A number of countries, both developed and developing, have taken steps to liberalize their financial systems during the past decade. Interest rates have been liberalized in Argentina, Australia, Chile, France, Ghana, Indonesia, Japan, the Republic of Korea, Malaysia, New Zealand, Nigeria, the Philippines, Sri Lanka, Turkey, the United States, and Uruguay. In other countries, such as Thailand and Yugoslavia, interest ceilings have been managed more flexibly than before. Several countries, such as Chile and Korea, privatized their commercial banks. Argentina, Chile, Pakistan, and Turkey reduced their directed credit programs, and interest rate subsidies were reduced or abolished in Korea and the Philippines.

Several factors prompted these shifts in policy. During the past decade many developing countries began to place greater emphasis on the private sector and on market-determined pricing. In higher-income countries, the inflationary shocks of the 1970s and early 1980s underscored the limitations of regulations on interest rates and credit. Rapid advances in telecommunications and information processing have spurred the development of new financial instruments and have promoted greater financial integration both domestically and internationally. This has made it harder for governments to control financial markets.

The lessons of reform are obscured by difficulties in interpretation. The starting point and the pace and breadth of financial reform varied among countries, and it is difficult to disentangle the effects of financial reform from those of other reforms that were taking place at the same time. Overall, though, it seems clear that financial liberalization has helped to mobilize resources through the formal financial system and to improve the efficiency with which they are used.

The task of reform is not straightforward. This chapter discusses the pitfalls to be avoided in the transition from a regulated financial sector to one that is more market-oriented. It also discusses the issues raised by the integration of a country's financial system with international financial markets.

Recent experiences with financial reform

The pace and scope of reform have differed substantially from country to country. Financial sectors in most of the high-income countries were already mature and market-based, and reform focused on eliminating controls and thereby promoting competition. In some developing countries, however, financial systems were heavily repressed before reform. Three countries in Latin America—Argentina, Chile, and Uruguay—shifted within a few years from highly controlled to largely uncontrolled finance. The Philippines and Turkey also eliminated most of their interest rate
controls within a very short period, but they did not undertake major financial reforms in other areas. Elsewhere, reforms were even more limited and were introduced more gradually. Some developing countries—Malaysia, for instance—already had market-oriented systems, but in others, such as China, the overall economy remained controlled. The process of reform was frequently interrupted when political resistance or deteriorating economic conditions forced governments to slow or even to reverse liberalization.

With few exceptions developing countries introduced financial reforms in periods of economic stress as part of stabilization and structural adjustment programs. But the degree of stress also varied among countries. For example, Argentina, Chile, Turkey, and Uruguay had large fiscal deficits and suffered from inflation of between 50 and 200 percent in the five years before financial reform. In contrast, Indonesia, Korea, Malaysia, and New Zealand had relatively low levels of inflation both before and after financial reform. Although these countries were also attempting to stabilize their economies and restructure their trade and industrial sectors, their reforms were quite different because they were conducted against a more stable background.

Southern Cone countries

Three of the most dramatic and far-reaching programs of financial reform were carried out by Argentina, Chile, and Uruguay in the mid-1970s. The measures included the lifting of controls on interest rates and capital movements (local banks were allowed to offer dollar-denominated loans and deposits), the elimination of directed credit programs, the privatization of nationalized banks, and the lowering of barriers to entry for both domestic and foreign banks. These reforms were implemented relatively quickly, during periods of high and volatile inflation, and as part of broader programs of stabilization and liberalization. Each program encountered serious difficulties, partly because of the way in which financial deregulation was handled and partly because of problems in the real sector.

Following the reforms in Chile, inflation declined from 600 percent in 1974 to 20 percent in 1981. In the face of decelerating inflation, the real interest rate rose to extremely high levels: lending rates were more than 30 percent in real terms in the years between 1975 and 1982. In Argentina and Uruguay, in contrast, inflation remained high and volatile. As it surged from time to time, real interest rates fell, but even so they were often very high in both countries.

All three governments tried to change deep-seated inflationary expectations by publishing a schedule of preannounced changes in the exchange rate. These schedules (tablita) allowed for a slowing rate of devaluation and were intended to convince the public that the domestic rate of inflation would gradually converge with the international rate. Similarly, the countries liberalized their capital accounts to bring domestic and foreign interest rates into line. It was hoped that these measures would hasten the return to low inflation and at the same time bring down the countries' high domestic interest rates. Inflation, however, stayed higher than the rate implied by the tablita, and as a result the real exchange rate appreciated considerably and exports and output suffered. The wide differentials between high domestic and lower foreign interest rates, together with preannounced changes in exchange rates, promised very high returns and attracted large inflows of capital. These in turn caused rapid monetary expansion and made it difficult to control domestic demand. The lack of effective regulation and supervision allowed speculation and reckless lending to go unchecked.

To restore external balance in the early 1980s, all three countries had to devalue their currencies substantially. These and other measures were necessary, but, together with persistently high interest rates, they added to the financial distress of the corporate sector, and many financial institutions failed. By one estimate, the nonperforming assets of Chile's banks amounted to 79 percent of capital and reserves in 1982 and to more than 150 percent in 1983. The monetary authorities in all three countries were forced to rescue failing banks. Monetary expansion, partly caused by these efforts to assist the banks, undermined the governments' broader adjustment programs and jeopardized financial liberalization. Argentina and Chile were both forced to reintroduce direct controls on their financial sectors. But after nationalizing its failed banks, Chile resumed its liberal policies. It began a long-term program to rehabilitate and reprivatize the banks and to put in place a sound system of prudential regulation and supervision. Argentina, too, has been gradually liberalizing since it reimposed direct controls.

The financial crises in the Southern Cone countries were caused by macro- and microeconomic problems at home and shocks from abroad. Within
a brief period firms faced rapid changes in relative prices, a fall in domestic sales, sharp increases in interest rates, a major devaluation of the currency, and a sudden termination of external credit. The biggest problems began in the real sectors of the economy, but efforts to liberalize the financial sector undoubtedly contributed to the resulting instability.

The Philippines and Turkey

The Philippines and Turkey have also reformed their financial systems, which were once heavily repressed. Their reforms, however, centered on freeing interest rates. In the early 1980s the Philippines liberalized interest rates and allowed commercial banks to provide a much broader range of financial services. In the first years after the reforms, interest rates rose to about 10 percent in real terms, and the financial sector grew rapidly. But when the country suffered serious macroeconomic instability during 1983–85, a widespread financial crisis developed.

Beginning in the late 1970s the Philippines pursued expansionary policies to sustain high economic growth despite a world recession. The fiscal deficit increased from 0.2 percent of GNP in 1978 to 4 percent in 1982, and the current account deficit rose from 5 percent of GNP to 8 percent over the same period. Political uncertainty reinforced a gradual loss of confidence in the domestic economy; capital began to flow abroad just as the supply of foreign finance began to dry up. A smaller external deficit in later years was made possible only by sharp cuts in imports and domestic absorption. The peso devaluation of 1983–84 and the large fiscal deficit caused inflation to rise to 50 percent in 1984. In that year the government implemented a stringent stabilization program that included the sale of new high-yield instruments by the central bank, with the aim of slowing monetary growth. To keep their deposit base in the face of this new competition, banks and financial companies also increased their interest rates, which at times rose to more than 20 percent in real terms. The highly leveraged corporate sector thus faced mounting financial strain.

Financial distress in the corporate sector, bad management in the banks, political corruption, and inadequate regulation and supervision all led to a rapid deterioration in the balance sheets of financial institutions. Eventually the crisis forced the government to intervene. A number of smaller banks were taken into the public sector, and the two largest banks, both government-owned, were radically reorganized. Between 1980 and 1986 the banking system’s assets shrank 44 percent in real terms.

Until 1980 the Turkish government maintained strict control of nominal interest rates. Inflation was high, and real interest rates were negative. In 1980 the government removed the controls and allowed banks to issue negotiable certificates of deposit (CDs). At the same time it embarked upon a stabilization and structural adjustment program. The financial reforms were short-lived, however. Two years later, after financial difficulties, the central bank reimposed ceilings on deposit interest rates.

Turkey’s liberalization program differs from the others in several respects. The government’s budget deficit declined between 1980 and 1982, which took some pressure off the financial markets. The government did not liberalize capital flows between 1980 and 1982 and thus avoided some of the complications that plagued the Southern Cone countries. The annual inflation rate, as measured by changes in the wholesale price index, declined from more than 100 percent in 1980 to 25 percent in 1982. Real interest rates increased sharply during the stabilization period. The domestic currency depreciated in real terms, GNP growth became positive after two years of contraction, and the composition of demand shifted from domestic absorption toward exports. Turkey appeared to be on the right path.

These macroeconomic changes, however, hit corporate profits and left businesses struggling to adjust. Financial problems in the corporate sector then caused distress in the banking system. Nonperforming loans, especially among smaller banks, prompted intense competition for financial resources. Banks that needed liquidity increased their deposit rates. Bigger banks tried to limit this competition with a gentlemen’s agreement on interest rates, but they failed and the competition continued. Banks also issued large volumes of CDs through brokerage houses (which offered higher interest rates), even though this practice was prohibited after 1981. Additional financial resources were used to meet immediate obligations and to refinance nonperforming loans: in other words, many insolvent borrowers continued to borrow. Indicators of financial depth improved during this period, but a large part of the additional intermediation went to finance interest payments on nonperforming loans.

The government finally intervened in mid-1982. It found that some banks had failed to meet their reserve requirements because of liquidity prob-
Box 9.1  Financial liberalization in New Zealand

New Zealand is an example of a developed country that has made the transition from a heavily regulated financial system to one more reliant on market forces. By 1984 government intervention in finance had become widespread. Most intermediaries were subject to interest rate controls, credit was directed toward preferred sectors such as housing and farming, and intermediaries were obliged to buy government securities at below-market interest rates. Although these policies stimulated investment in housing and agriculture and provided the government with a cheap source of deficit financing, they contributed to slow growth by reducing the credit available for other, potentially more profitable activities. They also undermined financial stability and the effectiveness of monetary policy as financial intermediation shifted to firms less amenable to regulation and to institutions less constrained by prudential standards.

Following the 1984 election the government introduced a new market-oriented strategy. The comprehensive package of structural reforms sought to spur growth and to redress external imbalance by increasing the role of market forces in the economy. Included were trade liberalization, labor market reforms, measures to restore fiscal discipline, and reform of state-owned enterprises (including privatization). In the financial sector the government abolished all interest rate controls and credit directives, floated the exchange rate, introduced market-based tenders for sales of government securities, and established a new system of monetary control. To promote competition among financial institutions, the government encouraged the entry of new banks irrespective of domicile and extended the right to deal in foreign exchange to institutions outside the banking sector. External capital controls were removed to deepen the foreign exchange market. Liberalization was accompanied by strengthened supervisory capabilities. Prudential regulation emphasized the prevention of system-wide failure rather than failures of individual institutions, and the government chose not to introduce a deposit insurance scheme.

It is too early to make definitive judgments on the success of the financial reforms, but the evidence thus far is reassuring. The removal of capital controls did not lead to capital flight—an outcome attributed to the credibility and the comprehensive nature of New Zealand’s program of reform. The number of banks operating in New Zealand has risen from four to fifteen. Financial activity appears to have gravitated back toward the banking sector, and the narrowing of some banking margins, especially on foreign exchange transactions and consumer loans, indicates that competition has increased. New Zealand’s apparent success suggests the importance of incorporating financial reforms into a broader program of structural reform.

Reforms in other countries

Australia, Japan, Malaysia, New Zealand (see Box 9.1), and the United States have all liberalized their interest rates during the past decade. Restrictions on the services that could be offered by different institutions were also reduced or eliminated. Financial systems in these countries were already market-oriented, and the reforms were designed to stimulate further competition and efficiency. With modestly rising inflation in the 1970s and early 1980s, interest rate controls on deposits prevented institutions from competing effectively with unregulated suppliers in the securities markets and Euromarkets. Although the reforms generally improved the efficiency of financial systems, they caused stress for certain institutions such as the savings and loan system in the United States and finance companies in Malaysia. Interest rates in general were affected more by macroeconomic developments than by the financial reforms. Bank deposit and loan rates rose modestly in real terms. Financial depth increased substantially. Interest rate spreads and the dispersion of rates in different market segments narrowed—all signs of greater competition and efficiency.

Other countries that had more repressed systems have also undertaken financial reforms. The scope and pace of reforms, however, have been
Korea’s heavily regulated financial system was a key instrument in the government’s industrial policy of the 1960s and 1970s. Interest rates were controlled and were kept low during most of this period. A substantial proportion of bank credit—well above one-third—was directed by the government to designated sectors. By the late 1970s, however, a growing consensus had emerged that this approach was retarding the growth of the financial sector and preventing the efficient allocation of resources. Confronted with a significant macroeconomic imbalance and slower economic growth, the government changed directions.

Stabilization, structural adjustment, and financial reform programs were all introduced in the early 1980s. The government adopted several measures to encourage competition in the financial market. Nonbank institutions, which were relatively new and lightly regulated, were further deregulated, and barriers to entry were greatly relaxed. Additional foreign financial institutions, including banks and life insurance companies, were allowed to open branches. Commercial banks, most of which had been owned by the government, were privatized. The government eliminated its preferential lending rates and did not introduce any new directed credit programs. At the same time, the authorities fostered greater competition among different sorts of financial institutions by allowing them to offer a wider range of services.

The loans of commercial banks, even after privatization, continued to be closely monitored and supervised. The authorities continued to regulate the interest rates of banks and nonbank institutions, but they partially deregulated interest rates in the money and securities markets. Controls on capital flows were maintained. When inflation started to decline, real interest rates rose, and growing numbers of highly indebted firms found it difficult to service their debts. The government swiftly reduced nominal interest rates, but because inflation declined, real lending rates stayed between 5 and 10 percent throughout the 1980s. By the mid-1980s Korea had established macroeconomic stability: the annual inflation rate fell to 2-3 percent, and the fiscal and current account deficits were eliminated. Industry undertook a major restructuring. The financial sector has grown rapidly in the 1980s, largely owing to the explosive expansion of nonbank institutions and securities markets and, to a lesser extent, to growth in the banking sector. The ratio of M3 to GNP almost doubled between 1980 and 1987 (see Box 9.2). Building on this progress, the government began the full liberalization of bank interest rates in late 1988. Most lending rates were freed at that time, although deposit rates are still controlled. The government also announced plans to open Korea’s financial markets to further foreign participation.

### Box table 9.2 Korea’s financial sector, 1980, 1984, and 1987

<table>
<thead>
<tr>
<th>Indicator</th>
<th>1980</th>
<th>1984</th>
<th>1987</th>
</tr>
</thead>
<tbody>
<tr>
<td>M2</td>
<td>34.2</td>
<td>37.2</td>
<td>41.3</td>
</tr>
<tr>
<td>M3</td>
<td>48.6</td>
<td>68.1</td>
<td>94.4</td>
</tr>
<tr>
<td>Corporate bonds</td>
<td>4.5</td>
<td>8.0</td>
<td>10.2</td>
</tr>
<tr>
<td>Stock market capitalization</td>
<td>6.9</td>
<td>7.8</td>
<td>26.8</td>
</tr>
</tbody>
</table>

Note: M2 is currency in circulation plus demand, time, and savings deposits; M3 is the sum of M2, deposits at nonbank financial institutions, debentures, commercial bills, and certificates of deposit.

Source: Bank of Korea and Ministry of Finance, Republic of Korea.

Latin American countries, other than those of the Southern Cone, have proceeded much more cautiously. Several countries, particularly Brazil and Mexico, were more successful in building balanced and diversified institutional structures. But financial reform there and elsewhere in Latin America was hindered by the failure to reduce inflation.

In Sub-Saharan Africa financial reforms are in place or under way in several countries, including Côte d’Ivoire, Ghana, Guinea, Madagascar, Mozambique, Nigeria, and Tanzania. The objectives are to restructure institutions, improve regulatory procedures, and prepare the way for a greater reliance on markets. The centrally planned economies have also undertaken some financial reforms that

 limited and gradual. In Indonesia the major banks are still publicly owned, but the government has liberalized the credit ceilings and interest rates of public banks and shifted control to the banks’ managements. Certain categories of deposit and loan rates, however, remain controlled. Korea also changed its financial policy in the 1980s, moving away from heavy regulation to a more market-oriented approach. These reforms have led to rapid growth in the financial sector (see Box 9.2). Financial reforms in Greece, Morocco, Portugal, and Tunisia have included a substantial reduction in directed credit programs, an extensive—although far from complete—liberalization of interest rates, and efforts to develop money and capital markets.
involve higher interest rates and somewhat greater competition in the provision of services.

Lessons of reform

These attempts at financial sector reform point to certain pitfalls, although the longer-term benefits are considerable. The clearest lesson is that reforms carried out against an unstable macroeconomic background can make that instability worse. Complete liberalization of interest rates in countries with high and unstable rates of inflation can lead to high real interest rates and wide spreads between lending and deposit rates. Furthermore, it did not prove possible in unstable economies to prevent the real exchange rate from appreciating or to keep interest rates in line with the productivity of the real sector. As a result, the removal of capital controls allowed volatile capital flows and undermined monetary control.

In contrast, countries with reasonable macroeconomic stability were able to avoid the pitfalls of high real interest rates, fluctuations in the real exchange rate, and insolvency among firms and banks. Some countries with considerable macroeconomic instability chose to liberalize gradually; they retained certain controls on interest rates and capital flows while encouraging greater competition and adjusting interest rates to reflect market conditions. These countries also avoided serious disruption and achieved rapid growth in their financial sectors.

A second lesson is that where prices are distorted owing to protection or price controls, financial liberalization may not improve the allocation of resources, which is one of its key objectives. In fact, deregulation may make matters worse by causing the financial system to respond more flexibly to bad signals. For example, Chile’s overvalued exchange rate in the early 1980s greatly favored the nontradables sector, which led to excessive investment in real estate. Financial reform allowed more resources to flow to that sector. In the subsequent crisis, real estate was one of the sectors that were hardest hit. Exchange rate realignments and reforms in trade and public enterprise policy should precede, or at least happen along with, financial liberalization.

A third lesson is that direct intervention in finance must be replaced by an adequate, if less invasive, system of laws and regulations. Failure to provide adequate prudential regulation and banking supervision contributed to financial insolvency in the Southern Cone, the Philippines, and Turkey. In freeing the financial system from heavy economic regulation, these countries failed to establish an adequate system of prudential regulation. In Chile, for example, privatizing banks without an adequate framework of prudential regulation allowed them to be acquired by industrial groups, which used them to make excessive loans to group firms. Effective regulation and supervision by bank management, by market forces, and by public authorities are all necessary to reduce recklessness and fraud.

Financial liberalization, like other reforms, involves transfers of wealth and income. Creditors gain from higher interest rates, and debtors lose. Financial institutions with long-term loans and short-term deposits can be adversely affected by interest rate deregulation that results in higher rates. Firms with foreign exchange debt can suffer huge losses when the currency is devalued. In the long run the change in relative prices is necessary to bring about economic adjustment; in the short run the losses can be a political and economic obstacle to needed reforms. So a fourth lesson is that the authorities must anticipate how reforms will change relative prices and how these changes will affect different groups. Considerations of equity and political feasibility alike may make it necessary to provide transitional compensation to those most adversely affected.

All this suggests that in the initial stages of reform many developing countries will be unable to liberalize as extensively as some of the high-income countries. Although generalization is hazardous, experience to date suggests the following steps in moving from a regulated to a more liberal financial system. Reform should start by getting the fiscal deficit under control and establishing macroeconomic stability. The government should then scale down its directed credit programs and adjust the level and pattern of interest rates to bring them into line with inflation and other market forces. In the initial stage of reform the government should also try to improve the foundations of finance—that is, the accounting and legal systems, procedures for the enforcement of contracts, disclosure requirements, and the structure of prudential regulation and supervision. It should encourage managerial autonomy in financial institutions. If institutional insolvency is widespread, the government may need to restructure some financial institutions in the early stages of reform. Measures to improve efficiency in the real sector—that is, more liberal policies toward trade and industry—also ought to be taken at an early stage.
In the next stage, financial reform should seek to promote the development of a greater variety of markets and institutions and to foster competition. Broader ranges for deposit and lending rates should be introduced. On the external side, foreign entry into domestic financial markets should be encouraged to increase competition and efficiency—but perhaps with restrictions, until domestic institutions are able to compete fully. Until such reforms are well under way, it will probably be necessary to maintain controls on the movement of capital. If, however, a country already has an open capital account, the government should give priority to maintaining macroeconomic stability to avoid destabilizing capital flows. After substantial progress has been made toward reform, the government can move to the final stage: full liberalization of interest rates, the elimination of the remaining directed credit programs, the relaxation of capital controls, and the removal of restrictions on foreign institutions.

In sequencing the removal of exchange controls, trade transactions should be liberalized first and capital movements later. Latin America's experience suggests that liberalizing them simultaneously is undesirable. The speed of adjustment in the capital market is faster than in the goods market. An inflow of capital can lead to an appreciation of the exchange rate, which undermines trade liberalization. In the end, internal and external liberalization will be complementary, but external reform should wait until internal reform and the recovery of domestic markets are under way. When macroeconomic stability has been established and the domestic financial system has been liberalized and deepened, it will be safe to allow greater freedom for foreign institutions and capital flows, to link the domestic and international financial markets.

If the reform process as a whole is too quick, firms that entered into contracts and arrangements under the old rules and that would otherwise be viable may face heavy losses. A gradual liberalization will also impose losses, but it will allow firms time to adjust and financial institutions time to develop the new skills they will need. Undue delay, however, carries the cost of perpetuating the inefficiencies of financial repression. The appropriate balance must be judged in each case. Here, at any rate, generalization is not helpful.

Components of financial reform

Many countries have taken the first steps toward reforming their financial systems. The elements necessary to take the process further will vary, depending both on economic circumstances and on political possibilities. This section reviews the main components of a broadly conceived program of financial reform.

Financing fiscal deficits

Macroeconomic stability depends on reducing public deficits to a level that can be financed by means other than inflation or other taxes on the financial sector. Central government deficits have in recent years been equivalent to about one-fifth of total government spending for a large sample of developing countries. About half of this total was financed by borrowing from central banks. The resulting monetary expansion caused high inflation in many countries. Government borrowing from the domestic banking system through high reserve and liquidity requirements is less inflationary than borrowing from the central bank, but it reduces bank profitability, distorts interest rates, and crowds out private sector borrowers. To the extent that a government finances its deficit domestically, borrowing from a securities market is therefore preferable to forced borrowing from financial institutions, which in turn is preferable to borrowing from the central bank.

In most countries it is possible to start a market for government bills, provided the government is willing to pay the market interest rate. Indeed, several developing countries, including Indonesia, the Philippines, and Sri Lanka, have established short-term government securities markets. This is desirable not only because borrowing from such a market is less inflationary than borrowing from banks but also because a bills market makes it possible for the government to engage in open market operations. These can be used to manage the monetary and credit aggregates without the distortions entailed by direct controls. A government bills market is also a first step toward building a broader market for corporate securities. Once market participants have become familiar with owning and trading government instruments and the infrastructure of brokers and traders is in place, it is relatively easy for the private sector to issue its own securities. And by borrowing from a bills market instead of from the insurance and pension systems, governments free long-term funds for investment in private sector assets.

Interest rate policy

Studies suggest that rigid ceilings on interest rates have hindered the growth of financial savings and
reduced the efficiency of investment. High and volatile inflation worsens their impact. In most countries this overall rigidity has been compounded by a pattern of interest rates that failed to discriminate between borrowers on the basis of loan maturity, risk, or administrative cost. Governments have often told banks to charge lower interest rates on loans to small borrowers and on loans of longer maturity. Growing recognition of the harm that administered interest rates can cause has recently led many governments to give market forces a bigger say. Governments in developing and developed countries alike have deregulated interest rates during the past decade.

If the initial conditions are wrong, however, liberalization may fail to bring about the correct pattern of interest rates. In countries that have not yet been restored to macroeconomic stability, governments may need to continue managing interest rates. In such cases the aim should be to adjust interest rates to reflect changes in inflation and exchange rates. Countries with open economies need to pay close attention to the differentials between domestic and international rates. Beyond that, governments should phase out preferential interest rates. When good progress has been made toward establishing macroeconomic stability, liberalizing industry, and restructuring the financial system, the government might then move toward a more thoroughgoing liberalization of interest rates. Some countries began by setting ranges and allowing banks to fix their rates within them. As liberalization moved to later stages, the ranges were widened and then removed.

**Directed credit**

In most developing countries government intervention in the allocation of credit has been extensive. Although a degree of intervention may have been useful during the early stages of development, many countries have come to recognize that this policy has had an adverse effect on industrial and financial development. The evidence suggests that directed credit programs have been an inefficient way of redistributing income and of dealing with imperfections in the goods market. Some programs that were well designed and narrowly focused, however, have been reasonably successful in dealing with specific imperfections in the financial markets, such as a lack of risk capital. In the future, governments should attack the conditions that made directed credit appear desirable—imperfections in markets or extreme inequalities in income—instead of using directed credit programs and interest rate subsidies.

Many governments are unwilling to eliminate directed credits entirely but are nonetheless increasing the flow of credit to the private sector and reducing their own role in credit allocation. Two principles should guide the design of any remaining programs. First, there can be only a limited number of priority sectors: a wide variety of directed credit programs means that nothing is being given priority. Second, governments should be conscious of how little information they have in relation to the information they would need to price credit for different sectors appropriately.

With regard to interest rates, the aim should be to eliminate the difference between the subsidized rate and the market rate. The lowest interest rate should not be less than the rate charged by the commercial banks to prime borrowers. Increasing the availability of credit to priority sectors should be the main focus of the remaining directed credit programs, since experience has shown that generous subsidies badly distort the allocation of resources.

Charging nonprime borrowers the prime rate implies a subsidy to the extent of the added risk and administrative costs. Instead of forcing the banks to cover these costs by charging other borrowers more or paying depositors less, the authorities would be better advised to bear the costs themselves. Directed credit administered through central bank rediscounts rather than through quantitative allocations forced on the banks promotes voluntary lending. Governments should not, however, let central bank rediscounts become a significant source of monetary expansion. Sectors that require large subsidies should be dealt with in the budget, not through credit allocation.

Finally, it seems more defensible to provide directed credits for certain activities (for example, exports or research and development) or for specific sorts of financing such as long-term loans than to target specific subsectors such as textiles or wheat. Targeting specific sectors is too risky in a world of shifting comparative advantage.

**Institutional restructuring and development**

Many financial institutions today are insolvent, and successful financial reform requires that they be restructured. Insolvent institutions allocate new resources inefficiently because their aim is to avoid immediate bankruptcy rather than to seek out customers with the best investment opportunities. Because financial institutions often become insolvent as a result of ill-advised policies toward trade and
industry, policy reforms and the restructuring of industrial companies may also be necessary. Governments should not simply recapitalize the insolvent financial institutions but should seize the opportunity to restructure the financial system in line with the country's future needs.

Liberalization should not be limited to the reform of the banking system but should seek to develop a more broadly based financial system that will include money and capital markets and nonbank intermediaries. A balanced and competitive system of finance contributes to macroeconomic stability by making the system more robust in the face of external and internal shocks. Active securities markets increase the supply of equity capital and long-term credit, which are vital to industrial investment. Experience in countries such as Malaysia and the Philippines suggests that the liberalization of commercial banking will not add much by itself to the availability of long-term credit and equity capital. In Korea, by contrast, the rapid growth of the securities market and the development of new nonbank institutions substantially improved the supply of long-term credit even though only limited liberalization of the banking system took place.

In many developing countries today the financial institutions in the most distress are part of the public sector. Privatization of government banks is one way of improving their efficiency. But this course should be followed only after the quality of bank portfolios and the regulatory framework have improved. In some countries thin capital markets mean that selling bank shares to a large number of individuals is hardly feasible. Hence privatization of public banks may simply shift the ownership of the bank from the government to large industrial groups. That would increase economic concentration and undermine sound banking—as Chile discovered in the late 1970s. In small countries with few banks and weak regulation and supervision, greater foreign participation in bank ownership and management (as in Guinea of late) is well worth considering.

Where public institutions are not privatized, other steps should be taken to improve efficiency. It is important that managers of public banks be professionals with autonomy and accountability; clear procedures will be needed that keep government interference in individual loan decisions, asset management, and personnel policy to a minimum. It is equally important that public banks not be shielded from prudential regulation.

External financial policy

Financial reforms have been undertaken in international as well as domestic markets. Many high-income countries have eased their capital controls and cut restrictions on the entry of foreign intermediaries. The result has been an increase in cross-border financial flows and in foreign participation in domestic markets. Conversely, the development of offshore markets has reinforced the trend toward deregulation in domestic markets. Offshore financial markets have grown much more quickly than domestic markets in recent years—a sign of the pace at which finance is becoming an integrated global industry. International bank lending and net issues of international bonds grew two and a half times faster than GNP in the high-income countries during 1976-86.

The growing importance of international finance is also reflected in the rise in the share of foreign loans, or of purchases of foreign securities, in banks' transactions. For example, the ratio of external assets to total assets for banks in the high-income countries rose from 14 percent at the end of 1975 to 19 percent at the end of 1985. External finance went mainly to firms in high-income countries, but some of the growth represents commercial bank lending to the now overly indebted developing countries. Similarly, the greater participation of foreign financial institutions has been evident in most major markets. The number of foreign banking firms in the high-income countries has increased sharply. The ratio of the assets of foreign banks to the assets of all banks increased in Belgium from 8 percent at the end of 1960 to 51 percent at the end of June 1985, in France from 7 to 18 percent, in the United Kingdom from 7 to 63 percent, and in Luxembourg from 8 to 85 percent. In the United States the ratio increased from 6 percent at the end of 1976 to 12 percent in mid-1985.

Advances in telecommunications and data processing have driven these changes, which are likely to prove irreversible. The greater international mobility of capital, the globalization of financial markets, and the development of new financial instruments have rendered a closed financial policy costly and largely ineffective. To varying degrees, developing countries have participated in the trend toward more open and integrated financial markets, partly in response to the growing economic integration brought about by trade, tourism, and migrant labor. Some countries have adopted foreign currency deposit schemes to in-
duce a greater flow of remittances from migrant workers. To encourage remittances and to discourage and, if possible, reverse capital flight, countries will need to make domestic financial assets competitive in yield with foreign assets. Achieving macroeconomic stability with positive real rates of interest and a realistic exchange rate will also encourage foreign investors to increase direct and portfolio investments.

The merging of domestic and international finance has certain advantages for any country. Foreign competition forces domestic institutions to be more efficient and to broaden the range of services they offer. It can also accelerate the transfer of financial technology, which is especially important for developing countries. The countries that succeed in integrating their markets with the rest of the world will gain greater access to capital and to financial services such as swaps, which will permit them to diversify their risks. But opening financial markets also poses problems. If it is done prematurely, it can lead to volatile financial flows that can magnify domestic instability. Free entry of foreign institutions can lead to the disintermediation of high-cost domestic banks. Furthermore, internationalization means giving up a large degree of autonomy in domestic monetary and financial policy. Domestic deposit and lending rates can be kept in line with world rates only if reserve requirements and banks’ costs of intermediation are in line with those in other countries.

Entry of foreign financial institutions. Attitudes toward licensing foreign banks and other financial institutions vary widely among developing countries. A few exclude foreign financial institutions; others permit representative offices but not branches. At the other extreme, the Bahamas, Bahrain, Hong Kong, Panama, and Singapore view exports of financial services as a source of employment and foreign exchange. They either allow foreign institutions to operate under the same rules as domestic banks or provide liberal rules for offshore financial institutions.

Maximizing the benefits of foreign entry requires the deregulation of domestic financial institutions and the establishment of a competitive environment. Artificially low interest rates, directed credit, barriers to entry, and other impediments to competition make it likely that foreign intermediaries will simply capture monopoly rents rather than promote competition and efficiency. Where markets are not fully liberalized and domestic banks have not been restructured, foreign participation may be beneficial, but some restrictions will remain necessary to prevent excessive disintermediation by local banks.

Capital flows. The integration of domestic and world financial markets requires freer trade not only in financial services but also in financial assets. Restrictions on capital flows have been relaxed in many developing countries, generally as part of broader programs of reform. Capital flows are already quite free in Argentina, Chile, Malaysia, Mexico, the Philippines, Thailand, Uruguay, and Francophone Africa. A growing number of developing countries are encouraging foreign participation in their domestic securities markets. Since 1980 more than thirty closed-end funds have been established as a means for foreigners to invest in developing country equities.

Capital movements to and from the developing countries are already substantial. In 1982, for example, more than a quarter of cross-border bank lending went to developing countries. (In more recent years the flows have, of course, been much smaller.) The developing countries’ stock of outstanding foreign debt is very large—$1.176 billion at the end of 1988, of which more than half was lent by commercial sources. In 1987 the recorded amount of foreign bank deposits held by residents of developing countries was $290 billion; this is undoubtedly an understatement of capital held abroad. Economic agents in many developing countries have been borrowing and depositing more abroad than in their own banks. This partly reflects the natural international diversification of portfolios, but to a greater extent it reflects efforts to avoid the repressed yields of domestic financial systems.

The scale of capital flows to and from developing countries does not mean that their financial markets have been substantially open. On the contrary, many developing countries continue to restrict outward capital flows in an attempt to direct more domestic funds to domestic investment. Furthermore, fears that foreigners would gain control of domestic corporations have led to restrictions on inward portfolio investment in new ventures.

Although the capital market should not be opened prematurely, freer capital movements will promote better alignment of domestic interest rates with international rates, increase the availability of funds from abroad, and provide more opportunities for risk diversification.
Conclusions of the Report

This Report has tried to capture the essentials of the complex field of finance. In at least two respects it fails to do justice to the subject. First, too often the developing countries have been discussed as though they were all alike, when in fact policies and experience vary widely among countries. Second, the Report has treated in a perfunctory way the human and political dimensions of the subject, both in discussing the origins of the financial problem and in offering prescriptions for change.

Unlike the problems of industry, those of finance are not frozen in bricks and mortar, plant and machinery. Financial claims, together with the all-important "rules of the game," could be rewritten overnight by government decree. But this is not to imply that reforming a country's financial system can be accomplished quickly or easily. Time is needed for people to acquire the necessary skills in accounting, management, and bank supervision. Training staff, building new institutions, and—perhaps hardest of all—getting people to revise their expectations have proved among the greatest challenges to development. Moreover, change is certain to encounter political opposition: people benefiting from the present arrangements will resist reform. Others—although they stand to benefit in the long run—will be hurt in the short run and may not choose to make the sacrifices demanded today for uncertain gains in the future. Change may be most resisted in the very countries where it is most necessary.

Once reform is under way, the response will not be immediate; indeed, it may be painfully slow. After prolonged periods of inflation and many failed attempts to control it, the public will expect inflation to continue and will behave accordingly. Entrepreneurs unpersuaded of the permanence of new policy will be slow to change their ways.

This Report has tried to specify the prerequisites for building an efficient financial system capable of mobilizing and allocating resources on a voluntary basis. Such a system would continue to make mistakes and waste resources. But it would probably make fewer mistakes and waste fewer resources than the interventionist approach followed in many developing countries today.