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Financial Sector Reforms in Eight Countries: Issues and Results 1/

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Abstract

This paper examines financial sector reforms in eight developing countries--Argentina, Bulgaria, Ecuador, Egypt, India, Kenya, Tanzania, and Uganda--and derives general lessons from their experience. The paper reviews the initial situation of these countries; describes the financial sector (and related) reforms carried out, including sequencing issues, and points out the unresolved questions; and examines the effects of reforms on monetary control and financial development, investment and growth and the efficiency of financial intermediation. The main recommendations are the need to persevere with macroeconomic stabilization through indirect monetary policy instruments, and the need to substantially strengthen prudential regulation and supervision and restructure and privatize or liquidate ailing financial institutions.

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Table of Contents

Summary

This paper examines financial sector reforms in eight developing countries: Argentina, Bulgaria, Ecuador, Egypt, India, Kenya, Tanzania, and Uganda. In all these countries, financial sector reforms were staged simultaneously with other structural reforms and in the context of Fund-supported adjustment programs designed to accelerate growth with price stability and external viability. The objectives of the financial sector reforms were to improve monetary control, the efficiency of financial intermediation, and the safety and soundness of the financial system. The actual experience differed across the countries because of differences in the weights given to the objectives and differences in the capacity or will to implement the reforms.

All these countries started their financial sector reforms from positions of macroeconomic instability and weak systems of prudential regulation and supervision. The paper finds that the degree of success regarding stabilization varied substantially, with Argentina being the only country that has fully conquered inflation, on the basis of a currency board system of monetary control backed by strong fiscal consolidation. All countries attempted to switch from direct to indirect monetary policy instruments based primarily on open market operations in treasury bills; however, two of the countries were forced to increase reserve requirement ratios for stabilization purposes because the progress made in developing more market-oriented indirect instruments was inadequate.

The results of financial sector reforms were generally favorable for maintaining appropriate real interest rates and achieving financial sector deepening. The rate of economic growth firmed up in all countries, especially Argentina, where reforms were the most advanced. Some progress was made in improving the efficiency of intermediation by reducing operating costs, although in some countries the measured spreads between lending and deposit rates increased after liberalization partly because they had been too tight before.

While there was no overt financial sector crisis in any of the countries, the situation remains fragile in most of them, especially Bulgaria, Tanzania, and Uganda, as a result of insufficient progress made in the capitalization, restructuring, and privatization or liquidation of financial institutions. All countries tried to improve prudential regulation and supervision, but progress in these areas was in all cases slower than expected and weaker than needed to ensure the safety and soundness of the financial system.

The main general recommendations of this paper are that all countries (except Argentina) should persevere with policies to improve the conduct of monetary policy through market-oriented indirect monetary policy instruments, and that all countries should substantially strengthen prudential regulation and supervision and promptly restructure and privatize or liquidate ailing financial institutions.

I. Introduction

This paper examines financial sector reforms in eight developing countries with largely diverse initial economic conditions, level of development, and geographical areas: Argentina, Bulgaria, Ecuador, Egypt, India, Kenya, Tanzania, and Uganda. They have however some common features which make them interesting from the point of view of this paper: their financial sector reforms began in earnest or acquired momentum around 1991, which is considered the starting date of reforms in this paper (these reforms are therefore all recent and in several cases still largely ongoing); all of these countries were initially riddled with substantial structural and macroeconomic policy deficiencies; in all cases financial sector reforms were staged simultaneously with wider reforms designed to improve economic performance, that is, to accelerate growth with price stability and external viability; the common focus of these reforms was a move toward an efficient market economy, one in which the economic role of the public sector is limited to providing support to private sector activity; and finally, these reforms were undertaken under Fund-supported adjustment programs (Table 1), and with significant technical assistance provided by the Fund and other organizations.

Although these countries differed substantially in their initial situation along the spectrum from less to more market oriented economies, 1/ in all of them the objectives of financial sector reforms were wide-ranging and designed to improve performance through more market oriented policies in three broad areas: (i) monetary control; (ii) efficiency of financial intermediation, and (iii) safety and soundness of the financial system. 2/ Possible improvements in monetary control with the ultimate goal of contributing to the reduction of inflation, were primarily related to the intended switch from direct to indirect monetary policy instruments, a switch that was also perceived as necessary to establish a more market oriented financial system; but other policies were also targeted to inflation control, including the tightening in the fiscal stance, the reform of public enterprises, and structural reforms in the exchange and trade systems and even in the labor market. The efficiency of financial intermediation was essentially related to the freedom of the markets to determine interest rates without direct official control, as well as to choose the appropriate financial instruments with which to carry out profitable financial transactions; a principal instrument in this regard was

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1/ These countries comprised, before the reforms, a transition economy (Bulgaria), two state dominated economies (Tanzania, Uganda), three controlled market economies (Egypt, India, Kenya), and two relatively more liberal market economies (Argentina, Ecuador).

2/ Nevertheless, as will be seen the degree of commitment to the reforms varied across countries in a manner that was not necessarily related to their initial positions, but rather more in accordance with the political will to reform.

Table 1: Fund-Supported Adjustment Programs, 1990-To-Date

Country	Program	Dates
Argentina	Stand-by Arrangement	July 1991-June 1992 1/
	Extended Fund Facility Arrangement	March 1992-March 1996 2/
Bulgaria	Stand-by Arrangement	March 1991-March 1992
	Stand-by Arrangement	March 1992-March 1993 3/
	Stand-by Arrangement	April 1994-May 1995 4/
Ecuador	Stand-by Arrangement	September 1989-Feb. 1991
	Stand-by Arrangement	January-December 1992 5/
	Stand-by Arrangement	May 1994-March 1996
Egypt	Stand-by Arrangement	May 1991-Nov. 1992 6/
	Extended Fund Facility Arrangement	July 1993-June 1996 7/
India	Stand-by Arrangement	October 1991-June 1993 8/
Kenya	ESAF Arrangement	May 1989-March 1993 9/
	ESAF Arrangement	Oct. 1993-Sept. 1994 10/
Tanzania	SAF Arrangement	October 1987-October 1990
	ESAF Arrangement	July 1991-July 1994 11/
Uganda	ESAF Arrangement	1989/90-1993/94
	ESAF Arrangement	1994/95-1996/97

Source: International Monetary Fund.

1/ Arrangement introduced in support of the Convertibility Plan launched in March 1991. After completion of the third review, it was replaced by the EFF arrangement.
2/ Extended for a fourth year through March 1996.
3/ The December 1992 review could not be concluded.
4/ This SBA was simultaneous to a first purchase under the System Transformation Facility. The mid-term review of the program could not be completed.
5/ This SBA was derailed from the start.
6/ The second review of this SBA was concluded in March 1993.
7/ The first review scheduled to be concluded by end-February 1994 could not be completed and further discussions with the authorities remained stalled over some policy issues.
8/ At the expiration of the SBA in June 1993, the authorities adopted an informally monitored program for the second half of 1993.
9/ Because of the failure to meet the program objectives for the third year, the initial three-year arrangement was extended through March 1993, but again the objectives were not met.
10/ The mid-term review scheduled for July 1994 was completed in November 1994.
11/ The program was interrupted by serious macroeconomic policy slippages in 1992/93 and the first half of 1993/94. An IMF staff monitored program put into effect in the second half of 1993/94 temporarily redressed these imbalances, but further slippages moved the program off track.

effective deregulation, but promoting efficiency was also related to the need to open up the domestic system to greater competition including that from international banks and capital markets. In the more liberal environment, however, it was considered even more essential to strengthen prudential and supervisory policies to contain excessive risk taking by financial institutions--especially ailing institutions--and other malpractices leading to a loss of safety and soundness.

The two main purposes of this paper are to summarize the process of financial sector (and related) reforms in the sample countries in relation to the above three objectives of financial sector reforms, and to provide an evaluation of the strengths and weaknesses observed to date in the implementation of these reforms, so that valuable lessons can be obtained for the future of these countries and for others that might follow in their path. Given the acceptance of the above objectives of financial sector reforms, one of the aspects to be considered is the speed and sequencing with which reforms are carried out in relation to the initial conditions and to reforms in other areas. 1/ One of the main tenets of the literature in this regard is the importance attributed to two "preconditions" of financial sector reforms: a stable macroeconomic environment and a proper system of bank prudential regulation and supervision. 2/ However, as will be shown later, neither of these two preconditions was met in the sample of countries in this paper. In each case, the authorities' approach was to launch a simultaneous program to establish a degree of macroeconomic stability that was initially lacking, and to take financial sector (and other)

1/ For a general presentation of these issues see Vicente Galbis, "Sequencing of Financial Sector Reforms: A Review", IMF, Working Paper WP/94/101, September 1994. This paper discusses the choice between big-bang and gradual reforms, the relationship of financial sector reforms to other economic reforms, the internal sequencing of financial sector measures and the influence of initial conditions. The paper concludes that a pragmatic approach to the sequencing issue is necessary because there are only a few general principles valid for all countries. For a previous examination of these issues in a different set of countries see Amer Bisat, Barry Johnston, and V. Sundararajan, " Issues in Managing and Sequencing Financial Sector Reforms--Lessons from Experiences in Five Developing Countries", IMF, Working Paper WP/92/82, October 1992. This paper--also within a pragmatic approach--discusses the experience with financial reforms in Argentina, Chile, Indonesia, Korea, and the Philippines during the seventies and eighties.

2/ These preconditions are thought to be necessary because of the perceived risks of undertaking financial sector liberalization without meeting them. First, the transition from direct to indirect monetary policy instruments is a complex process in the course of which the authorities could loose monetary control. Second, the lack of initial prudential regulation and supervision may leave too much room for ailing financial institutions to take excessive risks, creating the possibility of inefficient intermediation and an eventual financial sector crisis.

liberalization measures for efficiency reasons, while simultaneously attempting to improve prudential regulation and supervision. To anticipate the main results, this strategy has worked until the present without producing a crisis in any of the countries, but in some of them this has not come about without creating certain problems that have diminished the efficiency gains expected from liberalization and that have created risks for the safety of the system. Accordingly, the paper concludes that much remains to be done to consolidate financial reforms in most of these countries in a manner that brings about the efficiency gains without the threat of a financial crisis leading to a potential reversal of reforms. In particular, it is concluded that although there are perhaps no "preconditions" to initiate the reforms, there is now indeed an absolute need to make rapid and definitive progress in both macroeconomic stabilization and prudential regulation and supervision if the reforms are going to be sustainable.

The paper begins by reviewing the initial situation of these countries in relation to both the general economy and the financial sector (Section II). Next, the paper discusses the main issues in the financial sector reforms carried out, putting them in the context of the broader economic reforms (Section III). This section also discusses general sequencing issues and unresolved questions. A country-by-country chronology of the main reform measures is presented in the Appendix. The paper then turns to a review of the effects of financial sector reforms (Section IV). The last section summarizes the main findings of the paper and draws some concluding lessons.

II. Initial Situation

The importance of the initial situation in reform processes is well recognized, although not yet well understood, 1/ as is the fact that reforms usually are undertaken more or less simultaneously in different areas as they tend to be driven by similar efficiency considerations, often resulting in significant interactions. After a review of the general initial economic environment in the eight countries, this section presents an overview of their initial financial sector situation. A summary of economic and financial conditions prior to the financial sector reforms undertaken since 1991 is presented in Table 2.

1/ For instance, as indicated in the conclusions, there can be some room for disagreement about the importance of macroeconomic stability and strong banking supervision as "preconditions" to financial sector reform. This is especially the case of gradual reforms, which provide some time to correct deficiencies in these areas.

Table 2. Summary of Pre-Reform Situation

	Argentina	Bulgaria	Ecuador	Egypt
Macroeconomic situation				
Fiscal situation	Hyperinflation	High inflation	High inflation	Moderate inflation
	Difficult but improving	Serious difficulties	Significant difficulties	Significant difficulties
Monetary situation	Disorderly	Non-market system 1/	Complex and inefficient	Complex and inefficient
Exchange rate system	Managed floating	Multiple controlled rates 2/	Crawling peg system	Multiple controlled rates 5/
External debt	Heavily indebted	Heavily indebted 3/	Heavily indebted	Heavily indebted
Structural situation	Controlled market economy	Transition economy	Controlled market economy	Controlled market economy
Price system	Controlled public prices	Comprehensive controls 4/	Controlled public prices	Contrl'd pub & many priv.prices
Regulatory system	Moderately regulated	Central planning system	Moderately regulated	Heavily regulated
Tax system	Complex and inefficient	Undeveloped	Complex and inefficient	Complex and inefficient
Trade system	Fairly liberal	State trading	Fairly liberal	Restrictive system
Exchange controls				
• current account	Largely liberal system	Controlled system	Largely liberal system	Some remaining controls
• capital account	Ineffective controls	Controlled system	Ineffective controls	Controlled system
Financial sector				
• interest rate controls	Non-existent	Comprehensive	Some remaining controls	Comprehensive
• public ownership	Significant	Total	Significant	Widespread
• central bank independence	Limited	None	Limited	Very limited
• central bank losses	Very large	(Not estimated)	Large	(Not estimated)
• indirect instruments	Functional	Not developed	Not developed	Not developed
• money market	Partially developed	Non-existent	Not developed	Not developed
• prudential regulation	Inefficient	Undeveloped	Inefficient	Undeveloped
• bank supervision	Poor	Undeveloped	Poor	Poor

1/ With monetary overhang.
2/ Replaced in February 1991 by a unified exchange rate based on a free interbank foreign exchange market.
3/ External debt moratorium effected in 1990.
4/ Virtually the entire economy was owned by the public sector and all prices were under central planning control.
5/ Replaced in February 1991 by a dual exchange system consisting of a primary market and a free market. Exchange market unification achieved in November 1991.

Table 2 (concluded). Summary of Pre-Reform Situation

	India	Kenya	Tanzania	Uganda
Macroeconomic situation	Moderate inflation	Moderate inflation	Moderate inflation	Moderate inflation
Fiscal situation	Significant difficulties	Significant difficulties	Significant difficulties	Significant difficulties
Monetary situation	Complex and inefficient	Under progressive reform	Complex and inefficient	Disorderly situation
Exchange rate system	Adjustable peg	Dual exchange rate system 1/	Multiple controlled rates	Dual exchange rate system
External debt	Moderate indebtedness	Heavily indebted	Heavily indebted	Heavily indebted
Structural situation	Controlled market economy	Controlled market economy	State dirigist economy	State dirigit economy
Price system	Control'd pub & many priv prices	Control'd pub & many priv prices	Control'd pub & many priv prices	Contrl'd pub & many priv prices
Regulatory system	Heavily regulated	Under progressive deregulation	Under progressive deregulation	Under progressive deregulation
Tax system	Complex and inefficient	Complex and inefficient	Complex and inefficient	Complex and inefficient
Trade system	Restrictive system	Increasingly open	Increasingly open	Increasingly open
Exchange controls				
• current account	Some remaining controls	Some remaining controls	Some remaining controls	Some remaining controls
• capital account	Controlled system	Controlled system	Controlled system	Controlled system
Financial sector				
• interest rate controls	Comprehensive	Comprehensive	Comprehensive	Comprehensive
• public ownership	Near total	Widespread	Near total	Near total
• central bank independence	Very limited	Limited	Very limited	Very limited
• central bank losses	(Not estimated)	(Not estimated)	(Not estimated)	Very large
• indirect instruments	Not developed	Being developed	Not developed	Not developed
• money market	Being developed	Being developed	Not developed	Not developed
• prudential regulation	Inefficient	Under reform	Inefficient	Inefficient
• bank supervision	Poor	Under reform	Poor	Poor

1/ An official (public sector) exchange rate pegged to a basket of currencies and a parallel market rate in the private sector coexisted until unification in October 1993.

1. General economic environment

The general macroeconomic situation in these countries prior to 1991 was one of instability, ranging from hyperinflation in Argentina, to high inflation in Bulgaria and Ecuador, to less severe inflation (below 30 percent) in the rest of the countries. In all cases, the fiscal position was difficult and was a basic reason for the inadequate inflation performance. The general monetary situation was also difficult: Argentina was at a moment of grave monetary disorder reflected in hyperinflation; Bulgaria was barely in the initial stages of creating a modern monetary system in the context of its transition to a market economy, and had a large monetary overhang resulting from the central planning period; the rest of the countries started from a rather complex and inefficient system, although some like Kenya had already gone through some years of an attempted reform. The exchange rate system was of a managed floating rate variety in Argentina, a crawling or adjustable peg in Ecuador and India, and a dual or multiple controlled rates in the remaining countries. All countries, but to a lesser extent India, had a heavy burden of external debt.

The structural situation was also difficult in all these countries but to a different degree. While Bulgaria was a typical transition economy in the early stages of comprehensive reform toward a market economy, and while Tanzania and Uganda were at the early stages of exiting from a state dominated economy, the other countries were typical examples of a controlled market economy, that is, a market economy marred by comprehensive government intervention in the markets as well as by large and inefficient public sectors. A comprehensive price control system existed only in Bulgaria, but extensive controls were also applied in the remaining countries: in Argentina and Ecuador mainly on the prices of public sector enterprises, but in the rest also on many private sector prices. The general regulatory system was one of a comprehensive central planning in Bulgaria, and of a heavily regulated environment in all the rest except for Argentina and Ecuador which were somewhat more liberal; in Kenya, Tanzania and Uganda a movement out of excessive regulation was already underway. The tax system was complex and inefficient in all countries, and in Bulgaria it had yet to be developed. The trade system was fairly liberal in Argentina and Ecuador, where it was accompanied by a virtual absence of exchange controls on current account transactions; but, on the other extreme, Bulgaria still maintained a state trading system, and the remaining countries maintained extensive intervention, although Kenya, Tanzania, and Uganda were already undergoing substantial liberalization. Exchange controls on current account transactions were pervasive only in Bulgaria, whereas other countries had a fairly liberal system, especially Argentina and Ecuador. In all countries there were fairly comprehensive controls on capital account transactions, although in some of them (especially in Argentina and Ecuador) they probably were no longer effective.

2. Financial sector situation

The initial situation of the financial sectors of the eight countries differed in many ways but all of them had one or more deficiencies that needed reform. A significant initial difference was the absence of direct interest rate controls in Argentina, whereas comprehensive controls were maintained in the remaining countries, except for Ecuador which had already undertaken some liberalization.

The situation of the countries also varied considerably regarding the initial degree of financial deepening (as represented by a broad measure of banking system liabilities in relation to GDP). 1/ The situation was best, although by no means perfect, in countries like Ecuador, Egypt, and India, which had maintained approximate overall long-term macroeconomic stability, whereas it was worse in other countries--especially Argentina, where recurrent hyperinflation had been a problem--which had seen the size of their respective financial sectors reduced to a small fraction of GDP as a result of persistent financial repression. Another basic difference was in the degree of public ownership of banks, which in terms of market shares varied from being total in Bulgaria, to near total in India and Tanzania, to significant in the remaining countries. Partly in relation to the level of development, the structure of the financial sectors was also rather different across countries, with extensive networks in Argentina and India, somewhat less extensive ones in Ecuador, Egypt, and Kenya, and least developed networks in the remaining countries (Table 3). 2/ Several countries (Bulgaria, Kenya, Tanzania, and Uganda) started from a situation of serious difficulties in relation to the financial health of the banks, their liquidity and solvency position, and the quality of their portfolios; only Ecuador's financial system appeared to be largely free of these problems.

The initial degree of central bank independence with regard to the conduct of monetary policy ranged from limited in Argentina, Ecuador and Kenya, to very limited in the remaining countries, with no scope for independent action in Bulgaria. The quasi-fiscal losses of most central banks were significant, and in Argentina and Uganda they had led to

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1/ Although some basic data are available for all countries (see Tables 6 through 13 in Section IV), a fine comparison is not possible because of differences of coverage, especially with regard to nonbank financial intermediaries.

2/ The institutional structure of the financial sectors did not change significantly during the period of examination, except that some failed banks and other financial institutions were closed in some countries (e.g., Argentina and Kenya) and some banks (including foreign ones) were opened in some other countries (e.g., Bulgaria, Egypt, and India).

Table 3. Structure of the Financial Sector

Argentina	As of end-1993, the financial system consisted of 206 institutions, including banks, credit unions, finance companies, and savings and loan associations.
Bulgaria	As of March 1991, the banking system comprised the BNB, the Bulgarian Foreign Trade Bank, the State Savings Bank, 8 specialized commercial banks, and 61 commercial banks. 1/
Ecuador	As of late 1992, the financial system comprised the CBE, 32 commercial banks, 3 specialized state-owned banks, and many small intermediaries including finance companies and savings and loan associations. 2/
Egypt	As of end-August 1989 the financial system comprised the CBE, 27 commercial banks, 3/ 33 business and investment banks, and 4 specialized banks.
India	As of March 1993, the financial system comprised the RBI, 81 commercial banks (27 state owned, 27 private domestic, and 27 foreign owned), 196 regional rural banks, 180 center and cooperative banks, 3 state term-lending institutions, 18 state finance corporations, and many specialized institutions and non-bank finance companies. 4/
Kenya	As of March 1992, the financial sector comprised the NBK, 28 commercial banks, 5/ and 55 NBFIs.
Tanzania	As of early 1995, the financial system comprised the BOT, The National Bank of Commerce (a state bank which dominates the financial sector), 2 other state banks, 5 private banks and 2 development banking institutions.
Uganda	As of early 1995, the financial system comprised the BOU, 15 commercial banks, 10 credit institutions, 19 insurance companies, 2 development banks, and 1 building society. Uganda's banking system is dominated by one government-owned bank--the Uganda Commercial Bank (40 percent of deposits of the system)--and 5 foreign-owned banks (39 percent of deposits).

Sources: Authorities' reports and Fund staff estimates.

Note: It has not been possible to compile a table referring to the same date for all countries (ideally both the start of reforms and the present situation). However, the institutional structure of the financial sectors did not change significantly during the period of examination, except that some failed banks and other financial institutions were closed in some countries (e.g., Argentina and Kenya) and some banks (including foreign ones) were open in some other countries (e.g., Bulgaria, Egypt, and India).

1/ All except two of these banks had been created as a result of the 1989 banking reform which terminated the monobank system from early 1990 (the other two were newly established private banks). By early 1995 there were already 15 private banks, some of which were however "pocket" banks established to lend to the owner of the bank.

2/ The banking system accounted for about 90 percent of financial system liabilities to the private sector.

3/ This total counts the National Bank for Development and its 17 provincial affiliates (independently licensed) as one bank. The four fully government-owned commercial banks held both majority and minority shareholdings in a number of other commercial banks. At end-June 1989, the commercial banks held 86 percent of total private sector deposits.

4/ The 27 state commercial banks dominate the financial sector, with close to 90 percent of assets, and 92 percent of bank branches.

5/ These included the large state-owned National Bank of Kenya.

substantial total central bank losses that loomed large in the fiscal picture. 1/

Indirect monetary policy instruments were in use only in Argentina, although in Kenya preparations for their use had already been going on for a while. Money markets that could support indirect monetary policy instruments were moderately developed only in Argentina and embryonic in Kenya and India, whereas they were non-existent (Bulgaria) or undeveloped in the remaining countries. Treasury bills were issued in Argentina, Ecuador, Egypt, and India, but secondary markets did not practically exist. In Kenya, treasury bill auctions had just been liberated (late 1990) from all intervention. In Bulgaria, Tanzania, and Uganda, treasury bill auctions had not yet been introduced.

The prudential regulation and supervision systems were undeveloped or inefficient in all countries, although some efforts to improve these systems had already been underway for a while in some countries, like Kenya.

In sum, significant problems affected all countries. Argentina was most in need of macroeconomic stabilization, but this had to be built on a solid foundation of deep structural reforms. Bulgaria, Tanzania, and Uganda, were most in need of structural reforms, so that they could return their economies to a market model, without losing perspective of the continuous need for macroeconomic stabilization. The remaining countries needed a combination of measures to enhance both stabilization and structural reforms. All the countries were in need of better prudential regulation and supervision.

III. Reform Issues

The reforms undertaken by the eight countries followed somewhat different patterns partly owing to the differences in the initial situation but also as a result of different degrees of commitment on the part of the authorities with regard to both financial sector reforms and reforms in closely related areas. A summary of the main reforms in the financial sector and of other economic reforms is presented in Table 4.

1. Financial sector reforms

The following discussion presents financial sector reforms in four broad categories, beginning with a general overview of interest rate liberalization and its relationship to external capital account liberalization. The second category discusses the development of indirect

1/ Faced with this phenomenon, the Fund and other institutions developed the concept of the overall public sector deficit comprising the deficit of the nonfinancial public sector and that of the central bank.

Table 4. Summary of Financial Sector Policies and Accompanying Reforms

	Argentina	Bulgaria	Ecuador	Egypt
Financial sector reforms				
Interest rate liberalization	Maintenance of free rates	Freed in February 1991	Freed in September 1992	Freed in January 1991 3/
Capital account liberalization	Total immediate liberalization	Substantial liberalization	Substantial liberalization	Substantial liberalization 4/
Indirect mon. pol. instruments	Progressive refinement 1/	Recently introduced	Rapid introduction (late 1992)	Rapid introduction
Money market development	Further development	In progress	Rapid development	Rapid introduc.; slow progress
Reserve requirements	Gradual reduction	New system made operative	Gradual reduction	One-off reduction
Central bank independence	From September 1992	From June 1991	Proposed reform	Not yet contemplated
Central bank losses	Rapidly eliminated	(Not estimated)	Eventually eliminated	(Not estimated)
Prudential regulation	Tightened standards	Established BNB authority 3/92	Progressive improvement	Progressive improvement
Bank supervision	Progressive improvement	Established BNB authority 3/92	Progressive improvement	Progressive improvement
Opening new facilities	Allowed from early 1994	Bank entry encouraged	No explicit policy	Moderately encouraged
Restructuring	Substantial progress	Initiated in 1992 but slow	Modest restructuring	Modest restructuring
Privatization	Considered for provincial banks	Ultimate goal	No explicit policy	Slow privatization 5/
Other financial sector reforms	Currency board system from 4/91	Stock exchanges opened in early 1992	New securities markets law (5/93); privatized exchanges	New securities markets law and regulations (4/93)
Other economic reforms				
Fiscal reform	Substantial reform	Limited effectiveness	Progressive improvement	Progressive improvement
Privatization of state enterprises	Substantial progress	Slow process	Limited progress	Not pursued effectively
Price liberalization	Maintenance of market system	Prices freed in early 1991	Maintenance of market system	Progressive liberalization
Trade reform	Significant reform	Significant reform	Significant reform	Slow reform
Exchange rate regime	Fixed rate	Flexible rate	Flexible rate	Flexible rate
External debt	DDSR operation completed (4/93)	Paris Club and bank debt under negotiation	Paris Club and bank debt agreements completed 2/	Paris Club agreement pending last phase implementation

1/ But of limited use under the new currency board system.
2/ Paris Club rescheduling agreement reached in July 1994. DDSR operation with foreign banks completed in April 1995.
3/ With few exceptions, such as the prohibition to pay interest on demand deposits. Remaining controls removed in May 1993.
4/ But with a recent tendency of the Central Bank not to provide foreign exchange for capital account transactions.
5/ Partial sales of stock of joint-venture banks.

Table 4 (concluded). Summary of Financial Sector Policies and Accompanying Reforms

	India	Kenya	Tanzania	Uganda
Financial sector reforms				
Interest rate liberalization	Progressive liberalization 1/	Freed in July 1991	Progressive liberalization 6/	Progressive liberalization 8/
Capital account liberalization	Progressive liberalization	Progressive liberalization	Progressive liberalization	Progressive liberalization
Indirect mon. pol. instruments	Progressive introduction	Progressive introduction	Progressive introduction	Progressive introduction
Money market development	Progressive development	Progressive development	Progressive development	Progressive development
Reserve requirements	Some reduction	Increased for m. p. purposes	Increased for m.p. purposes	Reduced in early 1993
Central bank independence	Not yet contemplated	Proposed reform	From 1995	From May 1993
Central bank losses	(Not estimated)	(Not estimated)	(Not estimated)	Progressively reduced 9/
Prudential regulation	Progressive improvement	Progressive improvement	Progressive improvement	Progressive improvement
Bank supervision	Progressive improvement	Progressive improvement 3/	Progressive improvement	Progressive improvement
Opening new facilities	Liberalized private bank entry	No explicit policy	Moderately encouraged	Moderately encouraged
Restructuring	Progressive restructuring	Progressive restructuring	Progressive restructuring	Progressive restructuring
Privatization	Limited sale of shares	No explicit policy	Ultimate goal	Ultimate goal
Other financial sector reforms	Development of securities markets and stock exchange	Expansion of the stock exchange	(No stock exchange exists)	A stock exchange is under preparation
Other economic reforms				
Fiscal reform	Limited effectiveness	Progressive improvement	Progressive improvement	Progressive improvement
Privatization of state enterprises	Not pursued effectively	Not pursued	Progressive privatization	Progressive privatization
Price liberalization	Progressive liberalization	Progressive liberalization	Progressive liberalization	Progressive liberalization
Trade reform	Limited liberalization	Progressive liberalization	Progressive liberalization	Progressive liberalization
Exchange rate regime	Managed float 2/	Flexible rate 4/	Progress. flexible & integrated	Progress.flexible & integrated
External debt	Maintenance of moderate debt	Progressive debt reduction 5/	Progressive debt reduction 7/	Paris Club rescheduling 10/

1/ An early measure replaced all bank ceilings on deposit rates by a single deposit rate ceiling of 13 percent. Subsequently, the issuing of CDs with free rates was deregulated. However, the Reserve Bank of India still administers the maximum rate that banks can pay on term deposits.

2/ Following two step devaluations within the adjustable peg, a dual market was established in May 1992 with a market-determined rate for most current and capital account transactions. In March 1993 the system was unified under a flexible rate.

3/ Substantial slippages occurred in 1992-93.

4/ The private market and public sector (official) exchange rates were unified in October 1993.

5/ Kenya obtained a nonconcessionary debt rescheduling from Paris Club creditors in early 1994.

6/ A single maximum rate of 31 percent replaced all previous interest rate controls in July 1991. This ceiling was removed in July 1993.

7/ Tanzania's external debt to Paris Club creditors went through four reschedulings, the last one on "London terms" effected in 1992.

8/ Completed in July 1994.

9/ A plan for the recapitalization of the BOU through a Government bond is under consideration.

10/ Uganda became the first country to receive a stock-of-debt operation on "Naples terms" from Paris Club creditors in early 1995.

monetary policy instruments, with particular attention to open market operations and the development of supporting money markets, especially the market for treasury bills; reserve requirement policies are also discussed. The third category comprises reforms of the central bank as the apex institution of the system and it discusses the issues of central bank independence, restructuring of the central bank, and reduction or elimination of quasi-fiscal operations of central banks that cause operating losses. Finally, the fourth category discusses reforms of prudential regulation and supervision and the structure of the financial sector including the entry of new financial institutions, the restructuring, privatization, and liquidation of financial institutions, and the development of securities markets and stock exchanges. (For a brief chronological summary of the major financial sector reforms in the eight countries, see the Appendix.)

Interest rate liberalization is often considered the fulcrum of financial sector liberalization, as no market can function as such without a free price. Argentina was the only country in this study where interest rates were already market determined before the recent reforms of the financial sector were initiated. 1/ In Bulgaria, Egypt, and Kenya, the liberalization of interest rates was undertaken in 1991--right at the start of the main reforms--and in Ecuador in 1992; whereas India, Tanzania, and Uganda, carried out a more phased liberalization.

Full capital account liberalization was introduced early in 1991 in Argentina by the so-called Convertibility Law, which also involved the introduction of a currency board system with an exchange rate pegged to the U.S. dollar. This pegged system, supported by a 100 percent foreign exchange cover of domestic central bank liabilities, 2/ was (together with fiscal consolidation) the main pillar of the disinflation strategy. Capital account liberalization gained increasing significance in the remaining countries as a complement to the liberalization of the domestic financial sector. A near complete removal of capital controls was effected early in the reform process in Bulgaria and Egypt. The other countries adopted a more gradual approach.

1/ As is well known, Argentina had already undergone in the past several experiences with financial liberalization, the best known being that of the late 1970s, which unfortunately ended with the reintroduction of many controls following a severe financial crisis. See Tomás J.T. Baliño, "The Argentine Financial Crisis of 1980," in: Banking Crises: Cases and Issues, edited by V. Sundararajan and Tomás J.T. Baliño (IMF, Washington, D.C., 1991).

2/ The foreign exchange cover was made equal to 100 percent of domestic currency liabilities, but up to 20 percent of the cover could be held in the form of foreign currency denominated assets constituting credit to the government or some domestic financial institution.

At the beginning of the recent reforms, indirect monetary policy instruments were used only in Argentina. The introduction of the currency board system meant, however, that Argentina gave up monetary policy independence from the rest of the world and that, therefore, monetary instruments were not to be used except to smooth out short-term liquidity fluctuations. A possible remaining monetary policy instrument was the use of reserve requirement ratios. The authorities, however, decided against the use of this instrument except in exceptional circumstances, and instead focused on a phased reduction of all reserve requirements and their uniform application across instruments and financial institutions to avoid distortions in the financial system.

In Ecuador and Egypt, the introduction of indirect monetary policy instruments was effected rapidly after the liberalization of interest rates. This necessitated the further development of the incipient money markets and, in particular, of the market for short-term government securities (treasury bills) which could be used in open-market operations by the central bank. 1/ In Egypt the authorities introduced weekly treasury bill auctions from the beginning of the liberalization (January 1991), and shortly thereafter began to use treasury bills for monetary purposes. In Ecuador, the Central Bank began to operate in treasury bills for monetary control in late 1992 after setting a coordinated system of money and foreign exchange desks. In the remaining countries the introduction of indirect monetary policy instruments was staged more gradually, although for two different reasons. In India and Kenya gradualism was largely voluntary as the authorities proceeded to introduce indirect instruments only slowly despite the fact that they had already accumulated some experience operating in the money markets. By contrast, in the other countries the authorities had little choice but to proceed slowly; not only they had to start treasury bill auctions from scratch--Bulgaria (July 1991), Tanzania (August 1993), and Uganda (May 1992)--but they also had to establish from scratch a framework for the conduct of monetary policy in a market-oriented environment.

With a view to eliminating their implicit tax on financial intermediation and reducing distortions, reserve requirements were more or less rapidly reduced and harmonized in five of the eight countries (Argentina, Ecuador, Egypt, India, and Uganda); in some cases (Argentina and Ecuador) they were reduced from very high initial levels. By contrast, in Kenya and Tanzania, reserve requirements, while uniform, tended to be increased in order to restrain monetary expansion. This was the unfortunate result of inadequate progress in introducing other, more market-oriented monetary policy instruments and the accompanying development of money

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1/ For an overview of the importance of the development of money and financial markets, in relation to the adoption of indirect monetary policy instruments, see William E. Alexander, et al, The Adoption of Indirect Instruments of Monetary Policy, Occasional Paper 126 (IMF, Washington D.C., June 1995).

markets. In Bulgaria, a system of moderate reserve requirements came into operation with the breakup of the monobank and the creation of a decentralized banking system.

Central bank independence was introduced relatively early in Argentina (1992), Bulgaria (1991), and Uganda (1993) and more recently in Tanzania (1995). 1/ In Argentina, this came about through a new central bank charter, which complemented the earlier Convertibility Law. 2/ In Ecuador and Kenya, central bank independence was considered relatively early but legislative amendments to this effect are still pending from approval by their respective legislatures. No action has yet been considered in Egypt and India.

In most countries (Argentina, Bulgaria, Ecuador, Tanzania, and Uganda) the central banks themselves were the focus of substantial structural reforms. In Argentina, the Central Bank was subject to substantial downsizing and reorganization to conform with its new mandate under the Convertibility Law. In Bulgaria, restructuring was undertaken following the enactment of the new central bank law which provided the National Bank of Bulgaria with the powers of a central bank. In Ecuador, the new Monetary and State Bank law of May 1992 removed the development banking functions from the Central Bank and attributed them to the newly created State Bank. In both Tanzania and Uganda, the central banks underwent a process of reorganization and downsizing designed to strengthen performance and reduce operational costs.

Central bank losses were characteristic of most of these countries before the recent financial reforms, being especially large in Argentina and Uganda. Following best accepted practices suggested by the Fund, these losses when quantified were in most countries added to the deficit of the nonfinancial public sector to obtain a more complete picture of the overall public sector performance, as they in fact stemmed from quasi-fiscal operations of the central bank (one of the likely results of lack of central bank independence). Argentina very quickly and Ecuador more gradually eliminated these losses by discontinuing the operations giving rise to them or by transferring them to the government. In Uganda, a plan for the

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1/ However, a distinction can be made between central bank independence as acquired through the legal process (lack of dependence from the Government) and de facto independence, an achievement that in some countries can take longer as it can be gained only through the increased credibility of the central bank, which in turn may be affected by other policies, especially fiscal policies. Even in the strongest case represented by Argentina, it took time for the Central Bank to assert itself in the new policy environment.

2/ At the very beginning of the Convertibility Plan, the authorities responded to a run on the national currency with a severe and unexpected increase in reserve requirements, which dealt speculators sharp losses thereby helping establish the credibility of the new monetary regime.

recapitalization of the central bank through a Government bond is under consideration.

Reforms of the prudential regulation and supervision systems were undertaken in all countries to some extent, with a particular focus on appropriate bank capitalization, limits on loan concentration and insider transactions, and norms for loan losses, income recognition and provisioning against nonperforming loans. However, progress in these areas was generally slower than anticipated, and much remains to be done. In Bulgaria, the authority of the central bank to dictate prudential regulations and supervise the financial sector was not established until March 1992. Progress in bank supervision was especially slow, and none of the countries--except, beginning recently, Argentina--yet carries out comprehensive on-site inspections of financial institutions based on an effective off-site surveillance system (See Table 5).

The opening of new financial institutions and branches of existing institutions was given new impetus in some countries with a view to increasing competition. Private bank entry was deliberately encouraged in Bulgaria, Egypt, Tanzania, and Uganda. India further liberalized the entry of private banks to compete with the long-established public banks, although the latter still continue to dominate the financial system. In Argentina, regulations from early 1994 allowed the establishment of new banking facilities for the first time in many years. Ecuador and Kenya, countries with extensive private banking systems, had no explicit policy, but new entry was not discouraged. In all countries, the new tendency was to accept the entry of foreign banks to compete with the domestic banks. This policy was also related to the liberalization of capital movements across borders.

Restructuring of commercial and development banks and other financial institutions was undertaken in all the countries, and substantial progress was achieved in some of them. In Argentina, Tanzania, and Uganda, state-owned banks were forced to become more efficient by shedding excess labor, rationalizing operating costs, and closing loss-making branches, although in some cases the objectives of cost rationalization were not fully achieved. By contrast, only modest progress in restructuring of banks was made in Bulgaria, where the main issue was the appropriate consolidation of the numerous small and weak banks resulting from the breakup of the monobank system in 1990. 1/ Measures for the recapitalization of banks, strengthening their liquidity base, and other measures to ensure the solvency and liquidity of the financial sectors, were adopted in most countries, especially in Argentina and Egypt. In 1993 Kenya proceeded to close a number of banks and NBFIs that were insolvent and had engaged in irregular transactions with the Central Bank.

1/ The first consolidated bank, resulting from the merger of 22 smaller banks, became fully operational on January 1, 1993.

Table 5. Current Bank Supervision Systems

	Supervisory Authorities	Off-site Monitoring Capability	On-site Bank Inspection
Argentina	Central Bank of the Republic of Argentina: • Superintendency of Financial Institutions 1/	Reporting system for banks and NBFIs is used to analyze both solvency and compliance with prudential regulations.	Plan of regular inspections or audits put into effect and regular inspections of financial institutions commenced.
Bulgaria	Bulgaria National Bank	Limited capability; there is a plan to establish an early warning system.	Limited on-site inspections carried out since 1993.
Ecuador	Superintendency of Banks (separate from the Central Bank 2/	Reporting system for banks and NBFIs seems operative. 3/	Bank audits required, but only partial on-site inspections carried out.
Egypt	Central Bank of Egypt	Reporting system for banks and NBFIs needs upgrading.	Limited audits and off-site inspections being carried out.
India	Reserve Bank of India: • Department of Supervision • Department of Banking Operations and Development	Automated system to be developed in three-years time for banks, NBFIs, and AIFIs.	Carried out by 700 inspectors, but without benefit of good off-site monitoring capability.
Kenya	Central Bank of Kenya • Bank Supervision Department	Reporting system for banks and NBFIs needs upgrading for financial analysis purposes.	Limited on-site inspections being carried out.
Tanzania	Bank of Tanzania • Directorate of Bank Supervision	New bank reporting forms for both supervisory and analytical purposes have been implemented.	Limited on-site inspections being carried out.
Uganda	Bank of Uganda • Bank Supervision Department	New surveillance system to be applied to all banks and NBFIs.	limited on-site inspections being carried out.

1/ Semi-autonomous part of the Central Bank.
2/ In February 1995, a Banking Board with representatives from the Central Bank and the Superintendency of Banks with responsibility for strengthening the banks' regulatory framework and reinforcing the reforms of the Superintendency of Banks was established.
3/ However, the reporting system currently excludes offshore banking activities and reporting still suffers from considerable time lags.

Bank privatization was a goal in virtually all countries, although to a different degree. In Argentina, Ecuador and Kenya, where the banking system was already largely private, the restructuring of public sector banks was accompanied by some privatization. In Argentina, consideration also has been given recently to the possibility of privatizing most provincial banks, which are a major source of inefficiency in the system. In Bulgaria, Tanzania, and Uganda, bank privatization of their largely state-owned banking systems has been an ultimate goal since the beginning of financial reforms, but little has yet been accomplished, because of delays in restructuring of banks in anticipation of sale. In Egypt, the privatization of banks was conceived as a medium-term process, 1/ but progress has in practice been slow. In India, besides the licensing of private banks, the privatization policy also involved the sale of minority shares in public banks to the private sector, a goal falling short of outright privatization.

The development of the securities markets was considered necessary in all countries, as was the need for stronger prudential regulation and supervision in this area. 2/ Promotion of stock exchanges was considered necessary in all countries except Tanzania where it was considered premature. In Bulgaria, stock exchanges were opened in 1992 as part of the process of institutionalization of a market economy, and in anticipation of privatization of public enterprises and banks. In Uganda the establishment of a stock exchange is under consideration. In Ecuador and Egypt new modern security laws were enacted, and in Ecuador the stock exchanges were privatized. Further development of existing securities markets and stock exchanges was promoted in Argentina, India, and Kenya.

2. Other economic reforms

Macroeconomic stabilization through fiscal and other reforms was one of the policy goals in all countries. Fiscal reform was closely associated with the improvement in the public finances and was attempted in all countries with various degrees of effort and success. Substantial fiscal reform was accomplished in Argentina, involving the rationalization of expenditures (through staff attrition, salary correction, and general expenditure control), a substantial improvement in the tax system, and substantial privatization of public sector enterprises. These reforms quickly permitted switching from significant overall public sector deficits (including the deficit of the central bank) to an overall public sector surplus, which, together with the exchange rate anchor supported by the new currency board system, permitted a quick disinflation strategy. In Egypt, significant progress was made over time in fiscal consolidation primarily through tax reforms. Ecuador--and most recently Kenya--also achieved substantial fiscal consolidation. In the other countries the achievements

1/ Within two and a half years, all joint venture banks and one of the four main public sector banks were to have been fully privatized.
2/ A securities scandal in India in 1992 reaffirmed the commitment of the authorities to prudential supervision.

were more modest and public sector deficits continued to pose a challenge for macroeconomic stabilization and the success of ongoing structural reforms. Thus, despite initial efforts undertaken in Tanzania and Uganda, involving civil service retrenchment, expenditure rationalization, tax reform, and restructuring and privatization of public enterprises, fiscal consolidation remains an unfinished business. Fiscal consolidation was not pursued with any vigor in Bulgaria or India, where deficits continued to be very large.

In addition to helping to close the fiscal gap, privatization of public enterprises was viewed in most cases as having a significant effect on liberating the financial sector from the burden of government-imposed obligations to provide concessional credit to maintain afloat these inefficient enterprises. However, implementation posed numerous problems, and delays were frequent. Privatization of public enterprises was a major issue in Bulgaria in its transition from central planning to a market economy, but in its circumstances it proved to be an arduous and slow process which still has to be implemented. Similarly, Tanzania and Uganda only slowly initiated the process of privatization of their dominant public enterprise systems. In the absence of domestic capital markets it was difficult to find suitable buyers. In Egypt and India, where large and inefficient public enterprise sectors operated side by side the private sector, only slow privatization was contemplated and little was accomplished. Of the remaining countries with less intrusive public enterprise sectors, only Argentina engaged in a substantial privatization program. 1/

Price liberalization was undertaken in Bulgaria through a sweeping measure in early 1991, simultaneously with the freeing of interest rates and the adoption of a flexible unified exchange rate system. This liberalization led to an initial outburst of inflation resulting from the burning out of the monetary overhang inherited from the central planning period. In most other countries price liberalization referred mostly to periodic adjustment of public sector prices and to the deregulation of some controlled prices (often dictated by special marketing boards) in the private markets, in addition to the decontrol of prices inherent in the privatization of public enterprises.

Significant trade reform was accomplished in Argentina, Bulgaria and Ecuador. In Bulgaria, trade reform and currency convertibility were the main pillars in the establishment of a competitive price system in the short run, given the absence of a domestic market. Kenya, Tanzania, and Uganda made significant progress toward trade liberalization, the latter two

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1/ In Ecuador, only limited progress was achieved, despite the Government's comprehensive agenda, because of resistance from the opposition-controlled legislature.

starting from a highly restrictive regime. 1/ Egypt and India made only slow progress in dismantling their complex and inefficient trade systems.

Except for Argentina--which from the beginning of reforms maintained an exchange rate pegged to the U.S. dollar as part of its anti-inflationary policy--all countries adopted or maintained a flexible exchange rate system. In some cases, the authorities operated a dual or multiple exchange rate system for a while, with at least one free market rate, before complete unification and floating of the exchange rate was achieved. Interbank foreign exchange markets became the typical arrangement in all countries.

All seven countries that were heavily indebted before reforms (all except India) made progress in working out substantive agreements to reduce the level of external debt and debt burden. Argentina's debt and debt-service reduction operation (DDSR) with foreign commercial banks was completed in April 1993, thereby opening the door for the country's return to the international capital markets. Ecuador's DDSR operation was completed in April 1995. Egypt's Paris Club agreement went through two phases of implementation, before the third and final phase was withheld pending either approval by the Fund of a new arrangement or the conclusion of a review under the existing arrangement. In Bulgaria, both a Paris Club agreement and an agreement with the banks are awaiting approval of a structural adjustment program supported by the Fund. Kenya, Tanzania and Uganda moved to reach understandings with official creditors, following adoption of structural adjustment programs supported by the Fund. 2/ 3/ However, because of their low per capita income and their external vulnerability, Tanzania and Uganda continue to depend heavily on concessionary support from the international financial community.

3. Sequencing issues

In all countries financial sector reforms formed part of wider efforts to improve general economic efficiency and achieve macroeconomic stabilization in the context of a market economy. 4/ Thus, financial sector reforms were viewed as essential to the success of the overall reform and stabilization process. They were expected to bring increased monetary

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1/ A plan exists for the eventual integration of these three countries in a customs union.

2/ In Kenya, an interruption of the reform process and a series of public financial scandals in 1992-1993 caused the international financial community temporarily to withhold further support, until the authorities were able to resolve the difficulties. A nonconcessionary rescheduling agreement was reached with Paris Club creditors in early 1994.

3/ Uganda became the first country to receive a stock-of-debt operation on "Naples terms" from Paris Club creditors in early 1995.

4/ For an overview of sequencing issues, see Vicente Galbis, "Sequencing of Financial Sector Reforms: A Review," IMF Working Paper, WP/94/101, September 1944.

policy effectiveness to cope with inflation and to establish efficient intermediation as a focus for market-oriented savings and investment decisions, and therefore economic growth.

The degree of macroeconomic stability ranged from bad to poor in all these countries before the start of reforms, but none of them considered it appropriate to delay the implementation of financial and other structural reforms until after the achievement of advanced macroeconomic stability. In Argentina, which started from a severe hyperinflation, the authorities nevertheless already maintained free interest rates and were prepared to introduce further structural reforms simultaneously with macroeconomic stabilization. In Bulgaria, interest rates were freed early and simultaneously with prices and the exchange rate, and were accompanied by a substantial initial reduction of exchange and trade restrictions, in order to promptly subject the economy to the forces of international competition. Given the initial monetary hang up, inevitably this rapid liberalization resulted in high inflation initially, but it was hoped that with the introduction of fiscal and monetary restraint this would constitute a temporary phase in the adjustment process, and would not undermine the liberalization nor the further structural reforms that were being contemplated. In the remaining countries, although macroeconomic stabilization was being attained at a slower pace than anticipated, there was no question of turning back on the financial (and other structural) reforms and, in fact, both processes were viewed as reinforcing each other.

In all the countries, financial sector reforms were initiated before or simultaneously with attempting the removal of exchange controls on capital account transactions. In Argentina, interest rates had already been freed before the starting of the 1991 reforms, when an immediate and complete liberalization of the capital account was effected under the Convertibility Law. In Egypt, capital account liberalization was introduced in early 1991, at about the same time that interest rates were liberalized. In the remaining countries capital account liberalization was envisaged as a gradual process, to be achieved simultaneously with or shortly after financial reforms. India was perhaps the slowest to start the process of removal of capital controls, in consonance with its gradualist approach to financial sector reforms. 1/

The internal sequencing of financial sector reforms was in all cases--although not necessarily by design but because of practical realities--one

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1/ The domestic before external sequencing chosen by all these countries thus conformed to the traditional views regarding appropriate sequencing. However, experience in a range of other countries has shown that it is possible--and even desirable--in some cases to liberalize the capital account contemporaneously with financial sector reforms, sometimes as part of a very rapid process. Indeed, in some industrial countries liberalization of the capital account occurred before that of the domestic financial sector and was a driving force for financial reforms.

of relatively rapid removal of interest rate controls (liberalization) but a much slower resolution of structural issues. As noted, Argentina already had a free interest rate system at the start of the reforms, and Bulgaria, Egypt and Kenya introduced interest rate liberalization right from the start of the reforms in 1991, with Ecuador following in 1992, Tanzania in 1993, and Uganda in 1994; only a remaining ceiling on term deposit rates is still maintained in India. By contrast, all these countries to a larger or lesser extent still have to complete the process of restructuring and privatization of their financial sectors; this process involves many complex decisions and takes more time. In some countries, as in Tanzania, remaining structural deficiencies impeded progress toward effective interest rate flexibility in the new liberal environment. 1/

Although the strengthening of prudential regulation and supervision systems is generally viewed by both analysts and policy makers as a precondition for the success of interest rate liberalization, these reforms were only slowly introduced in most of these countries and, in fact, several of them still have relatively weak regulatory and supervisory systems, with largely inadequate on-site inspection. These weaknesses attest to the practical difficulties encountered in the reform of these systems, which require very significant legal and institutional undertakings, substantial training and technical assistance, and the appropriate level of funding. As discussed later on, the shortcomings of inadequate prudential and supervisory policies have become one of the major concerns regarding the efficiency and even future viability of the reforms.

The introduction of indirect monetary policy instruments has to be built, of course, on already functioning money markets or at least on auctions of treasury bills or central bank short-term market instruments. In Argentina, the only country with some traditional money markets, indirect instruments were already the principal vehicle for monetary control at the start of the reforms. 2/ In Ecuador, the switch from direct to indirect monetary policy instruments was effected rapidly after the liberalization of interest rates in 1992. The process of substitution of indirect for direct instruments took about two years in Egypt, following the near complete liberalization of interest rates in 1991, during which period the two systems were run in parallel. In the remaining countries, the development of indirect instruments was a slow process, which is still ongoing in some and not yet started in Bulgaria. It was risky to rely solely on indirect monetary policy instruments in a financial system that suffered from the lack of, or the insufficient, development of the treasury bill and other money markets on which to target the instruments. The necessary reduction

1/ The main problem in Tanzania was the nonmarket behavior of the National Bank of Commerce, the dominant state-owned bank.

2/ However, as noted earlier, the introduction of the currency board system obviated the need for the use of an active monetary policy, and monetary policy instruments were therefore relegated to smooth out short-term liquidity fluctuations.

of inappropriately high reserve requirement ratios to promote the efficiency of financial intermediation, in particular, required the application of offsetting instruments to prevent the expansionary monetary effects derived from such reduction. As mentioned earlier, some of the countries, in fact, had to recur to large increases in reserve requirement ratios during the reform period--a setback for reform--because market-based indirect monetary policy instruments had not yet reached sufficient development to be used as primary control mechanisms.

4. Unresolved questions

In all the countries reviewed in this paper financial sector reforms are still an ongoing process. 1/ This is particularly true of those that started from a more primitive and/or a more controlled system, which are all except for Argentina and Ecuador.

The situation of the financial sector in Argentina is probably the most advanced of the group. One of the main structural problems still pending from resolution is the restructuring and privatization of the provincial banks. 2/ Another area where reforms are at present being intensified is the further refinement and implementation of prudential norms and supervision to ensure the soundness and liquidity of the financial system. This issue came recently to the forefront because of the liquidity difficulties suffered by some private banks as a result of a sharp reversal of capital inflows in the aftermath of the Mexican financial crisis. 3/

Among the most pressing reforms still to be implemented in Ecuador are those related to the amendment of the central bank charter to grant independence to the Central Bank (a reform stalled in the opposition-controlled legislature for two years); implementation of a program to strengthen bank supervision; enforcement of tighter capitalization

1/ In a way, financial sector reforms can never be said to be completed, if only because the nature of the markets is continuously evolving as a result of market innovations and technical changes, which at a minimum require continuous adaptation of prudential regulations and supervision.
2/ These banks are a relic from the old system, and although generally not very large, they constitute a hindrance to the overall reform process because of their inefficiency, operating losses, and connections with the provincial governments which own them. The resolution of this problem has been delayed by the political implications over the power-sharing arrangements between the central and provincial governments.
3/ Most norms were introduced or updated in the period 1993-94, thereby predating the onset of the recent crisis. This proved helpful to deal with the crisis.

requirements; reform of official financial institutions; and clarification of conditions for entry of new institutions. 1/

The situation in Bulgaria remains one of slow progress and numerous unresolved issues. The main pending reforms are the consolidation of indirect monetary policy instruments (impeded by the lack of sufficient progress in the development of the money and securities markets); 2/ implementation of a clean-up program of nonperforming loans, completion of the restructuring of the banking system, and recapitalization and privatization of banks; improvement in the legal and institutional capacity to restructure the financial sector and to enforce prudential regulations and supervision; implementation of a long-contemplated program to establish bank credit limits on 100 selected state-owned enterprises as a way to stop credit expansion and impose a hard-budget constraint on these enterprises; initiation of steps to develop further the capital markets by selling government bonds and promoting trade in stocks of privatized companies; and enactment of appropriate legislation on commercial contracts, securities, and stock market transactions.

In Egypt, after a strong start with liberalization in 1991, the pace of financial sector (and other) reforms went through a period of consolidation before being reinvigorated in 1993. Reforms still pending are the completion of a program of reduction and eventual elimination of subsidized credit and the phased reduction of reserve and liquidity requirements; continuation of the sale of state shares in joint-venture banks and privatization of state banks and insurance companies (with at least one of the larger public banks and insurance companies to be privatized); certain refinements in bank supervision; strengthening of the monitoring and enforcement capacity of the capital markets authority; and enactment of modern general exit and bankruptcy legislation.

Progress in India has been slow. Despite financial liberalization efforts made in recent years, major distortions remain, including priority and concessionary lending requirements, as well as high cash and liquidity ratios; 3/ a ceiling on bank term deposit rates; a banking system still dominated by the public sector, which suffers from large nonperforming assets and high operating costs; weak income recognition norms and a system still struggling to meet capital adequacy requirements along the lines of the Basle Committee; lack of competition in the insurance industry, still a government monopoly; inadequate prudential regulation and supervision over

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1/ Another pending reform is that of the social security system to allow for the operation of private pension funds along with minimum pensions provided by the state.

2/ The BNB has engaged in shadow operations for reserve money management to gain experience.

3/ Because of fiscal weaknesses, the restructuring of public banks and the reduction of concessionary finance to government and state enterprises have been made difficult.

the financial system and over the capital markets; and lack of independence of the central bank. The development of money and securities markets has suffered in part as a result of the gradual and unfinished liberalization of interest rates and of financial transactions, and this has also slowed the introduction of effective indirect monetary policy instruments.

Financial sector reforms in Kenya dating back to the mid-1980s suffered from the vagaries of stop-go policy cycles and, although interest rates were freed in mid-1991, the following two years were marked by macroeconomic mismanagement and public financial scandals that culminated in an economic crisis in March 1993. To face this crisis the authorities implemented substantial measures to reform the financial (and other) sectors in the following two years. Nevertheless, there remain important issues to be resolved, including restructuring and sale of government shares of public commercial banks (especially the National Bank of Kenya); amending the Central Bank of Kenya Act and the banking legislation to strengthen the role and independence of the Central Bank in monetary policy; implementing a gradual reduction in the cash reserve requirement and enforcing this requirement on banks' affiliated financial institutions; improving prudential regulation and bank supervision and furthering judiciary reform to enforce financial regulations; 1/ developing a secondary market in treasury bills; reforming insurance institutions and enacting a modern insurance law; converting the National Social Security Fund into a pension fund and strengthening supervision over insurance companies and pension funds; encouraging further development of the capital market and the stock exchange; and amending the legislation on bankruptcy, liquidation, and recovery of debts.

Despite substantial progress made in Tanzania and Uganda in reconstructing their financial sectors after years of considerable disorder, some serious problems remain in both cases. In Tanzania, remaining structural issues in the financial sector include consolidating and extending institutional reforms through the restructuring and privatization of the three existing public banks, especially the National Bank of Commerce (the dominant bank), and the continued encouragement of entry of new private financial institutions, including foreign banks, to promote market competition; strengthening the supervisory, regulatory and market related functions; 2/ improving monetary policy design and implementation, with better integration of monetary and fiscal policy; strengthening the use of indirect monetary policy instruments and the development of reserve money programming; creating a wider array of financial instruments, including

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1/ This also includes completing the collection of CBK outstanding irregular credit, and establishing a commercial court for legal recourse to recover nonperforming commercial bank debt.

2/ Including the functioning of the treasury bill auctions, the wider treasury bill market, the payments and clearance systems, the operation of the foreign exchange interbank market, and external reserve management.

longer-term government securities with market-related yields; and establishing a stock exchange.

In Uganda, the main remaining issues are increasing the scope for flexible implementation of monetary policy and for further broadening and deepening of the treasury bill market; 1/ encouraging the development of a shilling interbank market to reduce the need for banks to rely on overdrafts with and rediscounts from the Bank of Uganda; completing the restructuring and recapitalization of the Bank of Uganda, and improving its regulatory and supervisory capabilities; improving check clearing procedures; implementing the restructuring and privatization of the Uganda Commercial Bank (the dominant bank) and other weak banks; and enacting legislation to facilitate the development of a capital market and establishing a stock exchange.

IV. Effects of Reforms

Financial sector reforms are expected to produce certain desirable effects, some of which are specific to the financial sector and can be mainly or exclusively attributed to these reforms, whereas others are more macroeconomic in nature and can not easily be disentangled from the effects of overall macroeconomic policies and structural reforms. The more direct effects of financial sector reforms (accompanied by appropriate monetary policies) can be judged on the basis of some indicators including the reduction of monetary expansion and inflation, 2/ the maintenance of positive real interest rates, the increase in financial deepening (decline in money velocity), the growth of credit to the private sector in real terms, the decline in normal interest rate spreads, 3/ and the reduction in operating costs. But financial sector reforms and policies can also effects such broad macroeconomic aggregates as savings, investment volume and efficiency, external capital movements, and economic growth. Some of the effects may be expected to be manifested rather quickly, like the maintenance of positive real interest rates, whereas others take time to produce measurable results--for instance the tendency to financial deepening and in general all the macroeconomic effects. Not all effects of reforms

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1/ For an overview of financial sector reforms in Uganda, see Uganda: Adjustment with Growth, 1987-94, IMF Occasional Paper No. 121 (Washington, D.C., March 1995).

2/ However, it is necessary to recognize that inflation is a complex phenomenon and that besides the expansion of monetary aggregates, other policies can influence the outcome, especially fiscal policy, enterprise policy, price policy, and a host of other policies and exogenous factors.

3/ The possibility of narrowing the spreads between lending and deposit rates will depend in part on the initial policies on these spreads. If the spreads had been artificially compressed before the reforms, then liberalization of interest rates may lead to an increase in the spreads, notwithstanding pressures to lower spreads from the increased competition that the financial reforms should bring about.

are easily quantifiable, however--for instance those on the efficiency of investment--and there are others, including for instance the scale of nonperforming loans, for which data often are not available, or are not made public, or are notoriously poor. Tables 6 through 13 provide available indicators for the eight countries in this paper. 1/

1. Monetary control and financial development

A consistent program of financial sector reforms, if properly backed by fiscal consolidation, should be able to deliver on the control of inflation, the main ultimate goal of monetary policy. In most countries in this paper, inflation abated progressively during the reform period relative to the year before the reforms. This is especially true of Argentina, which, starting from a hyperinflation in 1990, reduced inflation to the level of industrial countries by 1994. In this case, the crucial factors were the use of the exchange rate as a nominal anchor supported by a currency board type of monetary system and very strong fiscal restraint. The exceptions were Bulgaria, Kenya, and Tanzania. In Bulgaria--following the initial inflationary outburst in the aftermath of the decontrol of prices in 1991--the slowness of privatization and the lack of progress in imposing a hard

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1/ All these tables were constructed following the same general scheme as follows. Inflation (CPI based) was taken as the main general indicator of performance with regard to macroeconomic stabilization. Interest rates (where available, a short-term market rate and rates on deposits and loans) were taken as indicators of the efficiency of financial intermediation; when compared with the rate of inflation provide an index of financial repression (negative real interest rates); they also serve to form an idea of the spread between asset and liability rates and therefore of the internal efficiency of financial intermediation. A broad money growth aggregate (or closest possible indicator) was used as an indicator of the general stance of monetary policy. The ratio of broad money to GDP (or closest equivalent) was used as an indicator of financial deepening; the inverse of this ratio--the broad money velocity--was presented instead for some countries. The relative rates of growth of credit to the private and public sectors and/or the real rate of growth of credit to the private sector were used to indicate the shift from public to private sector financing. The investment ratio (investment as percent of GDP) was used as an overall indicator of the possible effect of financial liberalization on the volume of investment (absence of data for most countries prevented the use of an indicator of private real savings). The real rate of growth of GDP was taken as an overall indicator of the possible efficiency enhancing gains from financial liberalization (subject to the caveat that the rate of growth is influenced by many other factors besides financial liberalization). The uncovered interest rate differential (difference between comparable U.S and local rates) in conjunction with the change in the exchange rate was taken as the main indicator of market pressures for capital inflows or outflows. The overall balance of the public sector (including where possible the central bank) was taken as an overall ind2icator of the stance of fiscal policies.

Table 6. Argentina: Financial Indicators

	1990	1991*	1992	1993	1994
Inflation (CPI) avg.	2,314.7	171.7	24.9	10.6	4.1
Deposit interest rate	1,518	62	17	11	8
Lending interest rate 1/	9,695,422	71	15	6	8
Broad money growth (M3) 2/	1,059.4	142.3	61.7	47.7	17.5
M3/GDP (percent)	10.7	9.8	12.7	16.5	17.7
Private credit growth as percent of M3	...	102.8	68.8	31.2	20.9
Private credit growth in real terms	...	13.2	24.8	14.0	15.6
Investment/GDP (percent)	14.0	14.6	16.7	18.2	19.9
Real GDP growth (percent)	0.1	8.9	8.7	6.0	7.4
U.S. deposit interest rate 3/	8.2	5.8	3.7	3.2	4.6
Uncovered interest rate diff. 4/	1,510	56	13	8	3
Exchange rate change (average) depreciation (+)	1,127.8	95.7	3.8	0.9	0.1
Capital inflows (+) in relation to imports cif (percent)	-100.3	8.0	54.0	84.0	52.9
Overall balance of the combined public sector in percent of GDP 5/	-1.7	-1.2	0.6	2.4	-0.2

Sources: Data provided by the Argentine authorities; and staff estimates.
Note: The asterisk on the year 1991 indicates the start of reforms.

1/ The reported rate refers to the rate in the interbank market, which is not representative of the rate for loans to the private sector. A recently compiled series on the prime lending rate, shows the following numbers: 10.28 (average from April to December 1993); 10.06 (average for 1994); and 22.47 (average from January to June 1995).
2/ Liabilities of the financial system to the private sector.
3/ IMF, International Financial Statistics.
4/ Difference between Argentine and U.S. deposit interest rates.
5/ Includes the nonfinancial public sector and the Central Bank.

Table 7. Bulgaria: Financial Indicators

	1990	1991*	1992	1993	1994
Inflation (CPI) average	26.3	333.5	82.0	72.8	96.0
End-of-period	64.0	338.9	79.4	63.8	121.9
BNB basic refinancing rate	...	57.1	61.4	60.9	86.5
Broad money growth: (nominal)	16.6	110.0	48.4	52.8	78.6
(real)	-28.9	-52.1	-17.3	-6.8	-19.5
Velocity of broad money 1/	0.92	1.31	1.31	1.28	1.30
Velocity of lev money 1/	1.05	1.98	1.71	1.60	1.93
Domestic lev credit (percent):	15.0	67.5	44.9	68.9	18.3
Government	15.6	216.9	90.6	121.7	8.7
Non-government	7.2	47.0	31.5	46.7	25.1
Investment/GDP (percent)	21.3	18.2	16.2	11.9	9.8
Real GDP growth (percent)	-9.1	-11.7	-7.3	-2.4	1.4
Uncovered interest rate diff. 2/	...	51.3	57.7	57.7	81.9
Exchange rate depreciation (+)	184.5 3/	244.0	31.2	18.2	96.2
Capital inflows (+) in relation to import fob (percent)	-77.5	-85.5	-26.7	-21.1	-8.7
Balance of general government in percent of GDP	-12.8 4/	-14.7	-15.0	-15.7	-7.0
External debt in percent of GDP	53.0 3/	156.3	146.4	119.3	108.0
Debt service ratio (goods and services)	116.4	76.3	39.2	33.7	18.8

Sources: Bulgarian authorities; and staff estimates.
Note: The asterisk on the year 1991 indicates the start of reforms.

1/ Calculated as the ratio of annual nominal GDP to end of year money stock.
2/ Difference between Bulgaria's BNB basic refinancing rate and U.S. deposit interest rate. (For the latter see Table 6).
3/ The appropriate level of the exchange rate in 1989 and 1990 is uncertain, given the large difference between official and black market rates.
4/ Excluding London Club deferrals.

Table 8. Ecuador: Financial Indicators

	1990	1991	1992*	1993	1994
Inflation (CPI) avg.	48.4	48.8	54.6	45.0	27.3
Discount rate (end of period)	35.0	49.0	49.0	29.6	32.2
Deposit interest rate	40.2	47.2	38.8	25.7	41.0
Lending interest rate	53.9	55.8	56.5	40.4	49.6
Broad money growth (M2)	64.0	55.0	56.5	51.4	52.0
Reserve money growth	51.6	46.4	44.5	49.4	35.7
M2/GDP (percent)	18.4	19.1	18.5	21.0	25.4
Velocity of M2 1/	7.5	7.0	7.1	6.7	5.6
Private credit growth as percent of M2	20.2	27.1	29.0	41.2	47.8
Private credit growth in real terms	-5.1	8.5	2.2	32.8	41.9
Investment/GDP (percent)	17.5	22.2	21.2	21.1	22.6
Real GDP growth (percent)	3.0	5.0	3.6	2.0	4.0
Uncovered int. rate differential 2/	32.0	41.4	35.1	22.5	36.4
Exchange rate depreciation (+) avg.	45.9	36.3	46.6	25.1	14.5
Real effective exchange rate index	100.0	105.0	105.7	121.5	128.8
Capital inflows (+) in relation to imports fob (percent)	-16.2	-13.1	-7.5	-29.5	-26.7
Government balance in percent of GDP	1.8	1.4	-0.3	0.5	0.1
Combined public sector balance in percent of GDP 3/	-2.3	-4.3	-3.9	-0.4	0.4

Sources: Data provided by the authorities; and staff estimates.

Note: The asterisk on the year 1992 indicates the liberalization of interest rates, which signified the consolidation of reforms.

1/ GDP relative to average M2.

2/ Difference between Ecuadorian and U.S. deposit interest rates. (For the latter see Table 6.)

3/ Includes the nonfinancial public sector and the Central Bank.

Table 9. Egypt: Financial Indicators 1/

	1990	1991*	1992	1993	1994
Inflation (CPI) avg.	21.2	14.7	21.1	11.1	9.0
Discount rate (end of period)	14.0	21.0	19.8	17.0	15.3
Deposit interest rate (3-month)	10.0	10.9	16.2	15.3	12.1
Lending interest rate (1 yr or less)	19.0	...	20.5	19.5	17.4
Treasury bill rate (3-month)	...	19.9	18.2	16.3	13.9
Broad money growth (M2)	19.7	27.5	14.3	16.4	12.4
M2/GDP (percent)	91.0	92.8	88.5	92.9	93.5
Private sector credit growth as percent of beginning of period M2	6.1	6.4	1.8	6.9	7.6
Private sector credit growth in real terms	-4.6	1.9	-13.2	9.4	12.8
Investment/GDP (percent)	21.9	20.4	17.5	16.6	16.8
Real GDP growth	2.4	2.1	0.3	0.5	2.3
Uncovered interest rate differential on 3-month Treasury bills 2/	...	13.4	13.8	13.3	10.6
Exchange rate depreciation LE/US$ (+) (end of period)	4.9	23.5	-0.5	0.8	1.2
Private short-term capital inflows (+) in relation to imports c.i.f. (percent)	...	--	24.9	21.4	10.3
Fiscal balance (in percent of GDP)	-15.2	-17.2	-5.0	-4.2	-2.5
External public debt (in percent of GDP)	...	116.6	98.1	84.8	77.7

Sources: Data provided by the Egyptian authorities; and staff estimates.
Note: The asterisk on the year 1991 indicates the start of reforms.

1/ All data in this table refer to the fiscal year (that is, through end-June of the corresponding calendar year).
2/ Difference between the Egyptian and U.S. rates.

Table 10. India: Financial Indicators

	1990	1991*	1992	1993	1994
Inflation (CPI) avg.	8.9	13.9	11.8	6.4	10.2
Bank rate (end of period)	10.0	12.0	12.0	12.0	12.0
Money market rate	15.6	19.4	15.2	8.6	...
Lending rate	16.5	17.9	18.9	16.3	...
Treasury bill rate (end of period) (364-day rate) 1/	...	...	9.9	11.1	10.1
Broad money growth (M3)	15.1	19.3	15.7	18.2	21.4
M3/GDP (percent)	45.6	46.7	47.8	50.0	...
Private credit growth as percent of M3	5.9	5.8	10.5	6.2	...
Private credit growth in real terms	0.5	-3.5	6.7	4.4	...
Investment/GDP (percent)	22.7	22.0	21.3	20.9	...
Real GDP growth	5.2	0.9	4.3	4.3	5.3
Uncovered interest rate differential 2/	7.4	13.6	11.5	5.4	...
Exchange rate depreciation (+)	7.9	29.9	14.0	17.7	2.9
Capital inflows (+) in relation to imports cif (percent) 1/	33.2	27.4	21.6	18.3	...
Central Government balance in percent of GDP	-8.1	-5.8	-5.2	-4.7	...
Overall public sector balance/GDP 1/	-11.6	-11.9	-9.7	-8.7	-11.0

Sources: Data provided by the Indian authorities; and staff estimates and projections.
Note: The asterisk on the year 1991 indicates the start of reforms.

1/ Refers to the fiscal year (that is, from April of the corresponding calendar year).
2/ Difference between the Indian money market rate and the U.S. deposit interest rate (for the latter see Table 6).

Table 11. Kenya: Financial Indicators

	1990	1991*	1992	1993	1994
Inflation (CPI) average	15.6	19.8	29.5	45.8	29.0
Discount rate (end of period)	19.4	20.3	20.5	45.5	21.5
Treasury bill rate	14.8	16.6	16.5	49.8	23.3
Deposit rate	13.7	15.4	16.5	25.6	13.4
Lending rate	18.8	19.3	21.4	31.7	35.7
Broad money growth (M2)	20.1	19.6	39.0	28.0	30.4
M2/GDP (percent)	29.7	31.4	37.8	38.3	41.7
Private credit growth as percent of M2	8.0	13.9	19.9	3.2	15.9
Private credit growth in real terms	-3.2	1.9	1.0	-27.8	22.0
Investment/GDP (percent)	20.7	19.3	17.1	17.7	20.2
Real GDP growth	4.2	2.1	0.5	0.2	3.0
Uncovered interest rate diff. 1/	5.5	9.6	12.8	22.4	8.8
Exchange rate depreciation (+) avg.	11.4	20.0	17.1	80.0	-3.3
Capital inflows (+) in relation to imports cif (percent)	21.3	-8.6	-6.8	11.4	2.7
Overall government balance in percent of GDP					
excluding grants	-7.3	-6.4	-8.7	-9.5	-5.0
including grants	-5.1	-4.4	-7.0	-8.3	-3.7

Sources: Data provided by the Kenyan authorities; and staff estimates.
Note: The asterisk on the year 1991 indicates the liberalization of interest rates marking the intensification of reforms.

1/ Difference between the Kenyan deposit rate and the U.S. deposit rate (for the latter see Table 6).

Table 12. Tanzania: Financial Indicators 1/

	1990/91	1991*/92	1992/93	1993/94	1994/95
Inflation (CPI) avg.	19.8	21.1	23.2	29.0	38.0
Rediscount rate (end-of-period)	27.0	27.0	27.0	53.0	49.2
Twelve-month fixed deposit rate (end-of-period)	26.0	26.0	24.0	28.7	28.8
"High" lending rate (end-of-period)	31.0	31.0	31.0	36.0	39.0
Broad money growth (M2) 2/	26.9	40.5	43.9	33.5	31.0
M2/GDP	0.23	0.27	0.31	0.30	0.30
Velocity of broad money 2/	4.3	3.7	3.3	2.8	2.9
Domestic credit growth (end-of-period) 3/	18.5	0.4	40.5	43.0	14.9
Of which Government (net) 3/	(-9.2)	(0.9)	(19.9)	(18.1)	(13.9)
Investment/GDP (percent)	41.4	41.9	40.9	41.0	39.3
Real GDP growth (percent)	4.8	3.7	3.7	3.6	4.0
Uncovered interest rate differential 4/	17.8	20.2	20.3	25.5	...
Nominal effective exchange rate	11.7	8.7	16.9	12.1	16.0
Capital inflows (+) in relation to imports, f.o.b. (percent)	29.0	6.8	10.2	4.3	2.3
Government balance in percent of GDP 5/	-3.1	-2.9	-14.6	-11.1	-8.5

Sources: Data provided by the Tanzanian authorities; and staff estimates and projections.

1/ Data are based on the fiscal year (July-June).
2/ The broad money stock includes foreign exchange deposits.
3/ Changes as percent of initial period broad money stock.
4/ Difference between the savings deposit rate in Tanzania and U.S. deposit interest rate.
5/ Balance before grants.

Table 13. Uganda: Financial Indicators

	1990	1991*	1992	1993	1994
Inflation (CPI) avg.	33.3	32.9	42.2	30.0	6.5
Bank rate end of period	50.0	46.0	41.0	24.0	15.0
Treasury bill rate	41.0	34.2	...	21.3	12.5
Deposit rate	31.3	31.2	35.8	16.3	10.0
Lending rate	38.7	34.4	...	...	...
Quasi-money growth (M2Q)	128.8	59.0	87.7	72.3	...
Broad money growth (M2) 1/	56.0	47.0	53.0	42.0	33.0
Private credit growth of DMBs as percent of M2Q	132.7	154.4	31.4	65.1	...
Private credit growth of DMBs in real terms	25.0	2.2	6.8	28.0	...
Investment/GDP (percent) 1/	13.0	16.1	16.1	16.0	17.1
Gross national savings/GDP (excluding grants) 1/	-0.3	0.7	3.6	5.7	8.1
Real GDP growth 1/ 2/	6.0	5.4	3.6	8.6	5.1
Uncovered interest rate differential 3/	23.1	25.4	32.1	13.1	5.4
Exchange rate depreciation (+) avg.	92.2	71.1	54.5	5.4	-18.0
Real effective exchange rate depreciation (+)	38.9	23.3	8.8	-4.0	-25.4
Capital inflows (+) in relation to imports fob (percent)	45.1	36.6	30.1	34.9	24.1
Government balance in percent of GDP	-3.6	-3.5	-5.3	-3.9	...
Overall government balance					
excluding grants in percent of GDP 1/	...	-7.9	-15.0	-11.8	-11.0
including grants in percent of GDP 1/	-4.6	-3.7	-7.6	-3.3	-4.0

Sources: Data provided by the Ugandan authorities; and staff estimates.
Note: The asterisk on the year 1991 indicates the intensification of financial sector reforms and consolidation of a policy of positive real interest rates.

1/ Refers to the fiscal year (that is, through end-June of the corresponding calendar year).
2/ Real GDP at factor cost.
3/ Difference between the Ugandan and U.S. deposit interest rates (for the latter see Table 6).

budget constraint on poorly performing public enterprises created a deep inflationary inertia which monetary policy was unable to counteract. In Kenya, inflation increased through 1993 as a result of a lack of monetary (and fiscal) discipline, 1/ but the authorities regained a measure of control thereafter on the basis of a significant shift in policies. In Tanzania, inflation remained unabated at an average of over 35 percent in fiscal year 1994/95, reflecting to an important extent the weakness in the fiscal stance.

The behavior of interest rates following liberalization was not fully predictable because of numerous structural changes and because of rapidly shifting expectations, especially in countries with significant shifts in inflation. In Argentina, Bulgaria and Ecuador, interest rates seem to have remained somewhat negative in real terms at least for a few years. More specifically, in Argentina, interest rates fell faster than inflation in the two years following the Convertibility Plan, with most interest rates remaining negative in real terms until 1993, when they turned positive with the further decline in inflation to a single-digit level. In Bulgaria, judging by the basic refinancing rate of the Bulgaria National Bank, 2/ interest rates remained generally negative in real terms until the present. In Ecuador, real deposit interest rates remained somewhat negative, whereas real lending rates were somewhat positive, until both rates became firmly positive in 1994. In the remaining countries, interest rates appear to have remained largely positive in real terms. 3/ In Egypt and India, the decline in inflation to a single-digit level was not fully reflected in the discount and bank rates, respectively, and real interest rates remained largely positive.

Financial deepening as measured by the ratio of some broad monetary aggregate to GDP seems to have occurred in most countries. In Argentina, where financial repression policies preceding the recent reforms had brought down the ratio of broad money to GDP to only 11 percent, this indicator rose steadily, reaching close to 18 percent by 1993. In Bulgaria, the velocity of broad money (the inverse of the financial deepening ratio) tended to decline following a not unexpected once-and-for-all doubling during the year

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1/ Another factor was the reduction in imports prompted by failure to maintain the support of the international financial community as a result of inadequate domestic policies.

2/ No other interest rate data appear to be available.

3/ In Tanzania, there has been considerable disparity between comparable rates across the financial system, largely because of the absence of market-based criteria on the part of the National Bank of Commerce, the dominant bank.

of liberalization. In the remaining countries financial deepening seems to have increased, albeit perhaps not very rapidly in some cases. 1/

A deliberate policy of encouraging the growth of financial sector credit to the private sector at the expense of the public sector (government and other public entities and enterprises) appears to have been followed in all countries to further the principle of moving toward a more market-oriented economy. 2/ Another manifestation of this policy was the attempt to increase credit to the private sector in real terms. In several countries the growth in real credit to the private sector switched from being negative before the reforms to being positive from 1992 onwards. However, this policy appears not to have been successful in Bulgaria, Kenya, and Tanzania, the first as a result of lack of enforcement of a hard budget constraint on public entities, the second because of the financial disturbances in 1992-93, and the third because of problems with the fiscal stance.

2. Some possible macroeconomic effects

With regard to possible macroeconomic effects, the investment ratio increased in some countries (Argentina, Ecuador, and Uganda) but appears to have fallen or to have remained unchanged in the others. Apart from possible data deficiencies, it would be difficult, if not impossible, to speculate on how financial sector reforms affected the level of real savings and investment. 3/

The rate of economic growth was boosted to a historically high level in Argentina, where the reforms were most complete and enjoyed a high degree of

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1/ It is possible that broad money is not a broad enough indicator of financial deepening and tends to underestimate progress in financial deepening, especially in countries endowed with a large array of nonbank financial institutions and relatively sophisticated financial instruments.

2/ This policy requires the coordination of fiscal and monetary policies to achieve a policy mix under which the progressive reduction in the pressure of public finance leaves way to the use of funds to finance the private sector.

3/ Both the analytical and the empirical literature are ambiguous about the effects on real sector savings (as opposed to financial sector savings) and on the volume of investment but are positive about the effect on investment efficiency, and therefore real economic growth.

credibility. 1/ In Bulgaria, the initial impact of liberalization was to aggravate the ongoing depression as it required for its success a massive transformation of the productive structure, but this effect tapered off in subsequent years and growth became positive in 1994. In Ecuador and Egypt real growth proceeded at a moderate pace. In India, after an initial recession in 1991--largely resulting from the external sector difficulties that had led to the need for stabilization and reform mea-sures--the rate of growth returned to a healthy level of close to 5 percent in subsequent years. In Kenya, growth was slow during the period of instability leading up to the new stabilization and reform measures taken in 1993, but these measures appear to have turned around the economy from 1994. In Tanzania growth responded favorably to the liberalization steps and could have been higher if many reforms had not been delayed. In Uganda a relatively good growth performance continued to characterize the progressive reforms being implemented.

Capital movements do not appear to have been significantly affected in all countries, partly because some of them did not fully liberalize capital movements but also because they were still sorting out their significant external debt problems. 2/ However, in Argentina where the Convertibility Plan meant an immediate and complete removal of capital controls, and where final external debt agreements were achieved in the reform process, the return to international capital markets resulted at times in large inflows which contrasted with the heavy outflows recorded in previous years. 3/ In both Bulgaria and Ecuador strong capital outflows before the reforms appear to have been significantly reduced by the reforms. India and Kenya

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1/ It is not possible to disentangle the effects of financial sector and monetary reforms from the contribution made by other policies, including fiscal adjustment and reforms of the public enterprise sector. However, the evidence gathered here is consistent with cross-section results that show a positive long-run relationship between economic growth and the maintenance of moderately positive or negative real interest rates. See for instance, IMF, Interest Rate Policies in Developing Countries, a Study by the Research Department of the IMF, Occasional Paper No. 22, October 1983.

2/ The broad indicator of capital flows recorded in the statistical tables in this paper captures all flows, including public flows which were dominant in some countries but not necessarily related to interest rate differentials. A more disaggregated set of data would be necessary for a more conclusive analysis.

3/ The Mexican financial crisis of late 1994 had a negative effect on Argentina, temporarily inducing significant capital outflows.

appeared to have benefitted from significant private inflows. 1/ The capital inflows recorded in Tanzania and Uganda appeared to have been largely determined by the public sector, rather than the new favorable conditions in the private markets. 2/

3. Efficiency of intermediation and financial stability

Although data are scarce and patchy, some general comments on the effects of reforms on the efficiency of financial intermediation and the degree of financial stability are in order. The spread between bank asset and liability interest rates, a major indicator of efficiency, fell in Argentina, but appears to have increased in several other countries. 3/ The fall in Argentina reflected the decline in inflation, as well as the reduction in reserve requirement ratios and bank operating costs. In several countries the increase in the spread following liberalization could be attributed mainly to the need for banks to maintain profitability in the face of a large and sometimes rising stock of nonperforming loans. For, although several countries attempted to tackle the nonperforming loan problem, success in this area was rather limited, partly reflecting remaining weaknesses in prudential regulation and supervision. In Kenya and

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1/ In some of these countries, large capital inflows at times posed some complex issues for the receiving countries as they threatened to increase the growth of monetary aggregates and maintain an appreciated exchange rate which could prove harmful for external competitiveness. For a general overview of policies to deal with capital inflows, see Susan Schadler, et al, Recent Experiences with Surges in Capital Inflows, IMF, Occasional Paper 108, 1993.

2/ However, in Uganda private transfers as shown in the current account appear to include private capital inflows not captured in the capital account.

3/ Measurements of the spread are sensitive to the particular interest rates being used for comparison, particularly in countries with fragmented banking systems and remaining regulations on bank lending. A properly weighted average should be used in that case, but the average itself could be distorted by the existence of a proportion of mandated loans with concessional interest rates. Some increase in the spread might be expected following liberalization if the spread was artificially held too tight for bank profitability during the pre-reform period. Also, it should be noted that the measured average spread does not take into account the fact that the liberalization of the financial sector can result in a declining role of informal markets which typically operate with high lending rates. Unfortunately, little is known about the evolution of informal credit markets in these countries.

Tanzania, the increase in reserve requirement ratios was also a factor impeding the reduction in interest rate spreads. 1/

While there was no overt financial crisis in any of the countries, the situation remained difficult in several of them, as a result of inadequate restructuring and privatization of institutions, weak income recognition norms, inability to handle the large stock of nonperforming loans, and continued accumulation of nonperforming loans. Foreign exchange losses do not seem to have contributed significantly to these problems as countries moved to impose restrictions on the open foreign exchange positions of banks.

The problem of nonperforming loans remains perhaps the most serious one in some countries (Bulgaria, Tanzania, and Uganda), posing several risks: the possibility of an overt financial crisis if and when depositors begin to fear for the safety of their deposits; 2/ continued inefficiency in the allocation of credit as creditworthy borrowers avoid taking up loans at high interest rates, whereas bad borrowers step up their demand for credit; and a rising fiscal burden as the nonperforming loans become a contingent liability of government and an implicit burden on future tax payers. In these countries effective restructuring and privatization remain to be tackled, and there are also questions on whether some banks that have little chance of becoming profitable should be liquidated. In Bulgaria, a process of mergers of small nonviable banks into potentially viable institutions is being carried out. In Tanzania and Uganda the main issue remains the restructuring and privatization of their dominant commercial banks, as well as their recapitalization. By contrast, in other countries, like Argentina, the authorities mandated significantly increased provisions against nonperforming loans and a recapitalization or liquidation of weak banks.

1/ Another factor cited in some countries was the monopolistic behavior of banks, but hard evidence for this hypothesis is difficult to come by. Also in some countries, such as Egypt and India, the spreads were affected by the reduction in the mandatory allocation of a proportion of loans at concessional interest rates to the government, state enterprises and targeted sectors. This tended to increase the average measured spread but at the same time, by increasing the profitability of banks, it permitted a reduction in the free market lending rates. Finally, operating costs were not tackled with sufficient vigor in most countries, although in some this was one of the explicit instruments of reform.

2/ Up to the present, an overt financial crisis seems to have been avoided because of the market's believe that the authorities would step in to bail out affected financial institutions, thereby de facto ensuring 100 percent of deposits. Perhaps in recognition of this problem of complete albeit implicit deposit insurance, some of the countries (e.g., Argentina, Uganda) have recently introduced explicit deposit insurance schemes designed to lower the insurance to less than 100 percent and to charge part of its costs to the financial institutions.

V. Summary and Conclusions

The results of financial sector reforms can be judged in terms of the original objectives: monetary control, efficiency of intermediation, and financial sector stability. Monetary control was improved in all countries, subject to a caveat: in several countries the continued existence of ailing financial institutions with substantial nonperforming loans has created a risk that official support for ailing institutions will override normal considerations for a tight monetary policy. Although the efficiency of financial intermediation was probably improved in all cases by the more market oriented approach, still significant problems persist, as indicated for instance by the still fragmented structure of interest rates in some countries. With regard to financial sector safety, there was probably a deterioration in most countries, and in those cases a risk of a financial crash cannot be brushed aside.

Overall, financial sector reforms differed across the countries both because of different weights given to the ultimate objectives (some countries were more ambitious than others) and because of different capacity or will of implementation. Financial sector reforms were most ambitious in Argentina, where the capacity and will of implementation was also the strongest of the group. By contrast, India appeared to be the least ambitious, taking a most gradualist approach to liberalization of financial markets as well as to the restructuring and privatization of financial institutions. Ecuador, Egypt and Kenya could be placed between these two extremes, since despite their gradualist approach the liberalization measures were more decisive and there was a clearer consensus regarding the need for ultimate comprehensive reform and privatization. Bulgaria, despite starting from the farthest position away from a market economy, had very ambitious and comprehensive plans for reform including the privatization of the entire financial system; but the political will and perhaps the capacity to implement foundered and major reforms needed on restructuring and privatization still remain to be accomplished. A similar syndrome could be perceived in Tanzania and Uganda, where the ultimate goals were very ambitious but the capacity of implementation (at times also the will) was lacking. 1/

1. Sequencing perspectives

Neither of the two main preconditions often cited as being necessary before commencing financial sector reforms--macroeconomic stability and strong bank supervision--was met in the sample of countries in this paper. However, the importance of the preconditions is somewhat reduced if the financial sector reforms are implemented gradually, as was the case in most

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1/ In Tanzania the initial impetus of financial sector reform was not well utilized and a second bank bailout was needed in 1993. Further recapitalization will be required to proceed with the restructuring and privatization of the three state banks.

of these countries. A gradual reform gives the authorities time to orchestrate a concerted attack on inflation and also to secure fundamental reforms of the prudential and supervisory systems.

All countries started the liberalization of the financial sector from a position of macroeconomic disequilibrium (evidenced by inflationary pressures and/or large fiscal deficits) and of weak prudential regulation and supervision. In Argentina, interest rates had already been liberalized prior to the start of the recent reforms, despite the hyperinflation and remaining fiscal problems. In all the other countries the authorities more or less rapidly moved to deregulate interest rates as a basic tenet of a liberal financial system. In Bulgaria, interest rate liberalization was introduced early in the reform process, despite the existence of a substantial monetary overhang and notwithstanding the serious transition problems. All countries, in fact, considered it both possible and desirable to launch a simultaneous attack on macroeconomic stabilization and structural reforms, rather than waiting to introduce reforms after macroeconomic stabilization. Moreover, the lack of immediate success with stabilization was not regarded as an obstacle to continue with reforms of the financial sector. Therefore, stabilization and financial (and other) reforms were generally seen as complementary and mutually supportive.

Simultaneously with financial sector reforms, all countries attempted to achieve fiscal reform and consolidation (and other structural reforms) as part of the general stabilization and reform efforts. Indeed, both fiscal and other structural reforms were seen from the perspective of a general program of progressive approximation to a market economy, with increasing devolution of economic functions (and especially public enterprises) to the private sector and general deregulation. Thus, for instance, Bulgaria moved quickly to eliminate price and other controls that essentially prevented the working of a market economy. Fiscal (and other) reforms were not always effective, however, with the result that in some countries there were remaining inflationary pressures and real interest rates remained too high.

The authorities in these countries generally preferred to carry out significant domestic financial liberalization before proceeding to remove exchange controls on capital account transactions. Liberalization of exchange controls on current account transactions, by contrast, was undertaken before or at an early stage of financial sector reforms. Trade liberalization--desirable on its own right--was viewed as generally supporting both domestic and external financial liberalization.

Both the degree of implementation and the internal sequencing of financial sector reforms varied across countries, and reforms were not always successful either in terms of the original self-imposed targets or more generally in terms of the broad objectives of the reforms. To begin with, despite the emphasis in the analytical literature and in policy making circles on improving prudential regulation and supervision under financial liberalization, progress in these areas was generally slow and in some cases deficient. Closely related to these deficiencies, there remained in some cases much to be accomplished in the area of restructuring of weak and failing institutions and in preventing the making of new nonperforming loans. In some cases, especially in Bulgaria, but also in Tanzania and Uganda, much of the problem continued to stem from the lack of adequate reform of parastatals, which continued to be the main and most unsound borrowers in the system. In the conditions of these countries, no banking reform could be fully successful without an accompanying reform of the associated enterprise sector, especially without the imposition of a hard budget constraint on public sector enterprises. The lack of efficient exit policies including bankruptcy legislation also created a major obstacle to sound enterprise behavior and in consequence to the rationalization of the financial sector. In some other countries (Egypt and India) the continuation of extensive programs of directed and concessional credit and of dominant public ownership of financial institutions reduced the scope for free financial markets.

The authorities in all these countries attempted to make the transition from direct to indirect monetary policy instruments as required by the new market oriented approach. The degree of success and the speed of achievement in this area varied as a result of different initial conditions and the strength of policies. The introduction of indirect instruments was closely interrelated with the development of the money markets, which in most cases were initially unavailable (Bulgaria) or little developed. In Argentina, the need for further development of indirect monetary policy instruments was largely obviated by the introduction of the currency board system.

Reserve and liquidity requirements on the liabilities of financial institutions tended to be lowered and standardized in five of the eight countries where they had ranged from high to very high at the start of the reforms. In each case the authorities ensured that the monetary expansion caused by lower reserve requirements was offset by other monetary policy instruments. By contrast, in Kenya and Tanzania, reserve requirements were significantly increased during the reform period to restrain monetary expansion. This appeared to have resulted from insufficient progress in the development of alternative, market-oriented indirect monetary policy instruments, and of the associated money markets.

2. Observed results

The results of financial sector reforms were relatively favorable in the areas of monetary control and financial development. All countries, except Bulgaria, gained some strength in the fight against inflation, with Argentina becoming a major exponent of the benefits derived from a radical reform that reduced the central bank to a currency board supported by strong fiscal consolidation. Entrenched financial repression was eliminated in all countries, although in some of them many real interest rates continued to be moderately negative. Financial deepening, as measured by the ratio of some broad monetary aggregate to GDP, appears to have gained momentum in most countries. Again, most countries succeeded in redirecting domestic credit from the public to the private sector.

The rate of economic growth was boosted to a historically high level in Argentina, and to a lesser extent it was raised in most other countries. Although Bulgaria did not yet implement many of the structural reforms needed for the full transition to a market economy, it was eventually able to reverse economic decline.

The efficiency of financial intermediation as measured by the spread between lending and deposit interest rates was clearly raised in some countries, like Argentina, as a result of lower inflation, reduced operating costs and lower reserve and other requirements. However, in some other countries the spreads increased as a result of both high loan rates designed to offset the costs of nonperforming loans and the increase in reserve requirement ratios. In some cases, the spreads went up with the liberalization because they were too tight for bank profitability during the pre-reform period.

While there was no overt financial sector crisis in any of the countries, the situation remains difficult in several of them as a result of inadequate restructuring and privatization of financial institutions, weak income recognition norms, and inadequate enforcement of prudential regulations and supervision. Indeed, it would seem that the breakout of an overt financial crisis would necessitate not only the existence of these adverse fundamentals but also a market perception of lack of capacity or willingness on the part of the authorities to resolve the problem. Thus, although the fundamentals in several of the countries were serious enough to be capable of inducing a financial crisis, it would appear that in each case the market believed that the authorities were prepared to prevent such a crisis from occurring at any cost, which in practice meant that the authorities were prepared to pick up the tab for the losses incurred by financial institutions, including future losses. This is of course a situation that, while diminishing the probability of an immediate crisis, can create a serious problem of moral hazard by removing the discipline of financial institutions' owners and managers. Besides the fiscal implications and the continued risk of an overt crisis, the failure to impose financial discipline can diminish the effectiveness of monetary control, and perpetuate an inefficient allocation of credit and resources.

3. Main lessons and recommendations

The main lessons that come out from the experience of these countries can be summarized in terms of the three general objectives of financial sector reforms: On macroeconomic stabilization, the main lesson is the need to persevere with monetary policies that are focused on reducing inflation, which is the best and most direct way to overcome financial repression (low real interest rates) and establish a system where interest rates perform their proper allocative function. At the same time, the authorities must be prepared to strengthen fiscal consolidation both to avoid excessively burdening monetary policy as an anti-inflation devise and to reduce the incidence of excessively high real interest rates that can create problems for sound investors while attracting unsound ones, thereby distorting the allocation of resources.

The second lesson is the need to persevere in the arduous task of improving bank prudential regulation and supervision. This means first of all creating an appropriate bank surveillance and warning system and a capable cadre of trained inspectors to conduct on-site examinations. This necessarily requires much time and effort, but also the full financial support of the authorities. In a liberalized environment, bank supervision should explicitly be recognized as one of the major functions of the monetary and supervisory authorities.

The third lesson is the need to carry out as soon as possible the much needed programs for restructuring and privatizing ailing financial institutions. Restructuring could in some cases involve internal reorganization (especially a change in management) while in others it could be mergers, takeovers of weak financial institutions by larger and stronger ones, or possibly liquidation. Recapitalization of surviving institutions should be an essential part of the program, but this should affect only the reconstitution of past losses and should not provide any guarantees to bail out financial institutions that may get in trouble in the future. A credible liberalization strategy requires that the authorities grade the performance of financial institutions by the operational results that they obtain in a competitive market.

The main general recommendations that follow from these lessons can be summarized as follows. 1/ With regard to macroeconomic stabilization, all countries except Argentina appear to be in need of better performance in the conduct of monetary policy, and greater scope for the development of indirect monetary policy instruments and their effectiveness. In particular, countries like Kenya and Tanzania that have been in danger of loosing monetary control to the point that the monetary authorities have seen it inevitable to increase reserve requirement ratios, obviously urgently need to develop alternative more market oriented indirect monetary policy instruments; these should, if possible, be focused on open market operations in treasury bills. On the issue of bank prudential regulation and supervision, all the countries to a greater or lesser extent urgently need to strengthen their regulatory and supervisory systems. Even in countries with a sound monetary system, like that of Argentina, external shocks such as those registered during the recent turmoil in emerging markets, can create problems for financial institutions that the supervisory authorities will have to address for reasons of safety. Finally, on the issue of restructuring and privatization all countries have urgent tasks to

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1/ For specific measures that remain to be taken on an individual country basis, the reader is referred back to Section III.4 on "Unresolved questions."

accomplish. In Argentina, the new banking problems created by the recent turmoil in the emerging markets require that the authorities restructure or liquidate the affected banks, besides correcting the old problems of the provincial banks. There is an urgent need in all the other countries especially in Bulgaria, Tanzania, and Uganda, that have significant ailing public sector banks, to restructure and privatize these banks to eliminate further losses or if necessary to liquidate some institutions.

Brief Summary of Major Financial Sector Reform Measures

Argentina

March 1991. The so-called Convertibility Plan for macroeconomic stabilization and reform radically changed the economic policy-making environment, through strengthened fiscal discipline and the Convertibility Law. The latter transformed the Central Bank essentially into a currency board, pegged the exchange rate to the U.S. dollar, and established full currency convertibility by eliminating all foreign exchange restrictions on both current and capital account. Interest rates would continue to be market determined, while open-market operations would henceforth be limited to smoothing seasonal liquidity needs of banks. Legal reserve requirements would be progressively reduced from high initial levels, and standardized. At the same time, the authorities began to implement measures to increase the efficiency and soundness of banks (including the Central Bank) by cutting operating costs, eliminating specific financial sector taxes, and strengthening the banks' liquidity and capital base.

September 1992. A new central bank charter reinforced the Convertibility Law and paved the way for an independent, efficient monetary authority.

January 1993. The Central Bank announced measures (e.g., lowering reserve requirements) designed to lower interest rates, reduce financial intermediation costs and lengthen the maturity of deposits.

July 1993. The Central Bank issued new regulations on portfolio concentration and on lending to "connected" parties.

1991-93. Official national and provincial banks underwent reforms designed to streamline operations and improve efficiency by closing loss-making branches and reducing the labor force, whereas private banks expanded operations substantially. The ratio of nonperforming loans for all banks was reduced from 37 percent to 17 percent. The authorities took measures to strengthen the Superintendency of Financial Institutions and improve the accounting system.

End-1994. The Central Bank accelerated the existing schedule for all banks to comply with the Basle capital adequacy standards (originally set to be complied with by some troubled banks only by 1996).

1995. In the aftermath of rapid deposit withdrawals in early 1995, following the Mexican financial crisis, the Central Bank accelerated the restructuring of the banking system (through mergers, takeovers and liquidations), reintroduced an explicit deposit insurance system (albeit private and with partial coverage of deposits), and created two lender-of-last resort safety net Trust Funds to finance the restructuring of provincial banks and some troubled private banks, respectively. Further, to prevent the emergence of a systemic bank liquidity crisis, the Central Bank temporarily allowed banks to reduce (nonremunerated) reserve requirements and proceeded to replace them with prudentially oriented liquidity requirements to be applied uniformly to all deposits. It also allowed for utilization of the free reserves of the Central Bank (that is, reserves beyond those needed as cover against its liabilities). The measures appeared to have substantially calmed the financial markets, without altering the fundamentals of the Convertibility Plan.

Bulgaria

February 1991. The authorities launched a major economic reform program aimed at stabilizing the economy and initiating its restructuring toward a market-based model. This included the introduction of a unified floating exchange rate in a liberalized exchange and trade system, the freeing of most prices, and the liberalization of interest rates.

June 1991. A central bank law was enacted.

July 1991. The authorities initiated bi-weekly auctions of treasury bills (weekly since July 1992).

September 1991. The central bank (Bulgaria National Bank or BNB) initiated bi-weekly auctions of BNB deposits with commercial banks, and also a Lombard refinancing window.

1991. The Government created the Bank Consolidation Company and transferred to it the shares of the 70 state banks (which had resulted from the elimination of the monobank system).

March 1992. A modern banking law was enacted.

October 1992. An electronic interbank clearing system was introduced.

1992. Two stock exchanges were opened up.

1992-93. The BNB issued six prudential regulations covering licensing; exposure limits; capital adequacy; provisioning; liquidity requirements; and internal auditing.

1993. Limited on-site inspections of some banks were initiated.

Mid-1994. Bank credit ceilings no longer were considered an effective instrument for conducting monetary policy and were replaced by reserve money management and indirect monetary policy instruments.

July 1994. A general (non-financial sector) bankruptcy law was enacted.

August 1994. The BNB intervened in one of the two major ailing banks, mandating a program to improve loan collection, limit activities, reduce expenditures, and reorganize its branch system.

Late 1994. Under a new bad loans law, the authorities designed a program for restructuring the two major ailing banks.

1992-1994. Economic developments were disappointing as the stabilization effort faltered and slow progress was made in the area of structural reforms. The pace of financial sector reforms slowed down and fell short of expectations in many areas, particularly in restructuring and privatization of the financial system, and bank supervision. Credit expansion continued to be excessive and dictated by interest capitalization of nonperforming loans, inter-enterprise arrears and the granting of special credit.

January 1995. The new Government quickly pushed reforms designed to reduce inflation, stabilize the exchange rate, and reform the ailing banks.

Ecuador

May 1992. A new Monetary and State Bank Law was enacted with a view to modernizing the Central Bank of Ecuador (CBE), removing its commercial and development banking functions--part of which were transferred to the new State Bank--and improving monetary policy instruments.

September 1992. The new Administration announced a package of stabilization and reform measures which included substantial financial sector reforms: the liberalization of interest rates (November 1992); setting up money and foreign exchange desks at the CBE and initiating open market operations on a weekly auctions basis (late 1992); reducing bank reserve requirements; providing for a recapitalization of the CBE; and floating the exchange rate applied to private market transactions (the official rate applied to public sector transactions continued to be controlled).

January 1993. A market-based system of reference interest rates was introduced (including for central bank bills) to increase market transparency.

May 1993. A new Securities Markets Law was enacted which privatized the country's two stock exchanges, created a National Securities Council, and regulated the activities of brokerage firms.

September 1993. The official selling exchange rate was linked to the rate in the free market.

May 1994. Congress approved a new Financial Institutions Law designed to increase the efficiency of financial intermediation. This law also clarified the respective responsibilities of the Superintendency of Banks and the CBE, and initiated a process of reform designed to strengthen the Superintendency of Banks. The Government submitted to Congress a new central bank charter designed to strengthen the independence of the CBE (but this law remained stalled in the opposition-controlled legislature).

Late 1994. The CBE pre-announced an exchange rate path through end-1995, with an intervention band of 4 percent. (However, in early 1995, following the conflict with Peru, the authorities devalued the midpoint of the band by 3 percent and sought to contain the depreciation of the midpoint to 15 percent for the whole of 1995).

1994. The CBE underwent substantial restructuring with a reduction of about 40 percent of employment. Several public financial institutions were also subject to restructuring and streamlining of functions.

February 1995. A new Banking Board was created with responsibility for strengthening the financial sector's regulatory framework and expediting steps to improve the Superintendency of Banks.

June 1995. The maximum spread between buying and selling exchange rates for all official transactions was reduced to 2 percent.

Egypt

January 1991. The authorities freed bank interest rates (with few exceptions such as the prohibition to pay interest on demand deposits); started weekly auctions of treasury bills; unified and floated the exchange rate; and substantially liberalized all exchange controls. Throughout the year preparations were made for improvements in monetary policy formulation and introduction of indirect monetary policy instruments; maintaining a competitive financial sector; and strengthening prudential regulation and supervision.

1992. The pace of financial sector reforms went through a period of consolidation, with improvements made to the banking, credit, central bank, and securities legislation.

Early 1993. A new law permitted existing and future branches of foreign banks to operate in Egyptian pounds.

February 1993. The Central Bank of Egypt (CBE) effected the switch from direct to indirect monetary policy instruments, following two years during which both systems were run in parallel. (Credit ceilings by the CBE to public sector banks were retained until June 1993).

May 1993. The prohibition to pay interest on demand deposits was removed, and a program of reduction of subsidized credit was initiated.

Late 1993. The authorities developed a plan for selling the public sector's holdings in joint venture banks and for privatizing one of the four large public sector banks within a two and a half year time frame.

April 1995. For the first time the Government issued medium-term bonds, most of them purchased by the commercial banks.

India

Last quarter of 1991. In connection with an economic adjustment program supported by a 20-month stand-by arrangement with the Fund, the authorities conceived a plan for gradual financial sector reforms which included a progressive liberalization of interest rates, a more market-oriented allocation of credit (reducing thereby directed lending), switching from direct to indirect monetary policy instruments, enhancing the soundness of the banking system, and furthering the development of the capital markets.

October 1991. The authorities freed bank lending rates to nonpriority sectors, and also liberalized some interest rates outside the banking system. (Bank deposit rates remained under control, but were raised).

November 1991. The Government issued the Narasimham Committee Report, which provided the blueprint for financial sector reforms. A significant early measure was the replacement of all bank ceilings on deposit rates by a single rate ceiling (13 percent) to be kept above the prevailing inflation rate. Other measures over time comprised the introduction of capital adequacy standards, improved provisioning, rationalization of the system of preferred credits and associated subsidized interest rates, a reduction in the statutory liquidity ratio and the cash reserve ratio, and the shift to market-related rates of interest for new government debt. Although large-scale privatization of state banks was not contemplated, the authorities liberalized the entry of new private sector banks to promote competition.

January 1992. The Securities Exchange Board of India was given statutory powers.

March 1993. India switched over from an explicit dual exchange rate system to a unified market-based exchange rate system.

Mid-1994. The 1994/95 budget stated the Government's intention to phase out its automatic access to RBI financing over the next three years.

1993-94. The authorities took various measures to revive the securities markets, which were affected by a securities scandal in 1992. A model National Stock Exchange with screen-based trading commenced operations in July 1994. The authorities gradually removed capital controls on foreign direct investment, portfolio flows and nonresident deposits.

Kenya

Late 1990. The auction system for treasury bills was freed from all intervention, and new bearer bonds were introduced.

July 1991. The authorities removed all ceilings on bank interest rates, and almost simultaneously commenced open-market operations with treasury bills.

April 1993. The Government adopted a macroeconomic framework to resolve the deteriorating economic and financial situation. 1/ In relation to the financial sector, monetary policy was tightened, including through an increase in the statutory cash ratio from 6 to 12 percent in three stages; 2/ the stability of the financial system was largely restored by various actions including closing four commercial banks which were responsible for irregular transactions, replacing the management of two other banks, liquidating 8 nonbank financial institutions, and changing the management of the CBK and conducting an external audit of its balance sheet; and the exchange and trade system was liberalized, with unification of the private and official rates achieved in October 1993.

October 1993-September 1994. A new one-year economic program included further measures to ensure a sound banking system including restructuring of the National Bank of Kenya, the largest state bank; and rehabilitating another commercial bank. The authorities also contemplated amending the CBK and Banking Acts to strengthen the role and independence of the CBK and reinforce banking supervision but this legislation remains to be enacted. The program also included measures to improve the structure of interest rates, expand government securities markets, and encourage activity in the Nairobi Stock Exchange.

January 1995. The removal of restrictions on inward portfolio investment completed the liberalization of the exchange system.

Tanzania

April 1991. Amendments to the Bank of Tanzania Act and enactment of a new Financial Institutions and Banking Act enhanced the autonomy of the Bank of Tanzania (BOT) and provided it with powers for licensing, setting prudential regulations, and undertaking supervision. (The Financial

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1/ Structural reforms faltered in 1992 and new and pressing problems emerged, including a serious deterioration in the solvency and liquidity of many financial institutions. This culminated in an economic crisis in March 1993.

2/ The ratio was further increased in stages to 20 percent by March 1994, as the authorities needed to contain an excessive increase in the money supply but lacked alternative effective indirect monetary policy instruments.

Institutions and Banking Act of 1991 was amended in 1993 to provide for capital adequacy requirements in line with the Basle Agreement).

July 1991. A single maximum lending rate of 31 percent replaced the previous complex system of fixed rates and fixed differentials.

Early 1992. Following a comprehensive audit of the National Bank of Commerce (NBC)--the dominant state bank--and of the Cooperative and Rural Development Bank (CRDB), a large amount of their nonperforming assets was transferred to the new Loans and Advances Realization Trust (LART) and replaced by government bonds. (Further recapitalization of these two banks was undertaken in October 1993 but restructuring and privatization did not gather momentum until 1994; see below). A new Foreign Exchange Act increased the flexibility of the official exchange rate, and the authorities strived to keep this rate within 20 percent of the exchange bureau rate.

June 1992. The strengthening of the BOT began with a tightening of its rediscount facilities.

July 1993. The lending rate ceiling was removed, effectively deregulating interest rates. A foreign exchange auction system was introduced, and forex bureaus promptly became major participants in the auctions. The surrender requirement on proceeds from nontraditional exports was abolished.

August 1993. The authorities began auctions of treasury bills and initiated steps for the eventual introduction of indirect monetary policy instruments. (However, structural rigidities and the deficient liquidity position of the NBC prevented the effective utilization of new market-based instruments for monetary control. The BOT was forced to rely on repeated increases in the minimum reserve ratio which went from 4 percent in mid-1993 to 15 percent in November 1994). The exchange system was virtually unified with the official rate set on the basis of the rate determined in the foreign exchange auction.

Late 1993. Entry of new commercial banks started with the licensing of two new private commercial banks. (Several other private banks commenced operations in 1994 and 1995).

December 1993. The authorities restructured the BOT.

June 1994. An interbank market for foreign exchange replaced the foreign exchange auctions system. The surrender requirement on proceeds from traditional exports (except coffee) was abolished (for coffee exports abolished in December 1994).

1994. The authorities commenced the restructuring of the three existing state commercial banks beginning with the NBC, to be followed by the CRDB and the People's Bank of Zanzibar (PBZ). The NBC Act was amended in August 1994 to allow for private shareholding in this bank.

February 1995. A new Bank of Tanzania Act with provisions more appropriate for a market-oriented environment was enacted.

Uganda

Fiscal year 1990/91. Besides continuing the reform of the Bank of Uganda (BOU), the authorities began to focus attention on the rehabilitation of problem banks, especially the Uganda Commercial Bank (UCB) and the Cooperative Bank. A new management team provided under Swedish technical assistance took charge of the Cooperative Bank.

Mid-1991. The Government constituted a team headed by the BOU to address the reform of the financial system and, especially, the introduction of indirect monetary policy instruments. Although interest rates continued to be administered, they were set with a view to keeping them at positive real levels.

January 1992. The Government introduced an auction system for allocating donor import support assistance.

February 1992. After many years in which the BOU did not produce its own balance sheet, the audited accounts of the BOU began to be issued, which facilitated the preparation of monthly balance sheets with only a two-month lag.

March 1992. The BOU eliminated the official exchange rate by commencing to value all central bank external transactions not undertaken through the auction market at the forex bureau exchange rate; and efforts began at narrowing the gap between the forex bureau and auction rates.

May 1992. The authorities introduced an auction system for selling treasury bills.

November 1992. As a transitory measure before full liberalization, the BOU linked the one-year deposit rate, the lending rates on credit to the agricultural sector, and the rate on term credit, to the preceding month's average treasury bill rate. Other rates were freed to be determined by the market.

Early 1993. A new Bank of Uganda Act and a new Financial Institutions Act were enacted by Parliament. The new legislation affirmed the independence of the BOU. The BOU continued its restructuring and that of the UCB and other banks. Later in the year, the BOU issued regulations on capital adequacy requirements, prudential norms on asset quality, limitations of advances to insiders, reporting requirements, and new guidelines for licensing banks.

November 1993. The exchange rate auction system was replaced by a new interbank foreign exchange market for both banks and exchange bureaus. Subsequently, all exchange restrictions on current account were lifted.

July 1994. Interest rates were fully liberalized by abolishing all links between certain rates and the treasury bill rate. A Deposit Insurance Fund was established.

December 1994. The authorities took measures to broaden and deepen the treasury bill market and to establish appropriate conditions for the emergence of a secondary market in treasury bills. A recapitalization plan for the BOU was agreed upon.

First half of 1995. The Nonperforming Assets Recovery Trust (NPART) was established to receive and administer the nonperforming assets of the UCB in anticipation of formal recapitalization, restructuring and privatization of this bank. The need for an effective restructuring of other weak banks was also recognized.