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## THE FINANCIAL SYSTEM AND PUBLIC ENTERPRISE REFORM

### Concepts and cases<sup>1</sup>

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#### INTRODUCTION

Public enterprise reform is an important component of policy strategies to accelerate economic growth in many countries. Public enterprise (PE) reform consists of two distinct, but complementary, approaches. The private sector development approach to PE reform involves privatising PEs and encouraging private sector development both to enhance economic efficiency and to shrink the relative size of the PE sector. The corporatisation approach involves enhancing managerial incentives and clarifying PE budget constraints, so that PE performance improves without the government relinquishing ownership.

This paper studies the relationship between the financial system and the success of PE reforms. We first develop a conceptual framework that describes the role of three financial services – mobilising resources, evaluating firms, and monitoring managers – in promoting both the private sector development and the corporatisation approaches to PE reform. We then use nine country case studies – Chile, Egypt, Ghana, India, Korea, Mexico, the Philippines, Senegal, and Turkey – to study the linkages between PE reform and both the initial state of the financial system and financial sector reform.

We find that countries with initially relatively well-developed financial systems enjoy comparatively more successful PE reforms than those with comparatively under-developed systems. Furthermore, countries seeking to implement large-scale PE reforms achieve much greater success if they also implement substantial and well-designed financial sector reforms that involve financial infrastructure building, liberalisation, and private financial intermediary expansion.

These conclusions arise after formulating a conceptual framework and studying nine country experiences. Some important caveats should be kept in mind, however. The causal relationship between financial development and

PE reform runs in both directions, and exogenous factors help determine the ultimate success of both PE and financial reform. While this paper argues that financial services promote successful PE reform, we readily acknowledge that public enterprise reform can stimulate financial development and that PE reform and financial reform tend to be mutually reinforcing. Furthermore, we only examine nine country cases. Since many important factors influence PE reform, the number of important explanatory variables probably exceeds the number of country cases. Thus, instead of formal statistical support for our conclusions, we show that the cases are remarkably consistent with our conceptual framework.

The rest of the paper is organised as follows: the first section presents a conceptual approach to the linkages between PE reform and the financial sector. In the second section we evaluate the impact of the initial state of the financial system on PE reform, and the links between financial reform and PE reform are discussed in the third section. The final section presents some policy recommendations.

## CONCEPTS

### Financial services in a market economy

To exemplify the importance of the financial system in PE reform, consider the role of three financial services in a market-oriented economy. First, the financial system evaluates firms and allocates resources based on these evaluations. Financial market participants research firms, managers, and business trends and choose the most promising and credit-worthy ventures. This includes large financial intermediaries such as banks, mutual funds, pension funds and insurance companies, and small venture capital institutions and individual entrepreneurs. The better financial systems are at obtaining and processing information, the better will be the allocation of capital.

Second, financial systems mobilise capital from disparate savers through banks, insurance companies, pension funds, investment companies, and capital markets. This mobilisation is critical for economic development. Many worthwhile investments require large capital inputs and some enjoy economies of scale. By agglomerating savings from many individuals, financial intermediaries enlarge the set of projects available to society. Furthermore, financial systems that both mobilise savings effectively and select promising firms intensify competition. Currently dominant firms will be less protected from competition if sound financial systems are able to identify and fund competing enterprises.

Finally, financial systems compel managers to act more in the interests of firm claim holders (stock, bond, and debt holders). In large corporations, small equity and bond holders may be unable or unwilling to obtain and process information effectively and oversee the managers. Managers,

therefore, may funnel firm resources to themselves or make decisions based on personal as opposed to corporate criteria. Financial intermediaries may be able to improve corporate governance by undertaking the difficult and costly tasks of monitoring managers and obliging them to act in the interests of firm claim holders. Sound corporate governance will encourage more efficient resource allocation by aligning managerial goals with creditors' goals, and more investment by making investors more confident that firms will maximise owner profits and service debt obligations.<sup>2</sup>

### Finance and public enterprise reform

This discussion suggests that well-developed financial systems raise the probability of successful PE reform; put differently, countries with poorly functioning financial systems will need financial reforms to support PE reform. The remainder of this section argues that those countries contemplating large-scale PE reform are also likely to be the countries requiring large-scale financial reform; and further exemplifies how the financial system and financial reform facilitate PE reform.

### *Privatisation and financial reform*

Privatising an enterprise signifies a much reduced role for the government in funding the firm. If the financial system is unable to acquire and process information on firms on market principles, resources will be allocated poorly, savings will be mobilised ineffectively, and corporate governance will deteriorate.

Since PE reform and financial reform are both long-run co-dependent reforms, they need to be coordinated. For example, large-scale PE privatisation should be preceded by, accompanied by, and followed by financial sector reforms. Specifically, to initiate financial sector reforms and to begin laying the foundation for future reforms, policy makers should begin liberalizing interest rate and directed credit controls, improving the supervisory, regulatory, and legal systems prior to PE privatisation. During PE privatisation, authorities should continue liberalizing and building a market-oriented financial infrastructure and policy makers should remove impediments to financial intermediary development and initiate the process of privatising some state-controlled banks along with or soon after PE privatisation. Otherwise, PE privatisation with a poorly functioning financial system may prove disastrous.

Unfortunately, but importantly, many countries contemplating large-scale PE privatisation do not have a sufficiently well-developed financial system to support PE privatisation. Not surprisingly, countries with large PE sectors have frequently exerted a strong hand in directing credit to favoured PEs and have often created public banks to facilitate the mobilisation of resources for

PEs. In such an environment, state-controlled banks generally do not research firms carefully and allocate credit on market criteria, nor will state-controlled banks tend to compete aggressively to mobilise resources or exert tight, market-based corporate governance. Thus, the staff of state-controlled financial intermediaries frequently lack market-based financial skills.

This lack of financial acumen may be complemented by a lack of financial and legal infrastructure. Pervasive government interference in financial markets will reduce the development of corporate financial statements and laws concerning collateral, information disclosure, and bankruptcy.<sup>3</sup> Thus, countries with large PE sectors will typically not have the financial and legal infrastructure to support successful privatisation; financial reform may be a necessary condition for successful PE reform.

#### *Privatisation options and finance*

A well-functioning financial system broadens the set of privatisation options. First, liquid capital markets make it easier to privatise PEs by selling equity to a broad group of investors. Broad distribution may mitigate criticisms that the government is selling public property cheaply for political or personal advantage or that the government is giving the country away to foreigners. Second, banks and other financial intermediaries may improve the privatisation process. Banks that mobilise savings effectively, assess entrepreneurs, finance purchases of PEs and oversee new management energetically and competently, will expand the number of investors that can participate in the privatisation process, help ensure that PEs go to qualified owners, and compel new owners to act appropriately. Finally, a well-functioning financial system reduces the urgency for breaking up large firms prior to privatisation. Specifically, some large PEs may have market power even though they are not natural monopolies. Under-developed financial markets make entry difficult and therefore allow privatised enterprises with market power to remain relatively immune to competitive forces. On the other hand, a well-developed financial system would help subject even large firms to competition by strengthening the ability of new firms to bring better goods to market.

#### *Finance and adjustment costs*

The financial system can also reduce adjustment costs. Newly privatised firms that need to be re-tooled will adjust and grow faster if financial markets can allocate capital quickly to promising firms. Similarly, by redeploying the assets of bankrupt enterprises efficiently, a sound financial system will reduce adjustment costs. Furthermore, by accelerating private sector growth, an effective financial system will indirectly increase labour demand. Since unemployment may be an important obstacle to beginning and maintaining PE reform, the financial system may pacify political pressures emanating

Table 11.1 Privatisation and the changing provision of financial services

	<i>Less reliance on</i>	<i>More reliance on</i>
Mobilising resources to finance enterprises	Taxes State-owned banks	Financial intermediaries: banks, investment companies, pension funds, insurance companies Capital markets
Allocating resources to enterprises	Direct and indirect government subsidies and guarantees State-owned banks Private banks compelled by the state	Financial intermediaries: banks, investment companies, pension funds, insurance companies Capital markets
Corporate governance of enterprises	Government or government ministries	Financial intermediaries: banks, investment companies, pension funds, insurance companies Capital markets

from unemployment by boosting private sector labour demand. Table 11.1 summarises the changing roles of the government and financial system in PE privatisation.

#### *Corporatisation*

A well-developed financial system also assists PE corporatisation. A market-oriented financial system will oblige newly corporatised firms to compete for financing with private firms. Furthermore, a well-developed financial system will promote private sector development which, in turn, intensifies competitive pressures on corporatised PEs. For corporatisation to succeed, however, banks must be sufficiently strong and independent to reject loan requests from non-creditworthy PEs and the government must credibly quell expectations that it implicitly guarantees loans to PEs, or else banks will funnel credit to PEs instead of to more worthy firms.

#### *Financial system and type of PE reform*

As we argued above, a well-developed financial system would assist all types of PE reform, privatisation as well as corporatisation. Thus, in countries with well-developed financial systems, the optimal PE reform strategy will depend on other factors such as political pressures, labour market conditions, the macroeconomy, the legal system, and openness to international trade.

By the same token, a very under-developed financial system makes privatisation and corporatisation, which relies heavily on the financial system, relatively unattractive. Under such circumstances the only feasible option becomes corporatisation that consists of improved direct government monitoring of enterprises until the financial sector is further developed.

## INITIAL STATE OF THE FINANCIAL SECTOR AND PUBLIC ENTERPRISE REFORM

### Measuring financial development

This section examines the relationship between the initial state of the financial system and public enterprise reform in Korea, Mexico, Chile, the Philippines, India, Turkey, Egypt, Senegal, and Ghana. To conduct this examination, we first construct measures of 'financial development'. Each measure is imperfect, but together they provide a useful 'picture' of financial development. We then discuss how financial development compares across regions of the world. Finally, we classify the case study countries into three categories of financial development prior to starting their respective PE reforms.

#### Financial indicators

We mainly use four indicators to assess the state of financial sector development. The first is a traditional measure of 'financial depth': the size of the formal financial intermediary sector relative to economic activity. We call this indicator DEPTH, defined as the ratio of liquid liabilities of the financial system to GDP.<sup>4</sup> This is an indicator of the degree to which the formal financial sector mobilises domestic savings, so that larger depth should in most cases reflect greater financial development.

The second indicator we use is a measure of stock market development: the ratio of market capitalisation to GDP, MCAP/GDP.<sup>5</sup> Since better developed stock markets make it easier for individuals to price and diversify risk, to raise capital, and to take over poorly managed firms, higher values of MCAP/GDP should reflect greater financial development.

Our third indicator measures the importance of private non-bank financial institutions by computing the share of private non-bank financial intermediary assets in total financial assets. Non-banks complement commercial banks and, more importantly, they often function as effective substitutes for the commercial banking sector when that sector is suppressed by government regulations or taxation. Thus, for many countries, larger non-bank financial intermediaries reflect a broadening and deepening of the financial system.

Finally, our fourth indicator of financial development measures the degree of government ownership of commercial banks.

### Comparison across regions

Figure 11.1 gives the 1991 averages of three of our financial indicators for four regions of the world: Sub Saharan Africa (Africa), Latin America (LAAM), Asia, and the OECD. The 1991 GDP per capita figures for Africa, Latin America, Asia, and OECD are \$705, \$1489, \$2611, and \$15,016, respectively. As shown in Figure 11.1, moving from poorer to richer countries generally involves greater financial development. Although none of the indicators is perfect, overall they illustrate a distinct pattern. OECD countries lead with the highest level of financial development, since all our indicators, non-banks, MCAP/GDP, and DEPTH have the highest values for OECD. Asian countries follow with high financial depth and stock market capitalization. The importance of non-bank financial institutions is a distinguishing factor, since for Asian countries our indicator is considerably lower than that of OECD countries. Latin America follows Asia with considerably lower financial depth and stock market capitalisation. African countries have the lowest level of financial development, with lowest non-bank and MCAP/GDP values, although the value for DEPTH is slightly higher than that of Latin American countries. Based on Figure 11.1, these indicators in general provide an intuitively appealing ranking of financial development across countries. Now we turn to evaluating the initial level of financial development in our case study countries prior to their PE reforms.

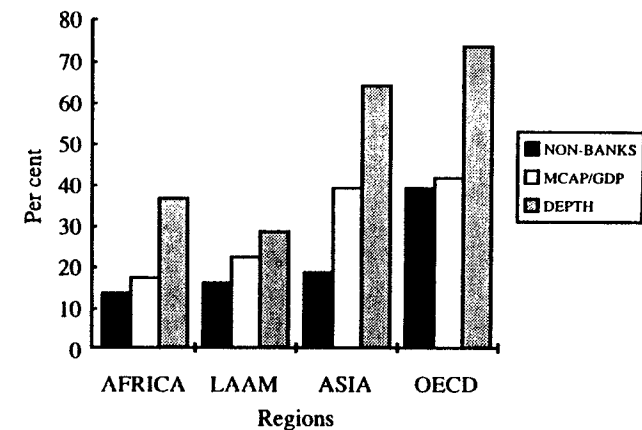


Figure 11.1 Financial structure in 1991

Notes: Non-banks: non-bank financial intermediary assets as a per cent of total financial assets; Depth: M3/GDP; MCAP/GDP: stock market capitalisation divided by GDP

*Initial state of financial development*

When the financial systems of countries prior to PE reforms are ranked based on the four indicators, DEPTH, MCAP/GDP, the importance of private non-bank financial institutions, and bank independence from government, they fall into three categories along a spectrum (see Table 11.2). Korea, Mexico, Chile II (Chile's second PE reform episode), and the Philippines had relatively well-developed financial systems prior to undertaking PE reforms. Financial depth was over 30 per cent of GDP, and they had relatively significant stock markets. Their private non-bank financial intermediaries had a significant share of financial assets (around 15 to 30 per cent) complementing the commercial banks. Senegal and Ghana are at the other end of the spectrum with under-developed financial systems. They had low levels of financial depth, no stock markets or private non-bank financial institutions in the formal sector, weak banking systems, and generally a very under-developed financial infrastructure. Finally, Chile I (Chile's first PE reform episode), Egypt, Turkey and India are difficult to rank and fall in between, since their financial systems are not as under-developed as Senegal and Ghana, but still less-developed compared to the first group of countries.

**Initial financial development and public enterprise reform**

The nine countries indicate a strong, positive association between the initial state of their financial systems and the ultimate success of their PE reforms. Galal (1994) reviews these cases in detail and finds that Korea, Mexico and Chile (especially Chile's second PE reform programme in the 1980s) successfully reformed, the Philippines enjoyed some success, while the other countries have thus far been relatively unsuccessful. Table 11.3 briefly summarises PE reform in each country. Table 11.3 shows that all of the most successful PE reform cases started out with relatively well-developed financial systems. Korea, Mexico, Chile II, and the Philippines had higher levels of financial depth, relatively well-developed stock markets, and other non-bank financial institutions prior to undertaking their PE reforms, than the other cases.

Countries that started out with less-developed financial systems (Chile I, India, Turkey, Egypt) or under-developed financial systems (Senegal and Ghana) were not as successful in their PE reforms. These countries had lower financial depth, highly regulated banks, less-developed non-banks, and either insignificant or non-existent stock markets prior to their PE reforms. One apparent exception is Chile's successful corporatisation in its first reform period. However, Chile's corporatisation involved greater government control of enterprise managers, investment and financing decisions, and therefore relied much less on the initial state of its financial sector to provide these services to PEs.

The nine country cases are consistent with the hypothesis that an initially well-developed financial system promotes successful PE reforms.

As discussed in the conceptual overview, a well-developed financial system will tend to assist PE reform by allocating funds to more efficient firms, by forcing other firms to restructure or fail, and by redeploying the assets of these bankrupt enterprises efficiently. While an initially well-developed financial system facilitates PE reform, countries with initially less-developed financial systems should not give up undertaking PE reforms. As we discuss below, financial reform is a long term process that can be synchronised with PE reforms to promote success.

**Initial stock market development and public enterprise reform**

In our country cases, the initial state of the stock market played a role in influencing the PE reform strategy and the eventual success or failure of the reform process in at least two ways. First, the existence of a well-developed stock market provides different alternatives for privatisation; and second, a well-functioning stock market can be an important source of financing for privatisation transactions.

*Privatisation strategy*

The extent of the stock market development helps determine available options for privatisation. A well-developed stock market promotes privatisations by enabling public offerings. Using a public offering to obtain widespread public ownership of enterprises requires a sufficiently liquid stock market to be able to absorb the new issues without negatively affecting the market as a whole. In Chile's first reform period, when the stock market was not adequately developed, the government sold controlling stakes of the enterprises in auctions. This concentrated economic power in the hands of a few groups. In the second reform period, however, Chile's stock market was much more developed as a result of the earlier financial liberalisation, the simultaneous strengthening of the regulatory and supervisory framework, and the privatisation of the pension fund system. Thus the government was able to sell small to medium sized packages of shares through the stock market and obtain a broader distribution of ownership.

The existence of a well-developed stock market also makes it easier for governments to privatise, since privatisations that lead to widespread public ownership are often politically more acceptable to the public than sales to a small group of investors – particularly if the investors are foreign. For example, in Turkey block sales of PEs to foreign investors were extremely controversial and led to charges that the government was essentially giving away public assets to foreigners. When the government decided to privatise by public sales through the stock exchange, this change was welcomed by the

Table 11.2 PE reform and the initial state of the financial systems

Country	PE reform period	DEPTH	MCAP/GDP	Share of private non-bank financial institutions	Commercial bank ownership before reform	Bank privatisation
<i>Well-developed financial systems</i>						
OECD	n.a.	72	41	38	Mostly private	n.a.
Korea	I 1981-1983	39	10	30	Mostly public	Banks were privatised 1982-1983, in the first reform period
	II 1983-1985	40	8	32	70% private	
	III 1986-	42	6	33	70% private	
Mexico	I 1983-1987	39	6	15	100% public	Banks were privatised 1991-1992, towards the end of the second reform period
	II 1988-1993	39	6		100% public	Banks were privatised 1975-1977, during Chile I
Chile II	II 1985-1990	38	22	23	Mostly private	The share of public banks fell from 28% to 14% of assets, 1980-1990
Philippines	1986-	34	4	16	Mostly private	
<i>Less-developed financial systems</i>						
Chile I	I 1974-1982	33	5	Some	100% public	Banks were privatised 1975-1977, early in the reform period
Egypt	1980-	57	-	Some	Over 50% public	Just starting. In 1993 one joint venture bank was privatised
Turkey	1980-	32	1	Some	50% public	There are recent plans, but no bank privatisation so far
India	1980-	36	4	None	90% public	No bank privatisation so far
<i>Under-developed financial systems</i>						
Senegal	1978-	24	-	None	Mostly public	In 1989, government ownership of banks was reduced to less than 25 per cent in each bank
Ghana	1987-	16	-	None	Mostly public	There are plans but no bank privatisation so far

Notes: DEPTH is the ratio of  $M_2$  (when not available  $M_3$ ) to GDP obtained from IMF's International Financial Statistics and MCAP/GDP is the ratio of stock market capitalisation to GDP from IFC's Emerging Market Data Base and are averages of five years prior to reform period. Share of non-banks and bank ownership figures are as of beginning of reform period. OECD figures are for 1991

Table 11.3 PE and financial sector reforms

Country	PE reform period	PE reform	Financial reform period	Financial reform
Korea	I 1981-1983	Privatisations. Four state-owned banks and two other PEs were sold through public offerings although government influence remained strong. Programme was reportedly successful in increasing efficiency	1980-	A gradual reform started in 1980. Deposit rates were partially liberalised to establish positive real rates. Preferential lending rates were abolished in 1982. Privatisation of the public city banks started in 1982 and was completed by 1983. Restrictions on non-bank financial institutions were relaxed.
	II 1983-1985	Corporatisation. Financial performance of PEs improved substantially, although started deteriorating later. The programme was very successful in the short run		New domestic entry into the financial system was allowed.
	III 1986-	Privatisations. In 1991, 7 PE subsidiaries and Korea Stock Exchange were privatised. Government is planning to privatise 11 more PEs, while remaining a majority shareholder in 6. It is too early to tell if the programme is successful		A gradual opening up to international competition started. Capital markets were also gradually opened to foreign participation. Lending rates were officially deregulated in 1988. In 1991, government announced a plan to deregulate money market and deposit rates completely by 1997.
Mexico	I 1983-1987	Privatisation/liquidation of small PEs. Corporatisation of large PEs. 743 small PEs were liquidated or sold. Corporatisation had limited success	1988-	Financial sector reform started in 1988 with liberalisation of interest rates. Exchange controls were abolished, forced investment in government securities was eliminated and most of the restrictions on commercial bank activity were lifted during 1989.
	II 1988-1993	Privatisation of large PEs. 192 large PEs were privatised. The privatisation programme is considered to be very successful, both in terms of budgetary impact and increase in efficiency		Regulation and supervision were strengthened during 1989-1990. Bank privatisation started in 1991 and was completed in 1992.
Chile	I 1974-1982	Privatisation of small PEs and corporatisation of remaining ones. Most of the privatised PEs were re-nationalised after the 1982 crisis. Corporatisations were successful in improving the performance of PEs	1974-	Financial liberalisation started in 1974 with interest rate liberalisation. Banks were privatised (1975-1977). Entry restrictions were relaxed, credit ceilings were eliminated, permitted scope of activities were expanded. Pension funds were privatised in 1980.
	II 1985-1990	Privatisations. After re-privatisation of firms which had reverted to government control during the financial crisis, larger PEs were also privatised. This led to a significant reduction in the role of the public sector in the economy. The privatisations are viewed as being very successful		Restrictions on foreign capital inflows were gradually lifted starting in 1977, and capital account was completely liberalised in 1980. Financial crisis came in 1982 and the government had to clean up and bail out the banks. After the crisis, prudential regulation and supervision was strengthened, culminating in the passage of a new banking law in 1986. Financial sector reform focused on strengthening the banking system, reducing taxation and increasing competition. Banks were allowed to expand into new areas of activity and loan and deposit rates were freed. The share of public banks in total banking assets was reduced from 28% in 1980 to 14% in 1990. The reform also started to address institutional features such as the legal framework and bankruptcy laws.
Philippines	1986-	Privatisations. Although privatisations are still continuing, government's privatisation efforts are considered to be successful, both in quantity and impact	1980-	Financial sector reform only started in 1992. Interest rates were liberalised and prudential regulation and supervision were strengthened. Banks were re-capitalised and entry barriers were relaxed. In 1993, one private/public joint-venture bank was privatised.
Egypt	1980-	Reform efforts mostly focused on corporatisation and were unsuccessful. Recently there is revived interest in corporatisation and privatisation	1992-	

Table 11.3 continued

Country	PE reform period	PE reform	Financial reform period	Financial reform
Turkey	1980-	Although there was limited success with corporatisation initially, generally neither the corporatisation or privatisation efforts have been successful. Recently, there are new efforts focusing on privatisation	1980-	Financial sector reform started with interest liberalisation on deposit and loan rates in 1980. Commercial banks were deregulated and foreign bank entry was allowed Financial crisis came in 1982. Interest ceilings were re-imposed and a deposit insurance system was established Later reforms emphasised prudential regulation and improved supervision leading to a new banking law in 1985. Interest rates were partially liberalised in 1988. Recently several state-owned banks were slated for privatisation Financial sector reform started quite late, in 1992. Entry and expansion conditions have been made less restrictive. Interest rates on term loans and most debt instruments were recently decontrolled and increased. Reform efforts to improve prudential and regulatory environment, to recapitalise weak institutions, and to promote greater private sector participation and further financial policy liberalisation are continuing
India	1980-	Corporatisation efforts have not been successful. There have been new corporatisation and privatisation efforts since 1991	1992-	
Senegal	1978-	Corporatisation and privatisation efforts have been unsuccessful so far	1989-	Financial reform programme started in 1989, and included restructuring of public banks, increasing capital requirements, and improving banking supervision. Government ownership in each bank was decreased to less than 25 per cent The financial reform initiated in 1987 included a strengthening of the regulatory framework, liberalisation of government controls, and bank restructuring. Interest rates were liberalised in 1988; 1989 banking law strengthened bank regulation and supervision In 1990, banks were restructured and government announced plans to privatise banks in 1993
Ghana	1987-	Corporatisation and privatisation efforts have been unsuccessful so far	1987-	



public.<sup>6</sup> Another example is Mexico, where block sales of the PEs have also been criticised for favouring a few investors, who have become very rich as a result of the privatisations.<sup>7</sup>

Rising stock markets can also help decrease opposition to privatisation by making employee or management buy outs feasible. A good example is the privatisation of TELMEX, the Mexican phone company, in which the trade union was offered a 4.4 per cent share of the company for \$325 million. Following privatisation, the market value of TELMEX rose to \$30 billion, resulting in an increase of 400 per cent over the employees' purchase price.<sup>8</sup> Such gains make it very difficult for trade unions to oppose privatisation, even if it is likely to result in job losses. Chile also relied on share purchases by employees to some extent in its second period of privatisations, when the Chilean stock market was booming.

Conversely, under-developed stock markets may hamper privatisation. For example, Swanson and Wolde-Samait (1989) assert that one of the reasons for failure of the Ghanaian and the Senegalese privatisation efforts was the lack of a domestic equity market on which public share offerings could be floated. Early privatisation efforts in Turkey were also adversely affected by the relatively under-developed state of its equity market. A government announcement in 1987 that it planned to accelerate its privatisation programme through new issues was one of the important factors that caused a sharp fall in the market and stalled the reform programme. Even when there is a well-developed stock market, success of privatisation strategies depends to a large extent on the general stock market environment. For example, Korea also used its stock market in its privatisation programme, but slowed down its efforts, partly due to a down turn in its stock market since 1989.<sup>9</sup>

#### *Financing of privatisation*

Stock markets can play an important role in financing the privatisations by complementing the banking system's ability to mobilise savings. For example in Ghana, a number of agreed privatisation transactions could not be completed due to the inability of the purchasers to secure financing.<sup>10</sup> The Mexican privatisation programme used a sealed-bid auction process to sell controlling stakes in each company and therefore the stock market was not the direct mechanism of sale. However, the stock market still provided important support as groups involved in the bidding issued equity to finance their bids. Eight financial groups raised a total of over 4 billion pesos in new equity in 1992, including 2.4 billion pesos domestically, to help finance the purchases of the commercial banks. The ability to attract sizable foreign portfolio investment also enhances the viability of privatisation. Indeed, privatisation programmes in both Mexico and Chile II benefited greatly from an inflow of foreign portfolio investment.

#### *Privatisation and stock market development*

Although the existence of a well-developed stock market is important in structuring a successful privatisation, the absence of a highly-developed stock market should not be used as an excuse not to privatise. Privatisation itself can make a major contribution to capital market development. For example, Turkey used bank branches as a substitute for brokerages in the 1988 divestiture of the government's minority stake in Teletas, and in the privatisation of the Bosphorus Bridge and the Keban Dam, which were heavily over-subscribed and sold to a total of 15,000 domestic investors. These banks are now building upon the experience with those sales and attempting to capitalise on the rapid development of capital markets by evolving into universal banks. The Chilean privatisations since 1985 have involved the sale of stock to institutional investors and employees equal in value to nearly 10 per cent of the domestic stock market capitalisation. Again, rather than putting stress on the stock market, the increased capitalisation has strengthened it. In Senegal, the government was even able to sell a small share offering by newspaper.<sup>11</sup>

#### **Initial financial development and corporatisation**

Successful corporatisation in Korea and Chile I involved intensified government monitoring of managers and strict enforcement of budget constraints. The government did not abdicate these responsibilities to the financial system. Nonetheless, successful financial reform in Korea helped corporatisation indirectly. By enhancing resource mobilisation, credit allocation, and corporate governance of private firms, financial reforms in Korea contributed to private sector development and thereby indirectly improved 'corporatised' PEs. Specifically, private sector growth seems to have promoted successful corporatisation by intensifying competitive pressures on PEs and increasing labour demand, which eased political pressures on large PEs that were reducing labour to improve financial performance. Similarly, although not ultimately accompanied by successful financial reform, private sector growth during Chile I heightened competition and helped PE corporatisation.

In contrast, PE reform efforts in Senegal and Ghana were less successful than they otherwise might have been because their corporatisation efforts included greater PE autonomy from the government without a sufficiently well-developed and independent financial system to impose a budget constraint and monitor managers. Thus, banks continued to finance PE losses, perhaps because of implicit government guarantees, and did not provide sufficient incentives for PE managers to improve enterprise efficiency. Thus, corporatisation that relies on greater PE autonomy requires a sufficiently developed and independent financial system to impose budget constraints and

cultivate market-based incentives, while a well-functioning financial system will bolster corporatisation indirectly, involving intensified government overview by promoting private sector development.

## FINANCIAL REFORM AND PUBLIC ENTERPRISE REFORM

This section discusses the linkages between PE reform and financial sector reform.

### Countries that successfully implemented large-scale PE reforms

These countries also implemented successful, large-scale financial sector reforms. The financial reforms involved enhancements to the supervisory, regulatory, and legal infrastructure; interest rate liberalisation, reduced directed credit, and less direct government control of financial intermediaries; and a shrinkage of public banks and an expansion of private financial intermediaries through bank privatisation and strengthening of private financial intermediaries. As discussed above, there were three cases of successful large-scale PE reform: Mexico II (the second part of Mexico's PE reform programme), Chile II, and Korea; each of these countries also executed successful financial reforms.

First, consider Mexico II where between 1989 and 1993 the authorities privatised many large PEs. In 1982 there were 60 private financial institutions, including 35 banks. In response to the economic crisis, the government nationalised all but two of these banks in 1982 and reduced the number of state-owned banks to 18 through mergers and closures. From 1982 to 1988, the government tightly controlled the banking system and used commercial banks to finance the government and PEs. Banks faced high reserve ratios, interest controls, and had to lend most of their funds to PEs and favoured sectors at concessionary interest rates. During this period, the non-bank financial sector – primarily brokerages, which were often managed by previous managers of the commercial banks – operated in a much less repressed environment and became important sources of finance for the private sector. By 1987, non-banks held more than 50 per cent of the financial system's assets, and state-controlled banks held less than half.

Financial liberalisation began late in 1988. The government freed interest rates, eliminated forced investment in government securities, and abolished exchange controls, while also strengthening the regulatory environment by imposing capital regulations. The stock market, which had deteriorated in the 1980s, started improving with the liberalisation. Bank lending to the private sector increased from 25 per cent of total assets in 1986 to almost 60 per cent in 1991.

Liberalisation set the stage for privatisation of the entire commercial banking system in 1991–1992. Unfortunately, bank privatisation was not accompanied by consistent monetary and exchange rate policies, which ignited the crises of 1994–1995. Up until that crisis, many observers considered Mexican bank privatisation a success and a model for other countries.

The private banking system helped to finance industrial growth to 1994, including the re-tooling and re-orientation of former PEs. Mexico's financial system is relatively well-developed, with an active securities market (market capitalisation is around 36 per cent of GDP), a diverse set of non-bank financial intermediaries, and a commercial banking industry with financial DEPTH greater than 33 per cent. Financial reform accompanied and seems to have assisted PE privatisation. Even with the crisis, the case of Mexico II is not inconsistent with the view that large-scale PE privatisation will typically require meaningful financial sector reforms to bolster the provision of critical financial services to the growing private sector.

The results from Chile II also support this conclusion. Chile began its second PE reform episode in 1985. The authorities re-privatised companies that were taken over by the government during the 1982 economic crisis and also sold large PEs that had not been privatised during Chile's first PE reform episode in 1974–1982. During Chile II, the authorities also implemented important financial sector reforms and designed many of these reforms to avoid the circumstances that contributed to the 1982 crisis.

During the first reform period, the government implemented many financial reforms. It abolished interest rate ceilings, eliminated credit allocation controls, reduced banks' reserve requirements, freed capital controls, and allowed new entry. The authorities also privatised state banks during Chile I, but without first establishing a sound regulatory and supervisory system. New bank owners used their privileged access to credit to purchase PEs, thus establishing a small number of huge conglomerates. In the absence of effective regulation, this provided an environment amenable for unsound banking practices and contributed to the economic crisis of 1982 that will be discussed below.

Following the 1982 crisis, Chile re-capitalised and re-privatised the banks. Importantly, during this second reform episode, Chile significantly strengthened the role, staff, and funding of prudential supervision and regulation. In addition to its banking system, Chile also has non-bank financial intermediaries, including large private pension funds. Today, Chile's private financial system is quite well-developed and supports a booming private industrial sector. Financial DEPTH is almost 50 per cent of GDP, and the stock market capitalisation to GDP ratio is over 95 per cent. Thus, Chile II is also consistent with the hypothesis enunciated above: large-scale public enterprise reforms benefit from financial sector reforms which include

liberalisation, strengthening of prudential supervision and regulation, and privatisation.

Korea also combined effective PE reform with significant financial sector reforms during the 1980s, though Korea's PE reforms focused on corporatisation. Korea's corporatisation involved intensified government monitoring of PEs through a rigorous managerial performance evaluation system.<sup>12</sup> These reforms improved PE performance.

Korea also initiated important financial sector reforms during the 1980s. Early in the reform process Korea liberalised interest rates, reduced directed credits, lowered entry barriers, and formalised the curb market into an important and booming private non-bank financial intermediary sector. Korea strengthened supervisory procedures of both banks and non-banks during the 1980s. Banks were also privatised in 1983, but without cleaning their portfolios of bad loans or re-capitalising the banks, so that the privatised banks remained dependent on the government for subsidies. Later bail outs both of non-financial firms and banks decreased the non-performing loans to less than 1 per cent of commercial banks' assets, but the government still retains significant control over bank lending decisions. While bank lending as a share of GDP stagnated in the 1980s, non-bank credit as a share of GDP has boomed from around 10 per cent in 1976 to close to 40 per cent by the end of the 1980s. Thus, as in Mexico II and Chile II, financial liberalisation, a strengthening of supervision and regulation of financial intermediaries, and development of financial intermediaries, focused on providing market-oriented services, also accompanied successful PE reform in Korea. Although the independent relationship between financial reform and corporatisation is difficult to assess, it is important to establish that successful large-scale corporatisation went hand in hand with substantial financial sector reforms.

#### Countries that were less successful in reforming PEs

These countries did not implement successful financial sector reforms (including liberalisation of interest rates and credit decisions, enhanced supervision and regulation, improvements in legal codes and enforcement capabilities, and public bank privatisation) along with or before PE reform. As noted above, Egypt, India, Turkey, Ghana, and Senegal have had, on aggregate, much less successful PE reform than Korea, Mexico II, Chile II, and the Philippines. Importantly, these same countries also did not implement comprehensive financial reform and bank privatisation – on the scale attained by Mexico II, Chile II, and Korea – early in their PE reforms. Recent Turkish financial reforms, however, should facilitate future PE reforms.

The remainder of this section reviews financial reform efforts in Egypt, India, Turkey, Ghana, and Senegal. The Appendix provides more details. Reviewing financial reform helps one understand why PE reform has been

relatively less successful in these countries and what financial reforms need to be stressed in the future.

#### *Egypt and India*

During the 1960s and 1970s, both Egypt and India pursued public sector-led development strategies. Consequently, state-owned banks dominate the financial landscape in both countries. For example, state-owned banks hold over 90 per cent of total banking assets in India and over 50 per cent in Egypt. State banks are used to finance government expenditures and provide subsidised credits to PEs. Furthermore, both countries used pension reserves to finance PEs, public banks and government projects. Prior to the 1980s, there were heavy taxes on banks, stiff barriers to entry, tightly controlled interest rates, and inadequate prudential supervision and regulation. In both Egypt and India, financial reforms started in 1992. Egypt and, to a lesser degree, India have eased interest rate controls, strengthened prudential regulation and supervision, relaxed entry barriers, and capitalised some weak public banks. Reform efforts are continuing in both countries with the goals of reducing domination by state banks and increasing private sector participation. Serious bank privatisation has not yet occurred, although Egypt privatised one public-private joint-venture in 1993. While Egypt and, to a somewhat lesser degree, India are setting the stage for successful PE reform in the future by reforming the financial system, successful large-scale PE reform will probably require a greater willingness to privatise large state banks if they are to break the legacy of state-dominated finance.

#### *Turkey*

Turkey initiated PE and financial sector reform in the 1980s. The main focus of the reform programme was on deregulation to increase competition and efficiency within the financial system. The government removed ceilings on interest rates, relaxed restrictions on domestic and foreign bank entry, and expanded the scope of banking activities. Another element of the government's stabilisation programme was a tight monetary policy, which led to high interest rates. While the liberalisation of interest rates was successful in greatly increasing the mobilisation of savings through banks, high interest rates caused difficulties for corporate borrowers. Firms increasingly borrowed to cover interest payments, and poorly supervised banks funded these firms in a failed attempt to save themselves from bankruptcy. This led to the closure of several banks in 1982. Liberalisation without adequate supervision helped foster financial instability.

The crisis shifted the emphasis of the reform programme from deregulation to building a sound regulatory framework. The government reimposed ceilings on deposit rates, enacted the banking law of 1985, which initiated the

process of improving prudential regulations, and established the Capital Market Board to regulate and develop securities markets. Interest rates were again liberalised in 1988, although some ceilings still remain.

Turkey's financial system has developed significantly in the last decade. Financial DEPTH is around 32 per cent, stock market capitalisation is almost 20 per cent of GDP, and the number of non-banks is growing. However, financial intermediation is still heavily taxed, both directly and indirectly, through high reserve and liquidity ratios, and state banks have not yet been privatised; the banking system remains 50 per cent publicly owned. Recently, the government slated several state banks for privatisation.

#### *Ghana*

In Ghana, PEs play a dominant role in most sectors of the economy, and state-owned banks dominate the financial system. PEs are very heavy users of bank credit, often with government guarantees; and taxes, tariffs, and social security funds all support PEs. Indeed the financial system is best viewed as an extension of the fiscal system, which is used to finance priority PEs. There is little to no systematic monitoring of credit to public enterprises and non-payment by PEs is a huge problem.

Ghana has implemented some financial reforms. In 1987–1988, interest rate controls and sectoral credit target controls (except to agriculture) were eased, and the Bank of Ghana began using indirect monetary control instruments. In 1989–1992, Ghana established the Non-Performing Assets Recovery Trust to re-capitalise seven banks, and efforts were initiated to strengthen accounting, provisioning for bad loans, supervision and legal reforms. Furthermore, Ghana plans to reduce financial intermediary taxes, encourage positive real interest rates, and divest some public sector banks in the future. At present, however, the financial system is still very under-developed with a DEPTH of 19 per cent and stock market capitalisation of around one per cent of GDP.

#### *Senegal*

Senegal's PE sector accounted for almost 30 per cent of total investment, about 17 per cent of total employment, and 7 per cent of GDP in 1988. In addition, the government plays a very heavy role in regulating private sector activities and allocating resources. In 1989 Senegal initiated a banking reform. This included a bank restructuring and closure of some distressed banks, privatisation of some of the restructured banks, a reduction in directed credits, elimination of government guarantees of PE borrowing, and a reduction of government ownership of all banks to less than 25 per cent. Although Senegal still has a very under-developed financial system with a financial DEPTH of 25 per cent and no stock market, the financial sector

reforms are promising steps. As these financial reforms improve financial development, and if Senegal strengthens existing efforts, the ability of the Senegalese financial sector to provide market-oriented finance will grow and foster more aggressive PE reform.

#### **Countries that implemented modest – though successful – public enterprise reform**

Countries which implemented modest PE reform in the presence of an already relatively well-developed financial system did not simultaneously implement large financial sector reforms. The Philippines successfully privatised a limited number of government corporations in the late 1980s. As indicated in Table 11.2, the Philippines already had a relatively deep financial system with a well-functioning capital market, a strong non-bank sector and private commercial banks when it initiated PE reform. Financial reform in the first half of the 1980s helped build a financial system capable of supporting enterprise reform in the second half of the 1980s. Specifically, liberalisation of interest rates in the early 1980s, strengthening of the legal framework, bankruptcy laws, regulations and prudential enforcement capabilities in 1987, and a reduction in the role of public banks from 28 per cent of banking assets to 1.4 per cent of banking assets over the 1980s, helped mould a financial system that was ready to support modest public enterprise privatisation in the late 1980s.

Similarly, Mexico's first PE reform from 1981–1987 was not accompanied by substantial financial reforms. This first reform period focused on privatising and liquidating small enterprises and limiting the losses of large PEs. Although Mexico's banking system was publicly owned, Mexico had a relatively well-functioning capital market and very well-developed non-banks. The experiences of the Philippines and Mexico I are consistent with the view that if the financial system is sufficiently well-developed at the start of the PE reform process, and PE reform is of a modest scale, then substantial financial sector reforms do not have to be implemented to promote successful PE reform.

#### **Effects of unsuccessful financial sector reform on PE reform**

Unsuccessful financial sector reform can hurt large-scale public enterprise reform. Chile implemented large-scale PE and financial reforms during its first reform episode, 1974–1982. Out of the 504 firms controlled by the government in 1973, only 109 remained publicly owned in 1982. In all sectors except mining, the government's share of production fell by about 70 per cent. The government also imposed a rigid budget constraint on PEs: PEs had to self-finance projects; any borrowing from banks had to be cleared with officials under strict guidelines; and no government guarantees were issued.

Thus, the private sector grew substantially, and corporatisation improved PE performance.

Chile's financial liberalisation and bank privatisation, however, facilitated the 1982 crisis.<sup>13</sup> Specifically, banks were privatised before non-financial PEs. Business conglomerates – *grupos* – purchased most of the banks with only a 20 per cent down payment and borrowed the remainder from the government. *Grupos* then used loans from their banks to purchase non-financial firms, where the government required only a down payment of between 10 and 40 per cent. This highly-leveraged concentration of industrial and financial power, together with an ineffective, under-staffed, and under-funded bank supervisory system encouraged insider lending, reduced the effectiveness with which banks evaluated clients, and weakened objective bank monitoring of firm managers. When domestic economic problems, external shocks, and inconsistent foreign exchange rate policies caused some non-financial *grupo* firms to flounder, the *grupos* used their banks – with government insured deposits – to support failing firms in a doomed attempt to avoid realising losses. In the resulting 1982 depression, GDP fell by 14 per cent, unemployment soared past 25 per cent, and the government had to take control of enterprises and banks that accounted for 60 per cent of total bank deposits. While changes in world interest rates and inconsistent exchange rate and wage policies would have combined to affect the Chilean economy negatively, with or without the financial reforms of the late 1970s, the lack of sound prudential supervisory and regulatory capacity created a fragile financial system that exacerbated the economic downturn and mitigated the success of Chile's first PE reform episode. Chile's experience suggests that bank privatisation and liberalisation of interest rates and credit controls are not enough. Sound supervision and regulation must also be in place or the financial system will not be able to support aggressive PE privatisation.

## CONCLUSIONS AND POLICY RECOMMENDATIONS

We find a striking link between financial development and the success of public enterprise reform: countries which initially had relatively well-developed financial systems enjoyed better PE reform than countries with less well-developed financial systems; and countries that synchronised financial reform with PE reform enjoyed greater success than countries that tried large-scale PE reforms without improving their financial systems. Since we only examine nine cases and focus only on the financial system among many other factors – macroeconomic, political, institutional, labour market, and product market factors – that may affect the success of PE reforms, our conclusions are suggestive. Nevertheless, by highlighting the linkages between the financial system and PE reform we seek to emphasise that once all the other conditions for successful PE reform are met, those reforms that also incorporate financial factors will have a greater probability of success.

Based on our analysis, we make the following tentative recommendations for countries contemplating public enterprise reform:

- 1 If a country initially has a very under-developed financial system, PE reformers should consider a strategy that relies less on the financial system for its initial success and start developing the foundations for a well-functioning financial system. Specifically, corporatisation that consists of improved direct government monitoring of enterprise managers, firm investment decisions, and PE financing may contain losses and improve performance without relying excessively on the financial system. At the same time, financial reforms, especially liberalisation and improvements in legal, supervisory, and regulatory systems, should be initiated to establish the financial sector basis for more comprehensive, large-scale PE reform involving expanded enterprise autonomy and privatisation and also for more comprehensive and complementary financial reforms involving state bank privatisation and further liberalisation and financial infrastructure building.
- 2 If a country initially has a relatively well-developed financial system, and the country decides to implement large-scale PE reform, the reform should be synchronised with substantial and well-designed financial sector reforms. Large-scale PE reform involves much greater reliance on the services provided by the financial system. Therefore, a comprehensive PE reform should also involve the reform of public banks that often exist to serve the PE sector. A sound financial reform, which includes bank privatisation, is an important component of any large-scale PE reform and its design is crucial since, just as well-designed financial sector reforms can promote PE reform, poorly designed financial sector reforms can jeopardise the success of the PE reform.
- 3 If a country initially has a relatively well-developed financial system, and the country decides to implement small- to moderate-scale PE reform, then the reforms can succeed without substantial financial sector reforms. However, unless the PE sector is small to start with, small-scale PE reforms, by definition, will still leave much work for future reform efforts.
- 4 If a country initially has a relatively well-developed financial system, the country can also choose between different types of reform in addition to choosing the scale of the PE reform. A well-developed financial system will promote all PE reform strategies either directly (privatisation, private sector development, corporatisation with increased autonomy); or indirectly (corporatisation with greater government control). Since these are all feasible choices for a country with an initially well-developed financial system, the choice may be based on other factors such as political pressures or relative sustainability of different options.

## APPENDIX

### Mexico – Financial sector reforms

1988 1989 1990 1991 1992

#### *Deregulation of the financial sector*

- (a) Ceilings on the issuance of bankers' acceptances were removed. x
- (b) All interest rate controls and lending restrictions were abolished. x
- (c) Most restrictions on commercial bank activity were removed. x

#### *Strengthening of regulatory, supervisory and legal systems*

- (a) Existing laws were amended to strengthen regulation and supervision. x x

#### *Reform of monetary control instruments*

- (a) Reserve requirements were replaced by a 30 per cent liquidity requirement which was later abolished. x

#### *Restructuring or privatisation of financial institutions*

- (a) Commercial banks were privatised. x x

### Turkey – financial sector reforms

1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990

#### *Deregulation of the financial sector*

- (a) Removal of interest rate ceilings on bank deposits and loans. x
- (b) Restrictions on foreign bank entry eased. x
- (c) Banks were allowed to expand into new areas of activity. x
- (d) Ceilings re-imposed on deposit rates. x
- (e) Istanbul Stock Exchange was re-opened. x
- (f) Deposit rates liberalised again (with informal CB intervention). x x

#### *Strengthening of regulatory, supervisory and legal systems*

- (a) Capital Market Board (CMB) was established with the power to develop and regulate the securities markets. x
- (b) Deposit insurance established. x
- (c) New Banking Law was passed. x
- (d) Minimum capital base was established for new banks. x
- (e) BIS capital adequacy requirements were adopted. x
- (f) Limit of 10 per cent imposed on lending to a single customer. x

**Turkey – financial sector reforms cont.**

1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990

(g) Central Bank supervision and accounting standards of the banking system were improved. X

*Reform of monetary control instruments*

(a) Limits on extension of credits from the Central Bank. X

(b) Establishment of a money market and government securities auctions. X

*Restructuring or privatisation of financial institutions*

(a) Failure of a leading money-broker precipitated the financial crisis. X

(b) Several state-owned banks are slated for privatisation. X

**Egypt – financial sector reforms**

1991 1992 1993

*Deregulation of the financial sector*

(a) Capital account opened; interest and exchange rates liberalised. X

(b) Foreign bank branches were authorised to engage in local currency business. X

(c) Bank specific credit ceilings were removed. X

*Strengthening of regulatory, supervisory and legal systems*

(a) Minimum capital requirements are established and capital adequacy standards are adopted. X

(b) Asset classification and provisioning guidelines introduced. X

(c) Foreign currency exposure regulations issued and implemented. X

(d) Loan exposure limits imposed at 25 per cent of capital to single borrowers. X

(e) Limits on equity holdings imposed. X

(f) Deposit Insurance Fund was established. X

(g) Central Bank powers were strengthened through amendments to the banking law. X

(h) Bank supervision and audit practices were improved. X

*Reform of monetary control instruments*

(a) Central Bank staff started training for the implementation of open market operations and indirect methods of monetary control. X

(b) Outstanding ratios for reserve and liquidity requirements decreased. X

*Restructuring or privatisation of financial institutions*

(a) Public banks were re-capitalised. X

**Egypt - financial sector reforms cont.**

1991 1992 1993

- (b) Detailed audits of public and other commercial banks. X
- (c) Restructuring of problem banks started. X
- (d) One joint-venture bank (public-private) was privatised. X

**India - financial sector reforms**

1992 1993

*Deregulation of the financial sector*

- (a) Interest policy somewhat liberalised. X
- (b) Capital markets were deregulated and their taxation was reformed. X
- (c) Entry of private banks was allowed, guidelines for entry were issued. X

*Strengthening of regulatory, supervisory and legal systems*

- (a) Reserve Bank of India (RBI) introduced new guidelines for income recognition, asset classification, and provisioning requirements. X
- (b) BIS capital adequacy requirements are adopted with a phase-in period of three years. X
- (c) Securities exchange board of India started to function as an independent regulatory body. X

- (d) Legal steps are being taken to improve the loan collection mechanisms for banks. X
- (e) To modernise supervisory practices a new supervisory body was established under the aegis of RBI. X

*Reform of monetary control instruments*

- (a) Incremental 10 per cent cash reserve ratio was eliminated and liquidity ratio was reduced. X
- (b) RBI introduced 364 day T-bill auctions. X

*Restructuring or privatisation of financial institutions*

- (a) Banks are allowed to raise private equity from capital markets while majority ownership will remain public. X
- (b) Government is prepared to re-capitalise banks. 1993-1994 budget includes an estimate of necessary funds. X

**The Philippines - financial sector reforms**

1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990

*Deregulation of the financial sector*

- (a) Functional distinctions between different financial institutions were removed. Commercial banks were allowed to operate as universal banks. X





### Korea - financial sector reforms cont.

1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1991

- (i) Most bank lending rates were completely deregulated. x
- (j) Government announced a plan to completely deregulate money market and deposit rates by 1997. x

#### *Strengthening of regulatory, supervisory and legal systems*

- (a) Supervisory procedures reformed and focus strengthened. x x x x x x x x
- (b) Over the counter market established for small and medium firms. x x
- (c) Capital market laws were revised. x

#### *Reform of monetary control instruments*

- (a) Reserve requirements were lowered and unified. x x x x x x x x
- (b) Reliance on directed credit was reduced. x

#### *Restructuring or privatisation of financial institutions*

- (a) Public banks were privatised. x x x x x x x x
- (b) Bank debts were rescheduled. x

### Chile - financial sector reforms

1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984 1985 1986

#### *Deregulation of the financial sector*

- (a) Short term money market rates were freed. x
- (b) Barriers to entry were lowered. x
- (c) Quantitative credit controls were removed. x
- (d) Interest rates were liberalised. x
- (e) Restrictions on scope of activities were eased. x
- (f) Foreign bank entry was allowed. x
- (g) Commercial banks were allowed to borrow abroad. x x x

#### *Strengthening of regulatory, supervisory and legal systems*

- (a) Limits were imposed on bank lending to interrelated entities. x
- (b) Loan classification and provisioning rules were established. x
- (c) Measures to tighten bank supervision were approved. x
- (d) A banking law further strengthened prudential supervision. x

**Chile - financial sector reforms cont.**

1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984 1985 1986

*Reform of monetary control instruments*

- (a) Auctions of central bank credit and t-bills introduced. X
- (b) Reserve requirements were lowered and unified. X

*Restructuring or privatisation of financial institutions*

- (a) Commercial banks were privatised. X X X
- (b) Pension funds were privatised. X
- (c) 1981-1983 financial crisis started with a run on a major bank. Authorities had to intervene and took over eight institutions. X
- (d) Government took over eight more institutions. X
- (e) Banks were re-privatised. X X

**Ghana - financial sector reforms**

1987 1988 1989 1990 1991 1992

*Deregulation of the financial sector*

- (a) Lending rates were partially liberalised. X
- (b) Interest rates were completely liberalised. X
- (c) Government controls over bank fees and charges were eliminated. X

- (d) Sectoral credit allocation targets were phased out. X
- (e) Bank specific credit ceilings were abolished. X
- (f) New entry was allowed. X
- (g) Ghana stock exchange began operating. X

*Strengthening of regulatory, supervisory and legal systems*

- (a) Banking law was amended to establish prudential lending limits and capital adequacy requirements. Uniform accounting and auditing standards were also instituted. X X X

*Reform of monetary control instruments*

- (a) A T-bill auction was introduced. X

*Restructuring or privatisation of financial institutions*

- (a) Government restructured banks. X
- (b) Government announced plans to privatise banks in 1993. X

Senegal – financial sector reforms

1989 1990

*Deregulation of the financial sector*

(a) Directed credits were reduced. X

*Strengthening of regulatory, supervisory and legal systems*

(a) Bank capital requirements were increased and prudential regulations were strengthened. X

(b) Bank supervision was improved. X

*Restructuring or privatisation of financial institutions*

(a) Banks were restructured. Some institutions were closed. X

(b), Government ownership in each bank was reduced to less than 25 per cent. X

PUBLIC ENTERPRISE REFORM

NOTES

- 1 We received very helpful comments from Philip Brock, Gerard Caprio, Ahmed Galal, Michael Gavin, Mark Gersovitz, Niels Hermes, Robert Lensink, Bharat Nauriyal, Steve Saeger, Hemant Shah, Mary Shirley, and Paulo Vieira Da Cunha. The views expressed in this paper are the authors' own and not necessarily those of the World Bank or its member countries.
- 2 Sound capital markets can assist intermediaries in exerting corporate governance. If capital markets competently obtain and process information, equity and bond prices will reflect managerial performance and thereby influence managerial behaviour. Also, if capital markets effectively mobilise capital and identify inferior managers, capital markets offer motivated groups a vehicle for raising capital, acquiring firms, and changing management.
- 3 Levine (1996) provides reasons for government supervision and regulation of financial intermediaries. He cautions that care must be taken since government interventions and regulations themselves frequently thwart the stable provision of high quality financial services.
- 4 Liquid liabilities consist of currency held outside the banking system plus demand and interest bearing liabilities of banks and non-bank financial intermediaries. This equals 'M3'. When it is not available 'M2' is used.
- 5 Demirgüç-Kunt and Levine (1993) discuss a broad range of stock market indicators.
- 6 Although complaints arose as soon as the prices of shares started to fall. See Saeger (1993).
- 7 See *The New York Times*, 27 October 1993.
- 8 See Tandon (1992).
- 9 See Saeger (1993).
- 10 See World Bank (1993).
- 11 See Gavin (1993) for all these examples.
- 12 Korean corporatisation also involved greater autonomy of day to day management decisions while keeping management criteria focused on bottom line issues.
- 13 See Cortes-Douglas (1992), De la Cuadra and Valdes-Prieto (1992), and Edwards and Edwards (1987).

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## FINANCIAL LIBERALISATION AND FINANCIAL FRAGILITY

The experiences of Chile and Indonesia compared

*Hans Visser and Ingmar van Herpt*

### INTRODUCTION

Ever since the early 1970s countries in Asia and Latin America, and to a lesser extent in Africa, have moved from inward-looking policies with heavy government involvement in the economy to more outward-looking policies that primarily rely on the price mechanism rather than on detailed government directives, protection and subsidies. The road to a more or less free market economy has not always been smooth. The most radical attempt at liberalisation, the Chilean experiment in the late 1970s, to all appearances foundered in 1982 and it took the Chileans several years to get their liberalisation process on course again. The Indonesian approach by contrast has been much more cautious and so far major crises have been avoided (though in all fairness it should be noted that Indonesia only seriously started her liberalisation process after the 1982 worldwide debt crisis and in addition had very little dollar-denominated debt).

We will first recount the Chilean experience in financial liberalisation in the 1973-1982 period in order to find out what went wrong and next trace the Indonesian liberalisation process. In the short final section, we will try to see what lessons can be learnt from the Chilean and Indonesian liberalisation efforts. Our aim is to discover where Indonesia avoided the pitfalls which bedevilled the Chilean approach and in what respects, if any, the Indonesian authorities failed to pay heed to the lessons the Chileans learned the hard way. The description of the developments in Chile until 1982, with their extreme reliance on the unfettered functioning of markets, is meant as a kind of benchmark with which to contrast the Indonesian experience.

Our approach thus is a comparative-historical one. The theoretical arguments in favour of a market economy and consequently in favour of liberalisation are taken for granted. The transition from a heavily regulated economy to a more market-oriented economy is fraught with difficulties. Deductive logic does not tell us what transition path is best. In financial