INTEREST RATE Deregulation: A BRIEF SURVEY
OF THE POLICY ISSUES AND THE ASIAN EXPERIENCE

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July 1994

The views expressed are strictly personal and do not in any way reflect the views of any institution in particular. Valuable guidance was received from Mr. P.M. Dickie. Comments from colleagues are also appreciated. Previous research undertaken by staff at IBRD and IMF is duly acknowledged.
Foreword

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I. Introduction

As the economies of Asia expand into new and non-traditional areas of production thereby increasing the number and complexity of economic linkages, the introduction of greater price flexibility as an allocative device becomes increasingly more important. Within the financial sector, the required new role of interest rates—a key price—becomes equally critical. This new function requires the redesign or elimination of controlled financial arrangements and the opening and institutionalization of more adequate mechanisms such as market-oriented mechanisms.

In this survey we examine the experiences of a group of Asian countries and the policies that they have implemented as part of their financial sector reforms, policies which have allowed greater flexibility in the adjustment of interest rates. The potential obstacles that arose in the process are identified and the manner in which these countries have dealt with them is elaborated on. This survey centers on the structural and institutional features which are relevant in influencing the relationship between interest rate deregulation and financial savings. The conclusion is that the experiences in the Asian countries indicate that a properly designed interest rate policy tends to lead to a deepening and widening of their financial sectors. On this count, at least, the net benefits have been consistently positive. This paper elaborates on this argument but places it within the major difficulties and issues that may arise during the actual implementation of the reform process.

In addition, the paper attempts to provide some views, based on actual experiences, and examines how these difficulties can be managed. Interest rate policy by itself, has been and will continue to be, important in the bag of tools that a government has at its disposal to attain specific policy/political targets. In this context, the issue of whether to deregulate or re-regulate interest rates is a controversial matter. The paper highlights some concerns that should be addressed.

As a survey, efforts have been made to minimize the generalities presented but it is acknowledged that, given the polemic nature of the topic, there may be some generalized statements which could be subject to disagreement from the readers. Specific details, both theoretical and empirical, are presented in the attached list of selected references which should only be considered as a first step in this developmentally relevant though polemical subject. The interested reader will find this selection of references to be a good introduction to the topic. Section II presents a general framework to place the issues in proper perspective; the seasoned reader can easily skip this section without any loss of continuity. Section III provides the reasoning that interest rates are subject to price analysis as well as to policy modification. It is, however, readily recognized that some schools of thought do not accept this approach and tend to treat interest rates within a different analytical paradigm, which is more concerned with income distribution rather than resource allocation. Section IV introduces the case for the deregulation of interest rates subject to the existence of an appropriate policy and prudential regulatory framework. Section V synthesizes the experiences of countries that have allowed the market to determine interest rates. Section VI is a summary and outlines a set of recommendations.
II. Basic Considerations

As part of their reform process and in accordance with their modernization drives, some countries have implemented specific measures in their respective financial sectors to ensure a more efficient adjustment process toward self-sustaining economic growth. An integral component of these reforms has included the modification of interest rate structures and their degree of flexibility in order to facilitate the establishment of market-determined price signals for the allocation of scarce resources. However, the introduction of market-based mechanisms has been a concern to policymakers, particularly in countries where macroeconomic policies have led to uncertainties regarding future interest rates and rates of inflation, or in countries where the regulatory framework has been inadequate (Friedman 1978 and Mundell 1963).

Within the reform process, economic authorities have focused on the level and structure of interest rates since it is well recognized that this is a significant factor in determining the performance of an economy. For example, interest rates fulfill a major role in the financial sector and the payments mechanism and provide the most important link between the financial and the real sectors. The financial sector comprises institutions whose role is to intermediated between savings and investment decisions with the aim of efficiently allocating scarce resources. This sector also comprises institutions (and markets) that engage in direct financing, particularly for longer-term maturities.

It has long been recognized that the path toward development and sustainable growth has always been accompanied by a complementary development in the financial sector; available data indicate that economic growth is highly correlated with the real growth in financial assets (Jung 1986). The economic development process requires that a growing share of savings be intermediated through the financial system due to the greater separation between the savers and the investors, as the economy develops and diversifies. Thus, higher levels of economic development, and the corresponding and increasing relative importance of financial intermediation, has brought the issues of the growth and determination of financial savings, macroeconomic stability, and the design and implementation of optimal financial policies to the forefront of the policymakers’ agenda.

These issues arise because financial development involves, in effect, not only the shifting of funds from wealth holders to investors but, equally important, among different sectors, with the corresponding reallocation of inputs and factors of production, thereby resulting in income redistribution. Nevertheless, the effects of intersectoral shifts of funds and the corresponding adjustment of real resources are necessary for sustaining the growth of the economy; the intersectoral shifts of funds also have important social and political consequences (particularly in terms of income distribution as mentioned earlier) which in the countries implementing reforms need to be given the appropriate level of attention.

The path toward economic modernization, therefore, requires an efficient mechanism which can transform financial assets into real assets, and vice versa, at minimum cost. Such an efficient financial system is a necessary condition in order to ensure that asset transformation takes place without disruption and at the lowest possible cost. In this context, it can be generalized that financial assets are active
participants in the development process and that it is a fundamental obligation of the economic authorities to ensure that such financial assets fulfill their appropriate and specific roles. That is, it must be guaranteed that the scarcity value of capital is truly reflected in the prevailing interest rate structure. This can be achieved not through the indulgent practice of cheapening financial assets (i.e. by increasing the money stock) but rather through the strengthening of channels, mechanisms and institutions in order to facilitate financial asset exchange and transformation, thereby lowering transaction costs and enhancing the authentic role of financial markets. The efficiency gains also come from lowering the costs of financial intermediation. The starting step in this process is for the monetary authority to direct its efforts at establishing a set of interest rates compatible with a relative price constellation which will enhance the role of financial markets in the development process (Flood and Isard 1989).

The allocation of scarce financial resources is guided by interest rates and, in their absence, by ad hoc decisions or direct controls. Investment, a significant determinant of the level and pace of activities in the real sector, is also in turn dependent on the level and structure of interest rates. In general, interest rates, and their regulation or deregulation, have direct implications for monetary control by policymakers, as well as savings mobilization and real resource allocation (Corsepius and Fisher 1986). The issue for policymakers, however, is to identify the monetary and real links in the economy and to design an interest rate policy which will take advantage of these links through its intended built-in flexibility thus enhancing real resource allocation, overall efficiency and welfare in the economy (Lanyi and Saracoglu 1983). Interestingly, in some countries interest rates have been constrained, or controlled, and in the short and medium term the results have been successful. The point, however, is whether this policy can be sustained in the long run, particularly when the economies of these countries begin to generate their own self-financing for further growth.

At a more specific level, the issues related to the degree of interest rate flexibility include the relationship between financial intermediation and economic growth, the sensitivity of financial assets to interest rate changes, the level and changes in net foreign assets through the capital account, the efficiency of investment, and last but not least, the nature of these effects on the welfare of society. However, a major issue of valid concern is whether a policy shift toward market-determined interest rates introduces disruptive factors, which in effect may precipitate inordinate social and economic costs and, in the process, abruptly halt the policy reform process. This concern is particularly valid if the reforming economy is undergoing macroeconomic instability and/or if the institutional financial framework is at an early stage of development.

The characteristics of financially underdeveloped economies include such features as deposit rate ceilings, subsidized credits and high reserve requirements; these are usually found in economies having both less than stable macroeconomic environments and insufficient financial diversification (Villegas 1982). The financial inadequacies have direct macroeconomic implications and vice versa.) In these circumstances, for example, as the government cannot finance its expenditures through market mechanisms, it resorts to the politically easier practice of requiring the central bank to finance the shortfalls. In addition, the government also utilizes the interaction of high reserve requirements and inflation to tax holders of financial assets, impairing the development of an efficient financial market. At the beginning there does seem to be an advantage for the government; however, in the long run, the mechanism itself becomes
one of the most detrimental causes of the deterioration of the financial system. The effects of this process are cumulative (as, for example, inflation leads to further financial controls, etc.), leading to the implementation of reforms in one way or another. In contrast, in most high-income countries, the development of financial markets has taken place simultaneously with overall development and growth, with the evolution in one sector stimulating growth in the other sectors.

III. Price Policy: Interest Rates

The economy-wide reforms of developing economies have been centered on a newer and more appropriate view of the role of prices in the economy. Along with overall growth, development and stability, the corresponding diversification in the factor and output mix, as well as the quality improvement, has directly contributed to the increasing relevance of the price mechanism as an allocative device.

The opening of the economies to allow a greater role to prices has required a redesigning of economic policies. Modifications have consequently been introduced in areas such as exchange rate policy, industrial policy, fiscal policy as well as monetary policy. The experiences of the countries that have implemented financial reforms, including interest rate deregulation, have demonstrated that they cannot be formulated in isolation or independently of the constraints posed by the other ongoing economic policies.

Another issue that financial sector reform has brought to the policymakers' agenda is the conceptualization of interest rate policy. Are interest rates a mere economic instrument or, more importantly, are these rates a target of overall economic policy or even an adjustment price mechanism playing the same role that the exchange rates play in aligning internal and external prices? Depending on what view is taken, interest rates will be dealt with differently. In this context, the idea that an interest rate policy is independent from other policy considerations has naturally led to the view that interest rates can be modified or manipulated at will for the common good.

The above belief has provided the rationale to utilize interest rates to steer (and to artificially stimulate) the demand side, that is, credit, at the expense of the supply side, (i.e. savings); it is indisputable that the former is easier to manipulate, particularly when there are political constraints. The demand side has been stimulated by maintaining depressed interest rates, i.e. relatively cheap credit. This non-economic view has led, for example, to the establishment of productive units whose financial viability remains highly dependent upon a continuation of subsidies from the government, to an increasingly deteriorated competitive position, to burdensome nonperforming loans carried by the banks, and to increasingly unmanageable resource gaps (irrespective of commercial or soft borrowing). On the other hand, if interest rate policy singled out the supply side, only then would the resulting problem be similarly adverse to the capital formation process. In this sense, interest rate policy requires that the policymaker considers, simultaneously, both the supply and demand sides of interest rate determination (Edwards and Khan 1985).
All in all, interest rate policy design cannot overlook the reality that a key economy-wide price is being influenced or targeted. Moreover, the linkages between this price and other prices in the economy also need to be considered in reformulating overall economic policy. For example, after a long period of curbing a price, such as an interest rate, its deregulation will set in motion an adjustment in its respective market. The movements toward a new "equilibrium", particularly for a key price, will have effects on other markets and depending on the economic authorities' capabilities and political mandate, the transition may not always prove to be smooth. Nevertheless, the longer the period in which interest rates remain misaligned, the less smooth will be the transition period, as other sectors will require commensurate, if not deeper, adjustments.

In contrast, interest rate deregulation, which as an integral component of overall price reform, in conjunction with the necessary accompanying financial measures, facilitates the implementation of a more appropriate and efficacious monetary policy. This advantage has permitted the economic authorities an extra degree of freedom which is enhanced by the fact that the financial asset structure of developing economies is heavily weighted in favor of deposit-taking institutions (Gertler 1988). That is, the first impact of a proper modification in monetary policy under a cohesive policy framework is initially experienced in the banking system's liability structure and with a lag, a secondary effect manifests itself on the availability of economy-wide credit. Among the secondary effects, the stimulus provided by the overall financial reforms, through the derived increase and diversification of the financial institutions, also creates a greater role for the deregulated interest rates to transmit the effects of monetary policy. Possibly, the greatest progress in overall economic policy in the regional countries which implemented interest rate deregulation was felt in the more intense use of indirect monetary control, sustained by a more responsive interest rate structure. In general, the elimination of credit controls, in concert with interest rate flexibility, facilitates the switch to indirect regulation of credit through reserve money management, which is the linchpin of modern monetary policy.

Generally, in designing a financial sector policy reform package, the policy-maker's intended result is the realignment of relative prices; that is, the relative price of financial assets vis-a-vis the relative price of real assets. This price relationship will determine the yield differential, which ultimately determines the attractiveness of each. As such, any financial sector reform package should aim at establishing a price constellation which will induce savers and wealth-holders to shift their resources toward these financial assets. As elaborated further on, the implementation of the reforms requires an adequate macroeconomic policy design to ensure an efficient allocation.

Equally important, for a developing country with a stable fiscal and monetary environment, an appropriate interest rate policy in conjunction with a proper alignment of exchange rates, will induce an adequate, if not healthy, net capital flow which will be self-financing. The appropriate interest rate level and structure will facilitate sound investments capable of generating sufficient cash flows to cover debt repayment. In this ideal case, a country will not and cannot remain for long in a foreign debt trap. In contrast, an inadequate interest rate policy will force the country to continually increase its outstanding internal, and the corresponding external, debt and related economic forces, such as a tendency for net foreign assets to become negative, will induce the required adjustment through a major devaluation (i.e. a realignment of internal and external prices). In identifying the adequate level and structure of interest rates, the aim
ought to be to gradually encourage self-financing of net capital inflows, in accordance with world economic conditions. This aim can only be accomplished through an appropriate set of prices. Interest rates are one key price in this process.

The introduction of market-determined interest rate flexibility to the financial environment brings the issue of interest rate determination to the fore. In particular, the behavior of interest rates in the post-reform period becomes a fulcrum of policymaking, in which the costs will need to be considered in conjunction with the benefits. A specific benefit, however, is that since interest rates will in a large part be set by the market, policymakers will have an additional policy tool for controlling the money supply indirectly, aimed at stabilization purposes (Fry 1988). (Through such means as sales and purchases of government paper and short-term repurchase agreements, policymakers can exercise important indirect control over the money stock.) In contrast, the costs will become particularly evident and may surpass the benefits when economic policy is poorly designed or implemented. Thus, how effective the interest rate reform can be will be determined by other policy considerations, the specifics of institutional reform in the financial sector, and the universal role that all prices in the economy are allowed to play. These are matters that demand the attention of the authorities.

IV. Interest Rate Deregulation: Experience and Policy Issues

From the available evidence it can be generalized that the most immediate result of financial sector reforms is the enhancement and maintenance of positive real interest rates, which usually have contributed to an increase in financial savings and an improved and more diversified financial set of instruments capable of servicing the needs of the real sector. The goal to establish and maintain positive real rates usually requires the easing or even the dismantling of ceilings on deposit rates and restrictions on lending rates so as to introduce market-based mechanisms to adjust rates in accordance with changing economic circumstances. Moreover, the modified interest rate structure also usually forces a diminution in financial market segmentation, exemplified by the smaller dispersion of interest rates.

In certain cases, as for example in Malaysia, the overall policy thrust of reducing inflation pressures through appropriate and cohesive policy measures led to a situation in which ceilings on deposit and lending rates become irrelevant due to declining inflation. Post-reform nominal rates in Malaysia came down shortly after the implementation of deregulative measures, while at the same time maintaining appropriate levels of real interest rates. The experience does suggest, however, that interest rates may inch upward after deregulation but this is only an adjustment in relative prices between real and financial assets. However, in some cases as for example in Indonesia, the increase in interest rates was larger than expected due to the leniency of bank licensing which followed deregulation and which led to a large number of banks competing for deposits. However, interest rates can also demonstrate "overshooting" which arises as a result of the upward drive compelled by inadequate fiscal and monetary policies; in this context, the perceived "volatility" is a normal dynamic adjustment in the market place. It is rather difficult to empirically separate "overshooting"
from mere volatility but it can be generalized that both can be kindled by an open capital account, which Indonesia introduced long before it embarked on its financial sector reforms. The latter, if properly employed, serves as an assurance to market players in the sense that the policymakers face additional constraints which compel the design of appropriate policies.

The most crucial issue that has been present in all instances of interest rate deregulation is whether deregulation contributes or even precipitates a financial crisis, leading to a scaled-down approach or even a reversal of the reforms (Hinds 1986). There are reasons to be concerned about a possible panic situation after the implementation of the reforms. However, one must be careful in establishing causality between the reforms and a subsequent financial crisis. For example, if financial reforms are effected in a healthy macro environment, the emergence of a crisis can only be attributed to exogenous causes such as a real shock. However, if financial reforms are superimposed on an already fragile financial system, or if the macro framework is unstable, this may directly contribute to the triggering of a crisis. The issue then, is not whether the reforms, and in particular interest rate deregulation, caused the crisis but rather why the financial system was weak and why these weaknesses had not been suitably addressed independently of the preparation for the introduction of financial sector reforms.

The role of the capital account in affecting the variability and level of interest rates is another issue that requires attention along the financial reform process. The degree of its openness has different effects on the behavior of interest rates resulting from external shocks. These shocks can be minimized by allowing interest rates to play the role of the adjustment variable; the magnitude of the adjustment depends on the nature and reach of the shock itself. It must be underscored, however, that it is not the open capital account which introduces the volatility or even the higher rates. Rather, an open capital account requires a more stringent economic policy. In some cases this additional restriction (more monetary and fiscal discipline) lends credibility to ongoing economic policy but if it is overlooked in the reformulation of economic policy, the leading adverse effects of poor policy design will be felt through interest rate variations sanctioned by the policymakers to avoid destabilizing capital outflows. Moreover, the insufficient financial depth, and particularly the limited money markets, are important factors contributing to less stable interest rate conditions when monetary conditions tighten as a result of external forces transmitted via the capital account. For these reasons, Indonesia, with one of the most open capital accounts of the selected countries, experienced one of the highest degrees of interest rate variability and levels among the Asian countries that have implemented financial sector reforms. In contrast, Malaysia, with a minor degree of capital account openness but still much more open than other Asian countries, managed a healthy interest rate variability sustained by a more judicious interest rate policy but within a financial market with more depth.

It has been mentioned earlier that in certain cases deregulation can be linked to financial crisis. We may consider several scenarios in which the deregulation of the financial sector may contribute to financial panic. Nonetheless, it must be emphasized that in all possible cases the financial fragility was already in existence or the regulatory and supervisory authority could not cope with the results. In general, we may classify six scenarios (not mutually exclusive), taken from the countries in our sample, all leading to further financial fragility and to excessive risk taking which may in turn escalate into a crisis:
(a) **Supervisory shortsightedness.** Before deregulation all the supervisory agencies of the countries in the sample had been trained to monitor compliance with controls and guidelines oriented toward developmental objectives rather than toward the soundness of the banking system and its institutions, (i.e. prudential regulation). The reforms require a restructuring of the supervisory agency to focus on bank solvency criteria and credit risk with appropriate means and power of sanctions for non-compliance; such expertise is not obtained overnight.\(^\text{10}\)

(b) **Inadequate banking supervision.** Increased freedom of entry and freedom to bid for funds in the banking sector may lead to excessive risk taking where widespread fraud can more easily occur. A situation of spiraling moral hazards might be created, and the deregulated environment may permit untrained individuals to enter the industry. This scenario was typical of the situation in both Indonesia and Philippines. To cope with this potential situation, it is essential that a sound supervisory agency is established.

(c) **Absence of competition.** The deregulated environment may permit the emergence of oligopolistic financial intermediaries. The effects can be compounded if these institutions establish interlocking relationships with nonfinancial producers. It is thus critical that the reforms encourage a competitive structure in the financial sector so that interest rates will have a favorable impact on the overall reforms. Again, to cope with this potential situation, a sound supervisory agency is required.

(d) **Inadequate monetary control.** Deregulation might be accompanied by shifts in wealth-holders' preferences, and the authorities might not have made commensurate monetary policy modifications (Hang 1986). This policy inertia will certainly contribute to higher interest rate levels. A fairly responsive money market, one with sufficient depth and a monetary authority adept at open market operations are indispensable in order to avoid such adverse consequences. Related to inadequate monetary control is the poor coordination of fiscal and monetary policies.

(e) **Unrealistic expectations.** The increase in unrealistic expectations, as a result of either the reform itself or the ongoing macro policy, may lead to sharp increases in credit demand and the corresponding rise in interest rates. A vicious cycle of interest rate increases may be created, fueled by distressed borrowing and aggravated by the usual high debt ratios in industry. This vicious cycle aggravated the situation in the Philippines (as in Chile).

(f) **Instability in credit markets.** Related to (e) above, credit markets may become somewhat unpredictable in which higher demands for credit are accompanied by (supply) credit rationing (Stiglitz and Weiss 1981). For example, high interest rates require further borrowing (demand), but at the same time the higher rates amplify the lenders' perceptions of risk, thereby curtailing its supply. This is an extreme case but it played a role in the financial crisis in the Philippines.
Deregulation of the sample countries' financial systems has introduced new constituents into financial sectors, such as the entry of new banks; this has drastically altered the sheltered setting in which banks, both private and state-owned, have operated for many years. The reforms have also often exposed problems carried over from a previous financial regime. The deregulated banking sectors are now exposed to greater risks (i.e., which is market-based allocation) and instability thereby requiring an adjustment process which in itself has not been free of costs, particularly in the early stages. In addition, management of banks confront greater pressures to make decisions which were previously directed and mandated by the economic authorities. Efficient management and sound business judgment become essential to running a financial institution in the new deregulated environment.

Besides the new, but necessary risks, other issues also need to be confronted. In emerging, but controlled, financial sectors, the maturity structure of the banking system is usually unbalanced so that a significant balance sheet mismatch exists, reflected in "abnormal" term structures (Fama 1984, Leiderman and Blejer 1987); this is particularly the case in the countries selected for this survey. For examples, time deposits were often heavily concentrated in maturities of less than one year, adding to the liquidity and interest rate risks of banks. The problem is compounded by the behavior of real rates of interest within a given macro environment; in particular, an unstable economic environment provides no tangible demand incentive to develop long-term instruments, limiting the potential for capital markets to evolve. Lack of long term funds also places additional pressures on banks to finance industry to an excessive degree. With working capital loans financing investments on a roll-over basis, resulting in highly unstable leveraged corporate structures (Sundararajan 1985). A stable macroeconomic framework, in particular, is required to lengthen the maturity of market instruments and improve balance sheet structures of banks. And, the stemming buoyant equity and bond market would allow industry to reduce its overwhelming dependence on bank debt as a means of finance.

In general, interest rate deregulation may generate apprehension on at least two different but related issues: (i) interest rate variability or more precisely "overshooting," (i.e., a higher than expected increase in the post-reform level of interest rates) and (ii) banking wildcatting (i.e. banking operations under lax supervision). The occurrence of any of these "worst case" events may consequently lead to the derailment or even the failure of the reform process itself. These serious issues deserve to be considered by the banking authorities when initiating a financial sector reform program. However, the evidence obtained from countries which have undertaken successful financial reforms demonstrates that a well-designed and politically decisive reform program need not fail. In this survey some guiding principles, derived from countries that have implemented financial sector reforms, are presented to indicate that the pitfalls along the reform process are identifiable and, more importantly, manageable. Evidence is provided from regional countries and the lessons learned are generalized.
V. Lessons Learned

Broadly, the lessons learned from financial sector reforms can be analyzed through an examination of the following factors: (i) growth of the financial sector, (ii) efficiency of financial institutions, (iii) variability of interest rates, (iv) maturity transformation, (v) interest rate differentials between equivalent domestic and external financial assets, (vi) quality of banking assets, and (vii) the financial structure of the real sector’s ongoing concerns. However, the analysis of the behavior of these factors should also take into account other aspects, such as the existence of economy-wide imbalances, and the degree of success in the implementation of stabilization programs.

In contrast to interest rate deregulation in the late 1980s and early 1990s, many Asian countries lifted credit controls during the late-1970s and the 1980s. However, to minimize macroeconomic instability, mostly the result of real external shocks (e.g., oil price changes), and to address the resulting monetary disturbances, some countries reintroduced credit controls, albeit to a lesser degree than before. This reversal might be an indication that the passage from regulation to deregulation requires more inputs than just the political will to implement such controls. In particular, the institutional framework needs to be put into place. As developing economies continue to reform their financial systems, accompanying specific measures need to be implemented to establish an appropriately competitive environment aimed at securing and enhancing the potential benefits. Specifically, the new measures and rules ought to be introduced with a view to minimally disturbing financial resource allocation and without discouraging actual and potential participants.

The financial sector reform effects can be measured through financial statements for firms and, with greater accuracy, for financial institutions (Galvez and Tybout 1985). For example, the average balance sheet of a commercial bank in a developing economy is markedly different from one in a developed economy; these differences, for example, are reflected in such indicators as loan/deposit ratios, liquid assets, and deposit maturities. However, the effect of successful financial deregulation has been most striking on changes in the liabilities of the financial institutions (mostly in the structure of deposits and in the ratio of deposits and central bank borrowing). Such structural changes have been measured in all countries that have undertaken effective financial sector reforms. In the end, the structural changes reflected in the liabilities of the financial institutions are a direct manifestation of the reform’s effects. It can be generalized that “financialization” of savings, or its equivalent, the banking system’s structural transformation of liabilities, is a necessary but not sufficient step in the direction of successful financial sector reforms.

At the same time as prices of the assets and the liabilities of the financial institutions are adjusting to the new market forces, successful financial sector reforms allow the market to establish a set of prices in which households are induced to shift their wealth to financial assets from real assets. In all countries in the sample, this process was observed, in one way or another. During this process, the authorities should be politically and technically prepared to utilize standard monetary policy instruments to control the money stock indirectly, although accompanying measures may be required to develop the money and capital markets. Malaysia, for example, modified the banks’ liquidity ratio requirements in 1979 and in effect reduced the cost of funds to
financial institutions, thereby encouraging the development of secondary markets in monetary instruments. The monetary authority allowed the introduction of two monetary instruments (bankers' acceptances and negotiable certificates of deposit) along with interest rate reforms. The central bank of Indonesia (BI), in addition to reducing liquidity requirements, also introduced and facilitated the trading of short-term central bank paper (SBI) and commercial paper (SBPU) as part of the ongoing financial reforms.

However, in some countries in the sample the authorities backtracked when monetary and/or economic conditions became adverse and resorted to the earlier mechanisms of direct monetary control. In Indonesia, for example, when inflationary pressures became worrisome in early 1990, the government mandated that all state enterprises shift their deposits to short-term central bank bills. The result was that while liquidity in the system was absorbed, it was done through direct means. Preferably, the needed liquidity absorption should have been effected through the most efficient indirect approach, i.e., through open market operations. To be fair, the short-term paper market in Indonesia is quite shallow and possibly even if an indirect means of monetary control had been utilized, the requirements of the inflationary situation would have demanded other policy instruments as well to deflate the bubble. (One may also inquire why the policymakers have done so little to develop deeper secondary short and long-term financial markets.)

The successful experiences in financial sector reform show a policy sequence which emerges as a clear pattern. During the initial stage, the fiscal framework, including tax reforms, is overhauled to reduce the government's burden on the financial sector. Also, during this stage savers are encouraged to shift their assets into the formal banking system as the subsidies or yields that previously went to the government now accrue to them. In this phase, the most crucial element becomes the supervisory capability of the monetary authority, assuming a stable macro environment.

At this stage, it is advisable that the government overhaul its budget and tax procedures to minimize any instability, since a troublesome issue that may arise after deregulation is the potential adverse effects of governmental financing on interest rates. As the macro environment has usually been unstable at the onset of the financial reform package, usually a reflection of poor fiscal management, the authorities have tended to overuse debt financing. This leads to unnecessary levels of competition between the government and the funding requirements of the deregulated deposit-taking institutions. This aspect cannot be overlooked, as a vicious cycle of increasing interest rates may ensue. The most extraordinary example occurred in the Philippines, in which the banks and the government competed fiercely for funds (Ghanem 1986). In the end, the country experienced a detrimental disintermediation. The financial collapse that followed is still affecting the balance sheet of the central bank, which was forced to hastily assume the tail end of the problem. This problem was avoided in the Republic of Korea (and also in Chile) by reigning in the fiscal deficit in such a manner that loanable funds in real terms actually increased to the private sector. This is also the approach being followed in India in its ongoing financial sector reforms.

The lessons learned have been costly and have provided a sobering experience for all those concerned. These lessons, however, must be grasped because the failure to absorb them could be more costly. Nevertheless, they provide the basis for an improved financial policy that is vital for sound financial development in the midst of regulated
adjustment in the financial system. The Asian countries in our sample can be considered to be in a transitional stage in which direct interest rate controls have been relatively abandoned but fully open market systems of indirect monetary control have not as yet emerged. In particular, the subservience of monetary policy (or in some cases, as in Indonesia, the over-extended reliance on it) to fiscal considerations needs to be modified to enhance the reach of the reforms.

As mentioned in the last section, financial sector reforms may cause concern to the economic authorities on two broad fronts: (1) insufficient banking supervisory capabilities in the new deregulated environment, and (2) interest rate variability, (including "overshooting"). However, of greater importance in the initial stage of the reform process is the degree of economic stability and the willingness of the economic authorities to ensure an adequate and stable macro environment to initiate and to secure the successful implementation of the reforms. Each of these three issues is elaborated as follows.

A. Macroeconomic Environment and Policy

Within a successful financial sector reform process, macroeconomic stability is required; the greater the stability, the more evident the benefits will be from holding financial assets. The macro stability also allows for a more certain investment planning process as, by any measure, project appraisal techniques are more reliable, allowing producers of tradeable (and also non-tradeable) goods to undertake longer term investments under safer conditions and without being forced to hold expensive hedges against inflation and foreign exchange risks through excess inventories, tax delinquency and any other means. Hence, a key objective of financial sector reforms is to alter the economy's relative price constellation in order to facilitate the transformation of liquid assets into real assets and vice versa, at a decreasing cost along the reform process. Under unstable macroeconomic conditions this transformation process becomes sterile and may induce adverse and negative effects such as currency substitution which tends to diminish the reach of monetary policy.

As has been highlighted and as the evidence indicates, macro policy and macro stability are sine qua non for successful financial sector reform, with the initial step being for public financing to be oriented toward hard-budget constraints. A corollary is that price stability is the main pillar of successful interest rate deregulation. (As interest rates are prices, the instability will also be felt in its behavior.) This is particularly important if the financial markets are shallow and corporate debts are high. Stability in the macro environment is required to ensure that the new set of relative prices is conducive to a higher level of savings mobilization and, through market-based criteria, to a more efficient allocation of it, i.e. the transformation of financial assets into productive capital accumulation. As has also been underscored, the evidence indicates that financial savings will increase after deregulation, but the evidence also indicates that the authorities have not been entirely successful in ensuring an efficient allocation provided by a stable macro framework. Sometimes the obstacle appears by way of a reluctance to stop financing state institutions with cheap credit, sometimes in a lack of supervisory capability, or even at times the obstacle is a lack of commitment and/or political
constraints to fully implement the complete reform package. Nevertheless, generally, the most pressing obstacle results from the lack of a stable macro environment.

The most general lesson derived from the deregulatory experience of the selected Asian countries, and from countries in South America, is that however genuine the will and the commitment in which the policy actions have been effected, the reforms will not be successful if macroeconomic stability is not present. There cannot be an effective reform process if macro policy is not appropriately modified, particularly in the fiscal area, conventionally considered the first step in the process. Financing government borrowing through the market will allow the phased reduction of reserve requirements to prudential levels, as well as allow a reduction in the inflation tax. (In turn, macroeconomic management also stands to gain from financial reforms as such reforms will increase the effectiveness of financial policies required for further macroeconomic adjustment.)

Deregulation based solely on the banking system without macro policy redesign might not succeed and certainly will have major risks. The greater role being played by interest rates and market forces may lead to adverse selection on the part of borrowers and to a moral hazard on the part of creditors. The problem can be compounded if the new macro design requires a restrictive monetary policy, reflected in the sharp increase in the cost of funds. In this sense, excessive levels of real rates are as deleterious as repressed ones. The so-called "overshooting effect" requires special efforts to get to the root of the problem. Thus, the optimum procedure is to establish macro stability before the full deregulation of interest rates to avoid the possibility of overshooting. A gradual but full deregulation in conjunction with the stabilization effort appears to be the most desirable approach. In doing so, it is necessary that the market is confident that the policymakers know what they are doing, that they will not backtrack and will be decisive in implementing the pre-advertised reform program.16

B. Interest Rate Variability

Most countries in the region have experimented with interest rate modifications to support overall development and growth policies. However, only a minority of regional countries have introduced a greater degree of interest rate flexibility to secure a deepening of their financial sectors and as an integral part of their financial sector reforms. Interest rates were fully deregulated in Singapore in the mid-1970s and in the Philippines, Indonesia and Sri Lanka in the early 1980s. Nepal deregulated most rates in 1986 although the public sector's banking system remains oligopolistic and is generally unresponsive to market signals. Malaysia, Thailand and the Republic of Korea engaged in a gradual deregulation process, characterized by more frequent adjustments and the removal of some ceilings. In all countries the introduction of flexibility in the interest rate structure created upward pressures, leading to positive real rates.15 In turn, financial depth, measured in terms of M3/GDP, increased measurably.16 This increase is the equivalent of increasing loanable funds. A problem which usually arises at this juncture is that the increase in loanable funds allows the authorities to continue with the old credit allocation criteria and mechanisms. It is at this stage that the move to the indirect allocation of credit through the market becomes a key policy shift, lest the whole process should be derailed.
Flowing from the argument in the previous paragraph is the issue of the relative behavior between real and nominal interest rates. In those instances in which the financial reforms included interest rate deregulation, the action was taken primarily because real rates were negative, and were being propelled by inflationary pressures. The adjustment measures coupled with price deregulation led to positive real rates at least temporarily for all countries in the sample. (A case in point is the Philippines in which real rates became deeply negative after the reforms but mainly as a consequence of exogenous factors.) However, the subsequent relative behavior of the nominal and real interest rates was different in different countries. In the Philippines and Malaysia positive interest rates were reached by controlling inflation. In the Republic of Korea, positive real rates were kept and sustained by their central bank's adjustments in the nominal rates in accordance with inflation movements, in such a manner that real rates were kept relatively constant.

It is worth noting that in three countries (Indonesia, Malaysia and the Philippines) real rates became positive almost immediately after the deregulation. However, only the first two managed to sustain a positive real rate structure. In the Philippines, a series of external events in conjunction with a poorly designed macro policy to confront the adverse external and internal forces, led to strong inflationary pressures which ultimately led to the real rate being driven down to minus 32 per cent. Notice that the strongly negative real rates were also accompanied by extremely high nominal rates. This scenario presents the worst case as the strongly negative real rates caused disintermediation, capital flight and currency substitution. Moreover, with loans at floating interest rates, the high nominal rates may have added to the debt burden of the corporate structure, eventually resulting in an increase of banks' non-performing assets. A second distinct cause of this crisis was the imprudent use of the money markets by the monetary authority; in this case, some observers have commented that the central bank became a direct instrument of fiscal policy as it crowded out the credit markets to help in financing public expenditure.

The record indicates that interest rate volatility can be exacerbated by shallow money markets and the lack of a market responsive reference rate as a benchmark for a "risk-free" financial asset. This deficiency has also impeded the development of a structure of interest rates consistent with the reform programs. However, the "risk-free" reference rate requires an extremely prudent macro policy, particularly on the fiscal side. In the sample, as mentioned earlier, the worst scenario was to be found in the Philippines, where the reference rate was utilized by the central bank to secure funding to bail out failing financial institutions. In the process, the benchmark kept increasing as the economic authority made increasing use of this facility, distorting the overall interest rate structure and other related key prices, such as the exchange rate.

During the transition toward market-based allocation of financial resources through interest rate deregulation, the most immediate risk arises from the reform's effects on the "older" non-competitive banks, particularly those effects resulting from adjustments in the level of interest rates. These banks will carry the bad assets and the balance sheet mismatch created by previous credit policies while the new banks will not be saddled with these burdens. Thus, the older banks will possibly be in a non-competitive position from the start. To smooth the transition, some countries took offsetting administrative actions. These have included the assumption of old low-yield loans until maturity by governments (e.g., Indonesia, Philippines, and Republic of
Korea) and the use of old loans as credits toward a reduction in the reserve ratio (e.g., Malaysia). Nevertheless, the basis of the problem (besides non-competitiveness) resides in the poor capitalization levels; thus, some countries took some (but not enough) measures to bring up capital adequacy levels. However, the most common remedial action, i.e., delaying both bank closures and recapitalization in the hope that lower interest rates will solve the problem in time, in fact place an additional constraint on further financial reforms. A good example is the Republic of Korea, whose banking system's old loans still prevent a more complete deregulation.

C. Banking Deregulation and Supervision

Financial reforms have usually been introduced when a country is facing economic adversity and foreign funds, either soft or commercial, are drying up. Thus, it is not surprising that a significant proportion of the sample countries, in fact, had insolvent or near insolvent banking systems at the onset of financial reforms, thereby requiring carefully designed reform packages, supported by capable bank supervisors well versed in overall and specific credit and interest rate risks. The experience of the countries that implemented financial deregulation but did not provide appropriate prudential safeguards indicates that the derived growth in banking assets was characterized by poor quality, affecting adversely the healthy development of the financial sector. (Please refer to endnote 12.)

To protect the direct benefits of deregulation, a strong and highly skilled supervisory agency capable of fully implementing and reviewing compliance with monetary authorities' instructions is required. Thus, training a highly competent corps of bank examiners should be included as a measure to be taken within the reform package. The record indicates that, with the exception of Malaysia, the surveyed countries did not channel sufficient resources to strengthen this reform component. In turn, in some sample countries the gains from the reforms were not fully captured and, consequently, the momentum of benefits was slower than expected.

The deregulated banking environment may induce the new and relatively inexperienced bankers to engage in financial activities for which higher risk-analysis skill levels are required. Thus, in some cases the deregulated banking environment tolerated a large increase in banking assets either through imprudent bank management in a highly competitive environment or through lax licensing requirements. The consequences of poor supervisory and prudential regulatory capabilities magnified the problems for the authorities and introduced greater variability on the degree of market confidence perception.

An interesting example is provided by the experience of Indonesia. After deregulation, Indonesia's banking system assets increased enormously, reaching in some cases a 60 per cent annual increase rate. By the time the authorities focused on this aspect, the difficulties (of dealing with the large volume of bad loans) had mounted considerably, requiring a higher level of efforts than if initial actions had been undertaken earlier. In contrast, Malaysia proceeded more gradually and ensured that an adequate supervisory and regulatory capability was in place before introducing some of the measures within the reform program. It must be emphasized, therefore, that the reform process requires a careful balancing act between effective regulation and efficient
deregulation, aimed at maintaining the viability of the banking institutions and a self-sustainable financial industry.

It is significant to note that in all countries that implemented financial reforms, the state banks held a significant share of total assets but almost without exception their capital adequacy was rather weak and efforts at increasing solvency requirements were somewhat inadequate. Thus, as an initial step, loan portfolios should have been cleaned up and the banks should have been adequately capitalized. In these instances, access to the capital markets and share issues is a further option for future consideration by the authorities to broaden ownership and strengthen future capital needs. In this regard, Malaysia and the Republic of South Korea took steps in this direction. (The record also indicates that financial deregulation was not always synonymous with a decrease in public sector participation in financial intermediation, indicating that greater efforts were—and are—required to strengthen the financial sector reforms.)

The most general lesson regarding sound financial development is that a re-educated bank supervisory staff becomes a necessity at the earlier stages of financial reforms. Prior to deregulation, the regulatory framework in most developing countries has tended to emphasize economic and social goals such as directing priority lending to specific sectors and, for example, expanding branches to underdeveloped regions, thereby giving less weight to the viability of the financial institutions themselves. In general, pre-reform practices in financial sector supervision ensured that government’s financial, credit and economic policies were being implemented, rather than directed to the maintenance of a stable and sound financial system. Little attention had been given to enforcing prudential supervisory principles. The retraining of the supervisory staff as well as the banking staff in the banking sector at large is imperative to ensure that previous patterns of (control) supervision are diminished while the new skills which the deregulated environment requires are increased. It is worth underscoring that prudential regulation of financial institutions has as its basic aim the preservation of the solvency of the regulated institutions. This function is derived from the fact that financial entities, and particularly deposit-taking ones, have the social function of creating money and of safeguarding the community’s wealth. Thus, if the supervisory role is not fully enforced, the economic distress overspills from the private to the public domain.

For example, the costs of poor coordination can be quite exorbitant, particularly if deposit insurance is part of the institutional milieu. Deposit insurance represents a potential burden to taxpayers in the form of an off-balance sheet liability (Merton 1977). The lack of supervisory and deregulatory coordination may directly contribute to converting the potential liability into a real one. Along the way, the supervisory agency, in order to avoid the immediate impact of defaulting banks on the national treasury or on the overall financial system, may relax supervisory due diligence and substitute an attitude of tolerance. (This tactic is usually referred to as “capital forbearance.”) However, trying to prop up insolvent banks through lax standards may actually encourage these banks to engage in riskier behavior as the increasing costs, short of jail time, will not affect the banks’ behavior for earning positive profits. This deregulation peril was quite significant in the recent U.S. financial crisis, leading to extremely high bail-out costs for the taxpayers and the derived fiscal imbalance. Thus, the introduction of deposit insurance requires careful consideration and should be based on the risk of each specific institution.
The evidence from the sample countries also indicates that the legal and accounting framework was usually lax at the onset of deregulation, contributing to undue fragility. It is necessary that all facets be reviewed to modernize laws and, particularly, to raise accounting standards. Most governments have recognized that the legal framework must also be improved but progress in implementing new laws has tended to be rather slow. These initial deficiencies indicate that governments must also initiate accounting development programs to improve practices in the public and private sectors, including auditing services. An adequate skill level of human resources is essential lest it becomes the major constraint, derailing the reform process. It is also imperative to develop professional accounting standards and improve the coverage, quality and consistency of financial reporting. Along the reform process, cases of financial misinformation have been particularly acute in Indonesia, Malaysia and Thailand.

There are also other aspects which the supervisory function should not overlook. In some countries, the deregulation of interest rates led to a scramble by the banks to increase their non-interest income as the deregulatory and competitive effects had reduced spreads, although by not as much as had been expected in those countries whose banking systems were saddled with significant non-performing loans. However, in some cases, as in the Philippines and Indonesia, market players tend to look for loopholes. Under these circumstances, the regulatory authorities must introduce additional measures to be confident that, among others, oligopolistic banking structures are not strengthened as non-interest income for the banks might become a monopoly rent, undermining the entire reform process. Or, the regulatory authority may need to introduce tighter standards to ensure that banks are not increasing off-balance sheet risk. In general, and in particular in Sri Lanka, the deregulation did contribute to a slight increase in the banks' average cost of funds but the interest rate deregulation did narrow the gap among interest rates charged by different financial institutions. All in all, if rates have been restricted, the expected increase in interest rates after deregulation need not lead directly to convoluted financial sectors; rather, problems may arise as a result of lax and inexperienced regulators (and banking managers) in the new market environment.

VI. Summary and Conclusions

It is generally recognized that controlled interest rates distort resource allocation and diminish the economy's capability to generate financial resources needed to promote further economic growth and development. It also leads to macroeconomic instability as the curtailed potential for generating the required financial funds is usually compensated by the central bank through an increase in its liabilities. With these generalizations in mind, it must be emphasized that the financial reform itself is no panacea to the obstacles hindering further development. Nonetheless, no country has escaped underdevelopment without taking direct and specific actions to reform and to strengthen the intermediary role of the financial sector. Moreover, no industrializing economy would be able to function without a financial sector in which a basic price—such as the interest rate—does not respond in one way or another to market forces. It can
also be argued, and data corroborates the fact, that the greater the financial repression and the less responsive is the interest rate to market forces, the greater the need for a country to seek external aid, as domestic savings mobilization is inadequate to maintain a stable and sustained growth path.

In formulating the financial reforms, the initial state of the economy needs to be carefully evaluated. If instability is present and supervisory capabilities are weak, the approach should be gradual so as to avoid any disruptions to existing financial contracts. Thus, the first step is ensuring an adequate adjustment process, coupled with stricter and enhanced supervisory actions, to avoid moral hazard and adverse selection; improvement or acquisition of indirect monetary control skills is also of considerable importance. This process should also be supported by institutional changes that can provide adequate information flows, credit appraisal and rating services, legal and accounting systems, and measures to encourage the development of long-term financial markets. These measures should aim at minimizing any adverse effect of the expected higher variability of interest rates on banks and firms, allowing a faster and greater degree of interest rate deregulation.

In initiating a financial sector reform which includes interest rate deregulation, the first step is to assess the adequacy of its structure in terms of the overall economy and, secondly, in terms of the existing distortions such as selective credit, market segmentation, interest spreads, and preferential rates. The questions that have to be kept in mind in designing the reform are:

(a) will competition be enhanced?
(b) are the market players sufficiently sensitive to interest rates changes?
(c) are the available monetary policy instruments capable of influencing the marginal cost of funds available to the banks?
(d) are there other substitutes available for bank financing?
(e) is the financial system sufficiently efficient to allow interest rates to respond promptly to shifts in monetary policy and market fundamentals?
(f) what is the present status of the prudential supervisory capabilities of the authorities?

The answers to these questions will indicate the sequencing and timing of the reform package. The main conclusion is that deregulation is not the same thing as freeing markets. However, its implementation requires the replacement of the controlled interest rates by indirect monetary control, operating through market processes.

All financial reforms have led to greater financial asset diversification (where it was permitted) and financial savings. Thus, banks and non-bank financial institutions have been forced to make the necessary adjustments to meet greater competition, hoping to maintain their market share and increase their profits. Nevertheless, the higher interest rates and the slower than expected growth of longer term funds have placed additional restrictions on the traditional activities of some banks, such as development banks, which have to be addressed and need suitable measures introduced in formulating the reform package. In general, the overall reduction of systemic risk as a result of a more stable macro environment and the establishing of the appropriate institutional infrastructure will reduce specific risks, facilitating the development of newer financial instruments and the lengthening of maturities. Thus, further steps in the
reform process should include or require the development of capital markets and long-term funding mechanisms and institutions.

All the reform packages were based on a premise which called for a significant increase in investment to be increasingly funded through private domestic savings mobilized by the financial sector. In some countries, such as Malaysia, the aim of mobilizing private resources was supported by the establishment of a commission to formulate appropriate legal and administrative procedures to recover the outstanding bad debts. Moreover, in some cases, through tax incentives, banks were induced to make appropriate provisions for non-performing loans. Other schemes to ameliorate the portfolio quality problem include allowing the banks to convert loans to equity with buy-back provisions. Nevertheless, non-performing loans have been at high levels, both before and after the reforms, particularly in publicly owned banks. The implemented financial reforms of the surveyed countries apparently have not addressed this issue adequately. Greater efforts are still required and vestiges from the pre-reform period, such as priority credits and directed lending, will need to be more firmly dealt with to diminish the detrimental effects of poor portfolios.

As has been stressed, central banks have a key role in the deregulation process; these key institutions need to take measures to strengthen their own monetary policy operations and procedures as well as improving their on-site and off-site bank supervisory procedures. The intricate and faster moving financial markets in the post-reform period demand special skills and knowledge, hence the quality of bank supervision and of bank assets has to be increased in accordance with the new market realities. Central banks need to implement programs to improve skills and strengthen techniques by recruiting additional high-level staff and implementing training programs.

The central banks also should ensure that the benefits of strengthened supervisory practices are not lost to the economy. Other measures may also include separate units for supervising problem banks experiencing financial difficulties and for registration, licensing and routine administrative matters. To further support these efforts, essential modifications in bank supervision need also to be implemented, including a framework and procedures to evaluate the soundness of the banking system effectively and objectively. Along the reform process but preferably as early as possible, an effective legal and accounting system must also be recognized as fundamental.

Financial sector reforms represent only one dimension within the overall reform package. Although the ultimate aim of the former is to establish an appropriate price relationship between real and financial assets, this relationship is only a necessary (but not sufficient) condition for establishing a sound and sustained growth path. As has been underscored, an appropriate macroeconomic policy is absolutely necessary to underpin the financial sector reforms and to guarantee that the ensuing increases in financial savings are properly transformed into capital goods via adequately appraised investments or working capital. The financial sector reforms will only facilitate the mobilization of financial resources whereas the macro environment and the supporting macroeconomic policy will ensure their efficient allocation. A poorly designed macro policy will certainly derail the potential benefits of the financial sector reforms as the key price—interest rates—will move in accordance with the built-in pressures of the economic system. In addition, the problem might be compounded if the supervisory capability of the economic authority is not at par with the requirements of the newly deregulated financial markets.
The changing liability structure of the financial system which follows the reforms is the moving force behind the requirements for the upgrading of the supervisory capabilities of the monetary authority, as this structural change usually entails more than proportionate changes in the financial system's risk-profile. Moreover, it can be generalized that the link between the changing liability structure of the financial institutions and overall macroeconomic stability is determined by the level, tendency and changes in the monetary system's domestic credit component, particularly the monetary authority's assets placed with the banks. As the financial reforms take root, the banks, and specially the state banks, will rely less on central bank borrowing and simultaneously will increase their funding from the public and the market. As the process progresses the banks will have to become more efficient to sustain adequate profitability levels. At the same time, with banks relying more on the market and less on the central bank for their financing, the monetary authority will endure less pressure to provide funding and liquidity as a mere routine to the banking system, endowing its spacious policy capability with a greater latitude to confront issues only when it is really necessary, as during a financial panic.20

In conjunction with an appropriate fiscal reform process to reduce credits to the government, the monetary authority should aim at securing a more appropriate economic role, imparting a greater degree of macroeconomic stability to the economic system. Thus, financial reforms will indeed increase financial savings, but this benefit could well be lost if the role of the central bank is not modified accordingly. The central bank's role should be to provide price stability to the system and not to perform as an habitual financier to the financial system. The success of the reforms will depend greatly on how this modification is accomplished as this will be the link between the economy's relative price modifications and macroeconomic stability. If in the process of implementing the reforms this link is not adequately addressed, the probability is quite high that the overall success of the program could be undermined.21

In summary, financial sector reforms must address at least three broad points: (1) the adequacy of existing instruments to improve monetary policy through indirect means; (2) institutional and regulatory measures to enhance the efficiency and soundness of the financial system; and, (3) the adequacy of the level and structure of interest rates. In this report the latter has been emphasized, within a stable macroeconomic environment. However, the first two issues must also be addressed to ensure a cohesive reform program.
Notes

1. In this area, the available evidence for Asia (and also South America) reveals that the net effect is positive. However, the evidence for the relationship between deregulation and the national savings rate is somewhat uncertain. [This ambiguity can be attributed to at least two factors: (i) impossibility of adjusting the data for macroeconomic stability, and (ii) the net effect of the substitution and income effects on the overall savings rate as a result of interest rate (prices) changes.] However, the evidence—cross-sectional and time-series—indicates that deregulation leading to positive real rates does yield gains in terms of national savings. However, the evidence also indicates that if the real interest rate reaches a high level, it might depress the level of economic (investment) activity, neutralizing the positive effects of interest rate deregulation. Accordingly, in formulating the interest rate policy, care must be taken to ensure that real rates are consistent with the requirements of the economy. Otherwise, adverse effects may show up, among others, in the appreciation of the exchange rate (as it happened in Chile) derailing the reform process through a more fragile banking system and an unsustainable current account deficit, among others.

2. A major disadvantage derived from controlled interest rates is that when real rates are negative or misaligned, the market will be facing distorting pressures; borrowers, recognizing lower payments in real terms in the future, will demand increasing credit, creating a permanent situation of excess demand. Savers, and intermediaries, finding themselves in the opposite situation, will limit and/or ration the supply of funds as they will try to hold their wealth in nonfinancial forms, which under these circumstances are more remunerative. This situation leads to vicious cycles in which interest groups insist that the Government step in to "correct" it by increasing credit levels or relaxing credit standards, contributing to the exacerbation of the disequilibrium.

3. In some cases the financial reforms have been propelled by forces beyond the control of the authorities. A case in point is Indonesia. As a result of the plunge in oil prices in the early 1980s and the derived fall in oil rents, Indonesia embarked on a wide-ranging set of economic reforms of which the financial sector's was the most critical.

4. In trying to provide cheap credit, policymakers have utilized a wide array of options, including ceilings, government guarantees, deposit insurance, interest rate subsidies, directed credits, regulations to divert the flow of savings, tax exempt financing, etc. Of this distorting measures, the least disruptive appears to be interest rate subsidies. Still, even this option cannot avoid the real problem of "hidden costs" which eventually must be paid by someone (Pyle 1974).

5. It is interesting to note that poor countries constantly appeal to this "gap" as a cause for further international soft lending.

6. In trying to increase the mobilization of financial savings, the positive slope of the supply curve would require increasing interest rate levels. In the short-run, this escalation may negatively influence the investment process; however, in the long run, the more appropriately priced investment allocation may lead to a more sustained level of economic growth. Moreover, if the financial institutional framework is not in place, the increases in financial savings will shift toward inefficient allocations, such as public current expenditures. Good examples of this perverse economic behavior are India and the People's Republic of China, both of which enjoy relatively high saving rates.

7. A financial analysis of interest rates usually centers on the concept of "yield." However, an economic analysis usually centers on the idea of interest rates as a "price." This difference is quite useful as long as both views are kept in mind. For our purposes, the idea of "price" is more appropriate as it allows us to place the interest rate within a general equilibrium framework; in addition, it is easier to handle analytically as it requires one arithmetical computation less (Fama and Miller 1972).

8. For example, a sharp increase in oil prices for a major oil-importing country.

9. At times of extreme external pressures, the Indonesian authorities have been forced to raise interest rates substantially to stem the capital outflow. This policy action, however, does not necessarily operate symmetrically during a converse situation.
10. The authorities must convince the banking community that wayward banks will be shut down and liquidated. Often, examples are most instructive. Setting an example imparts discipline to the banking system.

11. The financial management requirements after deregulation increase exponentially and some countries, i.e. Indonesia, find it difficult coping with the new market realities. The new environment might accentuate existing weaknesses, including human resource bottlenecks.

12. The link between the short and long-term ends of the financial market is provided by the interest rate structure. Analogously, the latter is a better purveyor of this link under stable price conditions. In this context, capital accumulation and growth are facilitated.

13. In developing countries the efficacy and success of financial reforms is first felt in the liabilities side of the banks' balance sheets; the asset side is also influenced but with a lag. In contrast, in the context of macroeconomic instability or lack of adequate market mechanisms, the impact of the "reforms" is first felt in the asset side of both commercial and central banks. Thus, an increase in financial assets faster than financial liabilities provides a warning bell that the reform process is not proceeding smoothly. (Financial assets are only created when the investment of an economic unit in real assets exceeds its savings.) Successful financial sector reforms, through banks' liabilities (excluding central bank borrowing), expedite an efficacious monetary policy. (A. Kashyap 1993 and King 1986.)

14. The implementation of reform programs can be boosted if the authorities announce and establish a scheduled set of specific measures as part of the reform package. The so-called "Tablita" in Argentina in the late 1970s is usually the standard. The Mexican reform programme has been sustained by a pre-arranged daily mini-devaluation to ensure export competitiveness and to avoid some of the problems which derailed the Chilean reform process. These measures were all aimed at ensuring a cohesive macroeconomic framework. However, pre-announced measures can also be implemented with regard to the financial sector. The gradual and scheduled implementation of banking prudential regulation in Indonesia is a good example. In all cases, however, the important element is that the authority adheres strictly to the measures and to the timetable. Credibility thus becomes an essential component of the reform package.

15. Since interest rates were originally controlled, the deregulatory package will tend to introduce upward pressures. This is a necessary and positive adjustment. The upward pressure becomes a problem when it is boosted by incoherent macro policy.

16. The usual indicators of deepening, i.e. M3/GNP, require specific scrutiny as the source of funds needs to be categorized, i.e. internal vs. external, portfolio redistribution, etc. The increase or high level in M3/GNP does not always indicate efficient allocation—such is the case of India.

17. That is, the countries had to be willing to adjust interest rates (most likely upward) or exchange rates (most likely through devaluation) to maintain balance in the credit markets.

18. This refers to the rate at which the central government or Treasury can borrow funds denominated in its own local currency.

19. This component would aim at assessing and improving asset quality, particularly in state banks, which must be competent and perceived to be sound considering they still have a very significant presence in most developing economies. Where they are not sound, measures should be taken quickly to restore their soundness and add competition to the financial system.

20. The introduction of new and additional risks is a case in point. For example, the owners of the (private) banks practically have a "put option" with the depositors: at zero or less net worth the owners can walk away and the depositors, the central bank and the taxpayers (if there is deposit insurance) are exposed to the downside consequences of the "put option." It is this asymmetry in risk that is affected by the volatility of interest rates. When this is the case (i.e. net worth of banks falls), banks will be encouraged by the prevailing risk constellation to engage in greater risks as its cost to the managers and owners is approaching zero but the potential for greater payoffs is increasing, providing incentives even to violate laws. This is the issue of moral hazard. On the depositors side, the same "put option" leads to "adverse selection" as they expect to obtain higher interest income as interest rates increase, endangering the health of financial institutions. For this reason, the deregulation of interest rates tends to create concerns for the authorities. However, this potential risk is the direct result of previous policy errors, including deposit and lending limits. Nevertheless, this
fear is only a potential one that can easily be controlled with appropriate supervisory and regulatory standards and capabilities. These have included: market-value accounting of loans, more rigorous loan quality and capital adequacy definitions, risk-based premia if deposit insurance is available, etc. Note that these requirements demand an adequate accounting and auditing system so that both the banks and the regulatory agencies can properly assess the credit risks of borrowers and lenders. The task is challenging for the authorities but the array of controls, such as deposit ceilings, are clearly second-best solutions. At the same time, it should not be overlooked that financial markets are more sensitive than other markets to uncertainty, misinformation and confidence levels and these characteristics bolster the need for efficient prudential supervision. Consequently, there is a heightened need for coordination between deregulation and proper supervision.

21. During the October 1987 crisis the U.S. Federal Reserve was able to successfully face the emergency head on. If the central bank had been previously engaged in other activities, its maneuvering room would have been greatly diminished.

22. A concluding comment is that money and savings have played a significant role in the earlier developmental process of the post-industrial economies, even before the establishment of the first central bank. This process is repeating itself in the developing economies of today (Yoo 1977). What is worthy to note is that the evolution of central banking has been accompanied by a commensurate development in the financialization of savings and in the role of financial intermediaries. Successful financial sector reforms have enhanced this process.

Selected References


