions, which was the case with regard to Barings Bank.

It is also worth noting that despite the valiant efforts of the Government of Argentina to strengthen its banking sector, including developing the BASIC system of banking monitoring and supervision, it failed to forestall a financial crisis. The third largest economy in Latin America collapsed in late 2001. After defaulting on a $3 billion debt repayment in 2003, Argentina clinched a three-year aid package from the IMF, which agreed to roll over approximately $21 billion of multilateral debt, opening the way for the country to renegotiate billions of dollars worth of private debt.[55]

The financial and economic crisis of the Argentine economy in the last three years offers some interesting lessons. First, the particular efforts of the Government of Argentina to develop and improve the prudential regulation and supervision of the banking sector did not succeed in preventing the financial crisis, and in particular, the system of banking regulation was not able to curb excessive private foreign borrowing, which was largely responsible for the crisis. Perhaps the regulatory system that was designed was defective or maybe the sheer size of international capital movements overwhelmed the monetary and fiscal capacity of a relatively small economy. It must be noted, however, that many small developed-economies in Europe, namely, Austria, Belgium, Denmark, Luxembourg, Norway and Switzerland, have all survived the past decade of turbulent international financial markets, thanks to their sound corporate governance and healthy financial systems.

Moreover, the example of a boom-bust cycle of short-term capital flows, which is reviewed above, illustrates that financial crises necessarily lead to economic crises in the form of deepening recession, which occurs when financial and capital markets are liberalized at a time when a system of banking regulation and

[54] Owen Evans and others, “Macroprudential indicators of financial system soundness”, Occasional Paper 192, (Washington D.C., IMF, April 2000).

[55] *Socialism Today*, “World take over breaking down”, No. 78, (October 2003). Available at: http://www.socialismtoday.org/78/editorial.html.

supervision is not yet functioning properly. In the context of such conditions, financial stress, for example, the payment difficulties of short-term loans, causes capital flight, which in turn devalues the domestic currency, leading to a downward spiral of economic deflation. As a result of the financial crisis, paralysis of the banking sector and consequent deepening recession, the standards of living of average Argentines collapsed in 2001-2002. According to the Government, more than half the population now lives below the poverty line. The Argentine experience underscores once more the importance of sound regulation and prudential supervision of financial intermediaries, particularly of the banking sector, as a precondition for financial liberalization that includes capital account convertibility.

VII. THE FINANCIAL SECTOR IN THE ESCWA REGION

A. MACROECONOMIC OVERVIEW

The focus of this chapter is not on the macroeconomic performance of ESCWA member countries,[56] rather on their financial sectors. In general, current developments in the financial sectors of most ESCWA member countries are consistent with theoretical expectations of financial sector development at different stages of economic development. Indeed, the financial systems in most ESCWA countries are reasonably similar to those in developing countries that are still in the initial phases of economic development. Characteristics that can be noted include pervasive government interventions in the financial sector and consequent financial repression in the form of interest rate ceilings and government-directed credit allocation, the dominance of indirect finance accompanied by the relatively small or virtual non-existence of securities markets, and striking structural deficiencies in the legal and regulatory frameworks.

For analytical convenience, the ESCWA region is divided into two clusters: oil dominated economies and more diversified economies (MDEs). The oil dominated economies refer to the Gulf Cooperation Council (GCC) countries, namely, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates and also Iraq. The more diversified cluster comprises Egypt, Jordan, Lebanon, the Syrian Arab Republic and Yemen, and also the West Bank and Gaza Strip. With regard to this classification, some countries in the MDEs group, namely, Egypt, the Syrian Arab Republic and Yemen produce and export crude oil; however, its importance relative to GDP and trade in these countries is relatively less significant as compared with the GCC countries. Moreover, in reference to the use of the phrase, ‘more diversified economies’, the term ‘diversification’ usually signifies a structural balance characterized by inter-industry and intersectoral widening and deepening, which is one of the major distinguishing features of economic development. None of the economies in the ESCWA region has achieved this advanced stage of economic development.

Moreover, only seven ESCWA member countries are WTO members, namely, Bahrain, Egypt, Jordan, Kuwait, Oman, Qatar and the United Arab Emirates; Saudi Arabia, has applied for WTO membership and should become a member in 2004. Iraq recently gained observer status in the WTO.

The average GDP growth rate for the ESCWA region as a whole, excluding Iraq and the West Bank and Gaza Strip, was 2.46 per cent in 2001, and was estimated at 1.88 per cent in 2002 in contrast to a remarkable growth rate of 4.97 per cent in 2000. The growth rate of the ESCWA region in 2002 compared unfavourably with those of most developing countries including those of Sub-Sahara Africa. A steady decline in the growth rate in recent years can be partially explained by the global recession, and more significantly by a marked decrease in the oil export revenues of the region, as a result of a substantial fall in the oil production of the main exporters in the region, which was not compensated by higher oil prices. Of course, economic performance varied substantially from country to country. Relatively high performers among the oil economies during the period 2001-2002 were Bahrain, at 4.79 per cent for 2001, and 4.01 per cent for 2002; Oman, with 9.3 per cent and 2.89 per cent; and the United Arab Emirates, with 3 per cent and 3.5 per cent. Kuwait, however, was mired in a negative growth rate of 1.12 per cent in 2001 and a zero growth in 2002, and Saudi Arabia recorded low growth rates of 1.19 per cent and 0.74 per cent in the two respective years. Among the non-oil economies, Jordan, the Syrian Arab Republic and Yemen registered a growth rate above 3 per cent, while Lebanon and Egypt lagged behind the others, with growth rates of approximately 2 per cent or less than 2 per cent in 2002 (see table 2).

B. THE BANKING SECTOR[57]

As highlighted by means of a stylized model of financial development in developing countries, the financial sectors in most ESCWA member countries are generally characterized by the dominance of the

[56] See ESCWA, *Survey of Economic and Social Developments in the ESCWA Region 2002-2003* (E/ESCWA/EAD/2003/6).

[57] This section, and the subsequent sections on institutional investors and capital markets are primarily based on: ESCWA, “The financial sector in the ESCWA region: The current status and prerequisites for strengthening and development”, a paper presented at the International Conference, (Monterrey, Mexico, 18-22 March 2002), (E/ESCWA/OES/2002/6).

banking sector and the relative underdevelopment of non-bank financial institutions, namely, insurance companies, pension funds, mutual funds and savings institutions, and capital markets. As of the end of 2002, nearly 365 banks were located unevenly in various ESCWA member countries, providing commercial, investment and Islamic banking services. In general, too many banks operated well below the level of market efficiency in some countries. For example, in 2002 there were 71 banks in Lebanon, a country of some 3.6 million people with GDP of $13 billion; and 42 banks in Egypt, which had a population of approximately 61.4 million with a GDP of approximately $90 billion. In sharp contrast, the banking sector is relatively underdeveloped in the Syrian Arab Republic and Yemen.

TABLE 2. REAL GDP GROWTH RATES IN THE ESCWA REGION AT CONSTANT 1995 PRICES, 2001-2002

	GDP (millions of US dollars)	Growth rates (percentage)	
Country/area	2001	2001	2002[a/]
Bahrain	7 228.4	4.79	4.01
Kuwait	27 609.1	(1.12)	0.01
Oman	17 792.4	9.3	2.89
Qatar	14 866	6.81	4.36
Saudi Arabia	163 510.1	1.19	0.74
United Arab Emirates	60 135.3	3	3.5
Oil dominated economies	291 487.4	2.16	1.64
Egypt	88 157.4	3.13	1.91
Jordan	8 175.3	4.18	4.01
Lebanon	12 526.4	1.5	2.01
Syrian Arab Republic	23 056.8	3.4	3.35
Yemen	5 757.2	3.38	4
More diversified economies	137 673.4	3.09	2.37
ESCWA[b/]	429 160.8	2.46	1.88

Source: ESCWA, *Survey of Economic and Social Developments in the ESCWA Region 2002-2003* (E/ESCWA/EAD/2003/6).

Notes: Parentheses ( ) indicate negative growth.

a/ ESCWA estimates.

b/ Excluding Iraq and the West Bank and Gaza Strip due to lack of data.

During the period 2001-2002, the banking sectors in the ESCWA region recorded a respectable growth rate in the aggregate. For example, total assets in the banking sectors grew 6.1 per cent to $520 billion, and customer deposits increased 9.4 per cent to $350.7 billion. Nearly 74.4 per cent of customer deposits, $257.2 billion, was extended to the economy in the form of credit expansion in 2002 (see table 3). However, these figures must be viewed in a global context. Despite considerable growth, the total banking assets in the region still constitute a tiny fraction of the world total of approximately $20 trillion, or less than 0.5 per cent (see table 1 above). In other words, the aggregated bank assets in the ESCWA region are less than the assets of a single large international bank.

There have been notable changes in the banking sectors in the ESCWA region in recent years. Some of the most prominent changes include trends towards universal banking services, which encompass financial leasing, investment banking and insurance. Activities related to retail banking increased, and linkages with global financial markets were expanded through the development of new products and channels, for example, subordinated debt instruments, fiduciary deposits, euro-bonds, global depository receipts and euro-CDs, in addition to credit lines and funds from international financial institutions. Participation in project financing of major investment programmes and projects in the region also increased. Furthermore, there were notable trends towards bank mergers and acquisitions. Banks in the region have also made conscious efforts to improve compliance with global standards in banking regulation and supervision, disclosure, accounting standards, corporate governance and Basel standards.

TABLE 3. ASSETS AND LIABILITIES OF THE BANKING SECTOR
IN THE ESCWA REGION, 2001-2002
(*Millions of US dollars*)

	Assets		Credit		Deposits		Equities	
	2001	2002	2001	2002	2001	2002	2001	2002
Oil dominated economies	293 510	312 176	133 231	143 408	183 037	204 150	30 951	35 234
Bahrain	10 354	10 445	4 653	4 209	7 411	8 322	832	857
Kuwait	49 012	55 440	19 929	21 927	30 510	34 111	5 472	5 624
Oman	10 933	11 148	8 427	8 397	6 978	7 135	1 107	1 120
Qatar	15 751	16 508	9 344	9 315	11 681	11 931	1 837	2 001
Saudi Arabia	125 982	135 272	51 305	57 132	76 668	85 327	11 678	15 184
United Arab Emirates	81 478	83 363	39 573	42 428	49 789	57 324	10 025	10 448
More diversified economies	196 671	207 881	105 290	113 771	137 573	146 537	11 461	13 230
Egypt	105 586	110 349	57 400	59 265	70 701	75 917	5 079	5 924
Jordan	19 963	20 000	6 980	8 240	12 301	12 460	2 026	2 400
Lebanon	47 700	51 100	31 931	39 395	40 100	41 100	2 960	3 280
Syrian Arab Republic	17 472	20 632	7 208	5 130	7 839	10 853	1 033	1 259
West Bank and Gaza Strip	4 300	4 100	1 127	1 078	5 479	5 000	224	221
Yemen	1 650	1 700	644	663	1 153	1 207	139	146
ESCWA[a/]	490 181	520 057	238 521	257 179	320 610	350 687	42 412	48 464

Source: ESCWA, *Survey of Economic and Social Developments in the ESCWA Region 2002-2003* (E/ESCWA/EAD/2003/6).

a/ Excluding Iraq due to lack of data.

However, despite the marked improvements that have been made through reforms in recent years, banking sectors in the region are still plagued by a number of fundamental weaknesses, including the following:

(a) *Small banks in terms of assets and capital compared to emerging and international banks*

Only nine domestic banks in the region had assets in excess of $15 billion and only four banks had shareholders’ equity exceeding $4 billion in 2001.

(b) *Overbanking, excess competition and the deterioration of bank assets*

Banking sectors are generally overcrowded relative to the size of their national economy, population and the size of the Arab banking sector as a whole. The excess number of banks hurts profitability and solvency. As a result, the quality of bank assets has considerably deteriorated and NPLs have substantially increased. Moreover, another major cause of NPLs is policy-directed bank financing of unprofitable public enterprises and institutions. For example, estimates suggest that NPLs accounted for 64 per cent of total loans in Yemen in 2001.

(c) *Excessive concentration*

Banking sectors are increasingly being marked by concentration on a small number of banks. For example, the two largest commercial banks in Yemen accounted for 64 per cent of total market deposits in 2001. In Egypt, the four public banks owned 65 per cent of banking sector assets, while in Qatar, the Qatar National Bank alone claimed a market share of 45 per cent of the country’s bank assets in that year.

(d) *Government-run banks*

Many banks in the region are owned and run through public sector participation. The public sector, therefore, dominates the management and operation of banks.

(e) *Inadequate information disclosure systems*

The accuracy and scope of bank reporting systems varies greatly from bank to bank and from country to country. There is no accepted minimum standard for publishing bank financial statements and information disclosure, which makes it difficult to make comparisons with international banks.

(f) *Inefficient payment systems*

In most ESCWA countries, the clearing system is the clearing record, which is based on the actual clearing of debt and credit instruments by manual procedures, and which suffers from frequent delays in clearing operations, a tendency to lose documents and an increased occurrence of overdrafts.

C. NON-BANK FINANCIAL INSTITUTIONS

Institutional investors, which largely comprise non-bank financial institutions, including insurance companies, pension funds and mutual funds are usually expected to develop to full strength, relatively speaking, during the advanced phases of financial sector development, when the necessary financial, legal and technological infrastructures are firmly in place. Given that non-bank financial institutions in the ESCWA region are in the embryonic stages of financial sector development, particularly the insurance sector, pension funds and mutual funds, these are generally underdeveloped compared to other emerging markets, let alone to developed countries, despite marked variations among countries in the region. The thinness or virtual non-existence of this financial subsector is clearly revealed by an international comparison of asset-GDP ratio indicators. According to an ESCWA report published in 2002,[58] the ratios of the total combined assets of insurance companies, pension funds and mutual funds to GDP was over 100 per cent for some developed countries, including the Netherlands, Switzerland, the United Kingdom and the United States; these ranged between 25 per cent and 100 per cent for the majority of the European members of OECD countries; and 25 per cent for many developing countries. In sharp contrast, the average ratio for the ESCWA region was only some 10 per cent in the same period. There were a few major exceptions. The average ratio for Egypt, where the markets for mutual savings are well advanced compared to other ESCWA member countries, was 40 per cent; while in Jordan it was 20 per cent. In relative terms, the insurance industry is less developed than mutual savings markets in the ESCWA region. Moreover, mutual savings and institutional investor institutions are dominated by government ownership or participation. Government dominance in these financial subsectors has resulted in serious market distortions and asset misallocations, and also diminishing investment returns.

1. *The insurance industry*

Despite the large number of insurance companies in the region, their importance in terms of resource mobilization and investment financing is quite limited. According to an ESCWA report published in 2002, the distribution of insurance companies and their premium receipts were quite uneven in the period covered.[59] For example, at the top end of the spectrum, there were 82 companies (foreign and domestic) in Lebanon, with premiums valued at $500 million; this was followed by Saudi Arabia, which had 69 companies with $770 million worth of premiums; United Arab Emirates, which had 47 companies with $690 million; Jordan, which had 27 companies with $100 million; Egypt, with only 11 companies, but with $550 million receipts in premiums; and in Qatar, just 8 companies with $170 million. Still, when these figures are compared against those of other country groups, they appear insignificant. For example, the total subscribed premiums of $5 billion for the ESCWA region constituted only a tiny 0.2 per cent of world total, which

[58] Ibid.

[59] Ibid.

amounted to $2,500 billion. Equally insignificant was the average per capita insurance premium in the ESCWA region compared to that of the developed countries, $120 compared to $500.

Insurance markets in the ESCWA region generally suffer from a number of structural weaknesses. One of these is that there are too many companies for the small size of local markets, which casts some doubt on their solvency and viability, which is further aggravated by weak capitalization, less than $15 million in many cases. This is particularly true in Lebanon, Saudi Arabia and the United Arab Emirates. Another weakness is that their portfolios are markedly imbalanced, and concentrated on a few sectors. For example, car insurance accounted for 33 per cent of total premiums, and oil and aviation for 55 per cent according to an ESCWA report published in 2002, while the life insurance market is virtually absent or has yet to be developed. Another weakness that can be noted is that the development of the most promising insurance products, namely, consumer-oriented products, including life insurance, personal accident, and pension and medical insurance, has been relatively neglected. Other structural weaknesses are well known and common to many developing countries, and include inadequate information systems, rudimentary stages of legal, supervisory and accounting systems, heavy public sector intervention with overemployment in the insurance sector, and protection of insurance services in trade.

2. *Pension funds*

Statistical data for pension funds in the ESCWA region are difficult to compile, and if available, tend to be fragmentary. Without adequate quantitative data, it is extremely difficult to assess the current situation of pension fund markets in the region. However, in general, pension funds are still at the very early stages of development and they exist in the form of mutual savings for social security. Pension plans are generally plagued by problems of shortfalls of pension contributions for future payments of benefits caused by the following three factors: (a) increases in benefits without corresponding increases in contributions; (b) political resistance to raising the social security rates of contributions; and (c) pension funds savings are diverted to finance government spending. It is imperative to design and implement fundamental reforms of pension systems to establish a strong link between contributions and benefits, and therefore to achieve the guaranteed long-term benefits. Conscious efforts must be exerted to achieve greater integration with international markets by opening domestic markets to foreign investors, who bring necessary capital and advanced techniques in asset management. This should have the effect of markedly enhancing efficiency in mobilizing domestic and foreign resources, and stimulating the development of pension funds and other social security institutions in the region.

3. *Mutual investment funds*

Mutual funds also remain at the rudimentary stages of development, and the paucity of statistical data makes it difficult to analyse the current status of the mutual funds sector. Country variations are considerable in terms of market development. This sector is virtually non-existent in Iraq and Yemen; at the very early stages in Jordan and Lebanon; fairly advanced in Egypt, and most advanced in Saudi Arabia.

All member countries have been underperformers in relation to other countries in this particular area. The underdevelopment of the mutual funds market can be clearly shown by the fact that there was a 7 per cent ratio of industry assets to GNP in the ESCWA region in 2002, compared to 50 per cent in the United States, 39 per cent in France, and 20 to 30 per cent in most OECD countries.

The first mutual investment fund was created in Saudi Arabia in 1979; by 1990 there were 24, and by 1999, 117 funds. In Kuwait, two investment funds were launched in 1985, increasing to 6 funds by 1999. In 1999, 28 funds existed in Bahrain; 22 funds in Egypt; 7 in Oman; 5 in Jordan; and 3 in Lebanon. These investment funds cover a wide range of investment instruments and include capital growth, fixed or variable return funds, stocks or bond funds, currency funds and real estate funds.[60]

As is the case in other financial markets, the investment funds in the ESCWA region face many difficulties and challenges. Prominent among the long list of obstacles are an inadequate institutional

[60] Ibid.

capacity for financial analysis, planning and risk assessment, coupled with a paucity of trained manpower and expertise. The development of investment funds has been stunted by the thinness of domestic stock markets. The dominance of family-owned and Government-run corporations in the ESCWA region is believed to be responsible for the shallowness of capital markets, on the basis that they are usually reluctant to list on stock exchanges. Moreover, there is also a relatively weak demand for securities as a result of the lack of financial transparency and very limited product diversification, in addition to a lack of supporting financial institutions, including brokerage firms, credit rating agencies and secondary markets. Finally, the underdevelopment of a legal framework for facilitating transactions in a wide range of financial instruments is also an important retardation factor with regard to the development of investment funds markets in the region.

D. CAPITAL MARKETS

The pattern of development of capital markets in the ESCWA region is typical of those in other developing countries in the early stages of economic development. As noted above, the fully-fledged development of capital markets typically emerges at the advanced stages of development. In line with this historical pattern of development, capital markets in most ESCWA countries are at present very rudimentary and shallow, and virtually non-existent in certain countries, namely, Iraq and Yemen. The relative underdevelopment of capital markets is vividly illustrated by the insignificant share of the region of the total market capitalization value of the world. The market capitalization value for the ESCWA region in 2002 was estimated to be less than $180 million (see table 4), whereas the world total value was roughly put at approximately $10 trillion. Therefore, the share of the region amounted to a tiny 1.8 per cent in that year. Likewise, the market value of the region in the world bond market accounted for only 1.2 per cent of the world totals (see table 1 above). Furthermore, the aggregate ratio of market capitalization to GNP, which provides one measure of the size of capital markets in the ESCWA region, was estimated at 43.3 per cent in 2002, which compared unfavourably with those of emerging markets and developed countries, which exceeded 100 per cent.

TABLE 4. SELECTED INDICATORS OF CAPITAL MARKETS IN THE ESCWA REGION, 2002

Countries	Market capital (millions of US dollars)	Number of listed companies	Amount of traded shares (millions of US dollars)	Number of traded shares	Price index
Bahrain	6 729	41	200	400	1 777.2
Egypt	26 431	1 136	19 850	5 410	627.4
Jordan	6 743	156	1 000	360	185.4
Kuwait	30 469	93	16 292	20 377	2 060.2
Lebanon	1 395	13	119	15	39.14
Oman	4 348	95	274	96	183.1
Qatar	5 800	24	500	51	170
Saudi Arabia	75 033	68	22 294	700	2 762
United Arab Emirates	21 615	32	..	1 543	1 295.3
Total	178 563	1 658	60 529	28 952	925.97[a/]

Source: Arab Monetary Fund and various Central Banks.

Note: Two dots (..) indicate that data are not available.

a/ Weighted average of the price index.

The status of market development varied greatly among countries in 2002. The ratios of market capitalization to GNP in that year stood above 50 per cent in Bahrain, Jordan, Kuwait and Qatar, and 42 per cent in Saudi Arabia, which accounted for a substantial share of the regional market. By contrast, other countries recorded relatively low ratios: 8.3 per cent in Lebanon and 28.7 per cent in Oman according to figures from the Arab Monetary Fund and Central Banks in various countries. Moreover, table 4 shows that the aggregate number of companies listed on domestic exchanges was 1,658 in 2002, and that the average number listed in member countries was 184 companies. Again, a notable difference exists between ESCWA region countries and other countries. For example, the average number of listed companies was 250 for emerging markets and 900 for developed markets.

The importance of sound and efficient capital markets in mobilizing domestic and foreign resources and allocating them to productive investments, hence establishing financial stability, cannot be overemphasized. When banks become dysfunctional, firms and households could turn to capital markets as another important source of finance, and therefore avert a financial crisis. A particular challenge facing the ESCWA region is how to develop and strengthen a system of direct finance characterized by investments in securities and investment trusts from the old system of indirect finance, which is primarily based on bank-deposit type savings.

Structural weaknesses and institutional obstacles to the development of capital markets are indeed numerous and daunting. First, markets in the region are very small in size and limited in their role of mobilizing and allocating resources. Small size and the limited role of capital markets can largely be explained by the very narrow range of investment instruments traded, usually shares and a few bond markets in private issues; the small number of listed companies; and the limited number of securities available for trading, owing to the pervasive ownership of securities by public entities, and family-owned and closed-type private enterprises, which are usually reluctant to go public. There are also other impeding factors, including the inadequacy of various legal, financial and organizational infrastructures for prudential regulation and minimal transparency of the system; information disclosure; market-supporting infrastructures, namely, brokerage firms, auditing firms and credit rating agencies; and the lack of training and skilled manpower in the financial sector. Some of these issues are scrutinized as part of policy options for developing sound and efficient financial markets in the ESCWA region.

VIII. CONCLUDING REMARKS AND POLICY OPTIONS FOR THE DEVELOPMENT OF THE FINANCIAL SECTOR IN THE ESCWA REGION

A. THE BENEFITS OF SUCCESSFUL FINANCIAL LIBERALIZATION AND ITS PRECONDITIONS

The present era of globalization is one in which a national economy prospers when it is judiciously connected to the global economy, and perishes when it is disconnected. It is through some form of financial liberalization that a national economy is linked to the global economy. Financial liberalization means opening domestic financial and capital markets to foreign companies in the fields of banking, insurance, securities, investment trusts, fund management and many other financial services. Judiciously and gradually establishing financial liberalization can stimulate economic growth through international competition and product innovation. As a result of liberalization, an economy gains varied access to capital at the lowest possible costs, and savers enjoy better returns on their money. In short, this process mobilizes global resources and allocates them to the most productive and profitable projects, thus maximizing economic growth of the global economy though not necessarily maximizing such growth of any of its component parts at any one time.

There are, however, some important caveats for realizing the benefits of financial liberalization in developing countries. Such benefits materialize only when an economy has developed a sound and efficient financial system. This requires the existence of a whole range of well-functioning and relatively sophisticated financial markets and institutions, namely, banks, equity and bond markets, pension funds, mutual funds, insurance, and other market supporting institutions, including brokerage firms, credit rating agencies and asset management firms. Equally important is the modernization and strengthening of prudential regulatory machineries and adequate legal frameworks for financial markets and institutions. Opening domestic financial markets without meeting these prerequisites inevitably invites a repeat of the currency meltdown and economic collapse that culminated in the Asian financial crisis in 1997. The majority of ESCWA member countries still have a long way to go with regard to establishing such preconditions for complete financial liberalization, and also developing a sound and efficient domestic financial sector coupled with a strong legal and regulatory system.

B. A STRATEGY FOR THE DEVELOPMENT OF SEQUENTIAL MARKETS

This study highlights many theoretical and empirical arguments in support of the critical links that exist between efficient financial systems and economic growth, and also notes the essential role that such systems play in providing connections to global markets and resilient cushions against external shocks that stem from global financial instability. There is little disagreement concerning the primacy of developing and strengthening domestic financial markets and institutions coupled with the modernization of a legal and regulatory framework. The crux of the matter is how best to design an effective and workable strategy for financial sector development. A simple enumeration of what needs to be done in building a strong financial structure is of little value as a policy proposal. ESCWA member countries simply have neither the sufficient financial resources nor the technical capacities to build and strengthen a whole range of financial service markets and institutions on all fronts simultaneously, and at the same time develop sound legal and regulatory frameworks for their financial systems. Given that limited resources cannot be stretched too thin, a better alternative might be to adopt a concentrated strategy that focuses on core specific financial activities that are of critical importance to present financial systems, and to use these activities as an initial condition or starting point for designing a viable strategy for financial sector development.

In this context, it is important to take note of the historical evolution of financial sector development. As discussed above, the indirect finance system as opposed to direct disintermediation usually dominates the financial system in the early stages of development. In other words, banks are major agents for financial intermediation. It is only at the fairly advanced stages of development that the direct financial system based on various capital markets, namely, equities and bonds markets, and non-bank financial institutions, which include insurance companies, pension funds, and mutual investment funds, typically develop. Without exception, current financial sector situations in most ESCWA member countries are generally consistent with this historical evolution. Banking dominates the financial sector in all member countries. Capital markets in the region, as compared to global markets, have been practically inactive, with insignificant transaction volumes, and virtually no new equity listed in recent years. Moreover, local corporate bond markets are almost non-existent. Some plausible reasons for the relative underdevelopment of capital markets include poor macroeconomic conditions, rudimentary regulatory environments, unsophisticated investors and a tight family ownership mentality.

C. THE BANKING INDUSTRY AS AN INITIAL LEADING SECTOR FOR DEVELOPMENT

The foregoing analysis highlights a strategy of financial reforms that is initially focused on the banking sector, and which then tackles other financial subsector problems in sequence. For example, an emphasis on indirect finance, through intermediaries, dictates priorities for legal development that are different from those pertaining to direct finance. As explained above, two types of legal systems support financial reform.[61] One of these incorporates the financial laws that govern the financial sector, and which cover banks, securities markets and institutional investors; the other is commercial laws, which govern other commercial activities, and which incorporates an extensive range of laws, including bankruptcy and trust laws. The promotion of a sound banking system requires an adequate legal framework for bank credit. This means that in terms of financial laws, and for the time being, there is a higher priority for developing a banking law and a lower priority for developing a securities law. Bank credit requires secured transactions, and therefore, it is necessary to glean specific laws from commercial laws concerning bank lending, for example, laws related to secured transactions, bankruptcy, property foreclosure, mortgage and land. This list grows as a set of specific activities is prioritized for legal institutional development. At later stages, when the banking industry is firmly in place, the need for capital markets and non-bank institutions becomes greater, and financial deepening must be enhanced. At this stage, it is possible to address the task of providing a legal framework for direct finance focused on money and capital markets rather than on bank intermediation. In this case, the specific financial laws that are required include those concerning securities, stock exchanges and institutional investors. Commercial laws include negotiable instruments law, property rights law, company law, contract law, and laws that govern fiduciaries, for example, brokers.

Similar parallels can be drawn for sequential financial institution building that is initially focused on the banking sector. First of all, an effective regulatory institutional framework for sound and prudent banking activities must be developed and strengthened. This entails the creation of an independent regulatory agency or commission within or outside such government agencies as the Ministry of Finance or the Central Bank. In addition, the enforcement of periodic prudential supervision and inspection of banks is required. The creation of credit rating agencies may be necessary to evaluate the quality of bank assets and overall performance. It may also be necessary to build a law enforcement mechanism in case of bank failures or to establish institutional steps to forestall systemic banking crises. As in the case of legal development, sequential financial institution building for capital markets and non-bank financial institutions is possible when the modernization of the banking sector is at a fairly advanced stage. The same regulatory framework for the banking sector can be expanded to cover prudential regulation and the supervision of all financial intermediaries, including equity and bond markets, insurance markets, pension funds and mutual funds.

D. THE IMPORTANCE OF A SOUND BANKING SYSTEM FOR ECONOMIC GROWTH AND STABILITY

In short, it is necessary to start with a financial strategy to modernize and strengthen the banking sector, and to gradually phase in the development of other financial intermediaries, namely, capital markets and non-bank financial intermediaries. In this context, the importance of building a sound banking system in the initial phase of the overall financial strategy cannot be overemphasized. At present, in the highly liberalized global financial and capital markets, the costs of weak banking systems coupled with primitive financial regulatory frameworks could be catastrophic (see chapter V).

[61] Philip A. Wellons, "Sequencing legal developments to support financial sector reforms", *Sequencing? Financial Strategies for Developing Countries*, Alison Harwood and Bruce L. R. Smith (eds.), (Washington D.C., Brookings Institution Press, 1997).

Moreover, anecdotal evidence pertaining to the disastrous financial and economic impacts of bank failures in developing countries abound. The collapse of Banco Intercontinental, known as Baninter, in the Dominican Republic in April 2003, is an example of the catastrophic impact of a bank failure. In the late 1990s, the Dominican Republic was the fastest growing economy in Latin America with an average annual growth rate of 7 per cent, which was fuelled by tourism, manufacturing and foreign remittances. Today, the economy is in collapse, as a result of the failure of this one bank, which was caused by cronyism, illegal lending, regulatory negligence and secretive management practices. Baninter was the second largest private bank in the country until its collapse. The bailout cost Dominican taxpayers $2.2 billion, which was equal to a hefty two-thirds of the Government budget for the year, resulting in inflation and a steep devaluation of the Dominican peso.[62] Such a bank failure graphically illustrates the extreme importance of developing a sound banking system for economic stability and growth.

On a much greater scale, China is in the midst of a banking crisis. The four biggest State-run banks, Bank of China, China Construction Bank, the Industrial and Commercial Bank of China, and the Agricultural Bank of China are mired in deep financial distress and together claim to have a heavy load of non-performing loans, estimated at approximately $290 billion, 20 per cent of their loans, according to an article published at the beginning of 2004. Some analysts say that the true figure is closer to $420 billion, some 40 per cent of GDP. The Government of China decided to offer a bailout of $45 billion, which was taken from the soaring foreign exchange reserves, to the two State banks, the Bank of China and the China Construction Bank. This was the third largest Chinese banking system bailout in less than six years, and the amount may not have been sufficient to recapitalize the ailing banks and clean up the heavy load of bad loans. The effects of the two previous injections and write-offs totalling 1.6 trillion yuan ($200 billion) since 1998 have quickly dissipated, and new bad loans have weakened their capital bases. To plug this money drain, management systems must be drastically restructured to minimize the creation of new bad loans. Above all, a new credit-risk assessment method for loans must be established.[63] It is evident that without drastic banking reforms the rapid economic growth of the country will be severely undermined.

E. A FOCUSED STRATEGY FOR DEVELOPING A SOUND BANKING SYSTEM

1. *Good governance and prudential regulatory environment*

One of the most important lessons of recent bank failures in many developing countries, particularly the 1997 Asian financial crisis, is that sustained economic growth is no longer possible without a sound banking system in the new integrated global financial environment. With regard to ESCWA member countries, therefore, the question remains as to what would be a better way to develop a sound banking system in the region. Sound banking requires good corporate governance, and with this in mind, a wide range of unproductive banking practices that have been nurtured within the framework of a long history of Government-directed financial systems, incorporating interest rate ceilings, policy-directed credit allocation, cronyism, secrecy and fraud must be eliminated. Rather, a market-oriented system of bank oversight must be developed to promote good governance in the banking sector. Ideally, bank monitoring must be carried out by all the stakeholders of a bank, for example, owners or shareholders, bank regulators and claim holders on the bank, namely, depositors, creditors and inter-bank participants. Good governance is promoted when the bank is managed in accordance with the interests and incentives of all the stakeholders, with the goal of sound and prudent banking. There is also an urgent need to design and build a market-driven system that provides strong incentives for each stakeholder to participate actively in the oversight of banks to promote good governance. When owners or shareholders have a lot at stake, for example, when they invest in bank capital, it serves their interests to ensure that the bank is efficiently run, and to monitor it accordingly.

In this context, however, it must be cautioned, that the excessive involvement of owners in bank management creates problems for good governance. Many banks in the region were founded by wealthy families, and continue to be owned and run by family members. This is particularly true with regard to the Lebanese banking system. While such practices can incur run the risk of mismanagement and succession

[62] *International Herald Tribune*, “Dominican Republic in Crisis”, (6 January 2004).

[63] *The Economist*, “Still out there”, (10-16 January 2004).

problems, there is a strong willingness on the part of shareholders to rescue the bank in the event of financial crisis. Strong owner management can damage the future financial health of the bank, and therefore, the separation of management from ownership is a step that may need to be institutionalized to maximize efficiency in certain cases. In a similar vein, outside participants, namely, creditors, depositors and other claimants on the bank, including participants in inter-bank markets, are in a position to contribute, in cases where the owners are not successful, to the control of their institutions. Therefore, reliable and timely information disclosure systems with credible penalty provisions must be established to facilitate the effective participation of outside claimants.

The important role of shareholders or owners, and other claimants on the bank, including depositors and creditors in overseeing banks to ensure sound banking practice is discussed above. However, given the problems of asymmetric information and moral hazard, there is always some risk that these stakeholders will not be able to supervise properly. For example, it is possible that a government deposit insurance scheme will create disincentives for depositors to monitor and supervise a bank. Therefore, as a second line of defence, an independent Government regulator body, which could also be part of the Central Bank or the Ministry of Finance, must be created to supervise and regulate the banking system. A detailed discussion of conceptual and practical issues related to prudential banking supervision has already been highlighted (see above); still, it must be reiterated that successful financial reforms, with a view to developing a sound banking system require, as a precondition, the construction of a good regulatory environment. A good system controls excess liquidity and curbs excess lending and investment, which is a major cause of a boom-bust economic cycle. It is expected that a good regulatory environment considerably reduces the likelihood of a systemic crisis arising from a single bank failure.

Given the enormous importance of a good regulatory environment, the question arises as to why many developing countries failed to develop and upgrade machineries for prudential supervision of the banking system, while adopting and actively pursuing financial liberalization relatively quickly, despite the fact that in most cases, this resulted in disastrous consequences. This can be attributed to the fact that it is relatively easy, less time-consuming and inexpensive to implement financial liberalization, compared with the task of building a good banking oversight system, which is extremely difficult, time-consuming and expensive to establish. Issues of particular note in this context are the intractable principal-agent problems associated with banking regulation and supervision, and the daunting task of training and retaining skilled but low paid supervisory manpower. There are other difficult problems related to banking supervision, including owners who are not usually receptive to inspection and supervision, and dubious or low-quality information.

In conclusion, Governments must initially create a favourable institutional environment for a sound and transparent banking system. Once such an environment has been established, bank management must remove high-level managers who lack confidence or the ability to sustain profitability even under adverse conditions. What matters most at this point is that banks circulate money to where it is most profitable and bring interest income and dividends to investors. When households and businesses benefit from the profitable management of their money, consumer spending and business investments rise, and the earning capacities of banks improve.

2. *Improving profitability in the banking sector*

Means of improving profitability in the banking sector are outlined below.

(a) *Fostering self-sustaining earning capacity*

One essential condition for developing a sound and viable banking system in the ESCWA region is to improve profitability and develop self-sustaining earning capacity in the banking sector. It is essential that banks generate sufficient profits to cover the loss caused by the write-off of bad loans, strengthen their capital position and pay out adequate dividends on equities, in addition to their normal operational expenses. Unfortunately, statistics on the profitability of banks in the ESCWA region, in the form of return on equity (ROE) and the average return on assets (ROA), are difficult to ascertain, and when available, are usually highly fragmentary. However, one study provides ROE and ROA for the top 100 Arab banks in 1996, of which 85 were located in the ESCWA region, based on the 1996 Euro-money Rankings of Arab banks.[64] Returns on equity for the nine countries, namely, Bahrain, Egypt, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia and the United Arab Emirates, ranged between 20.93 per cent for Lebanon to 8.12 per cent for Kuwait. Returns on assets for the same country group for the same period varied between 2.63 per cent for Bahrain to 0.64 per cent for Jordan. Despite the respectability of these results, they cannot really be used for an international comparison because they are outdated, and the statistical results only relate to the top 100 Arab banks, not the average ratio for all the banks. However, there is abundant anecdotal evidence revealing the fragility and low profitability of many banks, particularly many of the small and medium-sized banks in such member countries as Egypt and Lebanon.

There are two major ways to increase profits, namely, to cut costs or raise revenues. Cost-cutting measures include reduction of labour costs, consolidation of branch banks, and mergers or management collaboration with other banks. In many ESCWA member countries, banks remain State-owned, for example, in Egypt, the Syrian Arab Republic and Yemen. Often the State uses the banks as a political tool to increase employment, and therefore banking systems suffer from overstaffing. While employment reductions directly contribute to efficiency and increased profitability in such a case, this is often not a politically feasible option. In many ESCWA member countries, the real problem is that given that profits from core business lending practices stagnate at very low levels, many banks depend heavily on meagre profit margins from security investments, and in particular, risky government bonds. This has been the case in Lebanon in recent years, where opportunities for good quality lending have decreased as a result of the worsening macroeconomic environment. Moreover, in Lebanon, bad loans increased to their highest level, more than 19 per cent of gross loans at the end of 2002.[65] The decline in good lending opportunities and asset quality deterioration is not unique to Lebanon, but is also the case in most member countries.

With this in mind, the necessary measures for improving the profitability of banks must include the fundamental reform and restructuring of management systems, which must go beyond traditional cost-cutting tactics and reorganization through mergers and acquisition. In addition, banks must concentrate on how to rationalize and operate their assets more efficiently and aggressively beyond the traditional domain of lending and security investments to improve profitability. With the goal of improving revenue structure, banks must develop expertise not only for loan risk assessment, but also for a wide range of advisory services, including corporate restructuring, rationalizing and securitizing of client corporate assets. Indeed, in the present environment, corporate customers expect a different kind of service from banks: these days, it is not bank credit, but bank expertise that is much more highly valued.

Moreover, banks must not hesitate to withdraw from unprofitable lines of activities and concentrate on a small number of profitable core businesses. When profits cannot be improved at home because of the limited market size or economic recession, banks must venture to operate in foreign countries, particularly those within the ESCWA region where rapid growth is expected. In addition to the advisory services on corporate restructuring and portfolio management that are mentioned above, other financial business areas with a high potential for profit include asset-backed guaranteed securities, fund management services, international syndication, financial derivatives, project finance, corporate liquidation and rehabilitation. Undoubtedly, all of these fields require experts and specialists equipped with new financial engineering skills and knowledge. Banks must therefore, to fill a skilled manpower gap, be willing to recruit from outside, including foreign sources, and at the same time develop a merit-based pay system to attract and retain high-powered experts and specialists.

One promising revenue source that must be considered is retail banking. Retail banking services cover a wide range of financial products from credit cards, personal and car loans, personal finance to investment consulting, and other fee-based services. They also include such improved delivery services as ATMs, telephone and electronic banking. Retail banking is still at its infancy and holds the promise of great growth

[64] Mahmoud Abul-Eyoun, “Financial services liberalization in the ESCWA region: Challenges and opportunities”, a paper prepared for the Expert Group Meeting on the Challenges and Opportunities of the New International Trade Agreement (Uruguay Round): Post-Uruguay Preparations and Adjustments, (Kuwait, 24-26 November 1997), (E/ESCWA/ED/1997/WG.1/5), 1997.

[65] Moody’s Investors Service, “Lebanon”, *Banking System Outlook*, (June 2003).

as per capita incomes in the region increase in the forthcoming years. However, as this segment of the financial market expands, credit risk is also likely to increase, based on the fact that consumer lending is considered to be more risky than other bank finances, and hence greater care must be exercised to minimize risk. Moreover, banks must make substantial investments in technological infrastructure for the sophisticated delivery of retail services, for example, Internet banking. The revival of interest in retail banking is a global phenomenon. The recent two mergers of mega-banks in the United States, one between J. P. Morgan Chase and Bank One, and the other between Bank of America and FleetBoston Financial, signify a retreat from the heavy reliance on investment banking business during the late 1990s telecom bubble, and a return to consumer banking as a steady source of profits.

(b) *Removing structural impediments: Too small and too many or too few banks*

Banks are unevenly distributed among the countries in the region, which moreover, has too many small banks, which are considered to be below the minimum efficient size for long-term viability. Some countries, for example, Lebanon, with 71 banks in 2002, and Egypt, with 42 banks are overbanked, while others, namely, the Syrian Arab Republic, with only 6 banks, and Yemen, with 15 banks, are underbanked. With $53 billion worth of assets, the number of commercial banks, in Lebanon, which is a country of 3.6 million people, and an estimated GDP of approximately $13 billion in 2002, is one of the largest among Arab countries. However, the asset size distribution is highly skewed with approximately 65 per cent of banks classified as being small-sized with individual total assets of less than $500 million, and the 10 largest banks with some 70 per cent of total assets in the banking sector. In sharp contrast, the Syrian Arab Republic has only six banks for a population of 16.3 million. All the banks in the Syrian Arab Republic are Government-owned and total banking assets amounted to only 78 per cent of GDP compared to the asset GDP ratio of more than 300 per cent in Lebanon in 2002.[66] The relative underdevelopment of the banking sector in the Syrian Arab Republic can be attributed to decades of protectionism and weak private sector development.

It is evident that in the present environment, too many banks compete too fiercely in a market that is characterized by low profitability, particularly in overbanked countries like Lebanon and Egypt. What is worse is that the long-term viability of many small- and medium-sized banks in the overcrowded banking sector remains questionable, on the basis that these are usually disadvantaged by their narrow franchise base and by the fact that they lack the technological sophistication of their larger rivals. As a result of their low capital base, they are vulnerable to competitive threats and sharp deteriorations in macroeconomic conditions. One obvious solution to overbanking is consolidation, whereby larger banks are encouraged to acquire and merge with smaller banks to enlarge savings pools, achieve greater economies of scale and reduce banking vulnerability to external shocks. Given that banking consolidation leads to a more efficient banking system, Governments can play an important role in facilitating such a process, for example, by providing financial incentives through tax breaks and long-term soft loans. In fact, Government-encouraged consolidation has already reduced the number of small banks. In Lebanon,[67] the total population of commercial banks was whittled down from 66 in 1999 to 54 in December 2002. However, not all bank mergers are successful. Bank acquisition and mergers often fail because of difficulties in sustaining a market share, clash of two different corporate cultures and excessively time-consuming rationalisation processes.

It is apparent that the solution for overbanking through consolidation is necessary with regard to improving profitability. However, it is difficult to determine the optimal number of banks. Even when such an optimal size is known, Governments cannot coerce banks, with the exception of State-run banks without organized labour resistance, to reorganize and consolidate the number of banks and the scale of their operations. However, Governments are capable of facilitating consolidation by offering various incentive schemes, including tax benefits or long-term soft loans.

[66] Ibid., and ESCWA, “The financial sector in the ESCWA region: The current status and prerequisites for strengthening and development”, a paper presented at the International Conference, (Monterrey, Mexico, 18-22 March 2002), (E/ESCWA/OES/2002/6).

[67] Moody’s Investors Service, “Lebanon”, *Banking System Outlook*, (June 2003).

(c) *Limiting Government intervention in the banking sector*

One of the main causes of the stunted growth of private banks in developing countries and even in certain developed countries, for example, the postal savings banks in Japan, is the preponderant presence of Government-run financial institutions, which compete directly against private banks from a position of strength and unfair advantage.[68] As a result, the profitability of private banks is adversely affected and the normal growth of private financial institutions is hindered. It is difficult to find a well-functioning banking system in a country that is dominated by state-owned or controlled banks. State ownership does not usually lend itself to efficient and sound banking. State-owned banks are often used as an instrument to satisfy other objectives, for example, alleviating unemployment problems through overstaffing in state banks or financing unprofitable overmanned state enterprises. Unconcerned with profitability as the bottom line and assured by government financial support, these have few incentives to be cost-effective, and often engage in unfair cutthroat competition against private banks, which limits the profitability and normal growth of private banking. Moreover, banking systems dominated by State-ownership and control have a tendency to devote a greater share of resources to certain inefficient public sector and state enterprises, while offering a smaller share to the private sector. The possible end result is stunted private sector development and retarded economic growth. However, development banks can be State-controlled and still finance the private sector. Moreover, they provide long-term credit financing for investment, which private banks might shun or provide at high rates of interest.

Another major problem with regard to State-ownership is related to a lack of incentives amongst state owners in terms of exercising the ownership rights that are consistent with sound banking. For example, sound banking is enhanced when inefficient banks are allowed to go under, their owners lose their capital investment, and bank managers are dismissed, while the entry of more efficient banks into the market is actively encouraged. When the majority of banks are State-owned, it is extremely difficult to revitalize banking by eliminating old blood and injecting new. As a result, overall banking sector efficiency suffers and the profitability of banks diminishes.

Countries in the ESCWA region share the problem of a high degree of state control over the financial system that plagues many developing countries, particularly China on a massive scale. As highlighted above, in the Syrian Arab Republic and Yemen, all banks are State-owned. In Egypt, approximately 70 per cent of assets are controlled by State-owned banks. Even in a country where the banking sector is dominated by private banks, the Government is able to exert negative pressure on the profitability of banks and increase their vulnerability to a shock through high exposure to low quality government bonds. The Lebanese banking situation is a case in point. The high exposure of Lebanese banks to Lebanese sovereign debt through holdings of government securities amounted to more than a third of the total assets of the banking system, $11 billion, at the end of February 2003. The real problem is the low credit quality of the Government of Lebanon, which can be attributed to its mounting government deficits. Banks have no choice but to invest in government treasury bills, on the grounds that lucrative lending opportunities are rapidly drying up in an unfavourable macroeconomic environment. Meanwhile high exposure to government debt instruments increases the negative pressure on ratings and the profitability of banks.[69] The Lebanese case underscores the strong indirect effect that government finance can exert on the profitability of banks even in a predominantly private banking system.

The obvious solution to the problem of Government-owned banks is privatization. The question of how to best privatize state enterprises raises numerous complex issues as highlighted by experiences in many transition economies in Eastern Europe, and it is beyond the scope of this study. In particular, the problem of how to overcome strong resistance to privatization appears to be acutely difficult. When privatization is not a politically feasible option, fundamental restructuring and reforms of inefficient state banks may be necessary to improve profitability, which is the case in the current banking reforms in China.

[68] For an analysis of the problem of Government-run financial institutions and the current banking crisis in Japan, see Se-Hark Park, “Bad loans and their impacts on the Japanese economy: Conceptual and practical issues, and policy options”, Discussion Paper Series A, No. 439, (Tokyo, Institute of Economic Research of the Hitotsubashi Univeristy, 2003).

[69] Moody’s Investors Service, “Lebanon”, *Banking System Outlook*, (June 2003).

3. *Foreign participation*

As a component of policy measures to reform and rebuild weak domestic banking sectors in some ESCWA member countries, opening the domestic banking sector to foreign participation merits serious consideration as a policy option. In fact at present, foreign participation in developing countries is quite extensive. For example, foreign banks own approximately 40 per cent of domestic bank assets in Argentina. Other countries, including China and Thailand are also deregulating rules governing foreign ownership.[70]

Apparent advantages of foreign participation include the fact that foreign banks, particularly those that are globally competitive, enhance stability in a domestic financial system, making local banks safer, and better diversified in asset holdings. Foreign banks bring capital, modern management techniques and established global marketing networks, thereby enabling domestic counterparts to learn sound banking practices, including good corporate governance. Furthermore, they provide domestic banks with windows of opportunity to expand banking business beyond their small local and national markets, which is a matter of crucial importance to ESCWA member countries. However, there are some disadvantages in opening domestic markets, including neglect of small domestic borrowers in the small- and medium-sized business sector. The real problem is that regulatory restrictions on domestic banks place them at a disadvantage and put them in an uncompetitive position, as compared to most big global banks, which are free from such restrictions, and can readily move their investment elsewhere when the same restrictions are imposed on them. Moreover, regulatory restrictions also potentially hinder domestic counterparts from forming joint ventures or from merging with foreign partners.

4. *Regional cooperation and integration*

The assumption that the ESCWA region can be classified as a small open economy for the purpose of analyzing economic problems can be justified based on the fact that the shares of the region in world totals in most macroeconomic variables, including GDP, population, employment, production and trade are insignificant. Shares in world totals in most financial variables, including bank assets, stock market capitalization, market values of bonds and FDI, which all amounted to less than 2.5 per cent in 2000, are also equally quantitatively unimportant (see table 1). This signifies that there has been general underdevelopment of financial markets in the region, and that these are simply too small to be competitive on a global scale. In this context, bank assets provide an example of the glaring scale gap between the ESCWA region and other developed regions. According to a 2003 ESCWA publication, the value of total combined bank assets for the ESCWA region was estimated to be approximately $520 billion. This figure is dwarfed by the value of assets of any top three American mega-bank, for example, Citigroup had assets of $1.2 trillion, the newly merged banks, J.P. Morgan Chase and Bank One had combined assets of $1.1 trillion and Bank of America and FleetBoston Financial had total assets of some $900 billion as of 30 September 2003.[71]

Therefore, the importance of regional consolidation and the integration of the banking sectors and other financial markets must be re-emphasized. Indeed, there are a number of significant benefits of regional cooperation and integration. These include, firstly, the fact that regional markets offer member countries opportunities to expand their business franchise abroad, beyond the constraints imposed by the limited size of domestic markets. This enables domestic banks to extend economies of scale, which leads to the reduction of intermediation costs and hence the improvement of banking efficiency. Secondly, regional integration provides banks in each country with new sources of funds and lending opportunities, and therefore enhances the efficiency of resource mobilization and allocation within the region. Thirdly, regional integration permits banks to expand the scope of portfolio diversification and improve their ability to hedge against financial risks stemming from volatile movements in exchange rates, interest rates and many other financial products. Fourthly, foreign banking operations that are facilitated by regional integration provide means for diversifying income, particularly non-interest incomes in the form of fees and commissions, and increasing the funding streams of these banks. Moreover, such foreign banking operations work as a hedge

[70] Gerard Caprio and Patrick Honohan, “Restoring banking stability: Beyond supervised capital requirements”, *Journal of Economic Perspectives*, Vol. 13, No. 4, (Autumn 1999), pp. 43-64.

[71] ESCWA, *Survey of Economic and Social Developments in the ESCWA Region 2002-2003*, (E/ESCWA/EAD/2003/6).

and even a safe haven in case of social and political turmoil in individual countries, though not in the case of region-wide unrest, by holding profits and various assets in a currency other than the domestic currency. This minimizes the outflow of funds from the consolidated banks in the region and hence contributes to financial stability.

Despite the fact that there are many significant benefits of regional integration, obstacles to establishing regional markets are numerous and formidable. The list of impediments to regional integration is long and as such, only the most prominent are detailed here. One obvious obstacle to regional integration is the general underdevelopment of financial institutions, including banks, which are characterized by the shallowness and narrowness of markets. In turn, market thinness is caused by the limited supply of market instruments, limited investment opportunities, particularly in the oil-exporting economies with low-absorptive capacities, and traditional family-dominated management. Moreover, there is also the problem of limited demand for financial instruments, which is aggravated by low savings ratios and relatively low returns on financial instruments. In addition, the paucity of skilled traders and dealers for financial products has adversely affected the development of financial intermediation. These problems are further compounded by a whole host of legal, organizational and institutional structures, which are at different developmental stages, and at varying levels of sophistication in member countries, all of which can begin to be resolved through the daunting task of harmonization and regional cooperation. Moreover, the development of fairly sophisticated telecommunications and information networks to facilitate and strengthen links and cooperative ventures of a regional scope between banks and other financial markets in the region must be priortized. In this regard, the creation of a market-making institution for regional risk-taking, for example, the Kuwait-based Inter-Arab Investment Guarantee Corporation, could play a catalytic role in promoting regional cooperation and integration.

Regional integration of financial markets is a broad topic, and therefore this study has limited itself to a general discussion of certain key issues. Indeed, regional integration is a worthy goal within the context of building domestic financial markets and institutions; however the realization of such integration must be moderated with realistic expectations.

F. SEQUENCING FINANCIAL SECTOR REFORMS AND CAPITAL CONTROLS

As highlighted above, the development of a sound financial system is a necessary condition for building a strong fortification against the financial storm caused by sudden shifts in market expectation and confidence on the part of international investors. However, the crucial issue is how to design and implement a feasible strategy to rebuild and strengthen financial and banking sectors. In this regard, proper sequencing of the reform programme for the financial sector is of paramount importance. Economists and policy makers agree that trade liberalization must take place before domestic financial market reforms, and that capital account convertibility must be implemented only after domestic financial markets are sufficiently reformed and strengthened.

In this context, certain developing countries, namely, China and India, where the door to foreign capital flows is not yet completely wide open, must view the recent Asian financial crisis as a valuable lesson that highlights the importance of embarking on capital market liberalization only after a sound infrastructure for prudential supervision and regulation of the financial system has been firmly put in place. With hindsight, it seems that the Asian economies in question were not able to ensure the proper sequencing of various reform programmes. The capital markets of these countries were liberalized before their domestic financial markets were sufficiently reformed and restructured. This can perhaps be resolved through a two-pronged strategy. On the one hand, the present reform programmes to restructure the financial and banking sectors must continue and even be accelerated. On the other, it must be recognized that financial and banking sector reforms are highly daunting tasks in terms of the magnitude and complexity of the problems to be solved, and they constitute an extremely time-consuming process, involving the transformation of corporate governance, which is characterized by politically powerful families and groups, pervasive political interferences, rent-seeking activities and even corruptive practices, into a transparent market-oriented system. The value systems, deep-rooted business culture and state of mind unique to each country must also undergo a fundamental transformation. Furthermore, the countries in the Asian region must train a large army of technically competent financial cadres, namely, accountants, investment experts, institutional investors, financial analysts, information technology experts, bank examiners and supervisors.

However, these economies cannot be continuously buffeted by the shock waves of volatile and unstable global capital movements, while they are in the midst of revamping their entire financial systems. Any serious financial crisis, such as that in Asia, pushes a reform programme back to where it started or even to a previous stage. It seems essential, therefore, that appropriate interim policy measures to prevent the recurrence of such a financial crisis must be designed and implemented in step with a long-term financial restructuring programme. Such interim measures might include various forms of controls or a tax on foreign borrowings or capital inflows, particularly speculative investments; building sufficient reserves relative to short-term foreign debts outstanding; ceilings on deposit interest rates to prevent reckless competition from unhealthy banks from endangering the entire banking system; restricting the growth of bank balance sheets or the growth of credit in high risk sectors, for example, real estate. Many of these mechanisms have been used in developed countries, and there is some empirical evidence regarding their efficacy and costs. In addition, selective interim capital controls have been practiced in certain developing countries, namely, Chile and Malaysia in recent years. However, their effectiveness in restricting capital mobility has not been fully supported empirically, and has even been seriously questioned in some cases.[72] In this context, it is also worth noting the revival of a proposal that a global tax on foreign exchange transactions discourages short-term capital mobility and hence reduces macroeconomic instability.[73] However, such a scheme can only be effective when all countries implement it simultaneously, which, technically and politically, is difficult to ensure.

In conclusion, the economies in the ESCWA region must consider the proposal of simultaneously launching a two-pronged assault on the problem of financial sector reforms. This would involve designing and implementing a long-term sustainable financial reform programme on one front, and short-term or medium-term interim measures to shield the economy from the volatility and instability of global financial markets on the other. Such interim measures do not have to be perfectly effective or permanent. They can vary in nature and duration of enforcement to serve an urgent purpose, and can be phased out as soon as a particular task is achieved. Defining effective and feasible interim tools to mitigate the impacts of volatile international capital movements is an area that requires further research.

[72] Sebastian Edwards, “How effective are capital controls?”, *Journal of Economic Perspectives*, Vol. 13, No. 4, (Autumn 1999), pp. 65-84.

[73] James Tobin, “A proposal for international monetary reform”, *Eastern Economic Journal*, Vol. 4, Nos. 3-4, (July/October 1978), pp. 153-159.

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