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# Working Paper

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## **FINANCIAL POLICIES IN THE ADAPTIVE ECONOMY**

**Tony Killick and Matthew Martin**

**Results of ODI research presented in preliminary form  
for discussion and critical comment**

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**FINANCIAL POLICIES  
IN THE ADAPTIVE ECONOMY**

**Tony Killick and Matthew Martin**

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**OVERSEAS DEVELOPMENT INSTITUTE  
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## **Preface and acknowledgements**

ODI Working Papers present in preliminary form work resulting from research undertaken under the auspices of the Institute. Views expressed are those of the authors and do not necessarily reflect the views of ODI. Comments are welcomed and should be addressed directly to the author.

This Working Paper is one of a series of draft chapters of a book currently under preparation by Tony Killick with the provisional title of The Adaptive Economy: Adjustment Policies in Low-income Countries. The purpose of this volume will be to discuss general principles of policies for what has become known as 'structural adjustment' and to set these in the context of longer-term economic development. Those who make or seek to influence policy are the chief target audience, although it is hoped that this work will also be useful for students and other members of the academic community. The complete set of papers to be issued in this series is as follows:

- 31 Economic development and the adaptive economy
- 32 Principles of policy for the adaptive economy
- 33 Exchange rates and structural adaptation
- 34 Markets and governments in agricultural and industrial adjustment
- 35 Financial policies in the adaptive economy
- 36 Problems and limitations of adjustment policies  
(forthcoming)

Tony Killick is Senior Research Fellow of ODI and Visiting Professor of the University of Surrey. Matthew Martin is Project Manager and Research Officer at Queen Elizabeth House, Oxford. Thanks are due to the Economic Development Institute of the World Bank for financial support for this project, but the authors alone are responsible for any views expressed.

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## I. WHY DOES FINANCE MATTER?

### I.1 Financial development as an 'enabling' change

Why should a series of Working Papers about the promotion of economic adaptability merit a separate paper on policies towards the financial system? An answer has already been briefly set out in Working Paper No. 31. We there noted evidence that at the earlier stages of development the financial system grows substantially faster than both GDP and wealth, and we reproduced Goldsmith's calculations of rising ratios of financial assets to the total stock of wealth during the earlier stages of development of economies as disparate as India, Japan and the USA.

While the causality is by no means all one-way and financial sector development is partly a response to growing demands for its services by the rest of the economy, we went on to suggest that this 'financial deepening' promotes the flexibility and growth of the remainder of the economy in a number of ways. First, by reducing risks and losses of liquidity and by offering a financial reward it tends to increase total saving. By the same means it will discourage capital flight (outflows of savings to the rest of the world), and may encourage a return flow of past flight capital. It is also likely to attract a growing proportion of total saving out of real assets, such as jewelry or cattle, into the financial system, through which it is more likely to be devoted to productive investment. Any such effects in raising the availability of domestic savings are all the more important given the trend that has emerged during the last decade for developing countries to have less access to world saving and to have to become more self-reliant in mobilising resources for investment, although financial sector development can also help to attract inflows of savings from the rest of the world.

In these ways it will also promote capital formation, by increasing the supply of investible resources. There are further ways in which it will promote both the quantity and productivity of new investment. Savings are transferred to investors with different needs, degrees of risk and prospective rates of return, thereby permitting more diversified and efficient investment. Through diversification of financial instruments, and access to greater information than individual savers and investors can easily obtain, financial institutions reduce, bear or transfer risks. Through maturity transformation, they allow savers to hold liquid assets while investors borrow long-term. They match savers and investors with congruent preferences for risk and return, and they 'bulk-up' the small-scale savings of households for investment in sometimes large, capital-intensive projects, thereby increasing the volume of investment and enabling more risky investments with higher yields to occur. Managers of financial institutions who make wise investment decisions or develop attractive new financial instruments, thereby reducing the costs of intermediation, are rewarded.

Capital markets further exert pressure on investors to use resources for the maximum return, in order to repay loans and qualify for new financing. Finally, they provide a safe, efficient payments system which enables quick settlement of obligations, reducing

risk and the cost of financial transactions. In all these ways a well-functioning financial sector promotes more investment, at the highest available rates of return, and with minimum transactions costs.

Because of its beneficial effects on the volume and productivity of saving and investment we nominated the relative expansion of the financial sector as one of the 'enabling' ingredients of structural transformation, permitting and encouraging a pace of general economic development that otherwise would be frustrated. The general aim of financial policy, then, is to encourage the development and efficient functioning of the financial sector so that it can make the greatest possible contribution to the growth and adaptability of the economy.

How much can realistically be expected of this sector will, however, be influenced by the nature of the wider economy, for we have already noted the importance of the feedback from the real economy to the financial sector. The key stimuli to financial development are higher capital intensity, more diversified and greater output, and factors which affect the savings ratio, such as *per capita* income, the need for security through hoarding, consumer liquidity constraints, the population dependency ratio, social conventions, the terms of trade and the propensity to save in growth sectors of the economy. As a result, the scope for financial deepening will be constrained by the low level of development in small low-income countries.

We should also caution that there is much that economists do not yet know about these matters, particularly as they relate to the circumstances of small low-income countries. Data on such variables as saving are notoriously poor. Much of the research that has been undertaken relates to more advanced developing countries in Asia and Latin America, and we need to be very cautious about extrapolating results from these countries.

In what follows we will first examine the nature of the problems to be addressed by financial sector policies, following the now familiar procedure of examining the failings of both markets and governments. The second part of the Working Paper will then be devoted to a discussion of the policies that might be adopted to remedy these failings. A good deal of our time will be taken up by exploring the extent and consequences of financial sector 'repression' and the policy liberalisation that is commonly advocated as an antidote. We look first, however, at financial market failures.

## II. THE NATURE OF THE PROBLEM

### II.1 Market failures

It would be easy to be misled by the emphasis in the modern literature on the ill-effects of state-induced financial repression to lose sight of the facts that market failures are common in the financial sectors of low-income countries and that, to some extent, 'repressive' policies are a response to these imperfections in financial markets. Five types of financial market failure are common: segmented, incomplete or shallow markets; oligopoly; limited information; artificial excess demand for credit; and internal debt crisis.

Most financial markets in small low-income developing countries are segmented. This can be on the basis of geography, with different types and qualities of provision for rural and urban credit. It can be by type of investor - small or large, newly-established or long-standing, locally- or foreign-based - or due to ethnic or religious ties. Perhaps most commonly of all, formal and informal financial institutions (examples of the latter are local moneylenders and village savings and loan associations) are likely to exist side-by-side in a dualistic, poorly integrated manner.

Incomplete or 'shallow' markets take two forms - where markets for particular financial services simply do not exist at all, or where they are inadequately specialised. In most small low-income countries, formal rural credit facilities are underdeveloped, if not entirely absent, with a low density of bank branches. We already noted in Working Paper No. 34 (p.25) the unavailability of capital market institutions as a constraint on agricultural production, pushing rural savers and investors to less appropriate informal institutions or discouraging saving and investment altogether.<sup>1</sup> The absence of insurance facilities and forward markets prevents producers and savers from hedging to reduce risk, and the absence of markets in short-term financial instruments prevents them from saving at low risk, thus discouraging saving, or pushing it into real assets - in which case it is unlikely to be devoted to productive use - or encouraging capital flight to markets overseas.

Most small low-income countries have shallow financial markets, characterised by low levels of specialisation. Historically, financial deepening has involved a transition from savings mobilisation by the informal sector; to formal intermediation by commercial banks and monetised economic activity; then to more specialised financial institutions (insurance companies, building societies, pension funds, savings banks, *etc.*); and finally to direct savings mobilisation through government bonds, lotteries, equities and other capital market instruments. We characterised this in Working Paper No. 31 as an example of the product diversification which occurs as economic development proceeds. The paucity of specialised and direct institutions in most low-income countries is an

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<sup>1</sup> See Von Pischke *et al.* [1983] on the economic role of rural financial market institutions, and policies towards them.



important aspect of the incompleteness of financial markets from which they suffer. Such specialisation as does occur is often a result of decrees and prohibitions by government, rather than a competitive division of labour, as in the following description of the situation in the Philippines:<sup>2</sup>

*When it was observed that commercial banks made little effort to penetrate the countryside and to supply financial services to its residents, a system of rural banks was set up (1952). When a rising demand for medium- and long-term development finance was felt in the early years after World War II, development institutions such as the Development Bank of the Philippines (1947) and a number of private development banks (1959) were created or encouraged. Recognition of unfulfilled credit needs of small-scale industries led to the creation of the National Cottage Industries Bank (1963). The perceived shortage of financial services in the Muslim provinces of Mindanao prompted the establishment of the Amanah Bank (1963). More often than not new financial institutions were "tailor made" in the sense that the legal framework within which they operated reflected fairly rigidly the need - as perceived by the legislators - for additional financial services by particular types of potential customers.*

Such involuntary specialisation may promote inefficient compartmentalisation, raising intermediation costs rather than efficiency, as in the Philippines, where there was little competition among the numerous institutions, costs were high and credit allocation was inefficient.

Segmentation, incompleteness and shallowness are likely to encourage oligopoly within specialised areas. Most financial markets in small low-income countries are marked by oligopoly or monopoly, especially those of the formal sector, such as banking, security brokerage, and the provision of insurance services. They may also be honeycombed with interlocking common ownerships in a holding company structure.<sup>3</sup> Under pressure from the political power of existing institutions, the government may establish exclusive or oligopolistic franchises, and barriers to the entry of foreign or domestic competitors. Sometimes, to the contrary, they set up state-owned banks and other institutions intended to counter the monopoly powers of the private institutions, but all too commonly it is not long before these public enterprises have 'joined the club' and become part of a co-operating oligopoly.

Box I illustrates a rather extreme example of the dangers with a case history of Chile, where oligopoly contributed powerfully to a near-collapse of the entire financial system.

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<sup>2</sup> From World Bank, cited by Fry [1988, pp.312-13].

<sup>3</sup> Galbis [1986]. He excludes countries with largely state-owned or nationalised banking sectors from his analysis, but many of the faults he finds in the "holding company structure" apply equally to relations between parastatals and government-owned banks.

## BOX 1. FINANCIAL OLIGOPOLY IN CHILE, 1977-82<sup>4</sup>

During 1977-81, the Chilean government liberalised economic and financial policy. By 1979, inflation and unemployment had fallen and economic growth was at historically high levels. Yet by 1981 the financial sector was plagued by nonperforming loans; borrowers faced real interest rates of 40%; inflation and unemployment were rising; and production was declining.

One major cause of this reversal was the oligopolisation of the financial system. A handful of economic conglomerates, known as *grupos*, gained control of most major financial institutions and used them to make speculative capital gains and to allocate credit in favour of associated companies. This ultimately undermined the quality of financial sector assets, provoking a major financial crisis when the economy began to slow down in 1982-83.

The *grupos* appeared to be relatively profitable during 1977-81, but in reality the underlying rate of return on their operations was poor. They offset this in two ways, both made possible by their ownership of major banks and financial institutions. They made capital gains by speculative purchases of shares in related industrial and commercial enterprises. Although they had inadequate supporting liquidity or other assets, their own banks and others lent them large amounts at high interest rates based on the capital gains they were making. These loans allowed them to consolidate shareholdings and borrow more.

The *grupos* also used their control over banks and their overseas contacts to obtain low-interest dollar loans, which they on-lent to other companies at high domestic interest rates, to make large profits. The search for short-term profit led to a dramatic rise in demand for loans, which in turn sharply reduced their average maturity and pushed interest rates up. When combined with exchange rate overvaluation and a downturn in exports in 1981-3, falsely high interest rates slashed underlying operating *grupo* earnings. In addition, other domestic companies became unable to repay the high-interest loans and share prices fell. Both these developments undermined *grupo* profitability and made them a burden on the banks. As bad loans proliferated, banks capitalised interest and rolled it over by extending new loans, especially to companies in the same group. This "distress borrowing" created more false demand for credit, pushing real interest rates to unprecedented levels, and exacerbated the mounting financial crisis. The non-performing assets of banks rose from 11% of capital and reserves in 1980 to 150% in 1983. From mid-1981, the government had to intervene to prevent collapse of the financial system. Initially it propped up financial institutions by expanding credit to the private sector (thereby undermining tight monetary policy) but during 1981-83 it had to nationalise most major financial institutions (so that the state came to hold 87% of financial system assets) to protect depositors and foreign creditors.

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<sup>4</sup> Based principally on Cho and Khatkhate [1989]; Diaz-Alejandro [1985]; and Galvez and Tybout [1985].

Even in less severe cases, oligopoly raises intermediation costs and often enables institutions to widen the spread between borrowing and lending rates. Insofar as this depresses deposit rates, it discourages financial savings. Bank cartelization can also lead to collusion to limit competition or diversion of (frequently subsidised) credit to associated companies, as in Chile. Such vested interests can induce government policies to reinforce their monopoly powers and can undermine the effectiveness of

liberalisation. Within oligopolies smaller numbers of institutions often control the bulk of transactions, leading to virtual monopoly. Thus in Anglophone Africa, where there is little tradition of competitive banking, it is common for the commercial banking sector to be dominated by two or three banks, which co-operate to limit competition.

Limited information may apply to savers, investors and financial institutions. It is especially prevalent in informal markets (indicating that they may be inefficient) but exists in all financial markets. Ignorance deters savers and investors by increasing uncertainty and risk with no compensating extra return. When the costs of information about the comparative riskiness of different borrowers are large an unregulated banking system will impose credit rationing, in what is known as 'adverse risk selection'. This means that abolishing interest rate ceilings will not achieve optimal allocation of investible funds.

All of these market characteristics lead to malfunctioning financial institutions, which in turn cause two further imperfections. Banks engage in non-price rationing of credit by quality of collateral, political pressure, company reputation or loan size, or lending decisions are determined by corrupt 'rent seeking' by bank loan officers. Such decision processes discriminate inefficiently among loan opportunities, excluding less privileged borrowers, and creating an excess demand for credit.

Poor standards of bank management, described in Box II, are a more straightforward aspect of market failure, stemming from the organisational slack created by the possession of monopoly power, by the excess demand for credit and by inadequate central bank supervision. As the Box shows, mismanagement can cause banks to become overextended, with nonperforming loans (domestic or foreign) creating an internal debt crisis in which many banks or borrowers are close to collapse, as in the Chilean case. This is often hidden in bank or company accounts until state intervention reveals its true extent. The crisis limits new lending. It is also likely to encourage credit misallocation and upward pressures on interest rates and inflation. Most low-income countries have experienced internal debt problems to some extent in the 1980s. This pre-crisis stage, when bad debts distort resource allocation without triggering corrective government action, is also damaging, but in a more insidious way.<sup>5</sup>

As we have already hinted, informal financial institutions (hereafter IFIs) may in some degree provide an alternative to the formal sector, indeed may have expanded in response to the inadequacies of the latter. IFIs are severely understudied, particularly as they operate in African and other small low-income economies. In some cases, however, they have been found to be more responsive to borrowers' needs and more accessible than formal institutions, especially in rural areas, and to have lower lending costs, especially when dealing with small farmers and businesspeople.

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<sup>5</sup> The World Bank [1989, pp.70-1] concludes that not since the 1930s have so many firms in developing countries been unable to service their domestic debts.

## BOX II. ASPECTS OF BANK MISMANAGEMENT

The quality of management is an important difference between sound and unsound banks, and in most countries the better-managed financial institutions have succeeded in remaining solvent. Four types of mismanagement commonly occur in the absence of effective regulation and supervision.

- **Technical mismanagement.** Poor lending policies are the most common form of technical mismanagement and are usually a consequence of deficient internal controls, inadequate credit analysis, or political pressures. Poor lending policies often lead to excessive risk concentration, the result of making a high proportion of loans to a single borrower or to a specific region or industry. Banks sometimes lend excessively to related companies or to their own managers. Mismatching assets and liabilities in terms of currencies, interest rates, or maturities is another common form of technical mismanagement.

- **Cosmetic mismanagement.** A crossroads for management is reached when a bank experiences losses. Strong supervision or a good board of directors would ensure that the losses are reported and corrective measures taken. Without these, bankers may engage in "cosmetic" mismanagement and try to hide past and current losses. There are many ways to do this. To avoid alerting shareholders to the difficulties, bankers often keep dividends constant despite poorer earnings. And to keep dividends up, bankers may retain a smaller share of income for provisions against loss, thereby sacrificing capital adequacy. If a dividend target exceeds profits, bankers may resort to accounting measures that increase net profits on paper, even if more taxes must be paid as a result. By rescheduling loans, a banker can classify bad loans as good and so avoid making provisions. The capitalisation of unpaid interest raises profits by increasing apparent income. The reporting of income can be advanced and the recording of expenditure postponed.

- **Desperate management.** When losses are too large to be concealed by accounting gimmicks, bankers may adopt more desperate strategies. The most common of these include lending to risky projects at higher loan rates and speculating in stock and real estate markets. Such strategies, however, involve greater risk and may well lead to further losses. The problem then becomes one of cash flow: it gets harder to pay dividends, cover operating costs, and meet depositors' withdrawal demands with the income earned on the remaining good assets. To avoid a liquidity crisis a bank may offer high deposit rates to attract new deposits, but the higher cost of funds eventually compounds the problems.

- **Fraud.** Fraudulent behaviour sometimes causes the initial losses, but once illiquidity appears inevitable, fraud becomes common. As the end approaches, bankers are tempted to grant themselves loans that they are unlikely to repay. Another common fraud is the "swinging ownership" of companies partly owned by the bank or banker: if a company is profitable, the banker will arrange to buy it from the bank at a low price, and if the company is unprofitable, the banker will sell it to the bank at a high price.

On the other hand, the indications are that the extent to which they can fill a vacuum left by inadequacies in the formal sector is slight. The existence of large apparent differences in the effective interest rates charged by formal and informal sector lenders suggests a limited flow of funds, or highly imperfect arbitrage, between them. On limited evidence, it seems that IFIs in Africa usually operate at the extreme short end of the market, typically offering savings facilities and credits for a one-month term, thus limiting the extent to which they are able to mobilise genuine savings and channel them into productive investments.<sup>6</sup> The effective annualized interest rate charged to borrowers is often extremely high (although from the lender's point of view it may be much less so because of frequency of default). In terms both of sources of funds and type of borrower, IFIs and the formal sector seem to cater for separate groups of customers, with limited overlap between them. The financial market is, in other words, truly dualistic, with the consequential adverse effects on efficiency and investment, as described in Working Paper No. 31. If this characterisation is correct, the formal and informal institutions are complementary rather than competitive and IFIs cannot substitute for a well-developed formal sector, particularly when it comes to the mobilisation of long-term savings and the provision of low-cost credit.

Although there is little systematic evidence on the extent of the market failures described above, there is little doubt that they are widespread in the economies with which we are concerned in this series of Working Papers. Various adverse consequences of this have already been mentioned. Market failures will reduce the level of formal financial saving. The absence, segmentation or shallowness of formal markets will prevent savers from hedging to reduce risk and will discourage saving or drive it to informal or foreign markets. Oligopoly may raise intermediation margins or bring collusion on interest rate controls, both depressing deposit rates, or may lead banks to turn away depositors in times of excess liquidity. Insofar as market failures produce limited information, volatile real interest rates, or internal debt problems, they deter savers by raising the uncertainty of risk and return.

Additionally, there is considerable evidence that capital flight reflects insufficient opportunities to diversify risks in profitable investments within a nation's financial system. This is due in part to the underdevelopment and inefficiency of financial intermediation (although wider macroeconomic conditions will also exert a powerful influence). Capital flight is particularly encouraged by the lack of well-developed bond and securities markets; investors in these would face an implicit penalty in selling their assets to move savings overseas, by risking bringing down the value of other investments. Due to oligopoly and segmentation, investors may be unable to participate in profitable projects. Capital flight also reflects lack of confidence in financial institutions associated with internal debt crisis. Investors with poor information, and who are unable to hedge through forward markets or to reduce risk through short-term instruments, regard domestic investment as excessively risky. High

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<sup>6</sup> This discussion is based on Chipeta and Mkandawire [1989] and other research currently under way for the Nairobi-based African Economic Research Consortium.

interest rates, due partly to adverse risk selection, may discourage productive investment and push capital abroad.

Market failures will also reduce the efficiency of investment. Segmented, incomplete, shallow or oligopolistic markets reduce competition among lenders, reducing opportunities and raising costs for investors, for which IFIs are likely to be a highly imperfect substitute. Oligopolistic banks may divert credit to non-creditworthy associated companies or projects, as Box I on Chile illustrated. Limited information about risk may induce credit rationing or adverse risk selection based on criteria other than efficiency. Excess credit demand and bad debts may result, further distorting investment allocation, pushing up interest rates, encouraging new loans to roll over bad debts, and denying investment funds to other potential borrowers.

The growth and development of the financial sector and of the overall economy are related to the degree of financial depth, the volume of financial saving and the efficiency of investment. Since market failures have negative effects on all three variables, they also reduce growth and development. In addition, lower levels of financial saving (and therefore of intermediated investment) and less efficient investment are likely to reduce the profitability of financial institutions, deterring the specialisation or diversification which create new types of financial institutions, perpetuating market failures and financial underdevelopment.

These, then, are not failings to be lightly shrugged off. They call for a policy response, to which we will return later. Next, however, we will consider some failings of the state.

## II.2 Policy weaknesses

In doing so, the notion of 'financial repression' is of central importance.<sup>7</sup> This refers to policy actions which hold interest rates below market-clearing levels, which introduce non-market considerations into credit allocation decisions, and which in other ways directly frustrate the financial sector from developing and performing its economic roles. Box III provides an example of financial repression, drawn from Nigerian experiences.

Direct state controls over interest rate levels, bank asset structures and credit allocations are the most common instruments of financial repression, whose effects are often aggravated by domestic price inflation. The maintenance of over-valued currencies, exchange controls and tax policies is also frequently cited as contributing to financial repression, and Box III illustrates a variety of other ways in which the authorities can intervene. The regulation of interest rates is arguably the most

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<sup>7</sup> See McKinnon [1973] and Shaw [1973] for the classic statements of this concept and its intellectual underpinnings; and Fry [1988, chapter 1] and *passim*, for an excellent modern exposition and analysis.

common and important of these, and it is worth spending some time exploring the issues which are thrown up.

### BOX III. FINANCIAL REPRESSION IN NIGERIA, 1970-85<sup>8</sup>

During 1970-85, Nigeria exhibited the characteristic policies of financial repression: interest rate controls, bank deposit and credit controls and directing investment. Administered interest rates were kept at 3-6% during 1970-81, while inflation averaged 16%. Only in 1972 were real interest rates positive for savings deposits. In 1982-83 they were raised to 7.25% and in 1984-85 to 9.5%, but this enabled positive real rates only in 1985.

Between 1962 and 1970, the government fixed credit ceilings and interest rate ranges, and allocated 35% of each bank's loans to indigenous firms. The international oil price rise created huge domestic liquidity, and the government became a net lender to the banks. Banks were so awash with funds that some turned depositors away. The government rejected interest rate rises to restrict credit, and turned to credit allocation and control.

By the mid-1970s, the central bank was setting the share of loans and advances which each bank should make to each of sixteen different sectors of the economy, and lower interest rate ceilings for agricultural and other priority project areas. It also set targets for banks to increase branches in rural areas and, by 1980, even insisted that banks administer a car loan programme for federal employees. In addition, the government indigenisation programme ultimately insisted that 60% of equity in foreign-owned banks should be owned by Nigerians, and that Nigerians should manage the banks. An unforeseen side-effect of this was to concentrate power in commercial banks (which came to hold 80% of financial system deposits), and in three banks, holding 60% of bank deposits.

Repression pushed savers to look for other assets which provided a greater and safer return. Total and financial savings grew because many Nigerians, flush with oil funds, increased their saving in spite of low interest rates, but capital flight grew much more rapidly during a period of relative economic growth. Meanwhile the cost of funds for investment was higher than necessary because oligopolistic banks were able to insist on high intermediation costs, with a wide margin of 3-4% between deposit and loan rates. Banks often could not find sufficient viable projects to fill credit allocation targets, and were not allowed to use funds for more productive projects in more profitable industries. The low interest rates encouraged investment in projects dependent on economic boom. When the oil price fell after 1981, the effects of repression became clear. Big banks' profits rose, reflecting their ability to corner viable projects; small and newer state-owned banks, with weaker portfolios due to politically-directed lending, faced growing bad loans and several ultimately collapsed.

<sup>8</sup>

Derived from Agu [1988]; Cole *et al.* [1988]; and Hanson and Neal [1985].

## □ The interest rate question

Governments commonly impose ceilings on the interest rates which may be charged for loans. Sometimes they also specify ceilings on bank and other deposits but, in any case, ceilings on lending rates restrict the interest that banks can offer their depositors if they are to make a profit from the spread between deposit and lending rates. Such ceilings are imposed for a variety of motives. In some countries there is a strong anti-usury tradition, extending in countries with Islamic laws to outright prohibition of interest charges for loans.<sup>9</sup> Even in the absence of such religious or moral influences, governments have sometimes regarded it as necessary to introduce controls as a way of protecting borrowers from being exploited by monopolistic banks and other lenders. No less commonly, interest rates are held down in order to encourage investment and thus to stimulate economic development.

Some theory will help us explore the possible consequences of interest controls. First, we should introduce a by now familiar distinction between nominal and real variables. Interest rates are denominated in nominal terms. If a bank deposit of \$100 pays interest at 10% then after a year the deposit will be worth \$110 in nominal terms. In the presence of inflation its real value will be less, however. If inflation is running at, say, 5% *p.a.* then the real value of the deposit after a year will be only (approximately) \$105 and the real interest rate will be only (roughly) 5% *p.a.* If inflation were at 15% the deposit would after a year be worth less in purchasing power terms than it was originally and the real interest rate would be negative - roughly - 5%.<sup>10</sup>

Since many developing countries not merely regulate interest rates but are also plagued by inflation, real rates (hereafter denoted by  $R^*$ ) in these countries are often negative, as is shown in Table 1.

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<sup>9</sup> Islamic banking nonetheless flourishes! This is because such banks have been inventive in finding ways of charging for their loans which are deemed to conform to Islamic teachings against the charging of interest. On this see Khan [1986]; and Iqbal and Mirakhor [1987].

<sup>10</sup> The exact formula for calculating the real interest rate ( $R^*$ ) is as follows, where  $R$  is the nominal interest rate and  $P$  is the rate of inflation and where all variables are expressed in proportional rather than percentage form:

$$R^* = (1 + R)/(1 + P)$$

Solving for the first example given in the text gives us:

$$(1 + 0.1)/(1 + 0.05) = 1.0476, \text{ or } R^* = 4.76\%$$

As we will see shortly, the inflation term should strictly speaking be expressed in terms of expected inflation, although past inflation is often used as a proxy for expected inflation.



Table 1: Comparative Statistics on Real Interest Rates, 1985

	inflation rate	real deposit rate <sup>a</sup>	av. real financial return <sup>b</sup>
East Asia	5.4	5.5	2.4
Latin America	76.7	-4.5	-8.9
South Asia	6.3	3.4	-0.1
Sub-Saharan Africa	17.4	-3.5	-8.8
<hr/>			
Industrial countries	6.4	2.0	-0.2

**Notes:** (a) average real rate on bank deposit accounts;  
 (b) weighted average real return on financial assets.

**Source:** Neal, 1988, Table 2.

It is no surprise that  $R^*$ s are negatively correlated with the inflation rate, with low-inflation Asia offering generally positive rates of return. Perhaps the most significant figures in this table for our purposes are the entries for sub-Saharan Africa, for this contains a high proportion of small low-income countries. Africa is revealed as experiencing substantial inflation and as offering its savers substantially negative  $R^*$ s. Does this matter?

Part of the answer to that question depends on how we think savers behave. On the general presumption in economics that the supply of something is likely to increase as its price rises, we might expect saving to be positively related to the interest rate. We need to be careful about such an assumption, however. First, there is much evidence that the volume of household saving is principally determined by income and by past savings, so that the interest rate may exert only a slight influence on decisions whether to consume or save. Second, we should remember that much of an economy's saving is undertaken by firms, in the form of undistributed profits, and - perhaps - by the government in the form of current budget surpluses. The connections between these forms of saving and interest rates are likely to be quite complex, with the net outcome again rather indeterminate.

Whether the aggregate supply of saving is elastic with respect to the interest rate is thus in question, and can only be settled empirically. If, however, we confine ourselves to that part of total saving which is channelled through banks and other financial institutions then we are on safer ground in postulating interest-elasticity. Households can save either with these institutions, or by hoarding currency, acquiring

real assets (such as land, jewelry and cattle) or investing abroad (if they can get their money out of the country). Since there is much substitutability between these alternatives, it is reasonable to expect that financial saving will go up with the interest reward being offered, as people switch out of currency and real assets, and recall their capital from overseas.

What about the influence of inflation? Modern economic theory makes an important distinction between changes that are anticipated and can be built into present decisions, and unexpected changes. If we regard savers as rational decision-makers, and if past experience has taught them to expect there to be inflation, then we must expect them to discount the nominal interest rate on offer by the expected rate of inflation and to make their saving and consumption decisions on this basis. In other words, we expect the real rather than the nominal interest rate to be the key variable, except when no inflation is expected. In this case, the negative  $R^*$ s shown for Africa and Latin America in Table 1 can be presumed to act as a discouragement of financial saving and perhaps aggregate saving.

The likely effects of a government-imposed interest ceiling can now be illustrated, as in Figure A. We draw in an upward-sloping savings-supply schedule,  $S'$ , on the premise that saving will be responsive to changes in  $R^*$  (ignore the broken  $S''$  curve for the time being). This may relate to either aggregate or financial saving. We also draw in a downward-sloping savings-demand, or investment ( $I$ ), schedule (to be discussed shortly). In a freely operating market, the real rate would settle at  $r^1$ , and the volume of saving and investment at  $i^1$ . Now assume the government imposes a ceiling on interest rates which (with a given inflation rate) implies a real rate of only  $r^1$ .<sup>11</sup> At this rate the investment-demand for savings is  $i^2$  but the quantity of saving falls to  $i^1$ . Since investment is constrained by the availability of savings, only  $i^1$  amount of investment will actually occur, so that the effect of an interest control that may well have been intended to boost investment actually reduces it - that is, if aggregate saving is interest-elastic. If we do not think this condition holds, we can re-interpret the diagram as relating to financial saving and the investment resulting from it. If the savings effect takes the form of a reversal of capital flight, the analysis is similar to that for an increase in total saving. If the change is expected to be largely confined to a shift of savings from real to financial assets, the positive economy-wide effect is weaker but is still likely to be positive, on the grounds that it is financial savings which are most likely to become available for productive investment.

The impact on investment is not only a quantity effect, however. There is also liable to be a quality, or productivity, effect. If the quantity of saving and investment is confined to  $i^1$ , we can see from Figure A that the market-clearing interest rate would be  $r^2$ , and only projects offering investors a better real return than  $r^2$  would be undertaken. With interest rates pegged at  $r^1$ , however, there is an excess investment

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<sup>11</sup> For simplicity we will ignore the spread between bank deposit and lending rates and assume that savers and borrowers are faced by the same rate. Relaxing this assumption does not affect the thrust of the argument.

demand, of  $i^1$ - $i^2$ , and the question arises how the lending houses will make their credit decisions in this situation, for now any project offering a real return greater than  $r^1$  will be profitable. As we suggested earlier, they are liable in this situation to favour large existing customers, companies in which they have a financial interest, and friends. Bribes may pass between loan applicants and bank officials. In the absence of this, projects perceived as risky will be avoided. In short, the bundle of investments favoured in such an excess-demand situation is likely to offer substantially lower real returns, on average and at the margin, than would hold in a market-clearing solution. Note that this effect occurs whether saving is interest-elastic or not.

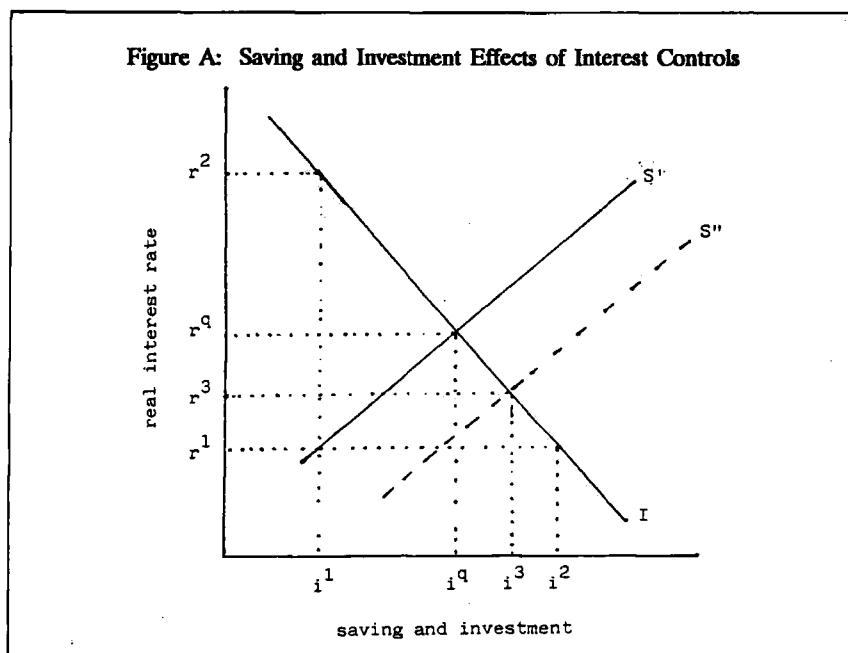


Figure A is drawn for a moment in time, with income levels therefore given. We can take the analysis a little further by imagining the results of a government decision to scrap the interest ceiling,  $r^1$ , and to allow the market to operate freely. The real rate then settles at  $r^q$  and saving and investment increase from  $i^1$  to  $i^q$ . The increase in investment will induce an increase in the rate of economic growth which, in turn, will induce additional saving, shifting the savings-supply curve to the right, represented in the diagram by the broken  $S^2$  curve. The consequence of this is not merely to increase the volume of investment, by  $i^2$ - $i^3$ , but also to bring down the interest rate, to  $r^3$ , reducing the initial upward effect of the decision to scrap the control.

Theory thus teaches us that interest controls are likely to have adverse consequences for both saving and investment, and hence for the economy as a whole. How far do these predictions take us in the real world? It has to be said that empirical investigations of the influence of  $R^*$  on saving have proved less than decisive. Different studies have produced contrasting results, depending on the data used, statistical methods, country sample, and the period studied. Many have limited country coverage and have to use unreliable data (notably on total saving and expected inflation). Measured effects vary tremendously for different countries, making cross-country averages an inadequate basis for policy recommendations. Moreover, there have been few studies of low-income countries.

There is, however, a consensus in recent studies that if higher  $R^*$ s have any effect on total saving, it is positive but relatively small. Only if previous rates were very negative and there are no severe liquidity constraints on consumers is there much scope for increasing total saving by raising interest rates.<sup>12</sup> The measured response varies so much among nations that it is impossible to arrive at any strong general conclusion. Though on balance  $R^*$  is likely to have a marginally positive impact on total saving, its effect is neither large nor reliable enough to make raising interest rates an efficient way of trying to increase total savings.

We have already mentioned one reason for this: the level of, and changes in, disposable income and past savings performance are the main determinants of saving and these influences tend to swamp the price effects. In addition, it has been found that consumer behaviour in some developing countries is dominated by pervasive liquidity constraints, which prevent people from postponing consumption and increasing saving. When Rossi [1988] screened out this constraint, she then found a positive correlation between  $R^*$  and total saving in all regions except sub-Saharan Africa and East Asia.

As was predicted in our theoretical discussion, there are stronger results from studies of the influence of  $R^*$  on financial saving. This relationship is usually approached by measuring the influence of  $R^*$  on the rate of financial deepening, as proxied by the ratio of liquid liabilities (M3) to GNP. Findings reported by the World Bank [1989A,

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<sup>12</sup> Thus Khatkhate [1988], whose study includes 20 low-income nations, concludes that the real interest rate by itself has little or no impact on total saving. Fry [1988, Chapter 6] finds a 1% real interest rate rise likely to raise the aggregate saving rate by only 0.1%, with even this effect disappearing as the real rate reaches competitive free-market equilibrium. However, Fry studies Asian countries (only 2 low-income), and Gupta [1987] argues that Asian results do not apply elsewhere: positive interest rates have statistically significant positive effects on total saving in Asia, but no significant influence in Latin America. Leite and Makonnen [1984] similarly found real interest rates to have no statistically significant direct positive effect on total saving in Franc Zone African countries. Various other studies also find no significant correlation. See Arrieta [1988] for a useful evaluation of some of these studies.

pp.27-28] are typical of the results of a substantial number of other studies.<sup>13</sup> The Bank found substantial financialisation: the M3/GNP ratio rose by 0.75% for each 1% increase in nominal deposit rates. It also found that financial savings fell by 1.7% for every 1% rise in the inflation rate. In other words, much of the correlation between  $R^*$  and financial deepening depends on the degree to which inflation is reduced. Lower inflation makes more contribution to financial deepening than nominal interest rate rises.

Gelb [1989] obtains a similar result, using a more accurate gauge of financialisation: the sensitivity to  $R^*$  of the ratio of the real increase in M3 to the real increase in total savings. He finds that a 1% rise in  $R^*$  increases financialisation by 0.7%. These findings are important because they suggest that financialisation of savings (M3/savings) rather than financial deepening (M3/GNP) is the key link between interest rates and growth. Raising  $R^*$  by raising nominal rates or (especially) reducing inflation is therefore likely to channel more savings into investment via financial intermediation.

Studies of the determinants of capital flight disagree over the influence of interest rate repression. Several studies<sup>14</sup> have found that legal capital flight is due largely to wider macroeconomic developments and that differentials between domestic and international interest rates are not a statistically significant factor; and that most of the effect of low  $R^*$ s is due to the associated inflation rather than directly through repression. Other researchers, however, do find that interest differentials matter and that interest rates below market-clearing levels drive capital overseas in search of higher returns.<sup>15</sup>

What about the effects of interest controls on the quantity and productivity of investment which we predicted earlier? While evidence on the effect on the volume of investment is ambiguous, empirical studies do support the hypothesis that they will tend to lower investment productivity. Thus, lower  $R^*$ s lowered investment efficiency (as measured by the incremental output-capital ratio) in samples of 12 Asian countries [Fry, 1988 pp.148, 422] and of 69 developing countries [Khatkhate, 1988]. Gelb [1989,

<sup>13</sup> Though Khatkhate [1988] finds no influence in the 1970s, Cho and Khatkhate [1989] find influence considerable in Asia. Gupta [1984 and 1987] finds that  $R^*$  raises financial savings. Lanyi and Saracoglu [1983] conclude that positive  $R^*$ s stimulate growth of financial assets. Fry [1988, pp.156-8] finds that a 1%  $R^*$  rise raises demand for financial assets by 0.8% in the short run and by 1.4% in the long run. It also increases the M3/GNP ratio by 0.4-0.7% (the higher figure applies to countries with a lower initial ratio). Most of this result came from household switches from real to financial assets: 75-85% of higher financial saving came from "substitution" out of other savings, and only 15-25% from a rise in total saving.

<sup>14</sup> See Conesa [1987]; Cuddington [1986 and 1987]; Dornbusch [1985 and 1987]; Fry [1988]; and Lessard and Williamson [1987].

<sup>15</sup> See Dooley [1986]; Khan and ul Haque [1985]; and Eaton [1987].

p.21] concluded that more efficient investment explained most of the positive relationship which he found between  $R^*$  and growth. Other studies of the impact of  $R^*$  on economic growth have produced mixed results, however.<sup>16</sup>

Overall, and notwithstanding our *caveats*, the predictions of theory stand up reasonably well. The implication is that interest controls are likely to reduce the financialisation of saving and the quality of investment, and thereby economic growth. That does not necessarily mean that such controls are always and everywhere a mistake. They may stem from religious values rather than fine economic calculation, or they may be seen as necessitated by market imperfections. It does mean that the imposition of interest controls is likely to impose an economic cost that must be set against - and which could easily be greater than - whatever benefits may accrue.

#### □ Other aspects of repression

While interest controls are the most potent source of financial repression, it is worth spending time considering some other dimensions. The direction of investment is one such. This takes many forms: requiring banks to lend to specific activities or sectors; central bank rediscounting of credit to key sectors at subsidised interest rates; government ownership of financial institutions; and government guarantees of private sector loans. These policies may restrict investible funds for other sectors (directly, and indirectly by discouraging deposits), to finance government deficits or large capital-intensive projects by parastatals. Directed investment through concessional selective credit policies may perversely reduce credit available to target groups, by breeding rent-seeking bank behaviour and non-price credit rationing. This may concentrate credit on the economically advantaged and force small and medium-sized borrowers to rely on self-financing and informal sector lenders, reducing the quality of their investment. If funds do reach target groups, they are fungible and may be used for economically unviable projects. If used as intended, they may encourage excessive capital intensity, by subsidising capital rather than labour. If subsidies are paid by the government or central bank, they may compromise fiscal or monetary restraint. However, what effects the controls actually have will be influenced by the precise method used to direct credit: in Indonesia in the 1970s, credit direction is regarded as having brought favourable results.<sup>17</sup>

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<sup>16</sup> Lanyi and Saracoglu [1983] find tentative support for a negative effect of interest repression on growth, but show many countries where it did not apply. Fry, [1988, pp.151-2], found for Asian countries that a 1% rise in  $R^*$  towards (i.e. not above) the "competitive free-market equilibrium level" was associated with a 0.5% rise in economic growth. However, Arrieta's 1988 survey article suggests that the evidence is decidedly mixed. Gupta [1987] concludes that  $R^*$  has had no significant effect on growth in Latin America. Khatkhate [1988] found no association between low  $R^*$ s and low growth.

<sup>17</sup> See Bolnick [1987]. Fry [1988, Chapter 16] and the World Bank [1989A] present the arguments against directed credit.

Directed investment does not necessarily affect growth or income distribution adversely. In some nations, well-run directed credit has improved resource allocation, notably of venture capital to new projects. However, it does tend to undermine the solvency of financial intermediaries. Intermediation becomes higher-risk and lower-return. Moreover, in a regulated market intermediaries may face such a large excess demand for credit that they are not forced by competition to market their product or to select projects on the basis of quality of project. Both factors increase the potential for bad loans.

Although it would not be appropriate to describe state ownership of financial institutions as an aspect of financial repression *per se*, the way in which these sometimes operate can magnify the adverse effects of repression and, in practice, can discourage the emergence of private sector institutions. Thus, government-run development finance institutions and banks are especially prone to high levels of non-performing assets. This is because their investment decisions are often dictated, subjected to political pressure, vulnerable to business cycle fluctuations, and insufficiently diversified with respect to risk. In general, the record of such institutions is poor; while they have attracted foreign resources, they have not mobilised domestic savings and have a deteriorating record in allocating investment to productive projects (although housing finance institutions have fared much better, notably in mobilising domestic savings).

Bank deposit controls are another important aspect of financial repression. These consist mainly of requiring commercial banks to maintain high minimum reserve ratios relative to bank deposit liabilities, and obligatory holdings of government securities by banks and other financial institutions. These requirements have the effect of directing a substantial amount of available funds to the government and the rest of the public sector. They also distort bank interest rate structures - given the low interest rates they receive on the reserves and bonds, banks enforce a wider margin between borrowing and lending rates in order to make profits. Governments impose other forms of taxation on deposits too, such as withholding taxes on interest income, stamp duties on financial transactions, and taxes on loan interest earnings. These reduce incentives for deposits, investment and intermediation, and decrease the overall amount of funds available for investment through the financial system.

The last paragraphs draw attention to a wider feature of financial repression; that it is associated with a diversion of investible resources from the private to the public sectors, often to an extent which is inconsistent with governments' own stated desired for the growth of the private sector. While such financial crowding out can occur in a liberalised system, the instruments of financial repression are frequently used as a way of financing the government's budget deficit, or that of the public sector as a whole. One of its effects is to shift the locus of credit allocation decisions from the boardrooms of the financial institutions into the offices of the Ministry of Finance and the Central Bank, so that it becomes temptingly easy to use those powers to give the public sector first bite of the credit cherry. Artificially low interest rates moreover reduce the cost of large-scale public sector borrowings and the future debt servicing consequences of so doing. Public ownership of, or control over, major savings

institutions adds to the state's ability to divert resources for its own use, leaving the private sector as the residual borrower.

#### BOX IV. REPRESSION AND CROWDING OUT IN KENYA <sup>18</sup>

Even though Kenya's above-average economic record is based largely on the dynamism of its private sector, and the government also sees the future growth of the productive system as based on private enterprise, the public sector has claimed a growing share of bank credit since Independence and there is evidence that this has been at the expense of the credit needs of private business. Thus, bank credit to the public sector as a proportion of credit to the private sector rose from 22% in 1969-73 to 72% in 1984-88. Econometric tests found a direct inverse causal relationship between banking system credit to the public and private sectors - when public sector lending went up this caused (in the sense of preceding) a reduction in lending to the private sector. This relationship was particularly strong when it was from the commercial banks (as distinct from the central bank) that the public sector borrowed.

The instruments of financial repression were used to increase public sector access to banking resources. The central bank used its control over the minimum levels and composition of banks' liquid reserves to ensure that the banks held large stocks of Treasury Bills. The central bank similarly sought to use its control over interest rates to divert money out of bank deposits into holdings by the general public of Treasury Bonds, although with limited success. Government-owned commercial banks had heavy exposures of loans to parastatal bodies, not all of them very creditworthy. The government also used its authority over the Post Office Savings Bank and National Social Security Fund to require these large-scale collectors of private savings to invest extensively in government paper - sums that otherwise would potentially have been available for on-lending to private borrowers.

Probably the most powerful mechanism of crowding-out, however, was through the use of ceilings on bank credit to the private sector, in order to accommodate the financing needs of the public sector. There was a type of vicious circle at work, for such ceilings were necessitated by balance of payments difficulties and inflationary pressures - which, in turn, were partly the result of public sector deficit financing.

<sup>18</sup> Based on Killick and Mwega, 1990.

Each of these features is illustrated in Box IV on Kenya. The 1980s records of the Franc Zone group of African countries provide a further illustration.<sup>19</sup> Because of restrictions under the Zone arrangements on central government borrowings from the banking system, as budgetary pressures built up governments forced commercial banks to finance expenditures that would normally have been met by government subsidies. At government behest, credits were extended to public enterprises that were not creditworthy. Banks were required to finance payments to commodity farmers in excess of the export value of the crops. These practices seriously undermined the

<sup>19</sup> The following account is based on World Bank [1989B, page 170].



financial position of the banks, leading in Benin to an actual collapse. In addition, the accumulation of large arrears in government payments to private contractors, besides representing a form of involuntary lending to government, also weakened the position of the banks by putting private sector borrowers into financial difficulties. As Collier and Mayer [1989, p.8] - authors rather sceptical about pro-market arguments for liberalisation - put it, *"The concern that financial repression raises is that it has provided inefficient and corrupt governments with easy access to cheap sources of finance."*

## II.3

### A summing-up

As elsewhere, so in the financial sector: both markets and governments are imperfect. Financial markets are often segmented, incomplete, even non-existent. In banking and other parts of the financial sector monopoly or oligopoly are frequently-occurring market structures. Information is imperfect and costly. Institutions' balance sheets are sometimes fragile, insecurity is considerable and collapse often averted only by accounting sleight-of-hand.

Government policies towards the sector, sometimes in response to the weaknesses just summarised, are often also flawed and sometimes actually make things worse by retarding financial deepening. A combination of inflation and interest rate controls will probably reduce that part of saving channelled through financial intermediaries, and are therefore likely adversely to affect the quality of investment. Other aspects of financial repression also have unwanted effects, though these depend on the precise methods used, and the whole process is associated with a crowding-out of private sector credit needs by the preemptive demands of governments and parastatals.

Naturally, the extent and precise nature of the problems vary from one country to the next - and we have emphasised the limited extent of available knowledge - but it is likely that most countries with which we are concerned in this series of Working Papers suffer quite seriously from them. The task to which we now turn, therefore, is to examine what lines of action might most appropriately be adopted to address these weaknesses and to accelerate financial deepening.

### III. POLICIES FOR FINANCIAL DEEPENING

A large proportion of recent writings about financial policies have been on the theme of liberalisation, and it is to that theme that we will turn first. We will then take up the options available to governments in combatting financial market failures, and to promote the institutional and product diversification of the sector.

#### III.1 Financial liberalisation

We have seen that financial repression takes a number of forms. 'Liberalisation' is a possible policy response, meaning a package of measures intended to remove any undesirable state-imposed constraints on the free working of financial markets. It encompasses the freeing-up of interest rates, the loosening of deposit and credit controls, and various other measures.

##### □ **Interest rates again**

Since we saw that interest rate ceilings are associated with negative real rates, and that these tend to reduce the volume of financial savings and to worsen the productivity of new investment, it seems a straightforward policy conclusion that they should be loosened or even eliminated. As we will see shortly, however, matters are not that simple and there are good reasons for proceeding cautiously. First, we examine how, if interest rates are to be liberalised, their levels should be determined. Should all controls be dropped so that rates find their market levels? If not, how should the authorities decide the level at which rates should be set? The answers to these questions bring in a number of the complexities that have to be considered when deciding the best policy response.

It is not enough to recommend that real rates should be positive. Policy-makers require more guidelines, and we suggest that the factors they should take into account include the following.

- [a] The desired balance between capital inflows and outflows, taking account of the extent of present and planned capital controls. This implies that, depending on the openness of the economy, domestic rates must be contingent on world real interest rates, especially those of countries which have been important past sources and destinations of capital flows. The other factors described earlier which influence capital flight also need to be borne in mind when deciding on domestic interest rates.
- [b] The probable impact of changed interest rate levels on the financialisation of savings and on the efficiency of investment, for we have seen that these are the key transmission mechanisms from interest rate policy to financial sector development and the overall performance of the economy.

- [c] The effect of changes on the government budget deficit, through domestic public debt interest payments, and on the government's ability to maintain monetary control (on which more below).
- [d] The extent of risk that financial market defects will prevent interest rates from rising, or cause them to rise too far or too rapidly; and the government's short-term ability to overcome these market weaknesses by other measures.
- [e] The level of assets in the financial system which are non-performing or of dubious value, the preparedness of the system and of government regulators to avoid or overcome internal debt crisis, and the degree of danger to lender and borrower solvency from interest rate rises.
- [f] The level of domestic inflation. If inflation is at all rapid, reducing that is likely to be more beneficial to the financial sector, as well as to overall economic performance, than raising nominal interest rates. Since raising nominal rates may contribute to inflation by increasing working capital and other production costs, countries with significant inflation should give priority to counter-inflation policies, rather than acting on nominal interest levels.

These considerations help to define the circumstances when it may be appropriate to free interest rates altogether:

- if the interest rate is not substantially negative;
- if destabilising international capital movements are unlikely;
- if financialisation and investment efficiency responses are expected to be strong;
- if the government's domestic debt servicing obligations are manageable;
- if financial markets are relatively competitive, stable and free of major imperfections; and
- if inflation is low and not very elastic with respect to nominal interest rate movements.

This is a daunting list of conditions but most writers caution that until they have been satisfied nominal rates should continue to be administered, to control volatility and negative side-effects. In this case the best course of action will often be an administered policy of increasing real rates gradually until they become moderately positive, as a preliminary to possible further liberalisation.

Related to this is the issue of how to maintain positive real rates in the context of continuing inflation and changes in international or domestic economic conditions. As we saw with the real exchange rate in Working Paper No. 33, positive real interest rates are a moving target. The first guideline here should be to minimise domestic

economic instability, especially to reduce the level of inflation. It is relatively easy to keep real returns on savings positive, by indexing financial instruments and raising nominal rates periodically. As with the exchange rate, the best method is small frequent adjustments, which are politically more acceptable and which minimise inflationary and other knock-on effects. These tactics will also permit reconsideration of policy should initial expectations be disappointed.

How much effect the liberalisation (*i.e.* raising) of interest rates is likely to have is hard to predict and will depend crucially on country circumstances. Box V (below) on Malaysia illustrates a relatively successful case, but Boxes I and VII on Chile and Sri Lanka show problems. The wider empirical evidence yields mixed results. It suggests that only if previous rates are very negative (and in the absence of severe liquidity constraints on consumers) will there be much likelihood of substantially increasing financial savings simply by raising interest rates.<sup>20</sup>

The evidence suggests that high rates are not likely to have any strong deterrent effect on capital flight, nor to attract much foreign savings. The effects of interest reforms on the quantity of investment are also disputed, and Cho and Khatkhate [1989] indicate that rate liberalisation does not increase the availability of long-term credit, especially if rates are unstable.<sup>21</sup> The best supporting evidence for positive real rates is their effect on the quality of investment [Khatkhate, 1988].

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<sup>20</sup> Most recent studies do not prove the case one way or the other, due to limited geographical coverage, unreliable data, or methodological problems. Of recent studies, Cho and Khatkhate [1989] and Khatkhate [1988] conclude that the effect is unproven; Gupta [1987] that effects are substantial in Asia and marginal in Latin America; Fry [1988] that a 1% real interest rate rise is unlikely to produce more than a 0.1% rise in the savings rate, even in the most favourable circumstances; Khan and Knight [1985] that results are uncertain; Leite and Makonnen [1986] that interest rates affect overall savings marginally, but are more influential on financial savings in the BCEAO countries; Bhatia [1985] and Giovannini [1985] that the influence is marginal. Summaries of earlier studies are given in Kitchen [1986] and Fry [1988], and again show division depending on countries and periods studied, and statistical methodology. Rossi [1988] shows the limiting effect of liquidity constraints. Sauve [1988] has also pointed to the difficulty of choosing a "market-clearing" interest rate in circumstances of market imperfection. The World Bank [1989A] describes the effects as "ambiguous", but likely to move non-financial savings into financial savings. Deaton [1989] concludes that the literature is not very enlightening, and that there is equally no evidence of a well-defined relationship between real (or expected real) interest rates and consumption growth.

<sup>21</sup> Fry [1988, pp.143-47] concludes that the effects on investment are much greater than those on saving; most other sources that investment is more likely to be encouraged than saving, but not by much.

## BOX V. EFFECTS OF INTEREST REFORMS IN MALAYSIA <sup>22</sup>

Malaysia's relatively successful financial sector reforms in 1978-83 centred on liberalising interest rates. From October 1978, commercial banks determined their own rates on deposits and loans. In 1981, the central bank stopped controlling lending rates, and by 1983 commercial banks had replaced rates linked to the government prime rate with rates based on the cost of funds, plus a margin depending on loan maturity, borrower standing and security, and the nature of the project. However, the central bank continued to impose ceilings on lending rates for small businesses and housing projects; and it actually increased directed credit programmes. Liberalisation was therefore gradual and selective.

Nominal rates rose only marginally, but real rates increased substantially to positive levels, because inflation went down. Real lending rates changed slowly before 1981 but thereafter deposit rates (and lending rates after 1981) moved slowly upwards. The consequences of liberalisation were almost all positive. The financial sector grew rapidly: ratios of M2 and M3 to GNP doubled and financialised savings rose by 50%, leaving Malaysia with greater financial depth than other nations with similar *per capita* GNP. Competition in the financial system increased. Small banks reacted to lower liquidity by increasing rates to compete with larger banks and their share of deposits rose sharply in 1978-81. Branches proliferated and though the profit rate in the banking sector fell slightly, it remained attractive. Non-bank financial institutions and foreign banks increased their presence and market shares. Competition made interest rates more sensitive to market forces and widened opportunities for financial savings.

Domestic financial markets became better integrated, with informal market premia falling and finance company rates moving closer to those of banks. Integration with international markets also increased: domestic interest rates became more sensitive to differentials with foreign rates, but the non-bank public had little access to foreign markets so sensitivity was limited. The term structure of deposit rates also improved, offering sufficient returns to increase long-term deposits. Commercial banks saw a gradual increase in long-term deposits and loans, especially after 1982, as inflation fell. However, overall long-term credit stagnated, because the securities market was saturated with issues of government bonds, and the share of development finance institutions in total credit stayed small. Intermediation margins also widened slightly due to limited initial competition, the cost of branch expansion and the widening of credit controls, but they later stabilised due to competition.

The success of Malaysian interest rate reform reflected the previously relatively liberalised financial markets, that the government acted gradually and that it implemented complementary anti-inflationary policies.

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Derived from Cho and Khatkhate [1989].

### □ Credit controls

We earlier criticised state interventions in the credit allocation decisions of financial institutions on the grounds that this was liable to be used to favour the public sector over the private sector in times of overall tightness in credit availability, that it more

generally tended to reduce the productivity of new investment and that it was liable to reduce banks' ability to offer attractive deposit rates to savers. On such considerations, the case for abandoning direction of investment through state institutions and credit subsidies appears clear. It should free investible funds for other sectors, directly and indirectly, by increasing the attractiveness of deposits and reducing rent-seeking and credit-rationing behaviour by banks. And, by freeing funds for projects with higher returns and lower risks, it should reduce the danger of non-performing loans.

Because the bulk of the literature treats the loosening of interest rates as a proxy for liberalisation, there has been less investigation of the results of other elements of liberalisation. We have found no empirical studies of the separate effects of ending the direction of investment on the quantity of savings and investment, or the quality of investment. Given evidence that imperfect financial markets are liable to cause banks to ration credit and discriminate against certain types of borrowers, even without repression, beneficial effects should not be taken for granted.

However, there is strong empirical evidence in support of the reform of directed credit and state-owned financial institutions. To the extent that governments regard it as desirable to intervene, they should direct or subsidise credit to narrowly-defined groups, and for specific purposes such as research or exporting. Macroeconomic distortions can be minimised by increasing credit to priority sectors (instead of subsidising interest rates) and by limited central bank rediscounting to shift some of the subsidy cost from the lending institutions.<sup>23</sup>

### III.2 Strengthening markets

We earlier identified a variety of ways in which financial markets typically fall short of the competitive ideal in developing-country conditions, so we turn next to consider ways by which the efficiency of financial markets may be raised.

One of the weaknesses identified earlier was that capital markets tend to be shallow. To redress this it would be desirable to encourage the growth of stock exchanges and bond markets, but this may be problematic. In their early years such markets may be unable to compete with indirect markets subsidised by deposit insurance, a central bank low-interest rediscount facility, and tax or regulatory discrimination against equity finance. Removal of these forms of discrimination can help, therefore, as can the creation of a proper framework of laws for the operation of such markets and for safeguarding the interests of savers.

One way of strengthening segmented and incomplete markets may be by encouraging commercial bank investments in an expanded network of branches, perhaps by

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<sup>23</sup> For more details of such measures and their effects, see World Bank [1985] and Fry [1988, Chapter 17, Section 3].

favourable tax treatment of such investments. Evidence suggests that branch proximity may raise financial savings rates by 1-5% over 20 years for each 10% reduction in branch catchment area population. The effect is especially strong in rural areas, where savings are diverted from informal markets and non-financial forms of savings. However, government encouragement of more branches should be subject to expected medium-term profitability and a degree of decentralisation to increase responsiveness to local conditions. Branch proliferation is no panacea. Measures to boost the efficiency of financial institution management, to improve investment decisions by increasing the flow of information about small investors, and to encourage semi-formal and informal markets if formal institutions see no opportunity for profit, may also be desirable.

The problem of oligopoly in banking systems can also be tackled by more effective regulation and by promoting new financial institutions to foster competition.<sup>24</sup> Thus, more specialised savings and other institutions can be fostered which can compete with the banks - a subject taken up in the next section. Regulation of lending may be difficult if it is in the interest of the holding company to allow some subsidiaries to collapse due to bad debt; strong and sophisticated supervision of holding companies will be needed in such situations. In the interim, competition may have to be imposed, by setting deposit rates at approximately their free-market levels; or it may be stimulated by issuing government bonds with attractive yields. The market may also be "educated" by introducing or encouraging markets in short-term financial claims, such as treasury bills and inter-bank money markets.

There is need for care in pro-competition policies, however. Earlier Working Papers in this series have pointed out that there can be benefits from monopoly - and the scale economies which it permits in small economies - so regulators have to balance the benefits from concentration against the risks that it brings.

There will often be a strong case for limiting ties between financial and non-financial companies and among financial companies, and for requiring divestiture where the public interest makes it necessary. Regulations on lending limits to individual borrowers should be extended to limits on companies with interrelated interests. They should also restrict "insider transactions" (loans to people influential in, or connected with, the lender), and interlocking directorships and other relationships among directors, officers and shareholders. Strict limits should be set on shares, bonds and real estate which financial institutions may purchase, to reduce the dangers for the rest of the economy if they run into difficulty. Scrutiny of transactions should include mandatory disclosure before transactions take place.

We saw earlier how oligopoly is often associated with conditions of internal debt crisis among banks, in which nominal interest rates are bid up to artificially high levels, there is a high proportion of bad or doubtful loans on banks' books, credit allocation decisions are distorted and insolvency threatens. In order to forestall such effects,

interest rate levels and monetary targets need to take account of interest-financing needs if they are to avoid unnecessary deflation. Supervisory authorities should act before banks become insolvent, which requires better information flows than usually occur in low-income countries. They should limit bank loans to risky firms and concentration of loans on one borrower; strengthen accounting and auditing (possibly commissioning external auditors) to stop fraud; reform bankruptcy and tax laws to encourage banks to write down non-performing assets; push banks to collect doubtful debts and sell the marketable assets of bad debtors; and penalise - or change - bad management.<sup>25</sup>

These measures should clear the decks for recapitalising banks and restructuring firms, where necessary. This is a labour-intensive and skilled task, and may require a new agency independent of the central bank. The government may need to close, subsidise or buy shares in limited numbers of banks or firms, preferably in transparent ways (though this may be impossible without loss of public confidence in the banking system). If larger numbers of institutions are involved, in-depth analysis of their future potential is needed to identify priorities for public funds. Without restructuring of distressed banks and companies, internal debt crises can easily frustrate liberalisation.

All of these market failures require government intervention, mostly of a regulatory nature, and Box VI sets out a framework of bank regulation, having particularly in mind the needs generated by policies of liberalisation. Pending such a framework, market failures may necessitate temporary residual control of interest rates, to guard against speculative demand for credit and prevent interest rates from rising too high, before adequate bank supervision and regulation procedures can be introduced.

In small, poor economies regulatory provisions often fall short of the standards suggested in Box VI and require reforms of organisation and powers. Organisation can be divided into two main strands: analysis by off-site supervisors of reports submitted by banks, and frequent on-site inspection to check the accuracy of the banks' reports and to follow up problems identified by supervisors. In turn, this implies greater staffing, and training and remuneration sufficient to retain skilled staff. Closely related to this is the need for political support. To be effective, prudential regulation must be backed by political commitment; central banks or other regulatory authorities must be given clear goals and responsibilities, adequate resources and independence from political pressures. Equally, it is vital to ensure the independence of those who design, adjust and enforce regulations from private business interests, to avoid conflicts of interest and abuse of regulations.

Powers need to be made both stronger and more subtle. Licensing should screen out owners and managers with inadequate qualifications, financial backing or moral standing, but not be so restrictive as to suppress competition or encourage oligopoly. Further, all previous guidelines require continual monitoring to ensure that they are

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<sup>25</sup> For more discussion of these issues, especially the key role of adequate and timely information, see World Bank [1989A, pp.80-82].



met. In many countries enforcement powers are blunt: unless breaches are criminal, or violate banking statutes, supervisors can only cancel the banking license. They should be given intermediate powers to impose fines, suspend dividends, deny requests for new branches or activities, issue cease and desist orders, remove managers or directors, and hold directors legally responsible for losses.

## BOX VI. A FRAMEWORK FOR BANK REGULATION <sup>26</sup>

Bank supervisors often have the multiple obligations of ensuring the soundness of banking practices, and compliance with monetary policy, foreign exchange and other macroeconomic regulations. There is much to be said for allowing them to concentrate more on their supervisory responsibilities. In carrying out this responsibility they should focus particularly on assessing quality of assets, accounting procedures and management controls. In turn this requires certain standard gauges:

- 1) Adequate capital-to-assets ratios. These are needed to exert discipline on lending, while leaving enough flexibility to permit the solution of internal debt crises and the absorption of losses. Regulators should set minimum guidelines for assets and off-balance sheet items (e.g. guarantees and lines of credit). These should vary with the degree of risk of the asset. They should apply equally to government-owned institutions, to avoid expectations of, or actual, bail-outs through government guarantees.
- 2) Realistic asset classification and provisioning. Supervisors need to be able to require banks to make realistic provisions for potential losses or problem assets, to write off or provide for actual losses, and to prevent accounting for interest as if it has been paid on non-performing loans.
- 3) Long-term liquidity ratios. Most countries already require banks to maintain minimum prudential cash or liquidity ratios so that they can repay depositors' funds if these are called (though this ratio is more often used as an instrument of monetary policy). However, liquidity risk arises because banks borrow short-term and lend long-term, and short-term interest rates may rise faster than long-term rates. This points in favour of careful monitoring of the whole structure of interest rates.
- 4) Portfolio concentration limits. Limits as a percentage of capital should prevent excessive lending to a single borrower, group of related borrowers or particular industry, especially when combined with the supervision of holding companies described below. These limits should be set at prudent levels, well below 50% of capital (especially if capital is being increased).
- 5) Audit standards. Supervisors should require external audits of banks, and set minimum standards for the scope, content and frequency of audits and related financial disclosures.

Many financial market failures are problems which even developed-country regulators are unable to overcome: given the lesser experience and resources available in developing countries, it is unrealistic to expect all regulations to be enforced. In addition, excessive regulation may distort and delay investment, and drive banks and companies to collude in noncompliance. For these reasons, each government must choose what is appropriate in its own concrete situation. Once in place, regulatory frameworks need to be monitored for changes in financial and market conditions, and the effectiveness of each regulation, so that rules or procedures can be modified as necessary.

In addition to the supervision of financial institutions, governments have a vital role in gathering and disseminating information on all types of financial transactions, to allow financial institutions to identify creditworthy borrowers and viable projects, and to help savers and investors to know which financial institutions are the most efficient and appropriate to their needs.

### III.3 Promoting financial diversification

We noted in Working Paper No. 31 (p.13) how deepening is accompanied by diversification of the financial system, as the requirements of the rest of the economy for vehicles of savings and credit become more complex and as more specialised agencies spring up to meet these developing needs. The success of financial liberalisation is also apt to be strongly influenced by the degree of diversification of financial markets. The deepening of markets will, by increasing the effectiveness of existing institutions and promoting new institutions, combat under-specialisation, segmentation and oligopoly.

In addition to the commercial banks, what types of financial institutions might have a specially valuable contribution to make in the circumstances of low-income countries starting with fairly rudimentary financial systems? Merchant and investment banks can be an important prerequisite for the development of other institutions but are scarce in many low-income countries. Though they generally neither mobilise savings nor invest their own funds, they can play key roles in all types of investment: brokerage, especially in securities and money markets; advisory services to domestic and foreign companies, commercial banks and other investors; management of investment portfolios, including investment trusts; arranging venture capital and leasing deals. Their willingness to take on high-risk, high-yield investment makes them a vital complement to commercial banks. However, they are management-intensive, require skills which are scarce in many low-income countries and depend on the existence of other types of institution.

Insurance companies and pension funds are important potential ways of mobilising savings and sources of long-term finance. They are growing rapidly in many low-income countries, but are likely to require relatively deep financial (especially securities) markets to achieve attractive returns; they are also likely to be cautious and avoid

higher-risk investment. Housing finance companies (building societies) lend very long-term and therefore provide the valuable service of transforming what might be short-term savings into long-term investments, mainly residential housing. They too are cautious investors, but insofar as they offer concessional housing loan terms to savers they almost certainly mobilise additional savings rather than diverting them from higher-risk uses.

Securities markets (or stock exchanges) exist in few low-income countries. Like investment banks, they are a key requisite for the development and efficient functioning of other institutions. They enable companies to raise capital directly by share issues and provide savers and financial institutions with an often profitable outlet for funds. They may help public enterprises to "go public" and raise capital, or to be privatised. They can increase the gearing ratios of public and private companies, improving prospects for their solvency and that of creditor banks. Their main disadvantage is vulnerability to speculative swings, which necessitates close regulation. Well-functioning stock markets are attractive to foreign investors, yielding high returns on a diversified portfolio.<sup>27</sup> However, many securities markets in low-income countries are not functioning well. They often suffer from short supply of shares and a small number of quoted companies. To some extent they also suffer lack of demand: domestic financial institutions desiring such long-term investments often do not exist.

Post office savings banks have the advantages of catering for the needs of very small-scale savers and of accessibility, especially in rural areas, due to the existence of a large network of post offices. They are also cheap to administer, because post offices fulfil other functions, permitting economies of scale. However, their record in savings mobilisation has been poor, due partly to unattractive interest rates imposed by the financial repression discussed earlier. Moreover, they are not usually allowed to lend to the private sector, being required instead to channel savings to the government, although there is no intrinsic reason why they should not invest in the private sector, subject to prudential safeguards. Savings and credit banks are, however, more likely to avoid capture by the state, allowing them to lend to private borrowers.

Semi-formal institutions, such as credit cooperatives and unions, and group lending schemes, can be a valuable means of mobilising rural savings and sources of credit for small farmers. Although they operate on a small scale and in some cases have poor loan repayment records, the Grameen Bank in Bangladesh is a widely-cited example of success in mobilising savings from groups previously regarded as unreachable, investing without formal collateral in small-scale productive projects at lower interest rates than moneylenders.<sup>28</sup>

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<sup>27</sup> See International Finance Corporation [1987 and 1988] for fuller treatments of this topic.

<sup>28</sup> On this see Hossain [1988]; Sadeque [1986]; and World Bank [1989A, p.117]. Seibel and Shrestha [1988] have also suggested the small businessmen's informal self-help bank in Nepal as a model, and the World Bank [1989A, p.117] cites

Cooperatives have an even better record in increasing savers' access to financial services and thereby stimulating financial saving. Their costs are often low because they use volunteer labour and because they reduce risk through group accountability. In addition, unlike informal institutions, their often nationwide federated structure gives them access to formal financial markets, and can therefore diversify assets and intermediate between regions.

Policies for diversification: What can governments do to promote financial diversification along these lines? To a large extent, we must expect such institutions to come into being autonomously as the demand for them emerges and supporting services from elsewhere in the financial system grow into existence. Nonetheless, there is a good deal that governments can do. Provision of appropriate legal and tax frameworks within which these institutions can operate, and of adequate supervision to safeguard the interests of savers and borrowers, can itself be an important condition - and one that is often not satisfied. Of course, ending financial repression and the devices that governments employ to capture a disproportionate share of total credit can also make a major contribution.

The practices the government follows with regard to the trading of its own Bills and Bonds can also exert a strong influence on the vigour with which secondary markets develop in these assets. Governments can also sometimes help by providing start-up capital and security, e.g. for credit unions, and by providing accounting and other 'extension services' for semi-formal bodies.

#### III.4 Questions of sequencing and speed

Financial liberalisation is like an aeroplane: of considerable potential utility but dangerous in inexperienced hands. Flown in the wrong conditions, or at the wrong speed, it can go seriously wrong. In the preceding pages we have urged measures to end or reduce repression, to strengthen markets and to diversify the financial sector. The question arises, in what order should these be pursued? The answer is that all three must be pursued simultaneously if financial sector adjustment is to be sustainable and excessive costs to the real economy avoided. In conditions of undiversified and shallow financial markets, where market failures abound, liberalisation must be gradual and cautious, even though this may itself retard financial deepening. Until policies for regulation, competition and institutional promotion are in place residual interest rate, deposit and credit controls are likely to be needed. Premature liberalisation without safeguards and institutional diversity may have little positive effect on savings and investment; may bring severe side-effects, including the risk of a financial crisis; and knock-on adverse effects on monetary control and economic stability. Once such complementary policies begin to take effect more rapid and comprehensive

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successes in Ghana, Malawi and Zimbabwe. Leonard [1986] suggests ways of making semi-formal and informal institutions more efficient, and of integrating them with the commercial banking sector.

liberalisation will become possible, and indeed desirable, to allow a well-functioning financial sector.

Absence of the necessary preconditions helps to explain why the results have frequently been disappointing, notably in low-income and/or non-Asian nations<sup>29</sup>, as Box VII illustrates in the case of Sri Lanka. Occasionally, the consequences of premature liberalisation have been near-disastrous, as in Chile for a time, and in Turkey in the late-1980s.<sup>30</sup> There are many reasons why practical realities do not live up to theoretical expectations (although data and methodological problems of measurement make it difficult to assess success with any confidence). Among the most important obstacles are continuing weaknesses in financial markets and lack of complementary macroeconomic policies.

To deal first with macro-policy, we should recall from earlier sections (i) that inflation is a major source of the negative real interest rates which characterise repression and (ii) that repression is often used by governments as a way of capturing more financial sector credit than would otherwise come their way, in order to finance large budget deficits. What must be stressed here is that liberalisation is unlikely to bring many benefits unless accompanied by fiscal measures to reduce budget deficits and the public sector's appetite for credit. Severe liquidity problems for firms and individuals make excess private sector demand for credit the usual state in most small low-income countries. This makes demand for credit interest inelastic; because the same liquidity constraints also make savings (and therefore credit) supply inelastic, disruptively large interest rate movements may be necessary to achieve a liberalised equilibrium. In such conditions liberalisation in the face of continuing large-scale deficit financing is likely to push nominal interest rates to very high levels, because total demand for credit will exceed supply and because high nominal rates are likely to be necessary if real rates are to become positive in the face of probable continuing inflation. In consequence, private investment will be discouraged and the fragile solvency of some banks may be threatened. Successful liberalisation thus requires fiscal discipline, avoidance of the 'crowding out' of private credit needs discussed earlier and the avoidance of rapid inflation. The full benefits are also unlikely to be achieved unless the exchange rate is flexible but fairly stable; and liberalising capital markets while maintaining an unrealistic exchange rate is an open invitation for capital flight.

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<sup>29</sup> Fry [1988] concludes in Chapter 13 that liberalisation has had no substantial impact on national saving or capital flight; Gupta [1987] that it had an effect in Asia, but not in Latin America; Dooley and Mathieson [1987] conclude that liberalisation has rarely produced a more efficient market-oriented financial system.

<sup>30</sup> See Aricanli and Rodrik [1989], who conclude that "*The Turkish experience... demonstrates the inherent destabilising nature of financial deregulation and capital account liberalization when the economy is still gripped by inflation, fiscal crisis, and continuous real depreciation.*"

## BOX VII. FINANCIAL LIBERALISATION IN SRI LANKA, 1977-86 <sup>31</sup>

Until 1977 Sri Lanka had experienced prolonged economic stagnation. Inflation was at 14%, due in part to a fiscal deficit of almost 8% of GNP. The balance of payments was precarious, even with tight exchange and trade controls. Its financial sector was fairly well-developed, with a variety of institutions, but commercial banks held 35% of financial assets. The financial sector was repressed, with negative real interest rates and subsidised credit to priority sectors. Its growth had fallen sharply during 1968-75.

Financial liberalisation, starting in 1977, centred on reducing controls on interest rates. The bank rate was raised from 8.5% to 10%, but remained negative in real terms. Deposit rates were raised more sharply, becoming strongly positive. This was largely due to harsh government restriction of monetary expansion: the Central Bank tightly restricted the access of banks to its credit, and charged a 5% interest premium for loans over the access ceiling. Government intervention also continued both on interest rates and on credit subsidies, though the latter were slightly scaled down. The government also encouraged competition by allowing foreign banks and deposit-taking non-banks (eg finance companies). In other words, financial reform was relatively mild and gradual, and government intervention was not abandoned, merely redesigned to encourage some market freedom.

Complementary policies were also introduced. The exchange rate was devalued, trade reform replaced quantitative restrictions with a simplified tariff structure, and exchange controls were diluted. Many prices were decontrolled, food subsidies were reduced and targeted at the poor, and policies in other sectors were liberalised.

However, this partial liberalisation did not produce many of the expected positive effects. Though real deposit interest rates remained generally positive, the level and structure of interest rates were not market-determined. The monetary authorities guided interest rates by changing the Treasury Bill rate and adjusting rates charged by state-owned commercial banks. Lending rates were barely positive because banks continued to lend to more risky borrowers due to political ties and other factors.

The liberalisation also did not increase financial deepening: M2/GNP and M3/GNP ratios barely increased between 1977 and 1986. There was a strong rise in domestic saving, but this did not translate into improved allocation of capital. Long-term credit and the equity market received some stimulus from liberalisation. However, the former remained constrained by a shortage of bankable projects and other factors. Much of the new credit issued went into short-term working capital, due to rapid expansion of domestic demand, continued high inflation and some speculative demand which raised the inventory/output ratio of companies. There was minimal increased competition for long-term capital. Partly as a result of this, high interest rates also brought a rapid rise in bad debts, necessitating new supervisory and legal machinery. Only strict adherence to prudential regulations and the continued existence of some selective subsidised credit prevented banking collapse.

The complementary liberalisation of other policies also caused problems: price decontrol and agricultural/industrial liberalisation caused a huge rise in demand for working capital, while trade liberalisation increased the supply of goods on which to spend short-term loans. A rapid expansion of public investment created soaring domestic aggregate demand. As a result, the inflation rate rose, turning real interest rates negative, and the real exchange rate appreciated, making foreign long-term borrowing more attractive. This experience pointed up the importance of careful sequencing of complementary measures if financial liberalisation is to have its full potential value.

<sup>31</sup> This account is based on Cho and Khatkhate [1989]; Khatkhate [1982]; and Roe [1982 and 1988].

Poor synchronisation of product- and financial-market liberalisation (suddenly raising prices after long-standing distortions) may also cause an artificial excess increase in credit demand. Product and financial markets adjust at different speeds, usually with longer lags in product markets.

Similarly, since the basic determinants of saving are likely to be income, past saving habits and growth in the export sector (due to a higher propensity to save in that sector), policies should seek to increase (or at least maintain) the level and stability of income, convince people to change their savings habits and boost the export sector.

The need for complementary policies does not imply an overall "quick fix" reform of all policies to achieve comprehensive liberalisation. This would be likely to exacerbate economic problems, by disrupting confidence and generating multiple and potentially conflicting price signals. Gradual change is usually preferable, carefully monitored and sequenced with other measures.

Turning to market imperfections, segmented and incomplete financial markets are liable to undermine liberalisation by continuing to allocate credit by various rationing devices, for reasons set out earlier. In the face of the oligopolistic banking structures also described earlier, liberalisation may merely increase bank competition for savings to channel to other enterprises to which they are connected, or the banks may respond by agreeing collectively not to engage in interest rate competition. Where banks are holding major proportions of questionable loans on their books and have weak balance sheets, liberalisation may worsen matters, forcing debtors who are in difficulty to borrow even more and encouraging indiscriminate lending by fragile banks in order to prevent debtors from defaulting. The consequence may be to push interest rates above true equilibrium levels, choking off sound investments, and to reduce the supply of loans to genuinely creditworthy businesses. The implication of these observations is that liberalisation needs to be accompanied by measures that will strengthen financial markets and increase competition within them. This is desirable, in any case, if the financial sector is to play the role which it can to promote the efficiency, flexibility and growth of the economy.

A final point to stress is the importance of tailoring financial policies to specific country conditions and on the basis of careful preparatory research. There are many grey areas in our knowledge of how financial systems - and the variables influenced by them - work, particularly as regards small low-income countries. It would be an easy mistake to build programmes on assumptions inappropriately imported from other countries. In any case, each country's institutions and the problems of the financial sector will be unique.

#### IV. SUMMARY AND CONCLUSION

This Working Paper is based on the premise that 'financial deepening' - the development of the financial system - has a specially important role to play in raising the adaptability and pace of development of an economy. It plays an 'enabling' role, through its effects on saving and investment.

In common with earlier Working Papers in this series, the problems to be tackled in the financial sector are weaknesses in both the financial markets and the government policies which impinge upon those markets. As regards market failures, we have suggested that among the most common in small low-income economies are that financial markets tend to be segmented, incomplete and shallow. Businesses and other users of financial services do not have access to the range of services which they could benefit from and the costs of the services is often high. Dualism is a common feature, implying failures to attract and invest savings efficiently. Competition within the sector is often limited, with the commercial banking industry commonly oligopolistic. Information flows are often poor, having particularly adverse effects on the efficiency of investment decisions. Banks' balance sheets are often fragile, with an unhealthy proportion of poorly-performing loans, creating an ever-present danger of crisis. At the same time, informal financial institutions, while they provide valuable services in their own spheres, do not offer satisfactory substitutes for the failings of the formal part of the sector.

Failures to provide attractive and secure outlets for savings and for potential overseas investors are among the consequences, depressing the volume of capital formation that can be financed. A lower-than-optimal productivity of new investment is a further result.

The state commonly has in place a variety of policies which impinge upon financial institutions and markets, partly as a response to the above market failures. Not uncommonly, however, state interventions make things worse. 'Financial repression' is a way of characterising some of the common failings of policy interventions, defined as policy actions which hold interest rates below market-clearing levels, which introduce non-market considerations into credit allocation decisions, and which in other ways directly frustrate the development of the financial sector. Much of our treatment of repression centred on the interest rate question, where we concluded that keeping interest rates highly negative in real terms is likely to reduce the financialisation of saving and the productivity of investment. If this is desired for non-economic reasons, these effects represent the costs of such a control.

We similarly suggested that interventions to influence the allocation of credit may also have adverse effects on the quality of investment (depending on how they are carried out), and that state-owned financial agencies have a generally poor record in savings mobilisation and quality of investment. We finally noted the strong connection between financial repression and state capture of larger proportions of domestic credit



than it otherwise would receive, with the corollary that there is a constant danger that it will 'crowd-out' the credit needs of the private sector.

When we turned to consider the policies that could be adopted to overcome these weaknesses and promote financial deepening, we placed the possibilities under three headings: liberalisation; strengthening financial markets; and promoting the diversification of the sector.

The liberalisation options related mainly to getting rid of the instruments of repression already summarised - moving gradually towards more positive real interest rates, reducing or changing the form of intervention in credit allocation, reforming financial public enterprises, etc. A variety of suggestions was made for strengthening markets. Establishing an adequate legal and regulatory framework was central to these, and detailed suggestions were made for strengthening systems of bank supervision.

A number of suggestions was similarly made to promote the diversification of financial institutions, identifying as particularly desirable the development of merchant and investment banks, insurance companies, pension funds and building societies, securities markets, savings banks and various semi-formal institutions. Although much of this diversification must be expected to occur autonomously, we again stressed the value of appropriate legal, tax and supervisory frameworks - as well as a dismantling of the instruments of repression - in promoting diversification.

Finally, we have pointed out the importance of questions of sequencing and the way in which the three strands of policy interact with one another. Major market failures in an undiversified financial sector will undermine liberalisation, indeed may cause it to have perverse results. Measures to reduce market failure and promote diversification will facilitate liberalisation, just as liberalisation will strengthen and diversify the markets. We have been particularly concerned to urge caution in proceeding with liberalisation. This arose first when discussing the conditions that should be satisfied prior to the liberalisation of interest rates and then reappeared as a more general consideration.

As part of this cautionary advice we have particularly stressed the potential dangers of financial liberalisation in the face of inflation and other macroeconomic imbalances, and the particular importance of strengthening the fiscal situation so that liberalisation does not occur while the government still has large deficit financing needs. Finally, we have at a number of points drawn attention to the considerable remaining areas of ignorance concerning the workings of financial markets in small low income countries, which adds a further reason for acting cautiously, as well as for tailor-making financial policy programmes to specific country circumstances.

These findings have reinforced a number of the general themes emerging from this series of Working Papers. One such is the importance - and delicacy - of striking a balance between the workings of market forces and the policy interventions of the state, with both sets of forces subject to large imperfections. As in the earlier

Working Papers, we still envisage a large role for the state. But the thrust of our recommendations has been to urge a change in the nature of policy interventions, away from the use of controls and other devices which get in the way of, or run counter to, the operations of markets in favour of measures which operate through, or strengthen, the markets. Specifically, we have favoured strengthening the legal and supervisory framework within which the financial sector can operate over direct controls over interest rates and credit allocations.

It is evident, however, that striking the right balance between the supervision of banks and other financial institutions and allowing financial markets to operate more freely will be difficult. It can only be attempted in concrete situations, with the best combination depending on a careful assessment of country circumstances. It is also likely to change over time. Initially, starting with a small undiversified financial sector subject to many market imperfections, the balance is likely to be struck more in favour of strict supervision and caution in liberalisation. But as the system deepens and market imperfections fade the balance is likely to shift in favour of allowing markets greater freedom.

The final recurring theme which re-surfaces above is the central importance of the general macroeconomic environment and of avoiding large imbalances. So important is this for the financial system that much of the liberalisation, however desirable, must await the strengthening of the public finances and of the management of the macroeconomy.

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**A NOTE ON FURTHER READING:** Read in conjunction with the footnotes, the following bibliography should be consulted as a guide to further study. There are, however, three works that provide exceptionally good coverage of the subject-matter of this Working Paper: Cho and Khatkhate's Lessons of Financial Liberalisation [World Bank, 1989]; Fry's Money, Interest and Banking in Economic Development [Baltimore, Johns Hopkins University Press, 1988]; and the World Bank's World Development Report, 1989 [Washington, 1989], which is on the theme of financial systems and development. The Winter 1989 [Vo. 5(4)] issue of the Oxford Review of Economic Policy is on the theme of 'Finance and Economic Development' and contains a recommended collection of papers.

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**Overseas Development Institute  
Regent's College  
Inner Circle  
Regent's Park  
London NW1 4NS  
England  
Telephone: 071-487 7413  
Fax: 071-487 7590  
Telex: 94082191 ODIUK**