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February 8, 1993

To: Members of the Executive Board

From: The Secretary

Subject: Review of Financial Sector Reforms Under Programs Supported by ESAF Arrangements

Attached for consideration by the Executive Directors is a paper reviewing financial sector reforms under programs supported by ESAF arrangements. This paper, together with the paper on the review of experience under ESAF-supported arrangements (EBS/93/16, 2/3/93), is tentatively scheduled for discussion on Monday, March 1, 1993.

Mr. W. Alexander (ext. 35366) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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Review of Financial Sector Reforms Under Programs Supported by ESAF Arrangements

Prepared by the
Monetary and Exchange Affairs Department

(In consultation with other departments)

Approved by Manuel Guitián

February 5, 1993

Contents

Contents | Page

I. Introduction

This paper reviews domestic financial sector reforms undertaken with the support of an ESAF arrangement. 1/ Efficient financial intermediation has been identified as an important factor contributing to both stabilization and economic development. All programs supported by ESAF arrangements included some financial sector commitments as part of their matrix of planned measures, although not always as structural benchmarks.

Financial reforms varied from country to country, but in general they contained measures designed to make the financial sector sounder and more efficient, and thus more responsive to market forces and more competitive. The main policy areas include: (a) making interest rates more market determined; (b) increasing reliance on indirect monetary policy instruments as opposed to direct credit controls, including supporting reforms to develop money markets; (c) reducing market fragmentation and increasing competition among financial institutions; (d) restructuring weakened financial institutions; (e) strengthening prudential regulation and supervision. This paper attempts to assess the rationale of the measures adopted by the authorities of the ESAF-arrangement countries in the light of the ultimate objective of achieving sustainable growth, and the degree of success achieved.

Making such an assessment is complex, because these countries are diverse in terms of the initial conditions, the exogenous disturbances they have faced, and their success in implementing other aspects of their ESAF programs. Available data do not readily permit the disentangling of the effects of financial reform from the effects of other elements of the overall ESAF program. With this heterogeneous sample, generalizations are difficult, but one can identify particular circumstances and policies that were conducive to success or failure. Moreover, there is seldom a clear beginning or end to the process of financial reforms, and many ESAF arrangements are of fairly recent vintage. Almost all the twenty one ESAF arrangements agreed by September 1992 developed out of lengthy adjustment programs, and by end-May 1992 only eight third-year arrangements had been approved, while five countries had not yet completed their first-year

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1/ The paper was written to complement the general ESAF review prepared by PDR. Additional information, especially on the relation between ESAF programs and antecedent programs, can be found in documents relating to the 1991 review of the operations of the SAF and ESAF (EBS/91/109 and 110).

reviews. 1/ Therefore, rigorous tests of the contribution of ESAF programs to allocative efficiency and long-term development are not normally feasible. An assessment at this stage of the reform process must be based on weaker criteria, such as whether the authorities' reform packages are comprehensive and internally consistent, address the problems at hand, and are implemented in a timely manner. By the same token, it is important to identify the financial environment at the beginning of the program period and recognize that comprehensive structural reform takes time.

The paper is structured as follows. Section II provides a stylized description of the financial system in ESAF countries at the beginning of the reforms and also highlights differences that may explain divergent performances under the programs. Section III discusses the most important financial sector measures contained in ESAF-supported programs, their motivation, and the record of implementation. Section IV summarizes the lessons for program design that can be drawn from this review. In order to be able to go into the details of financial sector reform, appendices contain several tables of financial statistics, and brief case studies of financial sector reforms in four countries. 2/

II. The Financial Sector at the Beginning of ESAF Programs

Countries with ESAF arrangements are diverse in many regards, but share certain structural characteristics. 3/ Table 1 shows some of the features of the financial sectors of the 21 countries before their adoption of ESAF programs. Several similarities can be found: reliance on direct credit ceilings for monetary control (14 countries); widespread selective

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1/ The countries considered, with the date of their first ESAF arrangement, are: Bangladesh (August 1990); Bolivia (June 1988); Burundi (July 1991); The Gambia (October 1988); Ghana (September 1988); Guinea (November 1991); Guyana (July 1990); Honduras (July 1992); Kenya (May 1989); Lesotho (May 1991); Madagascar (May 1989); Malawi (July 1988); Mali (August 1992); Mauritania (May 1989); Mozambique (June 1990); Niger (December 1988); Senegal (October 1988); Sri Lanka (September 1991); Tanzania (July 1991); Togo (May 1989); and Uganda (April 1989). The arrangements for Nepal and Zimbabwe were approved too late to be included in this review. Bolivia and Malawi have entered into additional fourth year ESAF arrangements.

2/ The evidence presented is taken from various Fund documents. Data on monetary aggregates and prices are taken from International Financial Statistics whenever possible in order to maximize comparability. Data on national accounts and projected and preliminary data had to be taken from Fund documents such as the relevant "Recent Economic Developments." Even so, the comparability and accuracy of all data cannot be vouchsafed.

3/ The "ESAF Review" prepared by PDR discusses the initial conditions of ESAF countries. See also the Statistical Annex.

Table 1. ESAF Countries: Financial Sector Characteristics Prior to Reform

(1=yes; 0=no)

Country	Interest Rate Controls	Negative Real Rates	Credit Ceilings	Portfolio Restrict-ions	Subsidized Interest Rates	Banks Largely State Owned	Central Bank Losses	Accountancy Problems	Tax Distortions
Bangladesh	1	0	0	1	1	1	0	1	0
Bolivia	0	0	0	0	1	0	1	1	0
Burundi	1	1	0	1	1	1	0	0	1
The Gambia	0	0	1	0	1	0	1	1	0
Ghana	0	1	1	1	1	1	1	1	0
Guinea	1	1	0	0	1	1	0	1	0
Guyana	1	1	0	0	1	0	0	0	0
Honduras	1	1	0	0	1	0	0	0	1
Kenya	1	1	1	1	0	0	0	1	0
Lesotho	1	1	0	0	0	0	0	0	1
Madagascar	1	0	1	1	0	1	1	0	1
Malawi	1	1	1	0	1	0	0	0	1
Mali	1	0	1	1	1	1	0	0	0
Mauritania	1	0	1	0	1	1	1	1	0
Mozambique	1	1	1	0	1	1	0	0	0
Niger	1	0	1	1	1	1	0	0	0
Senegal	1	0	1	1	1	1	0	0	0
Sri Lanka	0	0	1	1	1	1	0	1	0
Tanzania	1	0	1	1	1	1	0	1	0
Togo	1	0	1	1	1	1	0	0	0
Uganda	1	1	0	0	0	1	1	1	0
Total	17	9	13	11	17	14	6	10	4
					(In percent)				
Share of sample	81	43	62	52	81	67	29	48	19

credit controls in the form of subsidized interest rates (18 countries) and/or portfolio restrictions (14 countries); a large proportion of the financial sector under state-ownership (13 countries); the prevalence of nonperforming loans; weak competition in the financial sector, sometimes constrained by regulation; and difficulties in debt recovery where creditors could not readily either obtain security or enforce loan contracts.

Saving ratios tend to be low in many countries: the data in Table 7 of Appendix I show that 12 countries have had gross domestic saving to GDP ratios of 10 percent or less; however, five countries maintained savings ratios above 15 percent. 1/ Financial savings, as measured by the ratio of monetary aggregates to GDP, are below those found in industrialized economies, as illustrated in Table 8; in Burundi, Ghana, Niger, and especially Guinea and Uganda the ratio of broad money to GDP was persistently below 20 percent. 2/ Data on holdings of other financial instruments are not available, but in almost all ESAF arrangement countries there are few substitutes for bank deposits available to the public. The ratios of currency in circulation to broad money, reported in Table 9, are above 20 percent in 16 of the countries, indicating that in many countries even the provision of transactions services is not well developed. 3/

Tables 1 and 12 indicate that in most countries (17), interest rates were set administratively and inflexibly. One common feature, shown in Table 11, was for ex post real interest rates to be negative and sometimes highly variable. 4/ The data in Table 13 suggest that the spread between deposit and lending rates--often set by regulation--was rather narrow in a number of countries (most clearly Bangladesh, Guinea, Guyana, Kenya, Madagascar and Mozambique). Insofar as the spreads were set with little regard for banks' costs and credit risk, and constraints were binding, banks made abnormally low profits.

Other features were found in just a few countries. Examples include various problems in the area of accountancy, bank reporting or monetary statistics (10 countries), central bank losses (5 countries), and

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1/ However, of those five, the data for Lesotho represent national as opposed to domestic savings, which are dominated by large and variable remittances from workers in South Africa.

2/ This ratio is difficult to interpret in the case of Bolivia due to the high degree of "dollarization" caused by earlier hyperinflation.

3/ This ratio is positively correlated with the share of the primary sector in GDP. In some instances a high ratio of currency to broad money may be mainly a reflection of a flourishing illicit parallel economy.

4/ Real rates were negative in Ghana and Lesotho despite liberalization due to excess liquidity in the banking system and credit controls. Note that real interest rates are measured here ex post, as the difference between interest rates at the start of the year and inflation over that year; ex ante and ex post real rates may differ significantly insofar as inflation expectations are not fulfilled.

distortionary taxation of the financial system (4 countries). Also, the degree of financial sector development and competition was far from homogeneous, ranging from relatively sophisticated and/or competitive in Bolivia, Kenya, Sri Lanka, and Togo to relatively limited in Malawi and Mozambique.

Four countries--Mali, Niger, Senegal, and Togo--are members of the West African Monetary Union (WAMU), and therefore have only limited scope for autonomous financial sector reform. 1/2/ The BCEAO, the central bank of the WAMU, has been implementing a number of financial sector reforms since September 1989, aimed at the phased replacement of administrative controls on money and credit with a market-based system of monetary instruments. As a result, the preferential discount rate was abolished and the structure of interest rates was simplified; banks were given greater flexibility in determining rates on deposits and loans; a supranational supervisory authority was established in order to strengthen banking supervision; and the policy of sectoral credit allocation was abolished. These major reforms were implemented in all countries in the WAMU and, strictly speaking, were undertaken independently from the ESAF program. It was possible, however, to build on these welcome reforms and to take account of them in designing ESAF programs for particular countries.

By the time most countries started an adjustment program supported by an ESAF arrangement, they had already identified the need to engage in financial sector reforms as part of their overall economic strategy. Many had begun the process of reform in the context of previous Fund and World Bank-supported programs or, as in the case of the WAMU countries, in the context of a monetary union agreement. Yet even where this process had been pursued with determination and the ESAF program could build on substantial progress, the financial sector faced difficulties, and further reforms were needed.

III. Main Financial Sector Measures in ESAF Programs

Most of the structural characteristics of ESAF arrangement countries described in the previous section were considered important impediments to the stabilization and development of those economies. Hence, ESAF-supported programs sought to remove these impediments through improvements in resource mobilization, monetary control, and the efficiency of resource

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1/ Benin, Burkina Faso, and the Ivory Coast are also members of the WAMU.

2/ To a lesser degree, reform in Lesotho is constrained by that country's integration into the South African financial system.

allocation. 1/ These objectives are reflected in the four main groups of specific measures discussed in this section: interest rate policies, changes in monetary policy instruments, the removal of quasi-fiscal distortions, and institutional reforms.

Changes in interest rate policies contributed to all three objectives of financial reform. The refinement of monetary policy instruments was aimed primarily at maintaining monetary control in a liberalized environment. The elimination of quasi-fiscal distortions was geared to ensuring that policies that interfere with resource allocation did so transparently and with explicit distributional or efficiency purposes. Structural/institutional reforms covered restructuring of the banking system and modernization of central banks, including improvements in banking supervision and regulation, in order to improve resource allocation by increasing competition and removing institutional inefficiencies, and to enhance the effectiveness of monetary policy.

The question of the sequencing of financial sector reforms inevitably arises. As the answer depends largely on considerations of adjustment costs and the lags involved in the creation of new institutions, a thorough discussion of the issues goes beyond the scope of this paper. Although one might wish to advance in all areas at once, the "frictions" involved may differ, and therefore optimal sequencing is contingent on circumstances. For example, in removing quasi-fiscal distortions, allowance should be made for the difficulty of reallocating resources that were invested in anticipation of continued preferential support from the financial sector. Nevertheless, certain principles are generally applicable, such as the importance of not entirely eliminating direct instruments of monetary policy implementation such as interest rate controls and credit ceilings before indirect instruments are available and operational. Similarly, it is dangerous to deregulate interest rates fully with a noncompetitive and under-regulated banking sector, and without the prior or simultaneous establishment of an appropriate supervisory framework. 2/

1. Interest rate policies

ESAF-supported programs have contained four types of interest rate policies: (i) increases in interest rates to make them positive in real terms; (ii) rationalization and eventual liberalization of interest rates;

1/ Improved monetary control is not an end in itself, but is valued for its contribution to ultimate welfare objectives. It is useful, however, to distinguish this intermediate goal from the more microeconomic aspects of reform.

2/ See V. Sundararajan and Tomás J.T. Baliño, Banking Crises: Cases and Issues, International Monetary Fund (Washington, 1991).

(iii) changes in central bank interest rates; and (iv) reductions in the implicit subsidy in preferential interest rates. 1/

Most ESAF-supported programs, even some of those in countries where interest rates already had been liberalized, included an increase in interest rates. According to the respective Policy Framework Papers (PFPs) and letters of intent, the objective of this increase was generally to improve resource mobilization and/or allocative efficiency (14 out of the 21 countries). It is notable that the PFPs for Ghana, Guyana, Kenya, Malawi and Mauritania, where savings rates were already relatively high, mention the need to increase savings further; interest rate liberalization may be more important in increasing the efficiency of capital allocation than in raising savings. 2/ Foreign interest rates were most important as a factor guiding interest rate policies in those ESAF countries that have a largely open capital account or where remittances from expatriate workers are important (The Gambia, Guyana, Lesotho, Sri Lanka and the WAMU members), although all countries had to take capital flows into consideration.

Several ESAF countries have completely deregulated commercial bank lending and deposit interest rates (see Table 2). Four countries had already completed interest rate liberalization prior to the outset of their first ESAF-supported program, while five other countries have achieved market-determined rates in the context of the program.

The general approach was to maintain a system of ceilings on loan rates and/or floors on deposit rates while making more timely adjustments to ensure that key rates were positive in real terms until indirect monetary instruments could be developed and more competition in the financial sector could be achieved. Typically, but not universally, lending rates were liberalized before deposit rates, presumably to enhance or maintain banks' profitability, while the level of all rates was adjusted so that they were positive in real terms. At the same time, efforts were made to allow banks to differentiate more between their borrowers by decontrolling all but the prime lending rate and liberalizing bank charges. Of course, deregulation will not in itself lead to the competitive determination of interest rates, if the financial sector remains uncompetitive, as in Burundi, Malawi and Sri Lanka for example, or strongly influenced by the moral suasion of the authorities, as in Ghana and Malawi.

2. Changes in monetary policy instruments

After interest rate liberalization, the next step in a financial reform typically has been to begin the process of deregulating the

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1/ Only the first two will be discussed in this subsection; the remaining two will be discussed in the subsections on monetary policy instruments and quasi-fiscal distortions, respectively.

2/ See Gelb, A., "Financial Policies, Growth and Efficiency," World Bank Working Paper, Country Economics Department, No. WPS 202 (World Bank 1990).

Table 2. ESAF Countries: Reform of Interest Rate Regulations and Credit Ceilings

Country	Pre-ESAF	ESAF I	ESAF II	ESAF III
Bangladesh	Greater flexibility in interest rate guidelines Credit ceilings removed		Wider permissible risk and term premia	Deregulation of non-concessional lending rates, only minimum deposit rates set
Bolivia	Interest rates market determined No credit ceilings			
Burundi	Deposit rates and rates on nonrefinanceable lending deregulated Credit ceilings removed	All rates freed	...	...
The Gambia	Interest rates market determined Ceilings on bank credit			Credit ceilings removed
Ghana	Maximum lending and minimum deposit rates freed, then minimum savings rate freed Ceilings on bank credit		Credit controls removed	Decontrol of bank charges
Guinea	Minimum deposit rates and rates on refinanceable lending set No credit ceilings		...	...
Guyana	Only minimum lending rate set, and minimum term deposit rates suggested No credit ceilings			...
Honduras	Most lending rate limits lifted. Risk and term premia restricted No credit ceilings	Bank service fees deregulated	...	...
Kenya	Minimum deposit rate and maximum lending rate set Ceilings on bank credit		Constraint on lending rates made less rigid	Interest rates fully deregulated
Lesotho	Only minimum deposit rate and prime lending rate set No credit ceilings		Rates to be deregulated	...
Madagascar	Only discount and minimum deposit rate set Ceilings on bank credit		Allocation of credit ceilings rationalized	...

Table 2 (concluded). Reform of Interest Rate Regulations and Credit Ceilings

Country	Pre-ESAF	ESAF I	ESAF II	ESAF III
Malawi	Loan rates deregulated Ceilings on bank credit	Deposit rates deregulated		Credit ceilings removed
Mali	Rate schedule simplified, made less rigid Coverage of credit ceilings expanded	...	...	...
Mauritania	Rates administered Ceilings on bank credit		Rates to be freed but for a minimum deposit rate and a maximum loan rate	...
Mozambique	Rates administered Ceilings on bank credit	Rate structure simplified		...
Niger	Detailed schedule of interest rates Ceilings on bank credit	Rate schedule simplified, made less constraining Coverage of credit ceilings expanded		
Senegal	Detailed schedule of interest rates Ceilings on bank credit	Rate schedule simplified, made less constraining Coverage of credit ceilings expanded		
Sri Lanka	Interest rates market determined Credit ceilings reimposed	Credit controls removed		...
Tanzania	Rates administered Ceilings on bank credit	Maximum lending rate set, deposit rates free given positive real 12-month rate	Maximum on lending rate to be eliminated	...
Togo	Detailed schedule of interest rates Ceilings on bank credit	Rate schedule simplified, made less constraining Coverage of credit ceilings expanded		
Uganda	Spread between maximum lending and minimum deposit rates widened No credit ceilings			

allocation of credit, as shown in Table 2. In a fully liberalized financial system, both the allocation of credit among competing sectors and its price (the interest rate) are determined by the interplay of market forces, without direct intervention by the monetary authorities. The central bank must then seek to control the supply of short-term liquid assets available to the banking system, and so to affect monetary conditions indirectly by altering the circumstances faced by key participants in the credit market.

Several techniques are potentially available to influence the liquidity of the banking system: reserve requirements can be adjusted; the availability and cost of central bank refinancing can be varied; short-term government securities can be issued or redeemed in the primary market; and securities can be traded in the secondary market (open market operations). Some or all of these measures can be found in most ESAF programs, which usually have included the objective of implementing or improving a system of indirect monetary control.

Changes to reserve requirements have appeared most frequently (Burundi, Ghana, Guinea, Honduras, Kenya, Madagascar, Malawi, Mauritania, Mozambique, and Uganda), usually at an early stage of the ESAF program, or sometimes in the program that preceded it. 1/ Sometimes, technical refinements to improve reserve requirements as an instrument of liquidity management have been implemented, for example, measuring the reserve base as a period average rather than on a particular day such as a month-end. In some cases, too, the central bank has decided to use changes in reserve requirements more actively as an instrument of monetary control (Bangladesh, Kenya, Malawi, and Uganda) before the introduction of more flexible instruments.

Measures to make central bank refinancing more market-oriented included defining the refinance rate to be at a small margin above the treasury bill or bank rate (Burundi, Guyana, Malawi, and, it was once intended, in Sri Lanka), or the introduction of at least a primitive auction of refinance credits (Madagascar and, it was planned, in Mauritania). Some countries such as Burundi, Tanzania and Mauritania have also tightened what had been very easy access to refinancing, although in several cases control over refinancing was limited by the need to maintain the liquidity of financially distressed institutions (Kenya, Madagascar, Mauritania, Sri Lanka).

The introduction of securities, such as treasury bills, central bank bills or certificates of deposit, has been a feature in several ESAF programs and the preceding SAF programs. A security can provide the central bank with the means to inject or withdraw liquidity from the system and, once the security is widely held and actively traded, with a benchmark

1/ The WAMU countries do not have reserve requirements. Four countries introduced reserve requirements in the course of their programs (Burundi, Guinea, Malawi, and Mozambique).

interest rate determined in a competitive market. The term structure of interest rates may be clarified by the introduction of longer-term securities. In some cases (such as Ghana, Guyana, and Lesotho), they have also been used to reduce persistent excess levels of liquidity and so ensure that banks become responsive to central bank actions to adjust liquidity.

Programs often feature the introduction of a regular auction of short-term securities. Thereafter, programs typically concentrate on refining auction procedures to increase efficiency and (sometimes) to encourage nonbank participation (Bolivia, Burundi, Guyana, Honduras, Kenya, Lesotho, Madagascar, Malawi, and Sri Lanka). Issues are complex (e.g., selection of appropriate maturities and denominations), and addressing them typically has required substantial technical assistance.

Several countries have progressed beyond the establishment of bill auctions to the development of active secondary markets, interbank markets, and money markets. Such markets are essential for the full development of indirect methods of monetary control, since they provide the central bank with the means to adjust liquidity on a day-to-day basis through open market operations. Necessarily, progress at this level of sophistication has been slow, and is governed in part by the speed at which the central bank, financial institutions and the nonfinancial public can develop an appropriate operating strategy for conducting open market transactions, as well as experience in the new environment. As a result, few countries yet rely primarily on open market operations as an instrument of monetary policy. Some countries have attempted to improve the functioning of the interbank market (Madagascar, and Mauritania); others have focused on developing a secondary market for treasury securities (Burundi, Kenya, Guyana, and Sri Lanka), for instance, by issuing bearer certificates, having the central bank act as a broker, or licensing primary dealers. Only Bolivia, Kenya and, very recently, Sri Lanka began conducting true open market operations during their ESAF programs. 1/

Finally, the central bank must be organized to make good use of these instruments. The judicious use of indirect instruments of monetary policy implementation requires that the central bank has the means to acquire relevant information and formulate policy with consistency and speed. In most ESAF countries the importance of upgrading monetary programming skills in the central bank has been recognized, for example, through the establishment of a unit in the central bank dedicated to the conduct of open market operations (Bangladesh, Guyana, Kenya, Madagascar, and Sri Lanka), and often with technical assistance from outside experts.

1/ The term "open market operations" is often used loosely, and confusingly, to designate any sale of securities by the central bank in the primary market or at a secondary "window." Open market operations involve regular transactions, on a voluntary basis and at market-clearing rates of interest, in which the central bank is guided by monetary programming considerations.

Sometimes legislation was needed to increase the flexibility of the central bank in its operations (Malawi), or its independence from short-term political pressure (Tanzania).

3. Removal of quasi-fiscal distortions

ESAF programs have supported the reduction or removal of quasi-fiscal distortions that affect the financial sector. Quasi-fiscal policies operate through the financial system to affect the allocation of resources across sectors. They can be implemented either by regulating the distribution of credit through certain portfolio restrictions, or by influencing prices through the tax treatment of different financial instruments, interest rate subsidies and regulations, and subsidized domestically-funded (central bank) lines of credit. In several ESAF arrangement countries, as elsewhere, the cost of these quasi-fiscal activities was borne by the central bank, and the elimination of the resultant losses has become a pressing need.

Several ESAF programs contemplate the removal of quasi-fiscal portfolio restrictions because they interfere with commercial banks' ability to base their decisions on considerations of risk and return. Many ESAF countries have effectively removed (11 countries) or have plans to remove (2 countries) such restrictions. 1/ However, in a few countries selective credit controls remain important, and there are cases in which "moral suasion" was used to encourage credit to productive sectors (Ghana Lesotho).

Improvements in the taxation of the financial system do not seem to have been stressed in ESAF programs. Only the programs for Burundi, Lesotho and Malawi (and Sri Lanka under a previous program) called for specific measures, that is, a requirement to eliminate distortionary taxes which favor certain financial instruments over others. One element of the program for Honduras was the reduction in the implicit tax that had been generated by a high reserve requirement without remuneration.

Many central banks provide lines of credit to finance specific economic activities (e.g., manufacturing, agriculture). These lines of credit are generally funded with central bank resources, typically at subsidized interest rates. State development banks or commercial banks, in turn, on-lend these resources at below-market rates. Most ESAF countries have eliminated (11 countries), or have plans to eliminate interest rate subsidies (7 countries).

Limited central bank financing at below market interest rates sometimes continued under ESAF programs, at least initially. Particularly in countries where the agriculture sector is very important, seasonal crop

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1/ For example, in November 1990 the regulation was revoked requiring banks in Ghana to make 20 percent of their loans to the agricultural sector.

financing was used to protect the domestic market from high and fluctuating interest rates (Ghana, The Gambia, Mozambique, and WAMU members). 1/2/ In some countries, a gradual reduction of preferential credit was encouraged, to be replaced by external lines of credit which are to be auctioned to the banking system (Bolivia and Honduras). If a country insisted on maintaining subsidies, they were to be financed through the public sector budget (Sri Lanka). Even so, there have been delays in the implementation of these measures, in some cases due to the perception that interest rates were "too" high (for instance, in Bolivia, Guyana, and Sri Lanka).

Central bank operating losses brought about by involvement in quasi-fiscal policies not only pose a major threat to a central bank's independence, but they also impair its effectiveness by increasing its reliance on budgetary transfers, or by becoming a source of money creation. The principal source of such losses is the exchange rate exposure incurred when a central bank intermediates between foreign lenders and the domestic government and public enterprises without an adequate guarantee of reimbursement for debt service payments. The ESAF program for Bolivia was designed to eliminate the central bank's losses. 3/ It has been necessary to modify programs in a number of countries (The Gambia, Ghana, Madagascar, Mauritania) to deal with the nonperforming assets or expensive liabilities on the books of the central banks.

4. Structural and institutional reforms

Not only the central banks, but also the other financial institutions of many countries entering into ESAF arrangements were adapted to a system of administrative credit allocation and controlled interest rates. The development of the capacity of financial institutions to operate in a market environment has been an important element of ESAF programs. It is necessary that the market for financial services be competitive and sound, and that adequate prudential regulations be enacted and enforced; failure to adapt will lead at best to inefficiencies in the conduct of monetary policy and the allocation of resources, and at worst to a loss of monetary control and the collapse of the banking system.

1/ Often, public enterprises are directly involved in crop financing. ESAF programs seek a reform of state enterprises to minimize their financing requirements, e.g., the Gambian Public Marketing Board, the Cocoa Board in Ghana, and the National Milling Corporation in Tanzania.

2/ In the past, in WAMU countries, when the market price of a commodity was below the producer price, commercial banks had to finance this deficit, and received a preferential discount rate.

3/ The balance sheet of the central bank was restructured and a treasury bond with market yields was issued to cover both outstanding credit to the public sector and accumulated unfunded losses of the Bank. It is expected that with the interest income from this bond, the central bank will eliminate its losses beginning in 1993.

a. Bank management and ownership

Even when banks are financially sound and do not need drastic restructuring, measures may be available on a microeconomic level that increase the efficiency of intermediation. Such measures aim to ensure that banks allocate credit according to impartial rather than political or oligopolistic criteria, while avoiding the moral hazard that arises when banks know that they will be subsidized for their unprofitable loans. Furthermore, lowering costs in the production of financial services ought to lead to reduced interest rate spreads, thus allowing a simultaneous increase in deposit rates and a decrease in lending rates. Relevant microeconomic policies comprise both efforts to improve the management of existing institutions, and steps to promote competition through entry and privatization.

The management of existing institutions was subject to reform efforts in many ESAF arrangement countries (The Gambia, Kenya, Madagascar, Malawi, Mali, Mauritania, Mozambique, Niger, Sri Lanka, Tanzania, Togo, Uganda), often with assistance from the World Bank. Typically, the strategy has been to aim at a smaller but better qualified and compensated work force, improved internal controls, and a rationalized organizational and branch structure.

Sometimes regulations and legislation had to be changed in order to facilitate entry (Honduras, Madagascar, Malawi, and Tanzania), or efforts were made to broaden the range of financial institutions operating (Bolivia, Ghana, Guinea, Kenya, Madagascar, Malawi, Mali, and Niger) to include, for example, credit cooperatives, insurance companies, and stock markets. An extreme case is Mozambique, where a timetable was developed to break up the "monobank" into a two-tier banking system so as to separate central banking functions from commercial banking, and create a competitive market in financial services.

The privatization of financial institutions, which promises both to depoliticize credit allocation and to improve incentives for cost minimization, has been pursued in several countries (Bangladesh, The Gambia, Guyana, Madagascar, Mali, Mauritania, Niger, and Senegal). Indeed, all these countries have moved so far from the doctrine of state control of the financial system that foreign equity participation, or at least management, is sought for restructured public financial institutions. In addition, foreign direct investment in new financial institutions is now encouraged in those countries and in Malawi and Tanzania.

b. Bank restructuring

Programs in most ESAF countries have included the rescue, restructuring or liquidation of troubled banks or other financial institutions (development finance institutions in Bolivia, Kenya, The Gambia, Madagascar, Niger, Senegal, and Togo, commercial banks in Bangladesh, Bolivia, Burundi, Ghana, Madagascar, Mali, Mauritania, Tanzania, Senegal, Sri Lanka, Togo, and Uganda). Typically, failing institutions are reorganized or closed, and others are recapitalized by the Government, which takes over the nonperforming loans. Long delays in bank restructuring are encountered frequently (Bolivia, Ghana, Kenya, Madagascar, Mauritania, Tanzania, and Uganda). Such delays risk "moral hazard" by encouraging bank managers and borrowers to act imprudently on the assumption that any additional losses will be made good by the Government. This can further raise the cost of reform. Delays in bank restructuring and rehabilitation may in part be due to the associated costs, which can greatly burden an already stringent fiscal stance dictated by the need for macroeconomic stabilization. When appropriate foreign financing is lacking, a government may have great difficulty in rapidly mobilizing resources to invest in the soundness of the financial system.

In many countries, continued difficulties in enforcing contracts and recovering loans has prolonged bank distress, and added to the costs of rehabilitation (Bangladesh, The Gambia, Guinea, Lesotho, Mali, Mauritania, Niger, Sri Lanka, and Tanzania). The resolution of these difficulties often involves institutional and legal changes, for example, the reform in Guinea of the judiciary and the adoption of a land tenure code in 1992 under the first annual ESAF arrangement. That program also envisages the development of protective mortgage pledges and liens, the creation of a mutual guarantee scheme and a stabilization fund for private sector credit, and the settlement of land titles. The unsatisfactory rate of loan recovery was identified at least as early as 1988, soon after Guinea began to liberalize its financial sector, but only recently under the ESAF program does progress seem to have been made.

c. Prudential regulation and supervision

The Government's willingness to rescue financial institutions needs to be balanced by prudential regulation, for example, on provisioning against loan losses, maintaining minimum liquidity and capital adequacy, and the prevention of conflicts of interest involving bank directors. In some instances, reform of accountancy and reporting procedures has been important as a precondition for improving prudential supervision. Table 3 shows that the central banks in most ESAF countries have introduced new prudential regulations, often backed by legislation, as part of the program. However, in part because of difficulties in training and retaining qualified staff, many central banks have found the passage of prudential regulations easier than their enforcement.

Table 3. ESAF Countries: Reform of Prudential Regulations, Accountancy, and Reporting Requirements

Country	ESAF I	ESAF II	ESAF III and IV
Bangladesh	Passage of Bank Companies Act, tightening capital adequacy, exposure and bank governance rules Accounting for impaired loans strengthened	Bank reporting and supervision to be further strengthened Loan classification criteria extended to agricultural banks	
Bolivia	Central bank's accounting system improved Capital adequacy and collateral regulations enforced	Savings institutions brought under jurisdiction of the Superintendency of Banks	New banking law to be passed by Congress Central bank's accounts to be reconciled
Burundi		Bank supervision to be strengthened	...
The Gambia			Central Bank and Financial Institutions Act to be passed, tightening capital adequacy rules, reporting requirements
Ghana	Revised Banking Act passed, tightening capital adequacy and risk exposure rules, accounting and auditing standards, and reporting requirements	Implementation of new regulations, accountancy standards, audits, and reporting requirements Management of distressed banks replaced	Completion and publication of central bank audits
Guinea	Capital adequacy and minimum liquidity rules introduced Regular on-site inspection instituted Monetary accounts computerized	...	...
Guyana			...
Honduras	Enact Financial Intermediation Law, establishing supervisory powers over nonbank financial institutions		
Kenya	New Banking Act grants stronger supervisory powers, and tightening capital adequacy, exposure, and bank governance rules Bank reporting and inspection strengthened New guidelines on provisioning		New capital adequacy, exposure, bank governance rules enacted
Lesotho			

Table 3 (concluded). ESAF Countries: Reform of Prudential Regulations, Accountancy, and Reporting Requirements

Country	ESAF I	ESAF II	ESAF III
Madagascar	Shift to ex post monitoring		...
	Bank audits completed		
Malawi		Revised Reserve Bank and Banking Acts increases supervisory powers	
Mali		...	...
Mauritania	Bank audits completed	New banking law, and prudential regulations enacted	
Mozambique	Lending criteria, loan classification and provisioning guidelines set		...
Niger		BCEAO strengthens supervision	...
Senegal		BCEAO strengthens supervision	
Sri Lanka	Audits of state-owned banks completed	Bank supervision to be strengthened	...
	New loan classification and provisioning guidelines	Banks' Act to be amended	
	Reporting requirement imposed on Foreign Currency Banking Units		
Tanzania	Bank audits completed		...
	New Financial Institutions Act adopted, tightening prudential rules and reporting requirements		
	Reconciliation of accounts completed		
Togo	BCEAO strengthens supervision		
Uganda			Bring nonbank financial institutions under supervision of central bank
			Prudential regulations to be reviewed and a new banking law to be passed
			Central bank to improve its own accounting practices

IV. Assessment

Having described the components of financial sector reforms initiated under ESAF-supported programs, the questions arise of how effective these measures have been, and which factors hindered or facilitated progress. Circumstances dictate that the assessment of financial sector reform be based not only on the achievement of ultimate objectives, but also on the coherence of program design and the speed of implementation. This assessment will complement an analysis of the hurdles faced by financial sector reform, and the specific aspects of program design that can help overcome them.

1. Assessment of financial sector reforms

It would be desirable to conduct formal tests to determine whether ESAF programs had met their broad objectives in the areas of resource mobilization, improved monetary control, and more effective resource utilization. Such an assessment would seek to quantify: signs of financial deepening, such as a sustained increase in real and financial savings ratios; a decline in the proportion of nonperforming loans in bank portfolios; signs of increased competition and efficiency, such as sharp shifts in the growth of key financial aggregates or a perceptible reduction in the capital-output ratio; and an improved record of meeting monetary policy objectives, for example, inflation control and the maintenance of positive, stable real rates of interest.

Although ESAF programs are still very much "work in progress," as explained in Section I, some encouraging tendencies may be discerned. In twelve countries real interest rates have increased markedly, and in ten of those negative real rates were eliminated (Table 12). In some cases where interest rate spreads were very narrow, banks now obtain a more reasonable margin on their lending activities (Guyana, Kenya, and Madagascar). Financial deepening, as measured by rising money to GDP ratios, shows no marked pattern (Table 8), but some tendency for the ratio of currency to broad money to fall may be emerging in ten countries (Table 9). Less satisfactory progress seems to have been made in other areas. The data presented in Table 7 do not a reveal a distinct trend for savings rates to rise--a major objective of ESAF-supported programs. 1/ The retreat of a few countries (Guinea, Mozambique and Uganda) from the brink of hyperinflation lowered the sample means of the money growth and inflation rates (see Tables 9 and 10). However, the median rates were stable or rising, suggesting that monetary control had not significantly improved in most countries.

It is difficult to go much beyond such "casual empiricism" in assessing the progress made toward achieving ultimate objectives, in large part because only an insufficient period has elapsed since the

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1/ The scanty data available on private savings are equally inconclusive.

implementation--as opposed to the conception--of most reforms under ESAF programs. Therefore one must rely on an assessment based on the consistency and relevance of financial sector reforms, and on their timely implementation.

In principle, the internal logic and consistency of ESAF financial reforms can be inferred from Policy Framework Papers and the authorities' letters of intent which, in the initial stages of a program, typically articulate broad objectives. The details and precise timing of a multi-year reform have only infrequently have been spelled out at the outset of programs. Looking at the measures recommended in the course of programs, it seems that the design of ESAF programs does generally demonstrate broad internal consistency and a recognition of the interdependence between the various elements of financial reform, described above.

Whatever the design, there has been a distinct pattern to the implementation of measures planned under ESAF programs (and preceding SAF programs). The programs do generally meet their most immediate financial sector objectives, although not always as quickly or as easily as is envisaged at the outset of a program. 1/ As can be seen by comparing Table 4 with Table 1, it was often been possible to raise real interest rates to positive levels at the start of a program, and the structure of interest rates was simplified and intermediation spreads were raised. Subsequently, the market-determination of rates was often introduced approximately on schedule. Actions were usually taken early on to improve the central bank's skills in monetary management, and prudential regulations were formulated. In some cases, direct credit controls were removed at a relatively early stage in the reform, while in other cases, such as that of Ghana described in Appendix II, there was a reluctance to abandon them until substantial experience had been gained in using indirect instruments.

Countries also found it relatively easy to introduce or enhance government securities markets, to pass legislation, have audits performed, and introduce regulations. The case studies of Burundi and Ghana illustrate these points. Yet the elimination of quasi-fiscal distortions in the financial system, financial sector restructuring and increased competition, and the enforcement of prudential regulations have often lagged behind. Delay in one or more of these areas is found in all the case studies. Furthermore, several countries have found it difficult to employ newly available indirect instruments of monetary control actively, particularly open market operations (for example, Burundi and Ghana).

1/ The fact that programs are not fully specified at the beginning also suggests the acceptance of an implicit model of sequencing in program design.

Table 4. ESAF Countries: Current Financial Sector Characteristics

(1=yes; 0=no)

Country	Interest Rate Controls	Negative Real Rates	Credit Ceilings	Portfolio Restrict-ions	Subsidized interest rates	Banks Largely State Owned	Central Bank Losses	Accountancy Problems	Tax Distortions
Bangladesh	1	0	0	1	1	1	0	0	0
Bolivia	0	0	0	0	0	0	1	0	0
Burundi	0	0	0	1	0	1	0	0	0
The Gambia	0	0	0	0	0	0	1	1	0
Ghana	0	0	0	0	0	1	0	0	0
Guinea	1	0	0	0	1	1	0	1	0
Guyana	1	0	0	0	1	0	0	0	0
Honduras	0	1	0	0	1	0	0	0	1
Kenya	0	1	1	0	0	0	0	0	0
Lesotho	1	0	0	0	0	0	0	0	0
Madagascar	1	0	1	0	0	1	1	0	0
Malawi	0	0	0	0	0	0	0	0	0
Mali	1	0	1	0	0	1	0	0	0
Mauritania	1	0	1	0	0	0	1	1	0
Mozambique	1	0	1	0	1	0	0	0	0
Niger	1	0	1	0	1	0	0	0	0
Senegal	1	0	1	0	0	0	0	0	0
Sri Lanka	0	0	0	0	0	1	0	0	0
Tanzania	1	0	1	1	0	1	0	1	0
Togo	1	0	1	0	0	1	0	0	0
Uganda	1	0	0	0	0	0	1	1	0
Total	13	2	9	4	6	9	5	4	1
(In percent)									
Share of sample	62	10	43	19	29	43	24	19	5

The restructuring and strengthening of troubled financial institutions, including the central bank, is the principal area in which progress has been slow. In some cases, such as Ghana and Senegal, the full extent of the need for such measures became apparent only after the reform was underway and delays were encountered; these in turn slowed reforms in other areas. The need to eliminate central bank losses, to strengthen prudential supervision, and to facilitate the legal enforceability of loan contracts are examples of subjects which have received less emphasis in the initial formulation of some programs than what might, in retrospect, have been desirable. Interestingly, there appears to be a difference in emphasis in the reforms undertaken in the WAMU. Under the leadership of the BCEAO, these have placed more emphasis on improving supervision, and bank restructuring and privatization at an early stage than do ESAF programs in general, and less on implementing indirect methods of monetary control (see the case study of Senegal).

2. Impediments to policy implementation

The history of delays in program implementation can be informative about the overall effectiveness of program design. Generally, delays fall into two categories: those associated with specific financial reform measures; and those due to factors which are extrinsic to the financial reform, for example, uncorrected problems elsewhere in the economy or delays in implementing other aspects of the overall reform program, and unanticipated developments, typically in the form of macroeconomic disturbances.

a. Intrinsic factors

Some financial sector problems simply take longer to deal with than planned because they are particularly complex, or because their solutions depend on an appropriate operating framework or a minimum critical mass of trained personnel that are not in place (particularly in the area of banking supervision), or because the length of the "learning curve" associated with new methods and techniques was underestimated. Not only the authorities, but also the private sector must adapt to a deregulated environment; before private institutions will react, they must gain confidence that reforms will endure long enough for them to cover any fixed costs that may be incurred, say, by investing in staff training or entering new markets.

At the same time, an uneven pace of financial sector reform can generate its own problems. For example, if progress in liberalizing financial markets runs too far ahead of changes to the supervisory framework, the result can be renewed financial distress in the banking sector (as occurred in Kenya, Madagascar, Mauritania, and Sri Lanka). This can impair the use of indirect instruments of monetary policy because the central bank has to provide concessional refinancing, or cannot enforce reserve requirements. On the macroeconomic level, the very success of the stabilization and reform program can lead to strong capital inflows, before the authorities have the means to react to the disturbances (see the case studies for Ghana and Sri Lanka). Similarly, if interest rate liberalization and the introduction of new financial instruments destabilize the demand for money before an adequate framework for implementing inventory policy in the changed environment is in place, the result may be a temporary reduction in monetary control.

b. Extrinsic factors

As to extrinsic factors, the delays which they engender frequently demonstrate the high degree of interdependence between financial sector measures and the other elements of the overall reform program. One of the most difficult problems has been unanticipated macroeconomic disturbances which have required the authorities to respond with tighter monetary policy and sharply higher rates of interest. In some cases, as in Burundi, Ghana and Sri Lanka, the authorities initially were reluctant to take necessary measures because they were in apparent conflict with other aspects of the overall reform program, particularly the desire to reduce the size and role of government in the overall economy, and targets for the fiscal deficit.

For example, higher real interest rates, with unchanged inflation, will first increase the budgetary costs of the government's domestic borrowing. 1/ Second, higher and more equitable interest rates can undo what was often a system of implicit taxes and subsidies; those in favored sectors who might lose out will resist change until offered compensation. Third, the budgetary cost of supporting already weakened financial institutions may be increased. Moreover, governments may be reluctant to recapitalize financial institutions with budgetary funds when foreign financing is not available. For example, the case study for Senegal illustrates that even when the authorities place emphasis on privatization and the introduction of outside management, it may be difficult to attract foreign direct investment. When faced with such costs, the authorities in some cases have been reluctant to press on with financial sector reforms.

Another difficulty has been the persistence of problems in other sectors of the economy. For example, only limited and temporary benefits will accrue from restructuring financial institutions, unless governments are prepared to restructure or close insolvent enterprises in other sectors which borrow from banks, and assure their long-term viability by the imposition of a "hard" budget constraint. The case studies for Ghana and Sri Lanka each contain descriptions of how persistently preferred sectors retain exceptional financing. Thus, successful programs have to take account of the interrelationship between financial sector reforms and other reform objectives.

1/ It should be pointed out in this context that, given the low level of domestic government debt and deficit financing in most ESAF countries (some evidence is available in the Government Finance Statistics Yearbook, 1991), the direct budgetary cost of raising domestic interest rates to positive real levels is usually quite small.

3. Facilitating the implementation of financial sector reform

a. Program design and support

Looking at the overall experience with financial sector reform in ESAF countries, it would seem that program design could be improved by providing a more comprehensive specification of the program from the start, and, possibly, by adopting a more simultaneous approach to reform than has been used to date. The past experience of countries with ESAF-supported programs indicates in which areas, such as prudential supervision, the reform process is likely to advance more slowly. Efforts in those areas should begin as early as possible, lest other reforms have to be delayed in pursuit of correct sequencing, or the reform process itself be destabilizing.

It is especially important that attention and resources be devoted at an early stage to ensuring the soundness and good management of financial institutions. However, the restructuring and rehabilitation of banks and other financial institutions are associated with large direct costs to government. At the same time, domestic resources are severely limited and crowding-out by government needs to be reduced in many ESAF countries. The implication is that the provision of outside assistance fairly early in the reform process may be the best way to encourage a rapid and timely pace of financial sector restructuring.

b. Technical assistance

Sometimes delays in the implementation of reforms can be reduced through a program of technical assistance in central banking operations, which all ESAF countries have received in some amount in recent years, especially when coordinated with the overall program. However, while technical assistance has been effective in identifying problems and their solutions, the implementation of reforms must wait upon the political will for change (see the case studies for Burundi and Sri Lanka). The countries that have made most progress during an ESAF program in modernizing their financial systems or introducing indirect instruments, such as Bolivia, Burundi, Kenya and Sri Lanka, often have a long antecedent history of technical assistance provided in conjunction with Fund programs with an emphasis on financial sector reforms. At least in the area of financial sector reform in ESAF countries, technical assistance usually bears fruit eventually, but often after long and variable lags. Technical assistance may be especially useful when it contributes to the formulation of structural benchmarks and detailed components of the policy matrix, as was the case in Guyana, Malawi and Sri Lanka. The value of technical assistance has sometimes been diminished by the difficulties encountered by the national authorities in finding and retaining qualified staff.

c. Use of benchmarks

Also structural benchmarks and performance criteria can help encourage the implementation of reforms on schedule. Table 5 organizes the financial sector structural benchmarks that were laid out under ESAF arrangements into the main categories of policy measures. Benchmarks and performance criteria have been used sparingly in some instances, especially at the start of ESAF arrangements. 1/ Some benchmarks, mostly in the area of institutional reform, were not as demanding or specific as they might have been, perhaps due to the difficulty of defining success. 2/ Only three benchmarks in this area were not met, and they all concerned bank restructuring: on privatizing a bank in Madagascar, on reorganizing the post office savings bank in Malawi, and on loan recovery in Niger. The seven benchmarks that were satisfied with delay were also mostly in the area of institutional reform.

1/ The ESAF programs for Burundi, Guinea, Mali and Senegal included no benchmarks covering financial sector reforms, although in some cases related agreements were reached with the World Bank. Of course, a scarcity of benchmarks may indicate that the authorities' intent to carry out reforms needed no reinforcement.

2/ For example, Tanzania met a benchmark to complete audits of financial institutions by June 1992, but the difficult task of restructuring that sector lies ahead. The first ESAF arrangement for Sri Lanka set as a benchmark that the authorities merely agree to a timetable for bank restructuring, though in fact they have proceeded promptly to implementation.

Table 5. ESAF Countries: Financial Sector Reform Benchmarks

ESAF Arrangement (sample size)	Area of Reform			
	a. Interest rates	b. Monetary instruments	c. Quasi-fiscal distortions	d. Structural and institutional
ESAF I (21)	Guyana (1)	Bangladesh (1) Guyana (3) Honduras (1) Sri Lanka (2)	Ghana (1) Guyana (1) Honduras (1)	Lesotho (1) Madagascar (1) Tanzania (1) Togo (1) Uganda (1)
ESAF II (15)	Mozambique (1)	Ghana (3) Guyana (1) Lesotho (1)	Guyana (1)	The Gambia (1) Ghana (1) Madagascar (1) Malawi (1) Mozambique (1) Niger (1) Sri Lanka (2)
ESAF III (9)	Uganda (1)	Kenya (1) Malawi (2) Uganda (1)		Bolivia (3) Ghana (3) Uganda (1)
ESAF IV (2)				Bolivia (4)

Source: Fund documents. Number of benchmarks reported in parentheses.

Table 6. ESAF Countries: Real GDP Growth

(In percent)

	1987	1988	1989	1990	1991	1992 1/
Bangladesh	4.1	2.7	2.5	5.8	3.2	4.7
Bolivia	2.6	3.0	2.8	2.6	4.1	3.5
Burundi	5.5	4.9	1.5	3.5	4.9	4.0
The Gambia	5.4	5.5	4.6	6.0	3.0	4.5
Ghana	4.8	5.6	5.1	3.3	5.0	5.0
Guinea	3.1	6.0	4.1	4.3	2.4	5.0
Guyana	0.9	-2.6	-3.3	-2.5	6.0	6.5
Honduras	6.0	4.5	3.9	1.0	2.2	4.3
Kenya	5.9	6.1	4.4	4.5	2.4	5.0
Lesotho	4.4	7.0	12.4	9.3	4.6	3.9
Madagascar	1.2	3.4	4.1	3.1	-6.9	1.8
Malawi	0.5	3.3	4.1	4.8	4.8	-7.6
Mali	1.0	0.2	7.5	2.4	-0.2	5.9
Mauritania	1.9	1.7	4.8	-1.5	2.6	2.4
Mozambique	4.6	5.5	5.4	1.3	2.7	-1.4
Niger	-3.5	5.6	0.1	-1.8	1.9	3.0
Senegal	4.2	4.4	-0.5	3.6	1.2	5.1
Sri Lanka	1.5	2.7	2.3	6.2	4.8	4.5
Tanzania	4.7	5.1	3.6	3.2	3.7	4.2
Togo	0.5	6.2	3.8	0.6	--	2.9
Uganda	5.0	7.0	8.0	6.0	5.0	5.0
Mean	3.1	4.2	3.7	2.9	2.7	3.4
Median	4.1	4.9	4.1	3.3	3.0	4.2
Germany	1.5	3.7	3.8	4.5	0.9	1.8
Japan	4.1	6.2	4.7	5.2	4.4	2.0
United States	3.1	3.9	2.5	0.8	-1.2	1.9

Source: Fund documents.

1/ Preliminary, projected or programmed.

Table 7. ESAF Countries: Gross Domestic Savings Relative to GDP

(In percent)

	1986	1987	1988	1989	1990	1991
Bangladesh	2.5	3.7	2.5	0.7	1.4	2.5
Bolivia 1/	1.5	1.7	3.8	6.3	8.6	8.6
Burundi	1.2	6.6	1.7	3.3	-2.2	-0.8
The Gambia	5.3	6.9	4.4	2.5	6.1	5.1
Ghana	10.0	11.2	12.5	13.7	11.4	13.1
Guinea	11.2	5.4	1.7	5.8	7.2	5.2
Guyana	14.4	20.1	16.6	17.8	18.9	19.4
Honduras 1/	6.7	6.5	10.7	8.5	7.1	6.1
Kenya	18.9	15.3	15.4	13.5	14.4	10.6
Lesotho 1/	18.9	22.1	27.7	27.4	27.8	53.3
Madagascar	6.2	4.9	7.2	9.4	8.1	1.5
Malawi	10.1	13.5	12.6	12.2	14.2	14.1
Mali	-1.3	6.1	2.4	4.9	5.6	6.0
Mauritania	11.7	14.2	11.3	12.6	5.6	11.0
Mozambique	-1.1	-11.7	-16.4	-16.6	-11.7	-10.3
Niger	7.9	8.0	18.7	9.1	8.7	6.5
Senegal	4.2	6.9	7.1	7.5	8.5	8.8
Sri Lanka 1/	15.3	15.3	14.2	14.6	16.8	15.2
Tanzania	19.5	0.1	-5.4	-5.9	...	...
Togo	16.2	12.8	16.3	16.5	11.4	10.2
Uganda	-0.6	-0.6	-1.8	-4.3	0.1	...
Mean	8.5	8.1	7.8	7.6	8.4	9.8
Median	7.9	6.9	7.2	7.5	8.2	8.6

Source: Fund documents.

1/ Gross national saving.

Table 8. ESAF Countries: Money and Quasi-money Relative to GDP

(In percent; end of period)

	1986	1987	1988	1989	1990	1991
Bangladesh	28.5	29.2	30.0	32.2	31.8	33.1
Bolivia	9.2	15.5	16.5	16.8	21.6	26.3
Burundi	18.9	18.6	19.4	19.1	19.3	19.6
The Gambia	25.4	23.1	24.1	24.5	22.0	24.1
Ghana	14.7	14.2	14.7	16.9	13.4	13.4
Guinea	4.9	5.1	5.3	5.1	5.1	5.9
Guyana	106.7	109.9	129.2	103.0	106.0	83.4
Honduras	26.9	30.1	31.0	31.9	32.0	29.5
Kenya	30.3	30.2	28.4	28.1	29.0	29.3
Lesotho	61.3	56.2	50.3	46.1	48.6	44.9
Madagascar	16.7	15.9	15.5	17.8	16.2	20.0
Malawi	22.2	25.6	23.8	19.6	18.9	19.5
Mali	25.6	22.8	24.3	22.2	20.2	22.1
Mauritania	23.9	25.7	24.0	23.1	27.9	27.1
Mozambique	66.7	39.2	38.8	39.4	38.7	36.5
Niger	17.7	17.1	19.4	20.1	19.6	18.9
Senegal	25.5	24.1	22.5	24.7	22.2	22.6
Sri Lanka	29.4	29.4	30.4	29.8	28.1	29.3
Tanzania	24.3	21.0	19.2	21.4	25.3	30.5
Togo	45.3	44.0	35.1	33.8	35.8	35.8
Uganda	11.6	8.6	6.3	6.7	7.1	8.3
Mean	30.3	28.8	29.0	27.7	28.0	27.6
Median	25.4	24.1	24.0	23.1	22.0	26.3
Germany	30.0	31.9	33.7	34.9	38.6	36.6
Japan	53.4	53.9	53.7	52.0	52.7	53.8
United States	63.4	62.0	60.9	59.1	57.9	58.1

Source: Money stocks from International Financial Statistics, GDP from Fund documents.

Table 9. ESAF Countries: Currency Relative to Money and Quasi-money

(In percent; end of period)

	1986	1987	1988	1989	1990	1991
Bangladesh	14.3	14.3	14.1	12.8	12.8	11.8
Bolivia	36.0	25.3	26.1	20.3	17.0	13.2
Burundi	31.0	33.7	32.6	29.7	29.5	29.5
The Gambia	33.1	27.7	28.4	28.3	29.5	28.1
Ghana	46.8	46.2	43.8	34.6	29.5	26.2
Guinea	81.2	72.7	69.5	67.0	65.7	66.1
Guyana	20.4	19.0	19.6	18.8	18.0	17.1
Honduras	39.0	37.0	37.4	38.5	41.3	38.8
Kenya	17.8	19.4	19.9	20.0	18.6	18.4
Lesotho	8.6	8.1	8.3	9.4	9.6	4.7
Madagascar	30.8	32.2	32.1	30.4	28.9	29.5
Malawi	16.2	16.1	16.6	18.2	16.7	18.5
Mali	49.5	46.8	44.3	38.6	34.7	39.3
Mauritania	29.5	31.8	32.3	32.1	27.7	29.6
Mozambique	28.9	22.3	23.9	23.9	26.6	24.5
Niger	33.4	31.1	32.1	30.0	28.1	33.6
Senegal	31.3	30.3	27.7	27.8	27.1	26.2
Sri Lanka	21.9	23.3	27.4	26.1	24.5	22.4
Tanzania	47.3	52.7	49.7	38.0	35.6	35.6
Togo	27.8	29.5	16.1	14.6	20.1	22.0
Uganda	49.3	51.1	52.3	46.4	42.8	42.5
Mean	33.1	31.9	31.2	28.8	27.8	27.5
Median	31.0	31.8	28.4	28.3	27.7	26.2
Germany	19.4	19.5	20.2	19.1	17.1	18.1
Japan	14.7	15.2	15.8	17.8	16.6	15.6
United States	6.9	7.1	7.2	7.3	7.8	8.2

Source: International Financial Statistics.

Table 10. ESAF Countries: Growth of Money and Quasi-money

(In percent; end of period)

	1987	1988	1989	1990	1991	1992 1/
Bangladesh	18.8	13.6	18.7	10.2	13.4	14.1
Bolivia	92.9	28.6	22.2	52.8	50.5	33.4
Burundi	0.2	13.8	12.7	9.7	13.0	8.5
The Gambia	24.6	14.7	20.8	8.4	25.7	11.1
Ghana	53.3	46.3	54.7	13.3	16.7	11.8
Guinea	39.9	34.4	29.3	24.5	40.1	14.7
Guyana	53.5	41.5	48.5	53.1	76.5	24.6
Honduras	21.8	14.9	15.1	21.6	18.0	20.3
Kenya	11.1	8.0	12.9	20.1	19.6	12.5
Lesotho	11.1	9.4	21.9	15.1	23.1	1.4
Madagascar	18.4	22.4	33.7	4.5	31.1	16.2
Malawi	36.8	21.5	6.1	11.1	25.4	...
Mali	-4.0	8.1	1.1	-4.9	13.1	10.9
Mauritania	18.5	2.0	3.8	21.9	9.4	15.3
Mozambique	47.3	50.3	45.7	35.7	25.9	31.8
Niger	-5.5	15.2	5.8	-4.1	-8.9	4.0
Senegal	-0.3	0.5	10.3	-4.8	5.8	5.0
Sri Lanka	9.7	16.6	11.3	20.1	21.7	13.5
Tanzania	20.2	34.8	37.6	45.1	37.9	12.0
Togo	-1.0	-11.9	1.1	9.5	3.1	6.0
Uganda	161.3	110.8	101.8	48.2	63.1	...
Mean	29.9	23.6	24.5	19.6	25.0	14.1
Median	18.8	15.2	18.7	15.1	21.7	12.5
Germany	6.0	5.8	5.1	18.6	6.4	...
Japan	11.2	9.8	11.8	8.2	2.5	...
United States	4.0	6.1	3.9	3.1	3.1	...

Source: International Financial Statistics, projections from Fund documents.

1/ Preliminary, projected or programmed.

Table 11. ESAF Countries: Consumer Price Inflation

(In percent; end of period)

	1987	1988	1989	1990	1991	1992 1/
Bangladesh	10.1	7.6	8.6	11.8	1.9	6.5
Bolivia	10.7	21.5	16.6	18.0	14.5	10.4
Burundi	5.1	5.3	12.1	10.7	8.3	8.0
The Gambia	15.3	12.2	8.6	10.5	11.6	12.4
Ghana	34.2	26.6	30.5	25.9	10.3	5.0
Guinea	71.8	33.7	26.3	27.1	12.2	15.5
Guyana	34.6	51.5	104.7	75.9	81.5	15.0
Honduras	2.9	6.7	11.4	35.4	21.4	6.5
Kenya	8.7	12.3	13.5	15.7	19.6	18.0
Lesotho	8.8	15.9	12.1	17.7	15.5	17.1
Madagascar	29.2	14.2	10.6	8.6	11.7	10.0
Malawi	35.5	26.4	9.1	11.8	12.7	9.0
Mali	5.7	0.1	1.2	2.5	3.9	2.0
Mauritania	4.1	2.7	16.5	5.6	5.6	8.1
Mozambique	163.0	49.4	35.0	47.0	35.2	50.0
Niger	0.2	-4.7	1.7	-2.6	-6.9	1.3
Senegal	-5.2	-2.1	0.8	-0.9	-0.7	1.3
Sri Lanka	10.2	15.0	15.1	19.6	9.0	8.0
Tanzania	28.9	28.2	23.8	19.0	20.9	12.0
Togo	-0.5	0.7	-3.2	0.9	0.5	2.0
Uganda	253.0	186.0	42.0	57.0	28.0	35.0
Mean	34.6	24.2	19.0	20.5	14.7	12.1
Median	10.2	14.2	12.1	15.7	11.7	9.0
Germany	0.9	1.0	2.6	3.8	2.7	3.9
Japan	1.0	1.8	3.0	2.8	4.2	1.7
United States	4.4	4.4	4.7	6.1	3.1	2.7

Source: International Financial Statistics and Fund documents.

1/ Preliminary, projected or programmed.

Table 12. ESAF Countries: Ex Post Real Deposit Interest Rates 1/

(In percent)

	1987	1988	1989	1990	1991	1992 2/
Bangladesh	1.9	4.5	3.4	0.3	10.1	5.5
Bolivia	28.3	11.2	11.2	2.8	5.9	8.6
Burundi	2.9	0.3	-6.6	-4.4	-1.1	1.2
The Gambia	2.7	2.8	6.4	2.0	0.9	1.1
Ghana	-17.2	-8.6	-15.0	-19.9	7.9	10.0
Guinea	-56.8	-18.7	-9.3	-6.1	8.8	7.5
Guyana	-21.6	-38.5	-91.7	-41.6	-52.0	16.5
Honduras	7.3	2.5	-2.7	-27.9	-11.4	5.4
Kenya	3.3	-2.3	-0.5	-2.7	-3.9	-2.3
Lesotho	-2.8	-9.9	1.4	-2.2	0.0	-5.0
Madagascar	-16.7	1.8	3.4	5.4	-0.9	0.8
Malawi	-22.8	-10.6	3.6	1.0	0.5	3.3
Mali	2.8	7.4	6.0	5.1	14.2	7.5
Mauritania	1.9	3.4	-10.5	3.9	3.9	1.4
Mozambique	-159.0	-31.4	-17.0	-27.0	-3.2	-15.0
Niger	8.3	12.2	6.8	11.6	16.4	8.2
Senegal	13.7	9.6	7.7	9.9	10.2	8.2
Sri Lanka	1.3	-3.5	0.9	-0.2	11.5	10.5
Tanzania	-16.4	-8.2	-0.8	4.0	5.1	14.0
Togo	9.0	6.8	11.7	8.1	9.0	7.5
Uganda	-218.0	-164.0	-10.0	-20.0	5.0	1.0
Mean	-21.2	-10.9	-4.6	-4.7	1.8	4.6
Median	1.9	0.3	0.9	0.3	5.0	5.5

Source: International Financial Statistics and Fund documents.

1/ Nominal interest rate on one year deposits, or nearest equivalent, at the start of the year, minus the rate of consumer price inflation over that year.

2/ Based on preliminary, projected or programmed inflation over 1992.

Table 13. ESAF Countries: Interest Rates Spreads 1/

(In percent; end of period)

	1986	1987	1988	1989	1990	1991
Bangladesh	4.0	4.0	4.0	4.0	3.9	4.0
Bolivia	48.9	10.5	11.8	18.7	18.5	18.9
Burundi	4.0	5.4	5.9	6.0	5.7	5.5
The Gambia	12.0	13.0	13.5	14.0	14.0	13.0
Ghana	6.0	8.0	10.5	9.5	7.3	5.6
Guinea	1.0	5.0	3.0	-1.0	1.0	4.0
Guyana	2.0	2.0	2.0	1.8	1.5	3.0
Honduras	5.7	6.0	7.0	6.7	8.4	11.3
Kenya	2.0	4.0	2.0	5.0	3.3	13.3
Lesotho	5.0	5.0	4.5	4.5	4.5	6.9
Madagascar	2.0	0.6	0.0	0.0	6.4	6.3
Malawi	6.3	4.3	10.3	10.3	16.8	7.8
Mali	5.0	6.0	6.0	7.0	6.5	6.5
Mauritania	6.0	6.0	6.0	4.0	4.0	4.0
Mozambique	2.0	3.0	6.0	5.0	1.0	0.0
Niger	5.0	6.0	6.0	7.0	6.5	6.5
Senegal	5.0	6.0	6.0	7.0	6.5	6.5
Sri Lanka	7.8	6.7	2.2	-0.9	-3.0	1.1
Tanzania	6.5	9.0	8.0	8.0	5.0	5.0
Togo	5.0	6.0	6.0	7.0	6.5	6.5
Uganda	3.0	8.0	8.0	13.0	12.0	5.0
Mean	6.7	5.7	5.9	6.5	5.9	6.6
Median	5.0	6.0	6.0	6.7	6.0	6.3

Source: International Financial Statistics and Fund documents.

1/ Interest rate on one year commercial loans minus that on one-year deposits, or nearest equivalents.

Case Studies

The following case studies describe recent financial sector reform in five countries: Burundi, Ghana, Senegal, and Sri Lanka. The sample was selected to include almost all the problems encountered in financial sector reform in ESAF arrangement countries, and also to illustrate the diversity of their backgrounds and experiences. Each case study begins with a brief description of the structure of the country's financial markets, initial conditions, and progress under antecedent reform programs. The design and implementation of financial sector reforms under the ESAF program is described, before a few salient lessons are highlighted.

1. Burundi

The financial sector in Burundi is relatively sophisticated for an economy of its size and level of development, with four commercial banks and a number of other institutions specializing in savings mobilization, development and housing finance, and insurance. The three dominant banks all have foreign involvement in their management and ownership, but the other institutions are state-owned. In recent years, institutions have both entered and exited the financial sector. One savings institution has been a chronic loss-maker because its lending seems to have been based on noncommercial considerations. Other institutions mostly behave very conservatively, despite the near absence of prudential supervision. The principal lending activity is the financing of commodity exports, mainly coffee, which the banks undertake as a syndicate. It has proven difficult to encourage investment in nontraditional sectors, and the domestic savings rate has averaged around three percent of GDP despite a mandatory savings scheme in operation until 1990. Economic performance has been worsened by erratic and declining terms of trade, unfavorable weather conditions, and by internal political disturbances.

Monetary policy used to be implemented through a liquid asset requirement (LAR) on the banks, annual financing agreements with the banks, and the regulation of interest rates. Banks were also subject to a requirement to make medium and long term loans, and large loans needed the authorization of the central bank. Various activities, notably coffee exporting, were favored with preferential administered interest rates, matched with correspondingly cheap refinancing; before 1986, no less than 97 interest rates were specified. 1/

By the time the first SAF arrangement was agreed in August 1986, central bank financing of a growing fiscal deficit had resulted in high liquidity. Progress in financial sector reform began in mid-1988 under the second SAF arrangement, when the system of central bank authorization of loans was eliminated, treasury bill auctions commenced, interest rates were

1/ Also the LAR had a quasi-fiscal impact by favoring the categories of loans eligible for refinancing.

freed on deposits and credits not eligible for rediscounting, and the structure of administered rates was simplified and rationalized.

However, refinancing was still effectively available without limit, and at rates that favored the financing of commodities exports. The treasury bill auctions were dominated by a few public enterprises, and the quantity sold was not determined according to monetary programming considerations. The LAR was not enforced, and monetary (and fiscal) control was so weak that quantitative benchmarks were consistently missed. Nor were interest rates administered flexibly, for rising inflation led to negative real rates in 1989, despite the continued scarcity of domestic savings. Meanwhile, the financial situation of the troubled saving institution was deteriorating.

Burundi's ESAF arrangement effectively began in July, 1991, although approval was granted only in November. At the start of the arrangement, several measures were implemented, such as the introduction of reserve requirements and the unification and raising of refinance rates, that had been carried over from the previous SAF program. 1/ The treasury bill auction mechanism was refined through the lowering of the minimum bid size and the introduction of bearer certificates. Emphasis was placed on the prevention of collusion between the banks, and recognizes the need, in a liberalized environment, to strengthen prudential supervision through better reporting and auditing.

Despite these reforms, it became clear during 1991 that monetary policy implementation could not be strengthened until refinancing was limited in quantity and made more expensive than banks' other sources of funds. Indeed, at one stage only the central bank's moral suasion prevented banks earning arbitrage profits by refinancing their purchases of treasury bills. Therefore, automatic recourse to refinancing was terminated, and the refinance rate was defined by a flexible margin above the yield on treasury bills. Furthermore, the reserve requirement was made uniform across all components of the targeted monetary aggregate. The central bank has limited its reserve bidding in the treasury bill auctions; to encourage the secondary market in bills, it has made them eligible for refinancing and is preparing to designate primary dealers. The central bank is also to act as broker between banks in the interbank market. On the fiscal side, the tax treatment of "bons de caisse" (CDs) has been brought into line with that of term deposits. 2/ Despite external assistance, the troubled savings institution has yet to be either rehabilitated or liquidated.

1/ The introduction of reserve requirements was under discussion already in 1988, and many of the reforms introduced under the ESAF arrangement were anticipated by technical recommendations received in the late 1980s. Like the SAF arrangement, the ESAF arrangement did not rely on structural benchmarks in the area of financial sector reform.

2/ Technical assistance was influential in designing these reforms.

It is too early to say whether the financial sector reforms undertaken as part of the ESAF program will make an important contribution to the development of Burundi. Savings are still low, but monetary conditions seem to have become more stable than they were in the 1980s. Financial sector reforms in themselves cannot be expected to remove the constraint caused by a shortage of bankable investment opportunities in an economy as small as Burundi's.

The history of monetary policy implementation in Burundi illustrates the importance of introducing comprehensive reforms; reserve requirements, for instance, serve for naught if refinancing is unlimited, and instituting a treasury bill auction will be of only limited use if interest rates are not flexible. At the same time, Burundi seems to have had difficulty until recently giving up the quasi-fiscal use of preferential interest rates to support favored sectors, and allowing nominal rates to vary with monetary conditions, so that available instruments were not always used. Burundi's ESAF-supported programs have addressed these issues directly, perhaps in reaction to the slow progress made under SAF programs in financial sector reform. An important constraint on reform seems to have been the unavailability in such a small country of sufficient trained manpower capable of designing and implementing a monetary program (or of enforcing prudential regulations).

2. Ghana

Before the adoption of the ESAF program in June 1988, the banking system in Ghana consisted of 11 commercial banks, a discount house handling interbank transactions, and about 120 very small rural community banks. The government was a major shareholder in all the banks, either directly or indirectly through the Bank of Ghana, and was the majority owner in five of them. The banking system was characterized by several weaknesses: a substantial volume of nonperforming loans, insufficient provisions for losses, high operating costs, and inadequate accounting. Most of the non-performing loans had been made to parastatals, notably the Cocoa Marketing Board. Capital markets were not developed to any significant extent, and government securities were not actively traded. However, a discount house to develop a secondary market for money market instruments was created in November of 1988 in the context of a SAF program covering the period July 1987-June 1988.

The Bank of Ghana relied mainly on overall credit ceilings for the banking system, as well as ceilings for individual banks, to implement monetary policy. It also set different reserve requirements on sight and time deposits, and a liquid assets requirement was in force. Controls on maximum lending and minimum deposit rates were removed in July 1987, and control of minimum saving rates in February 1988, both in the context of the SAF program. Nevertheless, interest rates were not truly market determined, as the authorities still exerted significant pressure over the banks' posted rates. Although all formal requirements for concessional rates had been removed by 1988, banks still charged a lower rate for agricultural credit, apparently as a result of moral suasion by the authorities and a requirement to allocate 20 percent of lending to the agricultural sector. Also within the context of the SAF program, a weekly auction for treasury bills had been introduced in October 1987, but demand was implicitly limited by the banks' credit ceilings.

Despite the progress achieved under the SAF program, in 1988 the growth of output continued to be constrained by the lack of adequate domestic saving and investment, and the poor performance of the financial sector. The Government therefore embarked on a three-year reform program (June 1988-June 1991) supported by a Fund ESAF arrangement and by structural adjustment credits from the World Bank. In the area of financial sector reform, the original objectives of the program were to: (i) improve the regulatory framework and strengthen bank supervision; (ii) restructure financially distressed banks; and (iii) improve monetary management by gradually phasing-in a system based on indirect instruments of monetary control.

As regards the first objective, in August 1989 the Government enacted the Revised Banking Act, which tightened risk exposure limits, established higher minimum capital adequacy ratios, strengthened accounting standards, broadened the scope of audits, and imposed more stringent reporting requirements on banks. It also included several measures to improve the efficiency and financial position of the Cocoa Board and other state-owned enterprises.

In the area of bank restructuring, in January 1990 the government appointed new management and boards of directors for the financially distressed banks. However, plans to restructure the three banks that held more than 50 percent of nonperforming loans was finalized eight months late in April 1990, whereas similar plans for three other distressed banks were approved in November rather than September, as required by a structural benchmark. 1/ Delays arose in part because the problems involved proved to be more serious than had been anticipated, and in part because of delays in recruiting suitable consultants. With the restructuring of about 60 percent of credit to the nongovernment sector outstanding at end-1989 as well as some injection of new capital, banks were able to meet the new capital adequacy requirements by end-1990 and have become profitable. 2/ In March 1991 a restructuring plan for a seventh distressed bank was finalized, and the nonperforming claims on the private sector of four sound banks were replaced with Bank of Ghana bonds.

1/ The plan included appropriate provisions for substandard loans; recapitalization measures to deal with the banks' portfolios of non-performing loans; and the rescheduling or conversion of loans extended to banks by the government, the Bank of Ghana, and external lenders.

2/ In December 1990 the Bank of Ghana replaced the nonperforming claims on the private sector by the financially distressed banks primarily with Bank of Ghana bonds.

During 1988 the net foreign assets position of the commercial banks was stronger than expected, and broad money had grown above programmed levels. In the absence of indirect tools of monetary control, the authorities delayed the relaxation of credit controls, which left the commercial banks holding sizable excess reserves. As these reserves were not remunerated, bank profits were squeezed, and the commercial banks took advantage of the lifting of interest rate controls to reduce savings and time deposit rates. Consequently, deposit rates remained significantly negative in real terms.

After the delays experienced during 1988 in modernizing monetary policy implementation, the program for 1989/90 reemphasized the need to introduce market based instruments of monetary control, including a phasing-out of credit ceilings and the recapitalization of the Bank of Ghana by the Government. At end-1989 the Bank of Ghana introduced its own medium-term, nonrediscountable securities and began an active policy of removing excess liquidity through their sale in the primary market, in accordance with several structural benchmarks under the program. 1/

Despite the large volume of intervention, money market as well as bank deposit and lending interest rates remained almost unchanged until September 1990. Thus, in late 1990 and early 1991, the authorities implemented a number of policy measures to increase the sensitivity of interest rates to changes in liquidity conditions, including: an increase in the rediscount rate; an increase in money markets interest rates induced by intensified operations in the primary market; the unification of reserve requirements; the remuneration of reserve deposits with the central bank; and the elimination of controls on bank charges and fees as well as the requirement to lend to the agricultural sector. The process of auctioning of central bank securities was improved by preannouncing the timing and the volume of the intended gross sales, publicizing the results of the auction, and opening up the auctions to both the bank and nonbank sectors. Also, a stock exchange was set up and commenced trading.

Meanwhile, it had become apparent that the Bank of Ghana was inhibited in the operating of monetary policy by considerations of its own profitability. A program benchmark was satisfied by the completion of a four year audit of the Bank of Ghana, which detailed how the Bank had suffered heavy valuation losses on its large foreign liabilities incurred after 1983 when the Bank of Ghana assumed the foreign exchange risk of loans undertaken by certain state enterprises and government-owned banks. The Bank had also borne part of the cost of recapitalizing the banks. Losses through September 1990 were replaced in December 1990 with long-term government bonds offering an adjustable yield currently set at about 4 percent, and similar operations are to take place annually in case of further losses.

1/ The securities were of 6, 12 and 24 month maturities. During the ten-month period to September 1990, the equivalent of about 12.5 percent of broad money was sterilized in this manner.

Ghana's experience with financial sector reform displays several patterns typical of ESAF arrangement countries. Interest rates were liberalized early on, and a primary market in money market instruments was soon established, although a secondary market of significant proportions never quite developed. Much greater difficulties and delays were encountered in restructuring troubled financial institutions and removing quasi-fiscal distortions, such as preferential interest rates for agriculture. While the ratios of domestic savings and broad money to GDP do not display a marked trend over the period, the ratio of currency to broad money fell, perhaps because of increased confidence in the banking system (see the tables in Appendix I). A distinctive element of the reform in Ghana was the elimination of central bank losses, combined with early success with fiscal retrenchment, which served to free the conduct monetary policy from considerations of profitability.

The sudden emergence of large capital inflows in 1989, which were in part caused by the very success of the program, illustrates the need to develop new instruments in anticipation of policy actions, for the resultant problem for monetary control led the authorities to preserve credit controls longer than they might otherwise have done.

3. Senegal

As a member of the WAMU, monetary management in Senegal is closely controlled by the BCEAO: the level of interest rates is determined with reference to French rates; there is a minimum savings rate and a maximum lending rate; and the BCEAO sets global credit ceilings for each country. The parameters of monetary policy are dictated by the exchange rate peg against the French franc and by the absence of capital controls within the WAMU. Inflation in WAMU countries has been low in recent years, and real interest rates have been high.

At the beginning of the Senegalese ESAF program in October 1988, 15 banks, of which five were majority state-owned, operated in Senegal, along with eight nonbank financial institutions, of which two were state-owned. At that time, most banks in Senegal were burdened by substantial and growing portfolios of nonperforming assets, reflecting a history of inadequate risk assessment, the financing of loss-making public enterprises, and poor management. Quick action was required as the country's banking problems were seriously hampering financial intermediation and the conduct of monetary and fiscal policies.

Thus, in cooperation with the BCEAO, the Senegalese authorities launched a multiyear program in 1988 to create an independent, efficient and well-managed banking system. Emphasis was placed on disengaging the Government from the management of the banks and reducing its share in their equity to a maximum of 25 percent. They were helped by technical and financial assistance from the BCEAO, an adjustment loan from the World Bank, a three-year ESAF arrangement from the Fund, and resources from bilateral creditors and donors. In parallel, the BCEAO began reforming the instruments of monetary policy.

The process of restructuring the financial sector was carried out in two stages. The first stage, including the finalization of financial audits and feasibility studies, and the beginning of the rehabilitation and restructuring process, was meant to be completed in 1988/89, but was delayed until the period July 1989-June 1990. By November 1989, two private banks and three public sector banks had been closed, and liquidation procedures had been started against a third private bank. The state-owned development bank ceased normal operations and was transformed into a loan recovery institutions to deal with nonperforming loans. One private commercial bank (BIAO-S) was rehabilitated through an infusion of new capital and cost-cutting measures, and another was taken over by a foreign bank. A new private bank (CNS) was established, but due to a lack of capital it initially concentrated on managing the performing loans of the closed public financial institutions and one of the failed private banks.

The second stage of the reform (July 1990-September 1991) concentrated on the reorganization of the banking system. However, only part of the expected foreign capital inflows destined for the recapitalization of the troubled banks materialized, and progress on the recovery of the closed banks' outstanding loans remained slow. The authorities decided to accelerate bank closures and formally liquidated or revoked the license of closed institutions in October 1990. Since the CNS could not secure the required capital subscription during 1990/91, the BCEAO sold most of the liquidated banks' performing assets and rediscounted the remainder. The rehabilitation of the BIAO-S, however, was completed in September 1990.

To avoid the multiplication of loan recovery institutions, the government created a single loan recovery body in February 1991, which took over the nonperforming assets and corresponding liabilities of all liquidated banks. The performing loans and corresponding liabilities of the liquidated banks are being managed by the liquidators before their eventual transfer to the surviving banks.

The Government originally planned to reduce its shareholding in banks to 25 percent in 1989/90 under the second ESAF arrangement. It reduced its equity participation in the capital of a major commercial bank from 42 to 25 percent in April 1991. The privatization of the agricultural credit bank was begun in early 1990, and since June 1991 the Government has controlled just 24 percent of the equity.

As regards the reform of the monetary policy instruments, Senegal followed the recommendations adopted by the WAMU Council of Ministers in 1989. This reform too was implemented in two phases. During the first stage, (August 1989-September 1990) the BCEAO continued to rely mainly on regulating interest rates and setting overall credit ceilings. However, a number of measures were adopted, including: the elimination of the preferential discount rate (August 1989); the abolition of the policy of sectoral credit allocation (September 1989); and the simplification and rationalization of the schedules of interest rates of the commercial banks as well as increased flexibility for banks in the determination of their rates on deposits and loans (October 1989). Also, nonbank financial institutions were given access to advances from the money market, and direct interbank lending was liberalized. The discount rate remained above the money market rate, with the BCEAO intervening only as a lender of last resort. Furthermore, under the revised system, crop credit has been refinanced by the BCEAO only within its general refinancing limits, an has been included in the overall credit ceiling to the economy.

The second phase of the reform of monetary policy instruments covered the period October 1990-September 1991. It included, in particular, the entry into operation as of October 1990 of the banking commission of the WAMU, and the strengthening of the quantitative and qualitative instruments of credit control.

Senegal has made considerable progress reforming its banking system. The system has gone from a situation of sizable nonperforming loans and pervasive government intervention to one of rationalized and prudent credit and monetary policies. Two indicators of the banking system's transformation are the reduction in the number of banks from 15 to 8, and the fact that Senegal, which was a net borrower from the WAMU's money market until end-1988, has become a net creditor in that market. The ratio of currency to broad money has tended to fall, and the domestic saving ratio has increased slightly.

The process has taken years, absorbing substantial resources, and turned out to be more complex than initially envisaged, but the desired results were largely achieved. One source of delay was the difficulty encountered in inducing private investment, and especially foreign investment, in the recapitalization of the banks. Interestingly, Senegal's successful reform took place in the context of an ESAF program which included no financial sector reforms as structural benchmarks. Finally, the reform of the monetary policy instruments by the BCEAO has been gradual, and still has not resulted in full reliance on market-based instruments. The liberalization that took place occurred after the most financially distressed institutions were closed and new management installed at others, and the surviving banks are reported to be healthy.

4. Sri Lanka

Sri Lanka's financial system is well developed, with more than a score of banks, many other institutions offering specialized services, and an active stock market. Nevertheless, retail banking remains dominated by two state-owned commercial banks, and most longer-term savings are channelled into several other public financial institutions. Domestic savings are relatively high, and are supplemented by remittances from expatriots, which, however, are volatile.

The process of financial sector reform began in 1977, when entry was facilitated and interest rates liberalized. In 1981 the central bank began selling treasury bills at a secondary window, and in 1984 issued its own bills. 1/ Most bills were bought by institutions that were obliged to do so, and the market was further distorted by the central bank's sale of bills "on tap". Selective credit controls were slowly being dismantled, but refinancing at concessional interest rates was available to promote agriculture and exports, while public financial institutions were often directed to finance development schemes and parastatals with little regard for commercial viability. The savings bank was a chronic loss-maker, and the portfolios of the two public development banks were burdened with non-performing loans to the tourism sector. Lending rates were unregulated, and administered rates on bills and non-concessional refinancing were usually kept positive in real terms, but with significant variations due to their nominal rigidity.

Under the first SAF arrangement, approved in March 1988, Sri Lanka satisfied the structural benchmark on the strengthening of banking supervision and the introduction of regulations governing the finance companies, which had previously suffered a near-crisis. The envisaged removal of the bank turnover tax (BTT) on interbank transactions was not carried out. The reform of reserve requirements to include cash among assets eligible to fulfil requirements and exclude government securities was not implemented. The envisaged policies reflected technical advice received from the Fund and others. Indeed, the subsequent difficulty of the Sri Lankan financial system were largely foreseen, and many reforms only recently enacted were first detailed in the mid-1980s.

During the program, a rising fiscal deficit led to rapid monetary expansion, which was countered first by auctioning greater quantities of treasury bills and letting interest rates rise. However, by mid-1989 the authorities felt obliged to abandon this market-based approach and introduce new selective credit controls, freezing credits to "non-priority" sectors and imposing an advance deposit requirement on imports. By early 1990, real yields on treasury bills had fallen to negative levels, despite a commitment under the SAF II arrangement (approved in September 1989) to restore them to positive levels.

The second SAF arrangement contained no structural benchmarks in the area of financial sector reforms, although the importance of improving monetary management, reforming the treasury bill auctions, introducing a market in repurchase agreements ("repos"), and strengthening banking supervision were stressed. Little seems to have been achieved in this area under the SAF II, but the BTT was finally abolished. The SAF III placed more emphasis on financial sector reform, with benchmarks on the introduction of guidelines on loan classification and provisioning, and on reform of the primary market for treasury bills. The latter benchmark was met with a delay of three months when, in July 1991, the central bank decided to sell bills to the captive buyers at the average auction rate,

1/ The central bank ceased issuing its own bills in 1988.

and reduced the attractiveness of purchasing bills on tap. 1/ A number of areas to be reviewed under the program included monetary policy implementation, preferential refinancing facilities, means to deepen the market in government securities, and prudential supervision. Again, progress was limited, nor was the policy to maintain the bank rate above the treasury bill rate carried out. However, a monetary operations unit was established at the central bank, treasury bills were made ineligible to fulfill reserve requirements, and the tax-exempt status of deposits at the savings bank was lifted. 2/

Under the subsequent ESAF arrangement, which began in September 1991, policies were formulated to encourage savings mobilization and increase the effectiveness of monetary policy, while recognizing the importance of strengthening prudential bank supervision. The design of financial sector reforms seem to reflect a return toward faith in market-based instruments as inflationary pressures abated, and a growing realization that the state-owned commercial banks and the savings bank were in serious financial difficulties and mismanaged.

Short-term refinance rates were raised to move towards unification, and a number of long-term refinance rates were adjusted to reflect market conditions. In the context of the second-annual ESAF-supported program, some selective credit controls and the import deposit requirement were phased out ahead of schedule in September 1992. It was planned that under ESAF I, any interest rate subsidy would be administered through the budget, but this move has not been carried out.

The central bank was to start "open market operations"; before the creation of a secondary market in treasury bills, the intention was to set the quantities sold at auction and at the central bank's secondary window according to a reserve money program. The structural benchmark in this area was met before schedule, and initial results of the new operating procedures are said to be encouraging. The structural benchmark covering the licensing of government securities dealers and the issuance of longer-term securities was satisfied with a delay of several months. Meanwhile, the public commercial banks and the savings bank are to be restructured, with the aim of reducing costs, improving loan recovery, and increasing their commercial orientation; recapitalization will be achieved through the issue of long-term government bonds and the transfer of nonperforming loans to a recovery agency. 3/ The authorities met a performance criterion by agreeing to a restructuring plan for the commercial banks, although so far mainly administrative measures have been carried out. A number of measures taken under previous programs do not seem to have been entirely effective, and the ESAF program called for further strengthening of the central bank's

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1/ These new procedures were recommended by preceding CBD technical assistance missions.

2/ Again, technical assistance seems to have been effective in these areas.

3/ The interest costs are estimated at 0.4 percent of GDP in 1993.

capacity to enforce prudential and accounting standards, and for amendments to relatively new legislation on bank governance and debt recovery.

Despite this progress, monetary policy continued to be hampered by several problems that are to be addressed in the recently approved second ESAF arrangement. Bank credits to the loss-making state plantations corporations terminated but recently, interest rate subsidies are still to be budgeted, concessional refinancing is to be reduced only gradually, and the central bank continues to refinance finance corporations rescued in 1988. The two financial sector structural benchmarks included in the ESAF II arrangement concern the transfer of foreign currency lending to domestic residents from the "off-shore" banks (the FCBUs) to domestic commercial banks, and the removal of the compulsory import margin deposit on letters of credit. The latter was implemented ahead of schedule in August 1992. The central bank's new skills in monetary management will be tested in "mopping up" the liquidity created by capital inflows and in dealing with what appears to be structural instability in the demand for different monetary aggregates.

The experience of Sri Lanka with financial sector reform offers a number of lessons. First, even after a history of liberalization, a government may quickly resort to direct controls if the use of market-based instruments to counter inflationary pressure leads to interest rates that are perceived to be "too" high. Second, quasi-fiscal activities of the financial sector, such as noncommercial lending or concessional refinance facilities, are very difficult to eliminate. Third, technical assistance can be useful in identifying problems before they become acute and in developing a reform agenda, but time is needed to develop institutions, and reforms are often carried out only when inefficiencies are glaring. Therefore, reform in areas such as monetary monitoring and the enforcement of prudential regulations, which is not expensive, should be begun as early as possible. Failure to act early may increase the costs of reform by worsening bank insolvency, while monetary policy can be impeded by the need to continue concessional refinancing of rescued institutions. Fourth, the success of reform may bring its own complications in the form, for example, of money demand instability and capital inflows, which the central bank must have the knowledge and instruments to deal with.