FINANCE FOR GROWTH:
POLICY CHOICES IN A VOLATILE WORLD

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Foreword

A seminar on "Finance for Growth: Policy Choices in a Volatile World" by Dr Patrick Honohan, World Bank, was held at ICRIER on July 25, 2001. Dr Honohan presented the major research findings of the study. Mr S S Tarapore, former Deputy Governor, the Reserve Bank of India was the principal discussant at the seminar. The presentation of the report by Dr Patrick Honohan and comments by Mr Tarapore were followed by a lively discussion which is summarised at the end of the proceedings. The publication of the proceedings of this seminar should generate wider awareness of these very important issues.

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Director & Chief Executive
ICRIER

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force for growth.

This report presents an analysis of the evidence

This is not a book that relies on the application of some abstract principles; rather, our conclusions are based on an analysis of concrete evidence. Though much remains to be learned, a huge volume of empirical analysis, drawing on a growing body of statistical data, has been conducted on these issues over the past few years. The findings of this research greatly help to clarify the choices that are involved. Many long-held beliefs have found detailed empirical confirmation for the first time; some new and perhaps surprising discoveries have been made.

In other words, we are asking policymakers to face some facts about finance. It is now possible to define with some confidence the need for a refocusing and deepening of the financial sector policy agenda. In this study, we identify and synthesize what we believe to be the key findings of recent financial sector research, both that conducted at the World Bank and elsewhere, highlighting the policy choices that will maximize growth and restore the financial sector as a key sector for helping to cope with—rather than magnifying—volatility. A few key messages have emerged from this research.

Finance contributes to long-term prosperity

It is obvious that advanced economies have sophisticated financial systems. What is not obvious, but is borne out by the evidence, is that the services delivered by these financial systems have to come.

But well functioning markets need legal and regulatory underpinning—

Achieving an efficient and secure financial market environment requires an infrastructure of legal rules and practice and timely and accurate information, supported by regulatory and supervisory arrangements that help ensure constructive incentives for financial market participants. Success here will promote growth in a way that is tilted towards the poor and will stabilize the economy around the higher growth path; direct access to finance by many now excluded will also be expanded.

—and a strategy based on harnessing incentives

Incentives are key to limiting undue risk-taking and fraudulent behavior in the management and supervision of financial intermediaries—especially banks that are prone to costly failure. Instability and crashes are endemic to financial markets, but need not be as costly as they have been in recent years. They reflect the results of risk-taking going well beyond society's risk tolerance. These costs are very real: they represent a potentially persistent tax on growth. This can raise poverty in the near term, and can have longer-term affects on the poor, both through lower growth and through reduced spending on areas such as health and education.

Good safety nets require good institutions

Deposit insurance systems, an important part of the

Open markets can spur development—

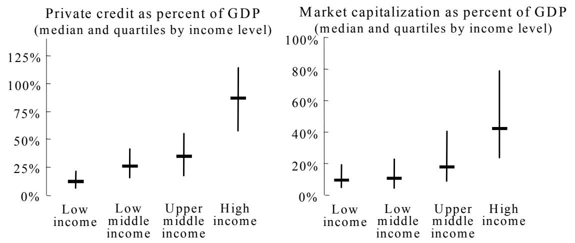
Most developing countries are too small to be able to afford to do without the benefits of access to global finance, including accessing financial services from foreign or foreign-owned financial firms. Facilitating the entry of reputable foreign financial firms to the local market should be welcomed too: they bring competition, improve efficiency, and lift the quality of the financial infrastructure. As such, they are an important catalyst for the sort of financial development that promotes growth. Opening up is accompanied by some drawbacks, including a heightening of risk in some dimensions, and will need careful monitoring. It also results in a loss of business for local financial firms, but access to financial services is what matters for development, not who provides them.

—as can technology

The financial sector has long been an early adopter of innovations in information and communications technology. Internationalization of finance (despite efforts to block it) has been one consequence. This has helped lower the cost of equity and loan capital on average even if it has also heightened vulnerability to capital flows. The precise future role of e-finance in accelerating the process of internationalization is not easy to predict, but it will surely be substantial. If volatility may have increased, so too have risk management technologies and their associated financial instruments.

— notably for access

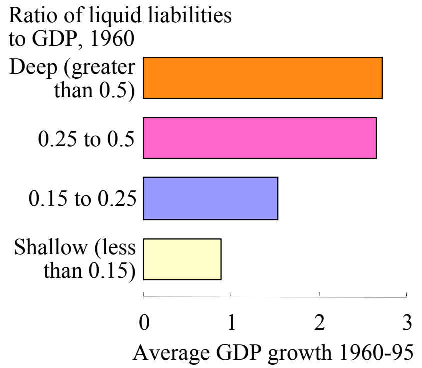
Some related credit information techniques, The vertical bar shows the interquartile range: the financial depth of 50 percent of the countries at each stage of development lie within this range; the median is shown as a horizontal bar.



Note: 87 countries, average of available dates in the 1990s.
Source: BDL database.

arrangements precede and contribute to economic performance. In other words, the widespread desire to see an effectively functioning financial system is warranted by its clear causal link to growth, macroeconomic stability, and poverty reduction. Almost regardless of how we measure financial development, we can see a cross-country association between it and the level of income per capita (figure 1). Association does not prove causality, and many other factors are also involved, not least the stability of macroeconomic policy. Nevertheless, over the past few years, the hypothesis that the relation is a causal one (figure 2) has consistently survived a testing series of econometric probes.

Figure 2 Financial depth generates subsequent growth



The reason finance is important for growth lies in what are, despite being less obvious, the key underlying functions that financial

Bank and equity financing are complements, not substitutes

The evidence on the importance of each of the two major institutional components of finance—banks and organized securities markets—is also clear. There is no empirical support for policies that artificially constrain one in favor of the other. Indeed, the development of each sector seems to strengthen the performance of the other by maintaining the competitive edge of individual financial firms. While banking is more deeply entrenched in developing economies than securities markets and other nonbank sectors (figure 3), distinct challenges face policymakers in trying to ensure that both banks and markets reach their full functional potential. Macroeconomic stability is, of course, one key, but other aspects relate more closely to the microeconomic underpinnings of finance.

With so much of the borrowings by firms coming from banks, the borrowing cost depends on the operational efficiency and competitiveness of the banking market. In this respect, too, the performance of developing economies falls behind. Liberalization has been associated not only with higher wholesale interest rates, but also with a widening of intermediation spreads—at least partly reflecting increased exercise of market power by banks.

functioning of the organized securities markets. These policies are likely to be more effective if directed to infrastructure rather than directly to the financial structures themselves. It is in the legal area that recent research on effective infrastructure has made most progress—and in areas going beyond the obvious and crucial need to ensure that the creditor's rights can, in the event of default, be expeditiously and inexpensively exercised. Naturally, the government has a comparative advantage in the design and implementation of law, and it needs to address itself to updating and refining laws and legal practice as they relate to financial contracts. Yet, to supplement—or make up for the absence of—government action, there is a clear and practical scope for market participants to amplify regulatory structures where this is needed. Practice in some of the more successful organized stock markets provides good examples of such private initiatives. This presents a promising way forward, especially where the development of public law is difficult.

There has been a major scholarly debate on whether the precise design of laws matter, with recent research focusing on the contrasting performance of financial systems with legal structures of differing origins. The evidence indicates that the main families of legal origin do differ in important respects relevant to financial development—notably in the differential protection they tend to provide to different stakeholders. These differences have been shown to have had an influence on the relative development of debt and equity markets, on the degree to which firms are widely held, or more generally the degree to which they are financed externally, and thus on overall financial sector countries.

Policy choices and new technology may expand access to finance

Measures that succeed in deepening financial markets and limiting the distorting exercise of market power result in more firms and individuals securing access to credit at acceptable cost. However, what of the poor and of the small or microenterprise borrower? What aspects need special attention to ensure that these do not get passed by despite overall improvement in the performance of financial systems? There is no point in pretending that the problem of access is easily solved. Experience shows that formal financial institutions are slow to incur the set-up costs involved in reaching a dispersed, poor clientele (even with minimal deposit-type services). But in looking to improvements, two aspects appear crucial, namely information and the relatively high fixed costs of small-scale lending. Recent research focusing on technological and policy advances points to how these barriers can be lowered.

A range of innovative, specialized microfinance institutions, mostly subsidized, has become established with remarkable success. Loan delinquency has been low—far lower than in the previous generation of subsidized lending programs operated in many developing countries—and the reach of the institutions in terms of sheer numbers, as well as to previously grossly neglected groups, such as women and the very poor, has been remarkable. This success has been attributed to reliance on innovation in, for example, the use of group lending contracts exploiting the potentialities of social capital and peer pressure to reduce means the risk of failure, sometimes triggering a chain reaction. In these conditions, expectations can change quickly, leading to swings in asset prices, which in turn may be exacerbated by the possibility of crowd behavior.

Financial markets are in the business of making efficient use of information, but substantial and even growing deviations from equilibrium prices are possible, manifesting themselves as bubbles, or speculative booms and busts. If the countless historical examples of asset price crashes are not sufficient evidence of this, theory, too, explains why, when acquiring information and contracting are both costly, financial markets will never be fully efficient and fully arbitraged. Carefully controlled experiments confirm that individuals are not fully rational in assessing risk: they attach too much weight to recent experience (display myopia), they trade on noise rather than on fundamentals, and they exhibit positive feedback (or momentum) by buying because prices are rising. As well as exacerbating asset-price fluctuations and contributing to euphoric surges of bank lending—followed by revulsion and damaging credit crunches—such behavioral characteristics also provide fertile ground for fraudulent Ponzi schemes.

If finance is fragile, banking is its most fragile part. Bankers have to place a reliable value on the assets they acquire (including the creditworthiness of borrowers), but banking also adds the complications not only of maturity transformation, but of demandable debt, that is, offering debt finance backed by par value liabilities in the form of bank deposits. The particular fragility of finance, and markets, there is more demandable debt, less access to outside equity for firms, and therefore greater fragility. Collapses in equity prices are not innocuous, but are clearly less disruptive than bank failures, which explains the need to focus on the latter.

Financial sector regulation and supervision—the rules of the game in the financial sector, and the way they are enforced—are essential to limiting moral hazard, as well as to ensuring that intermediaries have the incentive to allocate resources and perform their other functions prudently. Although there has been a remarkable convergence on paper in recent years, stark differences remain in regulatory environments around the world, and weaknesses in this area serve as a potential source of added vulnerability in some emerging markets.

Use market-based incentives to supplement regulations

Necessary though headline regulations may be, a clear lesson from recent and historical research is that they need to be supplemented by the use of incentives and information to maximize the number of well-informed, well-motivated monitors of financial intermediaries. Diversity in the set of monitors for banks is desirable not only because of possible differences in information that they may possess, but also because of the varying and possible opaque incentives that they face. But who can monitor banks? There are three main categories:

job.

In the face of financial fragility, governments provide a safety net of sorts, virtually always through lender-of-last-resort facilities and increasingly through explicit deposit insurance. Deposit insurance is increasingly popular in emerging markets because it appears to be an effective way to stem bank runs, at least in high-income countries, and helps foster indigenous banks. The existence of these schemes, however, may actually worsen the information and incentive environment, increasing the scale and frequency of crises. To some extent, establishment of a formal deposit insurance scheme can be expected to result in greater risk-taking—the age-old moral hazard that tends to be associated with most forms of insurance. That would be an argument against establishing a formal scheme, but it has to be recognized that absence of a formal scheme can be equivalent to implicit deposit insurance—perhaps unlimited in its coverage and potentially also entailing moral hazard. Thus, whether to adopt an explicit system, and what kind of system to adopt, are empirical issues.

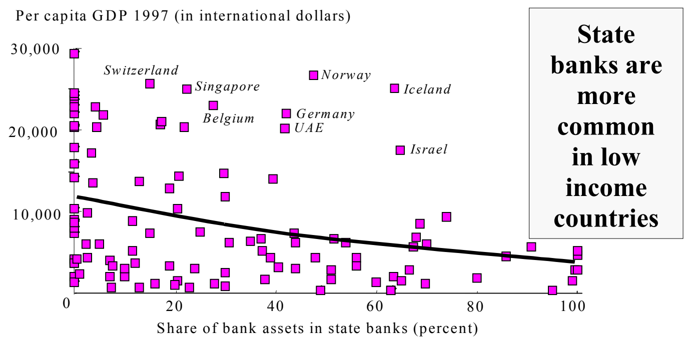
The weight of evidence from recent research suggests that, in practice, rather than lowering the likelihood of a crisis, the adoption of explicit deposit insurance *on average* is associated with less banking sector stability, and this result does not appear to be driven by reverse causation. Here the qualification "on average" is key: deposit insurance has no significant effect in countries with strong institutions, but in weak institutional environments has the potential to destabilize. This result is reinforced by the finding that they should suddenly end these schemes—doing so would likely induce a crisis—but instead should reconsider the design of their systems in light of the evidence presented herein. In deciding on design features, this report argues that authorities should draw on empirical evidence and in particular utilize market forces to ensure prudence, rather than simply attempting to copy existing practice—itself quite diverse—of rich countries. It is overwhelmingly important that governments do not provide banks with an excessively generous safety net, as this will hamper the development of other parts of the sector, as well as potentially underwriting excessive risk-taking.

Chapter 3: Government Failure in Finance

Government ownership of banks is greater in poor countries

More than 40 percent of the world's population still live in countries in which the majority of bank assets are in majority-owned state banks. Government ownership tends to be greater in poorer countries (figure 5). State ownership in banking continues to be popular in many countries for

Figure 5 Government ownership of bank assets and per capita income



Source: World Bank Survey of Prudential Regulation and Supervision, and LLS (2000).

largest 20 firms—often including inefficient state enterprises—getting more credit the greater is state ownership. In addition, there is some evidence that greater state ownership is associated with financial instability.

To be sure, there are exceptions: Germany, for example, has had little state ownership of the enterprise sector (outside transport and finance), which has reduced the temptation of allocating credit to government industries. Moreover, the tough penalties there for default and bankruptcy would make life easy for most banks, even those that are state run. However, although it remains possible for developing countries to find ways to reduce the damage done by state ownership, limiting state ownership itself likely will be easier to implement than the many institutional and political reforms needed to avoid the abuses and inefficiencies of state banking.

Privatization can lead to a more efficient banking sector—

The potential scale of gains from bank privatization are born out from detailed investigation in World Bank research of one country with comprehensive data and a major privatization experience, namely Argentina. This research suggests that in an incentive-compatible environment, the conduct of privatized banks—as reflected in their balance sheets and income statements—over time begins to resemble that of the other private banks. This is especially true in terms of the ratio of their administrative costs to revenues, and most importantly in terms of credit extended to public enterprises, consistent with the evidence above on improved allocation of resources. As part of the privatization process, the shedding or more efficient options, an approach that appears to have helped in Poland. To be sure, this approach can only succeed if the process is credible, otherwise the deferred compensation will be too heavily discounted to have any value. As also noted below, sale of state banks to strong foreign banks can be a way of bringing good skills, products and the capacity to train local bankers, and may even facilitate a strengthening of the regulatory environment. As long as the foreign banks are motivated to protect their reputation to behave in line with the highest fiduciary standards, this approach will increase the speed with which allocation decisions are made on market principles while minimizing the odds of a crisis.

Governments should intervene only when the crisis is systemic—

When a banking crisis occurs, authorities need to decide when and how to intervene. When the problem is not systemic, bank creditors and supervisors should be left to proceed as usual on a case-by-case basis through standing channels. However, widespread bank insolvency may force even a government not disposed to take a significant ownership position in the banking sector to become involved in restructuring banks and even their assets (for example, nonfinancial firms) in the process. In many cases, systemic crisis has led to a substantial increase in government ownership or "care-taking." Yet the evidence on governments' limited efficacy as owners of banks suggests that they will not excel at restructuring failed or failing banks either.

How then can one decide when the crisis has reached systemic proportions and when the government should financial claim on the bank—and then exercising that claim—is no more or less than a transfer from taxpayers to shareholders, which is the group that keeps the residual value of the bank.

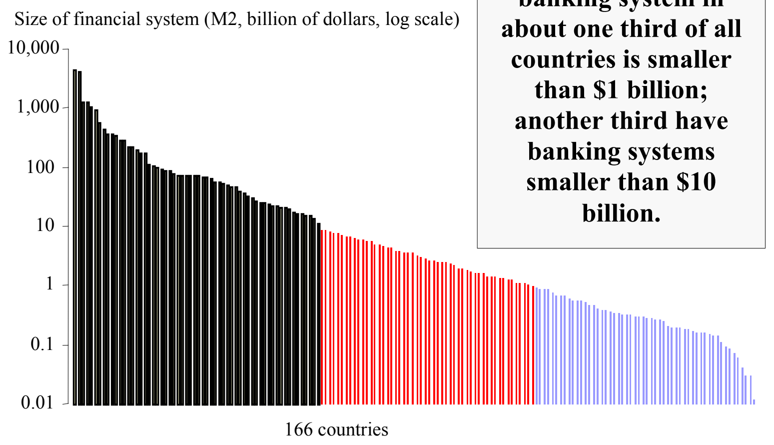
So if government funds are be injected, there has to be some government involvement. Governments that inject equity will want to make sure that it is used only where needed to fill an insolvency gap, and certainly that it is not looted. Yet they must recognize that they are not likely to function well as bank owners; accordingly their equity stakes in banks should be for a limited period only. One way of achieving both of these goals is for the authorities to make some amount of funding available for recapitalization of banks, but only to those that

Use the market to identify banks to be "rescued"

- secure matching of private sector funds in some ratio;
- agree to restrict dividends and other withdrawals by insiders for some time (likewise, contracts for senior managers should be structured to emphasize deferred performance-linked compensation); and
- adhere to stringent transparency requirements.

The virtue of such an approach is that it removes from government or government-sponsored agencies the selection of winners, a process that is ripe for abuse. By openly stating the terms on which it will assist banks and their new shareholders, and ensuring that those terms provide good incentives for the restructured bank going securely integrated in the world financial system through ownership and portfolio links. Small financial systems provide fewer services at higher unit costs, partly because they cannot exploit economies of scale, partly because of a lack of competition. Regulation and supervision of small systems is disproportionately costly, and even a well-funded effort would be hard pressed to ensure stability if finance is restricted to domestic institutions operating locally. Many financial systems fall short of minimum efficient scale and thus have much to gain from outsourcing financial services from abroad.

Figure 6 Most financial systems are small



Total assets of the banking system in about one third of all countries is smaller than $1 billion; another third have banking systems smaller than $10 billion.

Capital account liberalization: costs and benefits

It sometimes seems that a boom-and-bust roller coaster has been imported when the capital account has been liberalized. Undoubtedly, with the wrong incentives, this has

The internationalization of the provision of financial services, including the entry of reputable foreign banks and other financial firms, can be a powerful generator of operational efficiency and competition, and should also prove ultimately to be a stabilizing force (figure 7).

Foreign bank entry can strengthen the system

Some countries have remained slow to admit foreign-owned financial firms to the local market, fearing that they will destabilize the local financial system and put local financial firms out of business, with the ultimate result that particular sectors and particular national needs will be poorly served. There is no hard evidence, however, that the local presence of foreign banks has destabilized the flow of credit or restricted access to small firms. Instead, the entry of these banks has been associated with significant improvements in the quality of regulation and disclosure. The very threat of entry has often been enough to galvanize the domestic banks into overhauling their cost structure and the range and quality of their services, with the result that foreign entry has often proved not to be as profitable for the entrants as they may have anticipated.

There may be some downside: pressure on domestic banks from foreign competition could present prudential risks, if it erodes franchise value of high-cost operators to the point where they begin to gamble for resurrection. Also, there is the risk that some less reputable foreign bank entrants might prove to be unsound. Evidently these considerations reinforce the urgency of strengthening prudential regulation. Actually, the arrival of reputable foreign banks

—equity market liberalization has lowered the cost of capital without much increase in volatility

In practice, these questions are tougher to answer than might appear at first sight. Overall, though, it appears from research findings that equity prices have increased, thereby lowering the cost of capital, without an undue increase in volatility. Opening up has also accelerated improvements in disclosure and the efficiency of the local stock markets, even though these have lost some of their share of the increased business in the listing and trading of local equities.

Before the explosion in international equity investment, the classic form of international finance involved debt flows: international borrowing and lending. Though carefully designed tax-like measures can be somewhat effective in damping short-term debt flows, openness to international flows inevitably impacts domestic interest rates and the exchange rate. Here is where the risks arise, and where macroeconomic, fiscal, and monetary policy has long been directed to containing those risks. Exposure of financial intermediaries and others to exchange rate risks, both direct and indirect, can be a particularly severe source of problems.

Domestic financial liberalization would be possible even without opening up the economy to international capital movements; with the opening-up, it becomes unavoidable. Capital account liberalization weakens and distorts a repressed domestic financial sector, eventually forcing developed—such as pensions and other forms of collective savings—and international payments. Technology should allow those countries to access these services on terms comparable to consumers in advanced countries, especially insofar as physical distance from the provider begins to lose much of its importance. Undoubtedly, the accelerating presence of the Internet will begin to make direct international financial transactions available even to small firms and individuals.

The likely speed of these developments, and the extent to which they will displace the need for a local presence of financial service companies, remain unclear. The question that will be increasingly asked is whether smaller developing countries need to have local securities and debt markets in the traditional sense, and even how much of banking needs to be domestic. For policymakers in developing countries the questions will shift to considering the stability of domestic financial institutions in the face of the increased competition. Increased access to foreign financial services will entail more use of foreign currency, and this will accentuate the risks of exchange rate and interest rate volatility for countries that choose to retain their own currency. Once again, heightened prudential alertness will be needed.

an earlier round of crises, created some of the problems we see today, including the underinvestment in skills and in the infrastructure that are needed to support a market-based financial system. The design of the financial safety net also requires careful attention if it is not to become another type of misplaced regulation.

Another wrong solution is excessive reliance on one type of monitor to oversee intermediation. Prudential supervision is by now a universal feature of financial policy, but supervisors are hard-pressed to keep up with financial technology and the speed with which the risk profile of banks can change. Enlisting the help of private sector participants by arranging for well-funded investors to have something at stake in the continued viability of banks, and hence the incentive to monitor them, will be an increasingly important support to direct official supervision. Establishing appropriate incentives for supervisors themselves—recognized in some cases during the 19th century—will help as well and is an idea whose return is long overdue. Political structures that increase the risk that reforms such as these will be delayed need to be addressed, too; in the opinion of some scholars, it is here that the deepest causes of the wave of crisis of the past two decades should be sought.

The recommendations of this report are mutually supportive in some obvious ways. For example, financial systems that are not supported by effective infrastructure and incentives systems will not be entrusted with much of society's savings. A less obvious link is that countries that provide heavily subsidized deposit insurance or a lax sufficient to attract reputable international bank owners.

Legal infrastructure may need upgrading here, too, as discussed in chapter 1, though it is likely that judicial enforcement is the more relevant weak spot. In financial regulation, the political independence of the supervisors is an issue (chapter 2): clear legal protection for them is crucial. And the temptation to bolster the emerging private banks with a formal deposit insurance system should be resisted, in view of the demonstrated moral hazard effects.

Although this country needs nonbanking financial services, such as those of securities markets, it is likely too poor and too small to sustain a liquid securities market on its own (chapter 4). The authorities need to be aiming to remove barriers that prevent borrowers and lenders from accessing international capital markets. Evidently this will need to be supported by stable and sustainable macroeconomic policies, as policy-induced macroinstability may be amplified by this opening-up of capital markets. Achieving minimum efficient scale—both in market infrastructure and in such aspects as payments systems—is going to be a challenge: exploring the possibilities of regional cooperation on these fronts should bear fruit. If democracy is weak and ethnic conflict high, a significant level of uncertainty likely will prevail, which will deter physical entry by good foreign banks, as will low population density. E-finance or joining a regional financial system may be the best hope of getting access to higher-quality financial services.

(b) a transition economy with weak rule of law

Where the rule of law is weak, the financial sector cannot be expected to function well. Tackling this situation will be the primary challenge. The message from chapter 1 is that market participants may have to supplement formal law with private contracts that establish bright-line rules that can easily be

Also important is better monitoring of the banking system. Even to the extent that the crisis was brought on by external factors, virtually every crisis uncovers banks that have ventured far out on the risk frontier, and that may account for a large fraction of the fiscal cost. In addition to ensuring that excessive risk takers are not "bailed out," better monitoring is crucial here to convince financial sector participants that incentives have changed. Often, even if a formal deposit insurance system was not in place before the crisis, blanket coverage may be now, and it is important that this coverage begins to be limited as soon as possible. If the banks still are fragile or suspect, however, great care is needed, and introducing a subordinated debt requirement—addressing the enforcement problems noted in chapter 2—can both improve monitoring and increase the share of unguaranteed liabilities. Then over time the authorities can announce a schedule of reduction of the ceiling amount of deposits covered by an explicit system. For countries with relatively limited numbers of banks, the German system of private deposit insurance and mutual liability among the private banks in the scheme has much to recommend itself as a way to maximize market monitoring.

Official monitoring of banks also will need improvement, and correcting the "balance of terror" noted in chapter 2 will complement greater central bank independence and allow for vigorous oversight.

Admitting foreign banks also can help stabilize and improve the sector, and middle-income countries are more likely to have good and eager entrants, while chapter 4 shows how beneficial openness to international equity markets can be.

(d) a upper middle-income country with a still-shallow financial system

The financial development of some upper middle-income countries remains below average. They seem to have all the

This report represents the culmination of one generation of research on the financial sector, not the first generation, but perhaps the first that has been systematically based on statistical data from across the world. The research findings provide "first-order" solutions to policymakers: overall guiding principles and a sense of strategy. It also highlights key policy issues for the next generation of research. In many cases, the first-order solution needs further amplification and specification beyond overall principles.

Moving beyond general principles—

For example, given the principles of incentive-based regulation from chapter 2, which particular aspects of bank regulation and supervision deserve greater priority at different stages of development? Or, the case for reducing state ownership in many countries is clear, but how far should authorities go and how quickly? And given the dangers associated with bank privatization, what are the lessons on how to do this process? Although research has begun in this area, it comes too soon after the privatizations to provide definitive answers on the long-run effects. Also, although a basic approach to bank restructuring is proposed in this volume, a more systematic exploration of the links between bank and enterprise restructuring, informed by case studies of systemic crisis countries, would help to guide authorities' decisions in a crisis.

Another area of relative ignorance is how corporate governance and ownership in the financial sector affects reform strategies. When insiders or "oligarchs" control have destabilizing consequences. There is already a demand to know how countries are handling these pressures, how they are regulating "e-banks" and electronic exchanges.

The trends noted or urged here—better infrastructure, improved incentives, less state ownership, and a more receptive view to importing financial services—will all surely contribute directly or indirectly to a considerable expansion in the role of nonbank intermediaries and capital markets. How to regulate efficiently these markets to contain systemic risk could be *the* key research question of the next few years.

The last several years have seen impressive leaps in our understanding of the importance of the financial sector in development, and in the knowledge base for many key issues, but there is still much to be learned.

and informal sector interest rates closer together. It is not as if overall interest rates in the economy become usurious in the process of reform or that banks suddenly gather increased clout. What is more likely is the need for larger spreads in the context of stricter prudential norms which require larger provisioning. It is good to see the World Bank Report taking cognisance of micro finance. It is pertinent to mention that almost two decades ago, the late Professor D. T. Lakdawalla stressed that it is wrong to provide the indigent poor with subsidised credit if they do not have income generating activity and giving loans where grants are the real answer generates a climate of non-repayment of loans.

3. The Report rightly cautions against pushing credit expansion as a way of achieving finance driven growth. Engineering too rapid a credit growth inevitably leads to inflation and institutional insolvency. One should not be over zealous in trying to push entrepreneurs away from banks to the stock market without developing a mature financial infrastructure. The Report takes a pragmatic stance when it stresses the principle: "Work with the market but do not leave it to the market" *(Page 56).* I am indeed glad that the Report is forthright in referring to the dangers of *looting or* tunnelling of funds in the absence of an adequate financial infrastructure. Though "looting" is a word of Indian origin we in India seem to be hesitant to use this is the financial sector and we euphemistically refer to *irregularities.* The weakness of the Indian financial system is not the absence of strong financial regulation but the absence of a system of prompt corrective action and

prevention is worth a pound of cure.

6. Countries undertaking financial liberalisation have often abandoned bank liability control well ahead of developing adequate oversight of asset deployment which is a fertile ground for systemic failures. In essence, financial liberalisation can reveal the long-standing underlying insolvency of the banking system. The Report makes the telling point that while almost all countries claim to prescribe capital ratios in accord with Basel guidelines, there are wide disparities in their effective enforcement. As long as the net inflow of deposits and interest received on performing loans are sufficient to pay for operating expenses and interest on deposits, depositors and supervisors are lulled into a false sense of security. Provisioning requirements in no way keep up with the loan loss experience and bank supervisors can do little to ensure that there also should be backward-looking measures to ensure adequate provisioning when loans go into arrears.

7. The Report refers to the question as to how to get good supervision and in this context, the pertinent issue raised is what the Report calls the *balance of terror* i.e. the risks and rewards faced by supervisors. The supervisors are generally not well paid and there are instances, the world over, of good supervisors being punished overtly or covertly. (The Italian experience in the early 1980s holds a telling lesson). The insistence on greater disclosure requirements and mandatory prompt corrective action could reduce the load on supervisors who are vulnerable to predatory pressures. All this may just not be enough as

they have been endowed with. Herein lies the fragility of the Indian banking system and the longer a fundamental revamping is delayed, the higher the eventual cost.

11. The deposit insurance agency is the one agency which is dedicated to safeguarding depositors' money. Ultimately, depositors are the real stakeholders of banks and their interests should gain over-riding priority. Deposit insurance is meaningful only if the deposit insurance agency has equal, if not greater, regulatory/supervisory powers than other agencies, including the powers to inspect and direct banks.

12. In all this it is important to foster an environment wherein the regulator/supervisor is not shot for each infringement, while the violators walk away scot-free. It is essential to invert this environment if the Indian financial system is to become effective, efficient and vibrant.

13. On the issue of narrow banking, the Report takes an ambivalent view. While recognising that weak banks could possibly minimise their risks by resort to narrow banking, the Report seems to take the line that other intermediaries will undertake risky credit expansion and by paying higher interest rates, these intermediaries will wean away deposits from weak banks. The Report seems to miss a vital conclusion viz. that as the stronger banks undertake relatively more credit expansion, it is to the benefit of the system as risks are taken where they are best handled. It is the intellectual ambivalence of the international agencies on narrow banking which has encouraged authorities in countries like India with yet another excuse not to take decisive action on weak banks. The experience the world

banks and an abolition of the statutory liquidity ratio (SLR). The Narasimham Committee (1991) had already recommended a reduction in the public sector ownership of banks and the authorities were well on the way to introducing prudential norms and also gradually reducing the SLR from 38.5 per cent to 25 per cent. There was an explosive breakdown of the negotiations and the damage was so irreparable that the loan negotiations could not be revived despite sincere and persevering attempts from both sides. Had the Indian authorities been a little more forthcoming in their intentions, and the World Bank had been a little more deft in pushing their matrix, the loan could have easily fructified. It is gratifying to see recognition in the Report of the hazards of an ill-prepared privatisation of banks and the dangers of a sudden abolition of liability control without safeguards on the assets side.

15. The Report makes the pertinent point that government funded bank recapitalisation via bonds misses the opportunity to create strong incentives for future prudent behaviour and as such, recapitalisation suppresses the message that poor performance is costly. There must be clear safeguards to ensure against repeated looting. The Report rightly stresses that there should, if at all, be only limited recapitalisation and that too with stringent conditions. Privatisation of banks 'should be phased along with improvements in the financial sector. Rapid privatisation can come unravelled, though inordinate delays would entail heavy costs. Pre-privatisation recapitalisation appears unwise because the government erroneously feels that the problem is resolved and there

> markets in the previous two decades, highlighting questions about the consequences, benefits and costs of equity market liberalisation... Capital account liberalisation weakens and distorts a repressed domestic financial sector, eventually forcing domestic liberalisation. If the process is long drawn out, partial liberalisation of external and domestic finance can result in a very risky and unsound situation emerging. *(Pages 20-22)*

17. I clearly recognise that I am deliberately quoting out of context the spirit of what is being said, but the authors must realise that opponents of reform will hear but not listen and thereby seek support from this Report for maintaining a zareba of capital controls. It is pertinent to mention that in India, it is precisely such statements which have been used to slowdown the process of capital account liberalisation.

18. The Indian approach of recent years has been to virtually free capital inflows and outflows for non-residents but to continue with strong controls on outflows by residents. While Indian corporates have been given considerable freedom to invest abroad, Indian mutual funds have received only muted signals of liberalisation of outflows. It is unfortunate that on banking capital flows the restrictions are more stringent today than what they were in November 1997. As far as individual residents and non-residents with non-repatriable funds are concerned, the controls are totally prohibitive which is clearly inconsistent with the regime of current account convertibility.

Summary of Discussion

The discussion opened with Dr Arvind Virmani raising the issue of desirability of bank failure. There are two aspects to this: management control and equity value. In this context, he questioned if a public sector bank's equity value was below zero, would it necessarily imply privatisation of the bank? Dr. Honohan responded that banks failed not only when they are unable to repay depositors, but that the capital of the bank may have dipped below the prescribed regulatory levels, in which case the actual level of capital was usually far less than that reported by the management, implying strict action.

Mr Suman Bery asserted that this document shows that there has been a loss of nerve on capital account convertibility. Is this based on new research ? He also cited the case of Brazil where the authorities were decisive and severe in their treatment of crises. They established rules of the game and self-policing could be enforced in the domestic private sector system. He raised the question of how to share credit information among banks. Addressing the report’s emphasis on legal infrastructure reforms, he wanted to know what strategy should be followed for reform in the legal system in the Indian context. Dr. Honohan responded that their research compared different legal systems to reveal that the British Common Law system, which has a creditor bias as opposed to the Napoleonic system (which is the basis of the German and Scandavian legal systems) with a debtor bias, works better to deepen financial systems and make them effective. But there is a tendency for legal systems to be converging the helps economic growth was a fact even though the funds may be diverted from the informal to the formal sector. The problem of scale typically associated with informal sector also precluded it from being a replacement for the formal financial sector.

Dr. Tarapore observed that frequent bank recapitalisation implies that public sector banks cannot fail. He was of the view that there should be a control on liability growth of weaker banks. This unfortunately was not happening. Supervision in India is weak, he stated, although regulation is strong. There is an urgent need to strengthen the supervisory capabilities in the mutual fund segment, and banks and non-banking segments. The answer lies in devoting resources to train staff and to get them organised. Finally, a strong deposit insurance agency was needed. As regards capital account convertibility, IMF is concerned about moving away from the Big Bang. Tarapore Committee had made the same point.

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