FINANCIAL SECTOR REFORM

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Outline

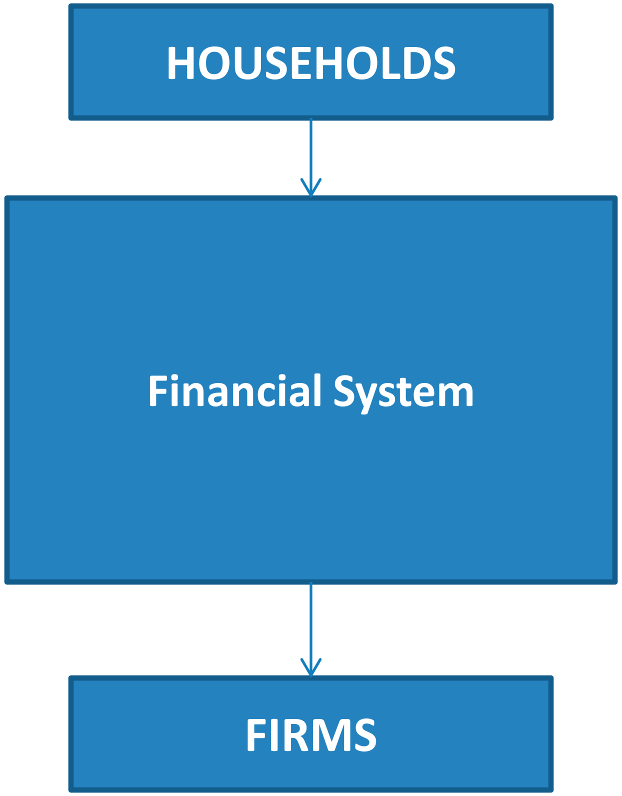
- Financial repression
- Financial reform
- Lessons from banking crises
- Lessons from post-Asian crisis reforms
- State-owned banks
- Capital market development

FINANCIAL REPRESSION

Key Objectives of Financial Sector Development

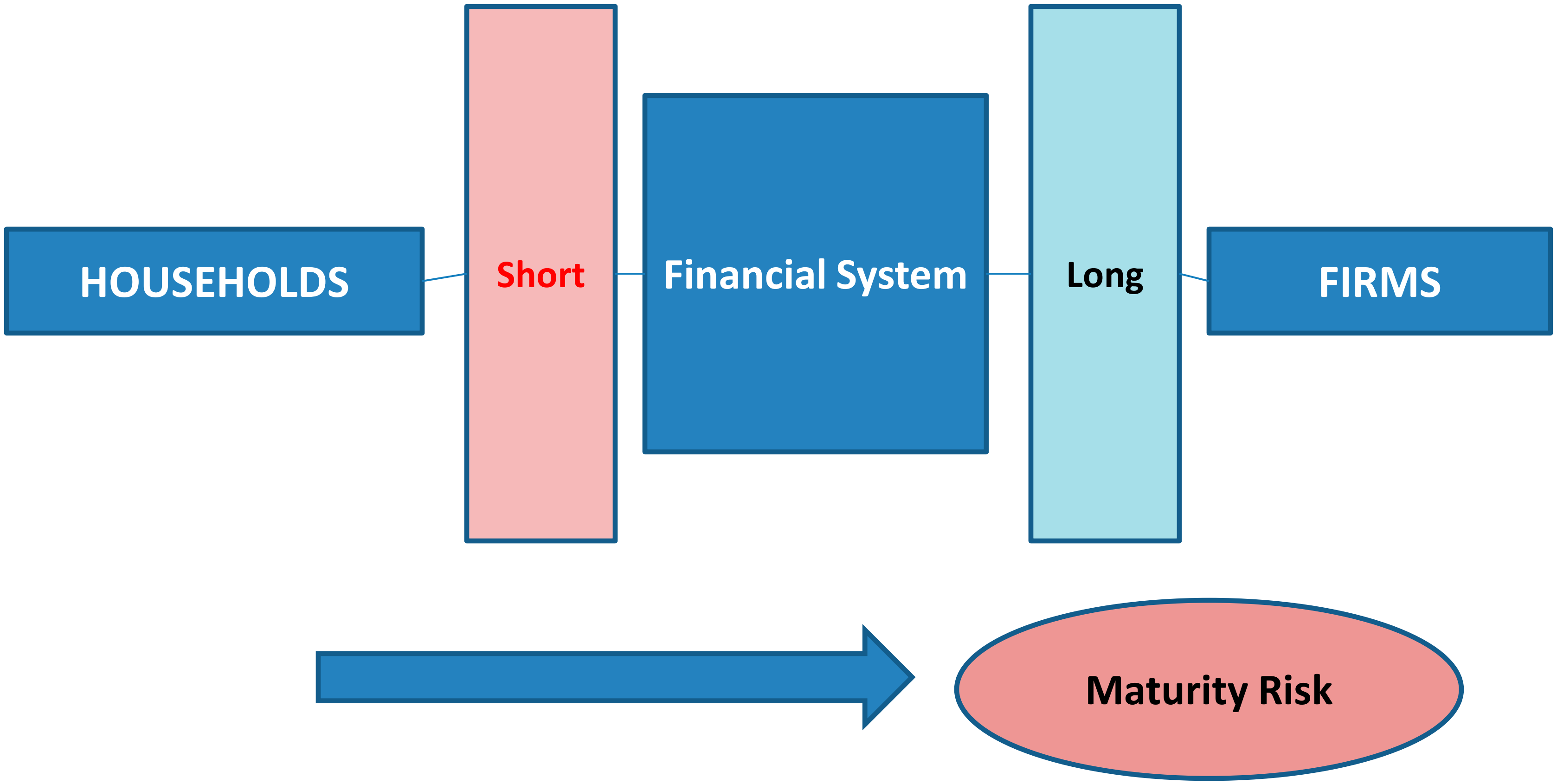
- Key objective: promote growth and development by intermediating resources from savers to investors, allocating the resources available in an efficient manner among competing uses in economy, leading to increased and more productive investment

- In accordance with this objective, the financial system needs to transfer resources across time and space



Functions of the Financial System

Liquid assets are transformed into more illiquid investments



Functions of the Financial System

- Managing the risks emanating from maturity transformation
- Managing risks for savers: confidence in deposits
- Managing risks in investments: loan practices

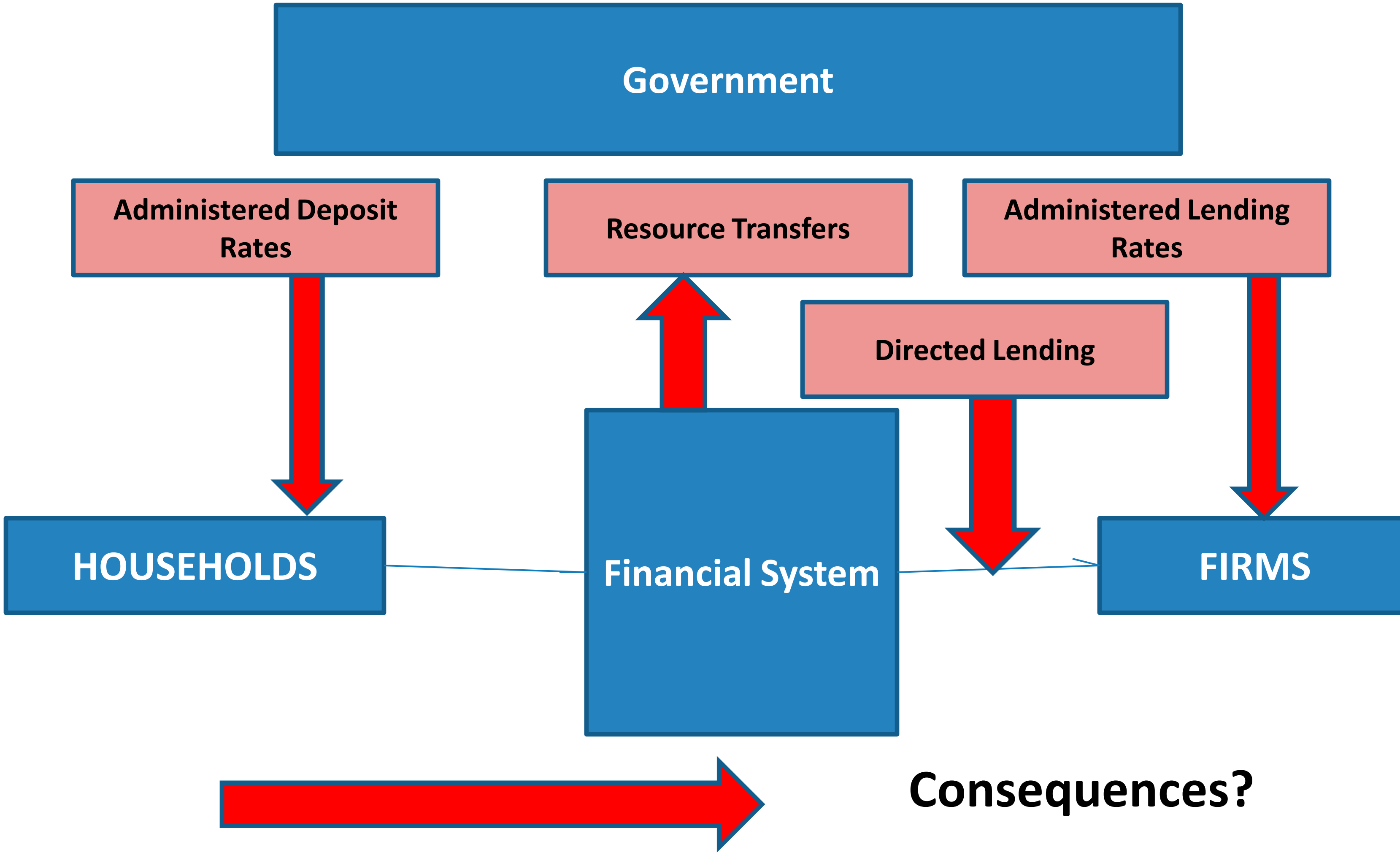
- Developed financial system allows diversification of asset holdings

- Payments system

What is “Financial Repression”?

- Covers wide variety of measures involving direct government use of the financial sector to achieve certain policy goals
- Government-imposed restrictions to use the financial system as a source of public finance
- Government directives to affect the level / allocation / cost of credit extended by financial sector
- Seeking competitive advantage to publicly-owned or domestic institutions
- May support non-profitable public enterprises

What is Financial Repression?



The Consequences of "Financial Repression"

- Difficult to quantify, though large body of research shows that such policies undermine growth

- Results of **administered interest rates**?
  - Effects on: savings / consumption? Debtors / creditors? Allocation of credit? Bank profitability?

- Results of the government using the financial system as a **source of public finance?**
  - Effects on: inflation taxation? Banking system which is forced to hold public debt? Pension fund rules that require holdings of sovereign bonds?

The Consequences of "Financial Repression"

- Results when public banks used to **direct credit to certain sectors** or offer credit at subsidized rates
  - Effects on: Public bank exposures? Resource allocation and industrial structure? Regulatory forbearance? Overall soundness of the financial system?

- What are the likely results of **restricting competition** within the banking system
  - Effects on: Interest rates and spreads? Banking efficiency? Stability of the banking system?

Case: Financial repression in India

- Prior to India’s ’91 crisis, government treated the financial system as instrument of public finance
  - Fixed deposit / lending rates and loan amounts;
  - Credit channelled to government and priority sectors at below-market rates;
  - Banks faced high reserve and liquidity requirements;
  - Competition between banks was limited

- Allowed government to fund large budget deficits at relatively low cost

India's First Steps To Reduce "Financial Repression" in the 1990s

- Lengthy process: gradual withdrawal of government influence + development of institutions and standards

- Steps taken in the 1990's:
  - Interest rates were gradually liberalized
  - Cash and liquidity requirements reduced
  - Priority sector lending requirements eased
  - Prudential norms tightened
  - Foreign institutional investors allowed to enter securities and debt markets
  - New private and foreign banks licensed: increase competition
  - Activities of public banks were commercialized

Financial repression and housing

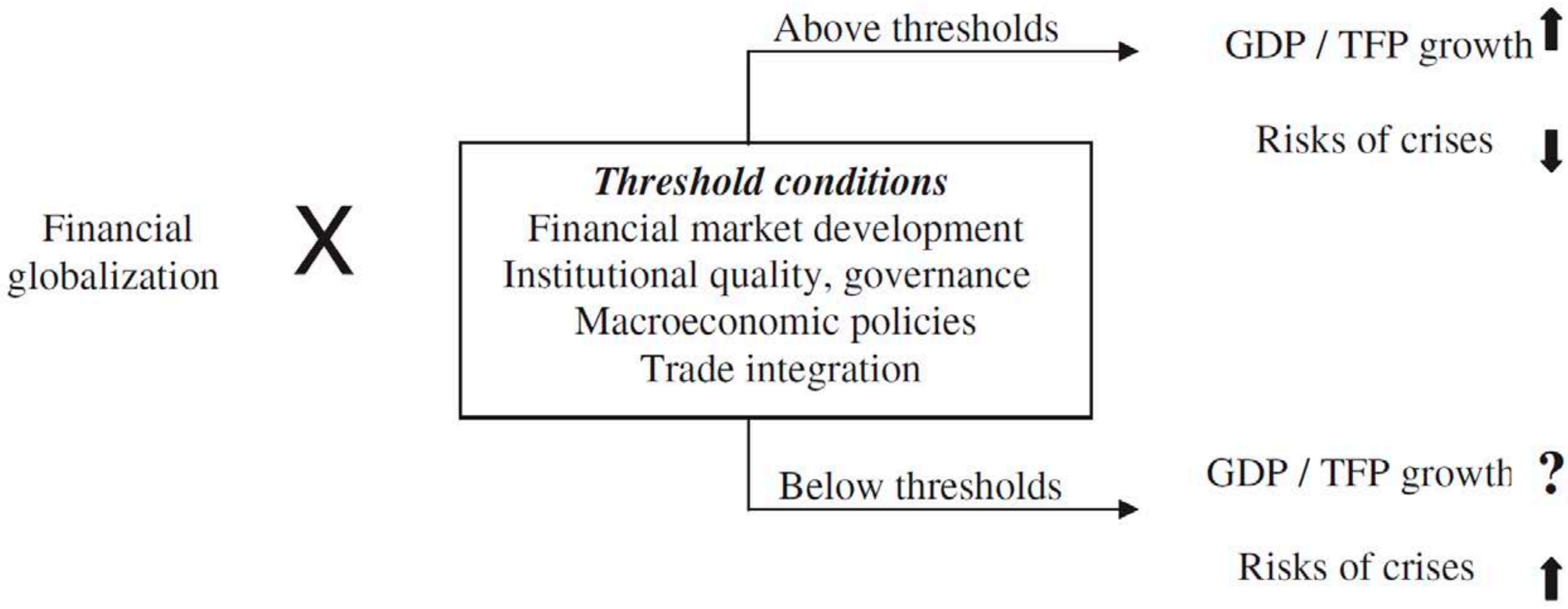
- Financial repression can have consequences that go well beyond the financial sector itself

- Vietnam and China are prime examples of how households seek alternatives out of financially repressed systems

- Risks housing bubble, even in country where mortgages play little role, like Vietnam

FINANCIAL REFORM

Pre-requisites for financial reform



Source: Kose et al. (2009) IMF Staff Papers 56(1)

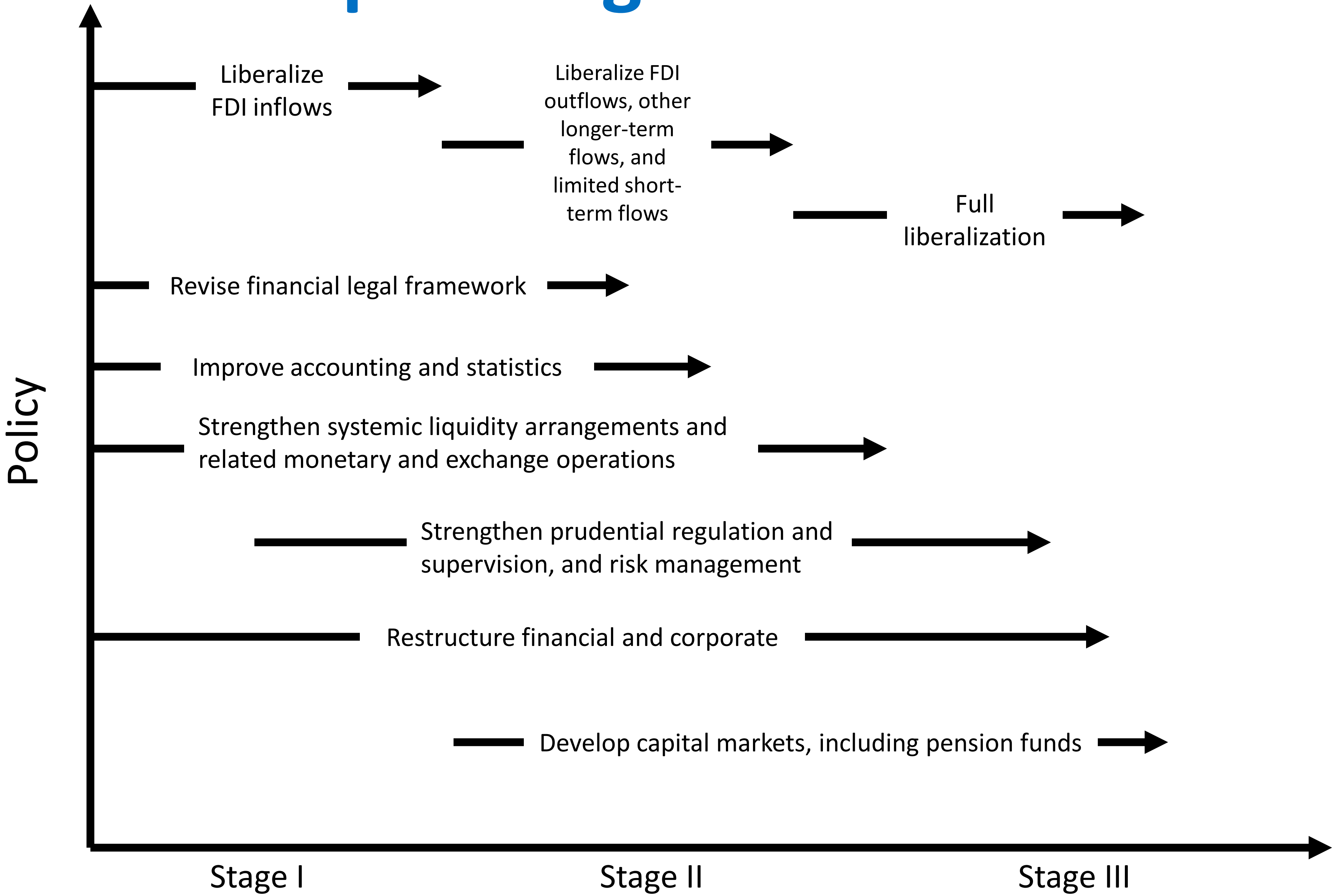
But reform is multi-faceted

- Some reforms can be implemented at earlier stages of development

- Example: FDI liberalization. Relatively stable flow, can facilitate competition and technology transfer (but not always… China vs. Caribbean)

- Versus: short-term debt flows. But recently also: long-term debt can be highly volatile

The sequencing of liberalization



Source: "The Liberalization and Management of Capital Flows: An Institutional View,", IMF (2012)

Markets and Institutions (I)

- To develop the financial sector, necessary to:
  - develop domestic financial markets (money market, foreign exchange market, government paper market, corporate bond and equity markets, etc)
  - encourage competition and a level playing field within the financial sector so that banks compete to attract savings;
  - develop a strong and transparent institutional and legal framework for financial sector activities

Markets and Institutions (II)

- In terms of institutions there is a need for:
  - a strong central bank to ensure functioning of markets and financial stability;
  - a financial regulatory institution (perhaps also the central bank) that can ensure effective implementation of prudential regulations and supervision across the entire financial system;
  - high standards of corporate governance, accounting and auditing regulations; and,
  - a legal and court system that will protect creditor rights, and enforce contractual regulations ("rule of law")

Markets and Institutions (III)

- Macro environment also of great importance in development of the financial sector

- Removal of Fiscal Dominance
  - In order to remove the vestiges of fiscal repression, the government needs to adopt a prudent fiscal policy under which any deficit financing would be raised at market-determined rates from nonbank sources

- Establishing Effective Macro Risk Management Capability
  - *Macroeconomic risk management* depends, inter alia, on well-functioning money, foreign exchange and government debt markets to allow conduct of monetary/fiscal policy.

Markets and Institutions (IV)

- Finally, the nature of political institutions is also found to be an important factor in sustaining financial sector development
- Financial liberalization measures need to be supported by a political environment that instils trust
- Of particular importance:
  - Property rights
  - Contract enforcement (judicial system development)
  - Limiting corruption and cronyism
  - Limiting conflicts of interest (overlaps corporations / banks / regulator/ politics)

Lessons from banking crises

Banking Crises

- Usually rooted in: Real estate boom-bust or crony investments. Quite frequent since 1970s.

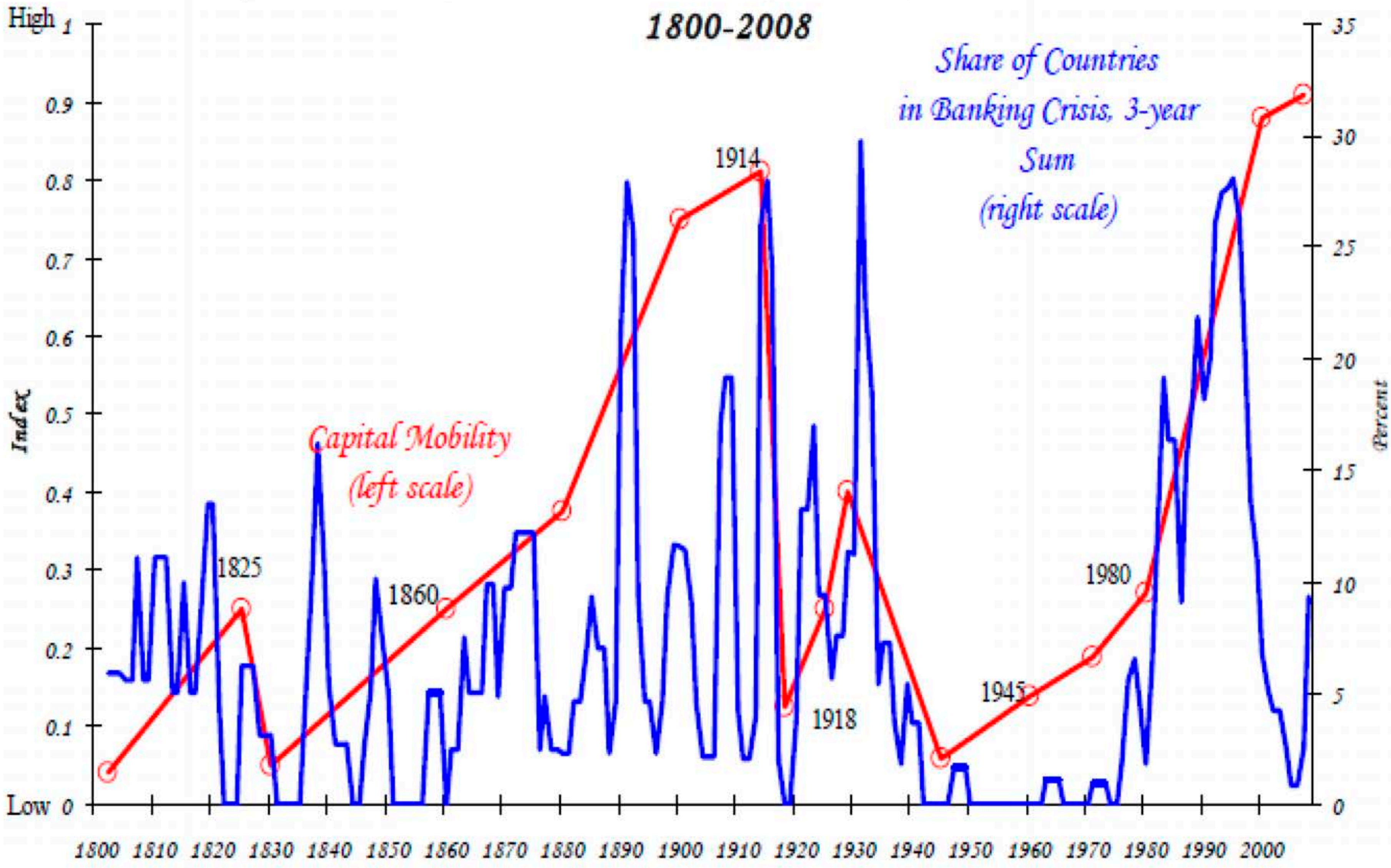
- Not just regular banks:
  – Advanced economies: investment banks, AIG (US ’08); LTCM ’98.
  – Developing countries: pyramid schemes (Albania), direct (“black”) financial intermediation (China now).

- In theory: should differentiate liquidity and solvency crises. But most liquidity crises triggered by solvency fears

Banking Crises: Historical Experience

- RR: Frequency of banking crises similar for advanced and emerging economies.
- Crises generally preceded by surging credit growth, fueled by capital inflows; leads to asset price bubbles
- Evidence linking banking crises to financial liberalization
- Anecdotal evidence: inadequate regulation and supervision at the time of liberalization

Capital Mobility and Banking Crises

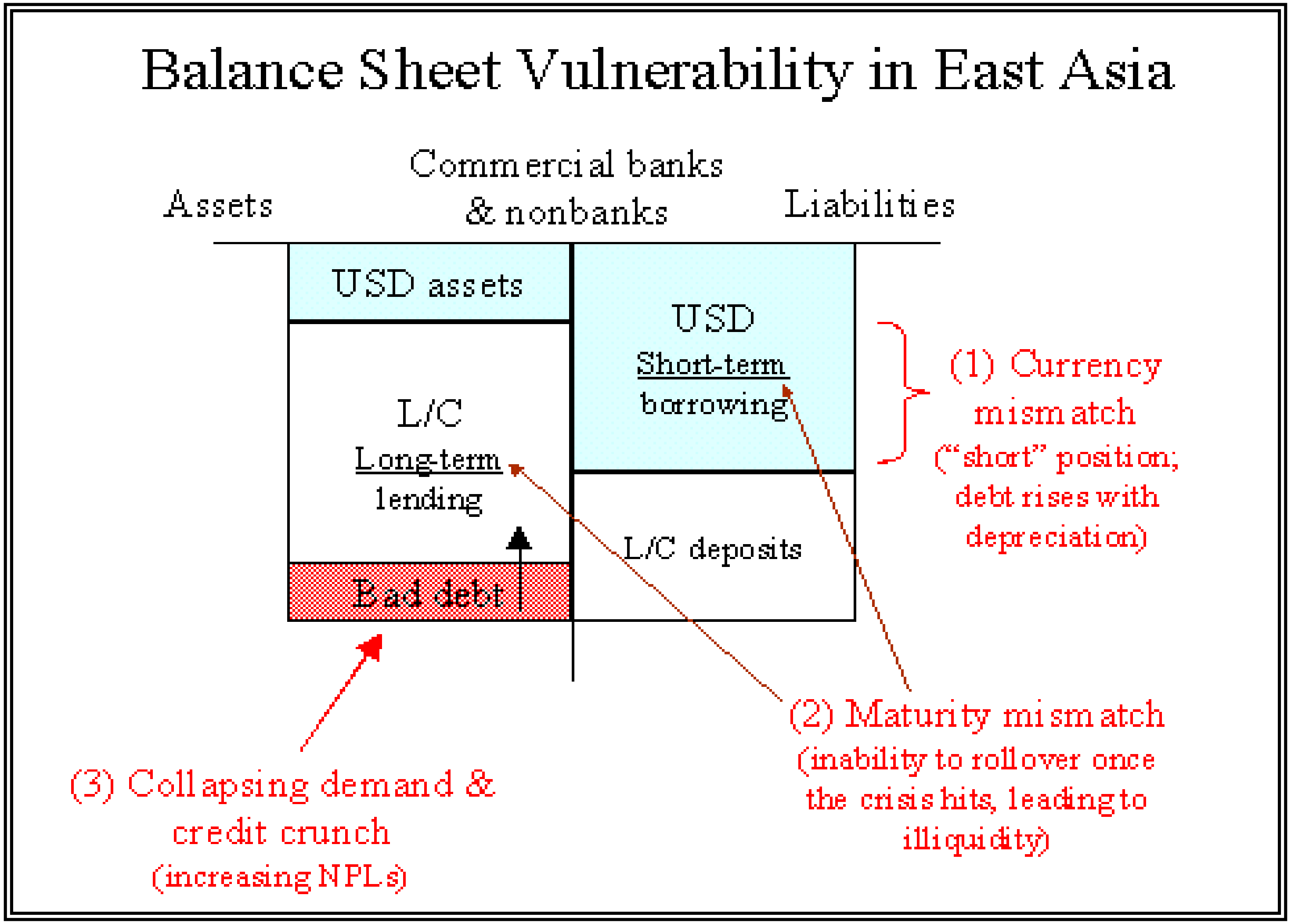


Source: Reinhart and Rogoff (2008)

What goes wrong with banks?

- Credit risk: making bad loans
- Liquidity risk: drying up of funds
- Market risk: the impact of falling asset prices
- Unauthorized “rogue” trading/major frauds

Exposures pre Asian Crisis



Source: Ohno, http://www.grips.ac.jp/teacher/oono/hp/lecture_F/lec11.htm

Costs of Banking Crises

- Banking crises usually involve significant welfare losses:
  - Fiscal costs: can lead to debt crises
  - Output costs: credit crunch; severe recessions
  - Capital outflows: often lead to balance of-payment crises
  - Micro losses: depositor-bank relations

Lessons from post Asian Crisis reforms

Lessons from post Asian Crisis reforms

- The Asian crisis exposed weaknesses in corporate governance, risk management and bank supervision;
- Bank-centric financial system, concentrated risks. Banks poorly capitalized, high credit risk, connected lending, and large exposures;
- Double mismatch (currency and maturity)
- Excessive dependence on volatile capital inflows

Impact of Asian Reforms

- 2000-07: Sharp rise in Asian aggregate savings. Insulated most of the Asian banking system from the interruptions due to international wholesale funding markets

- A substantial accumulation of foreign exchange reserves

- Asian banks have become stronger (well capitalized and more liquid) and more efficient;

- Risk-adjusted capital ratio of Asian banks has risen substantially;

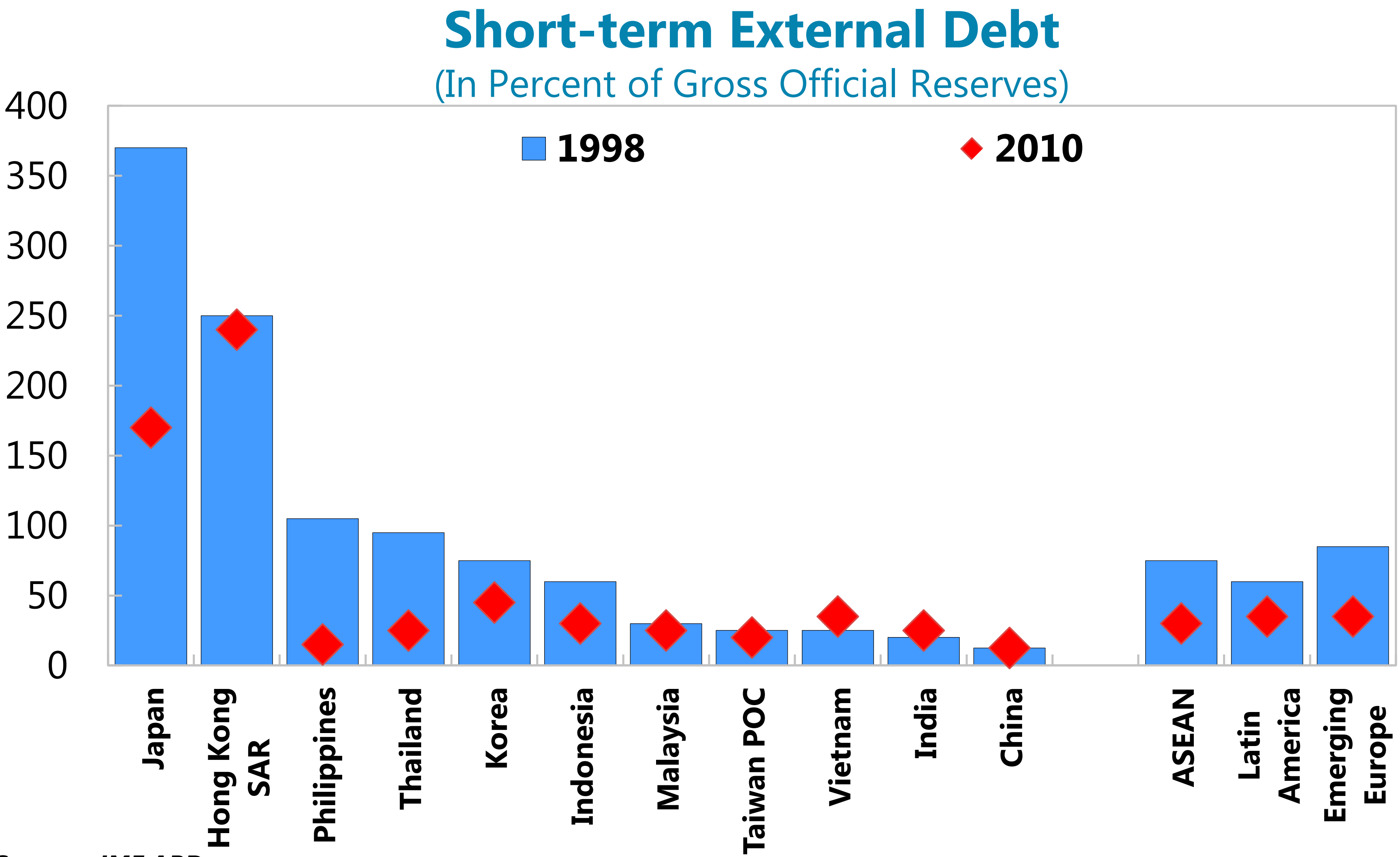
Impact of Asian reforms

- Asian regulators have gained reputation for stringent supervision;

- Between 1999 and 2004, many countries closed their weaker banks or merged their banking institutions (10-30% of banks in India, Indonesia, Korea and Malaysia) or privatized them;

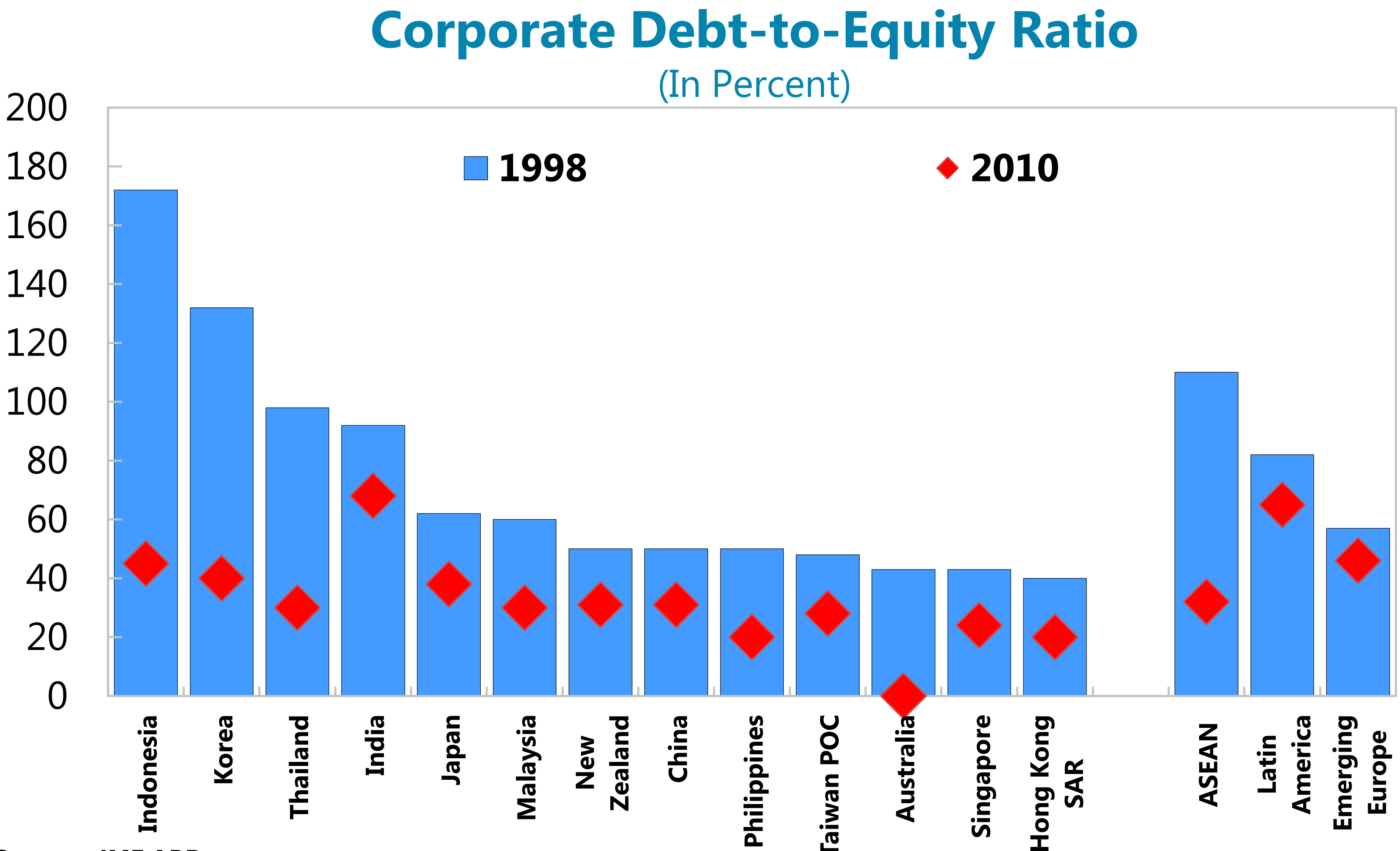
- In addition, there were efforts to increase foreign ownership of the banking system.

Asia in general: vulnerabilities much smaller than in 1998



Sources: IMF APD

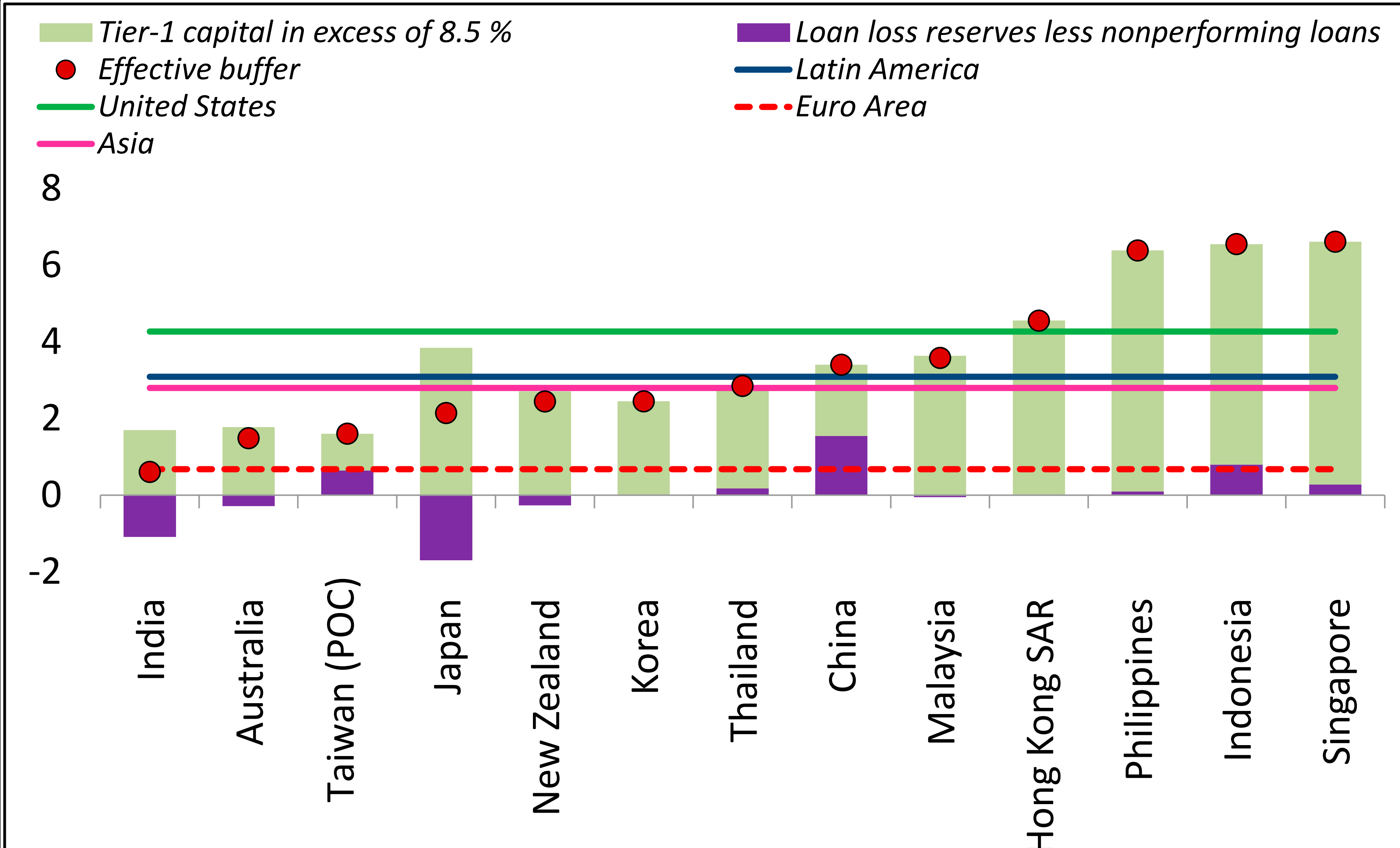
Also in the corporate sector



Sources: IMF APD

And Banks' Loss-Absorbing Buffers[1]

(In percent of risk-weighted assets, asset-weighted mean)



[1] Loss absorbing buffers are calculated as Tier 1 capital in excess of 8.5% plus loan loss reserves less impaired loans as percent of total risk-weighted assets

Source: IMF Asia REO, April 2013

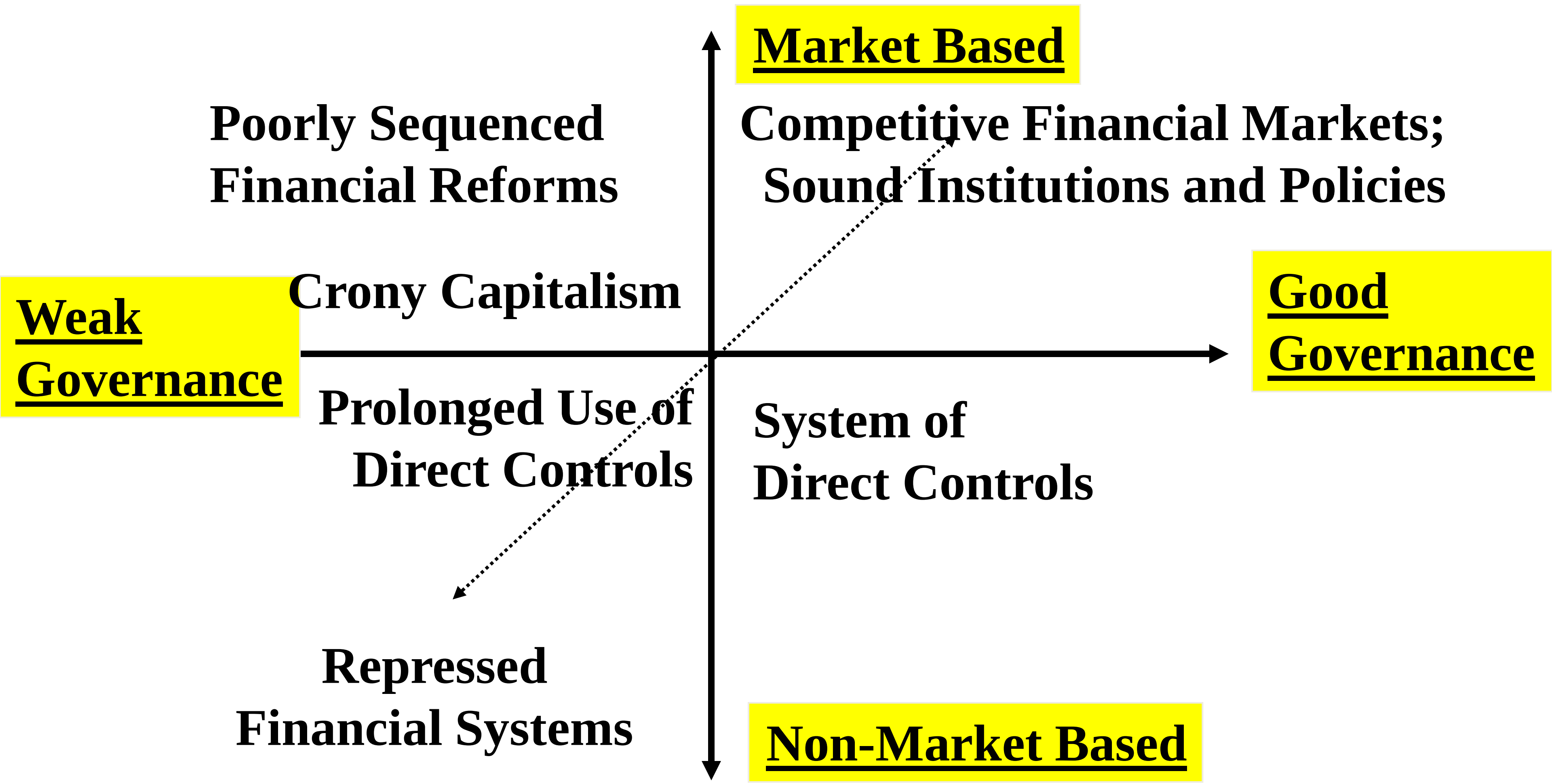
Reasons for Financial Reform

Reasons for Financial Reform

Are the functions of a financial system being adequately and efficiently performed?

- Transferring funds from ultimate savers to ultimate investors efficiently
- Risk management and allocation
- Information production and price discovery
- Dealing with incentive problems—e.g. adverse selection

So the challenge is:



Financial Liberalization

- Elimination of credit controls
- Deregulation of interest rates
- Bank autonomy
- Free entry into the financial services industry
- Private ownership of banks
- Liberalization of international capital flows

Issues in Financial Sector Reform

- **Central bank reform to enhance credibility and control**:
  - greater instrument independence
  - move toward indirect instruments of monetary policy
  - clarify role in supervision of financial system and coordination with other regulatory institutions
  - define role as lender of last resort

State-owned banks

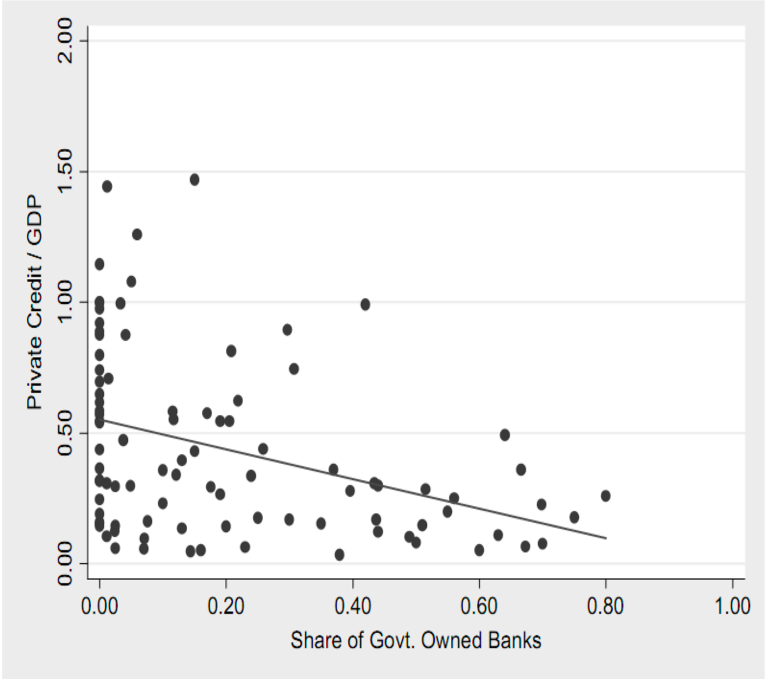
Reform of Government-Owned Banks

- Studies show that economies with higher share of state-owned banks have lower levels of financial development, more concentrated lending, lower growth, and are more likely to suffer systemic fragility

- Being owner, borrower and regulator, governments face conflicts of interest, usually resulting in high NPLs.

- Moreover, there are efficiency losses from reduced competition

The higher the share of government-owned banks, the lower the private credit/GDP ratio



Creating an Efficient Financial System: Challenges in a Global Economy Thorsten Beck (2006)

State-owned banks

- Important issue in your countries
- State ownership can matter for relationship between finance and the macroeconomy
- Two types:
  - “Intentional” state owned banks
  - “Unintentional” – nationalization after crisis
- Start from some examples for the first type…

Reforms to Develop Asian Capital Markets

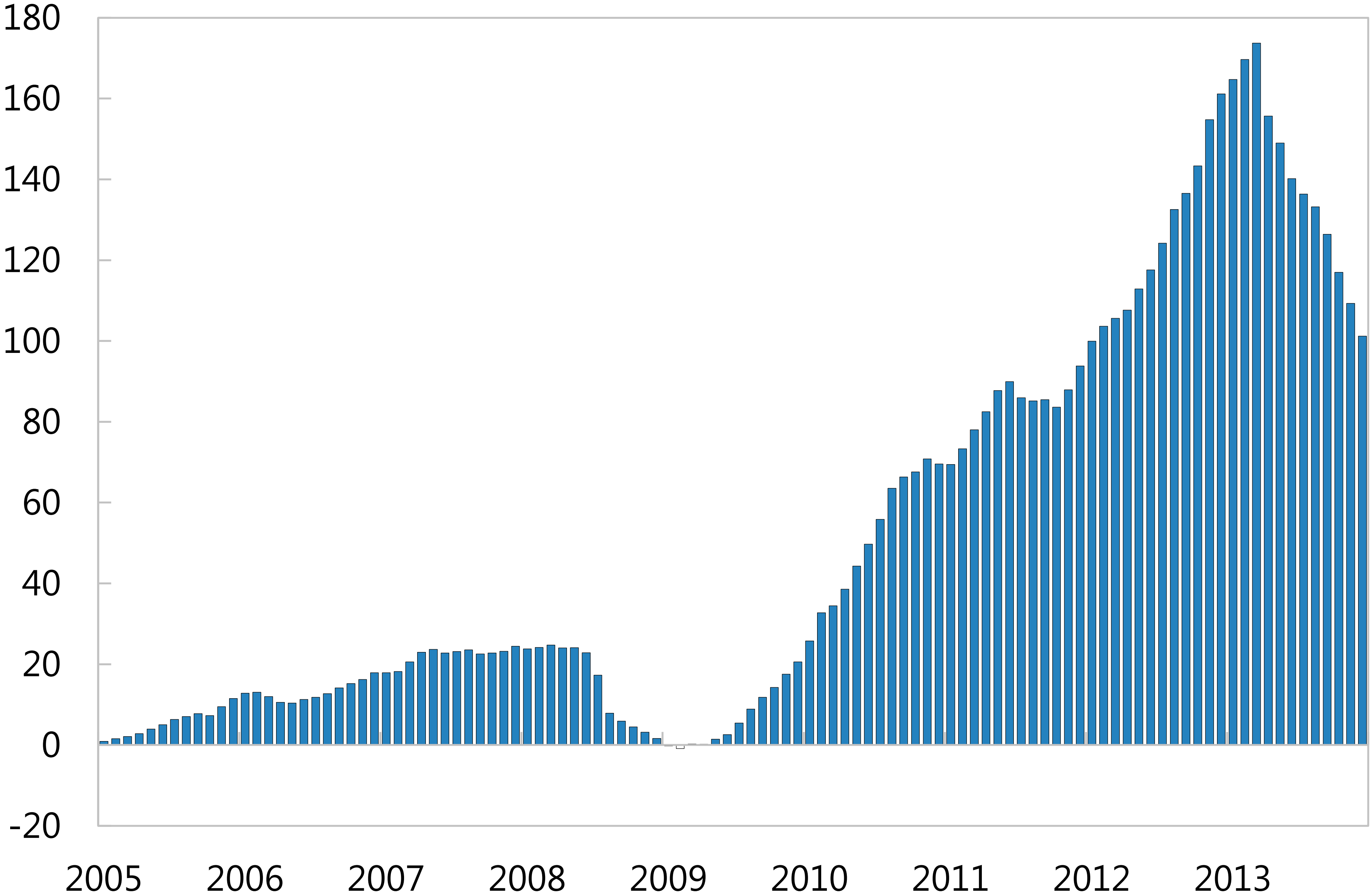
- Asia: priority on bond market development to promote financial deepening and financial stability

- Potential gains:
  - Longer maturity of debt
  - Reduced currency mismatch (rapid growth of local currency markets)
  - More liquid markets

- Diversification of investor base, especially foreign investors
  - But double-edged sword: also increases vulnerability to global risk appetite

Enormous Inflows - Recent Outflows

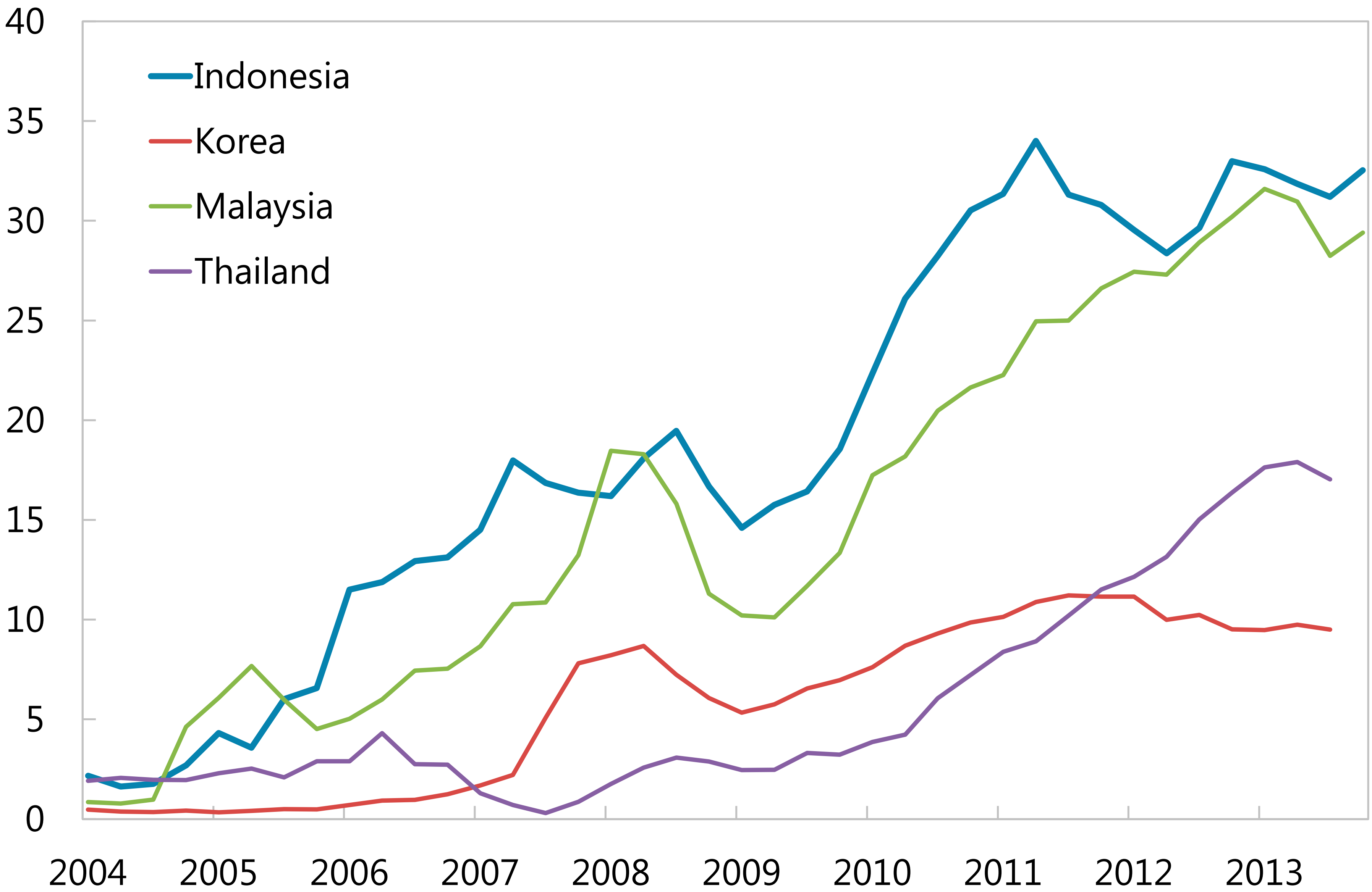
Cumulative Net Inflows to funds dedicated to EM Bonds (USD Billions)



Source: EPFR

Significant share of Foreign Investor Participation

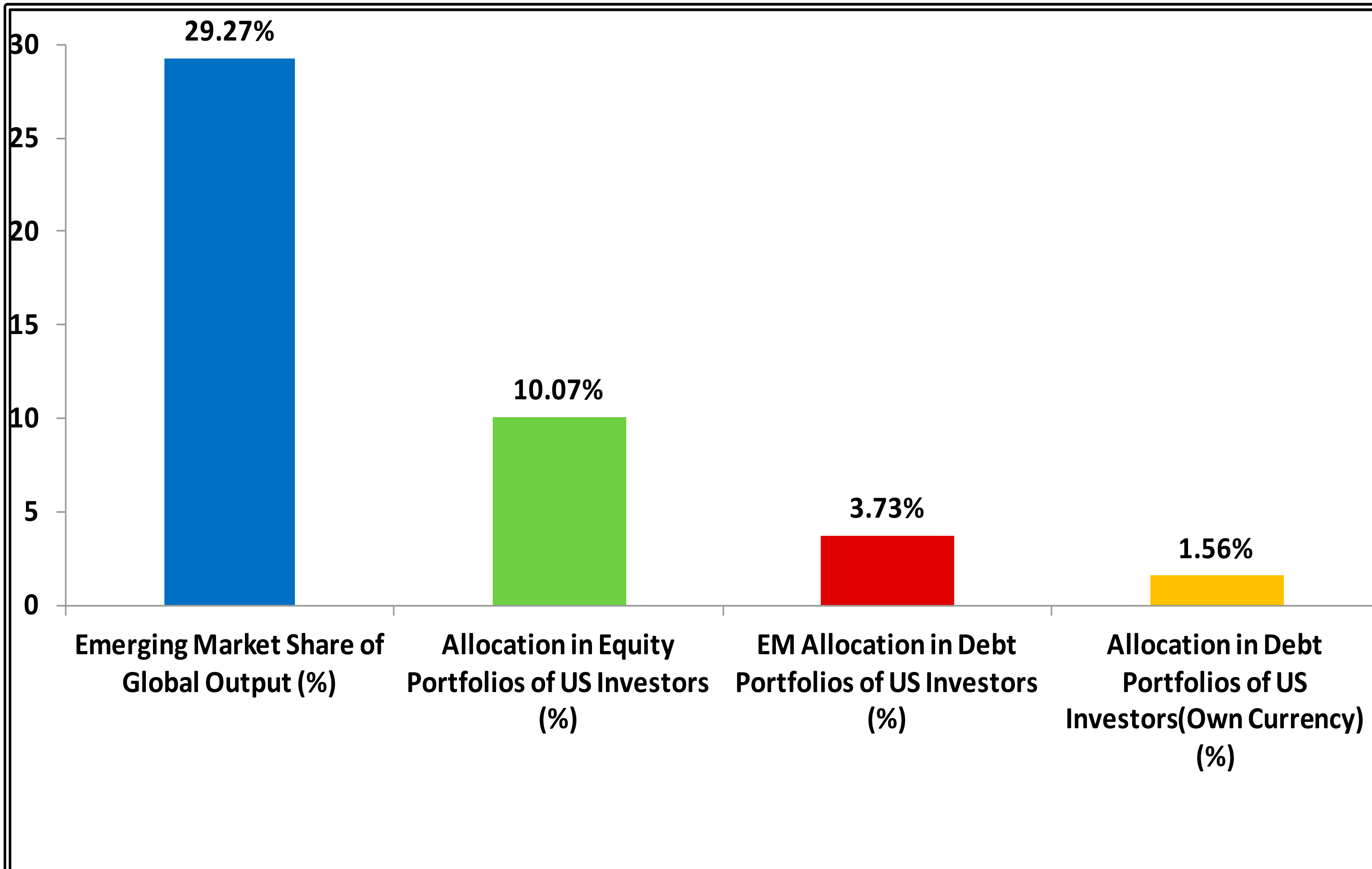
(% of Total Holdings)



Source: Asian Bonds Online

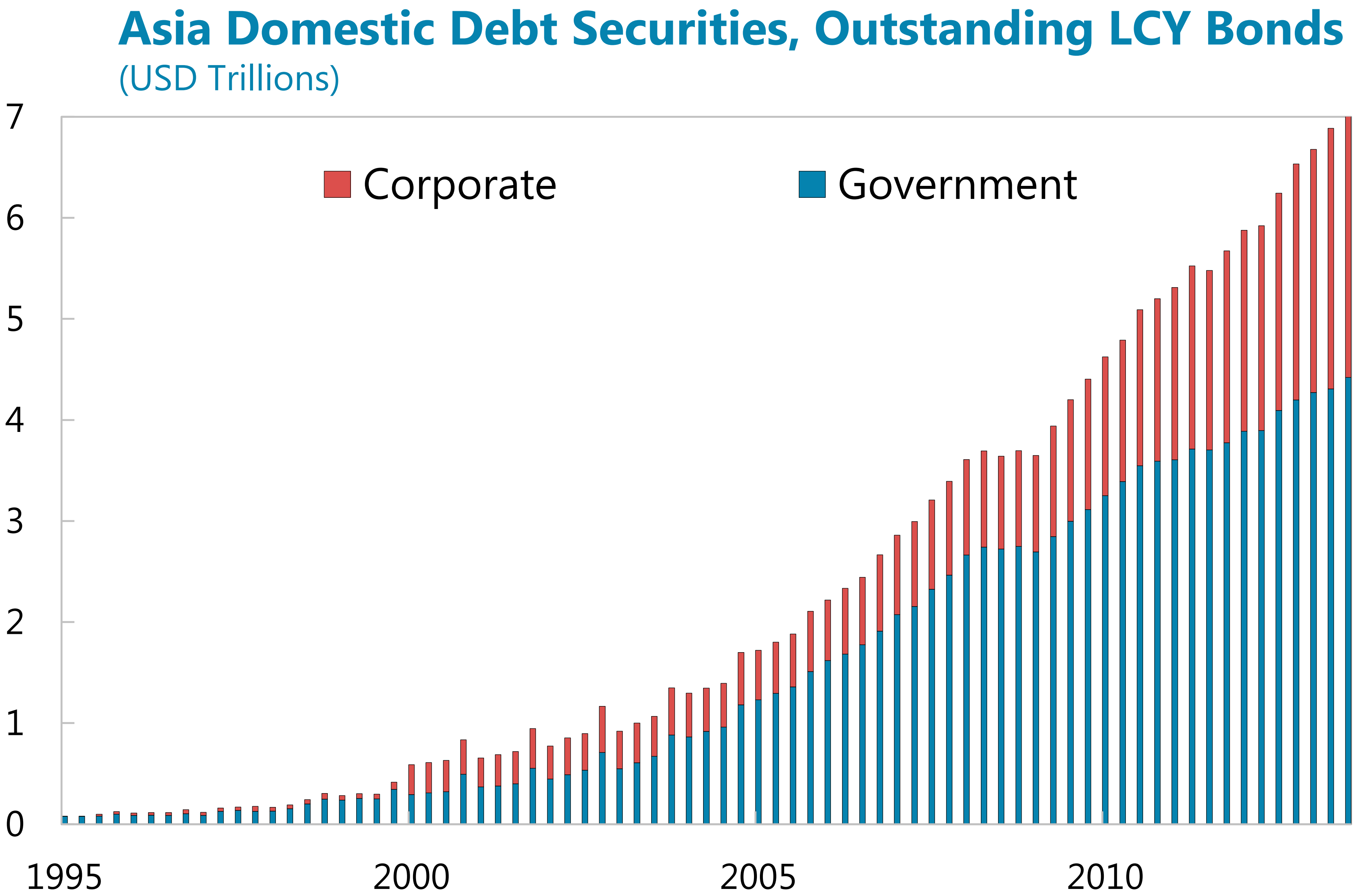
Structural potential for continued growth

(FY 2011)



Source: IMF WEO, US Treasury Reports

And not just in government bonds



Source: Asian Bonds Online

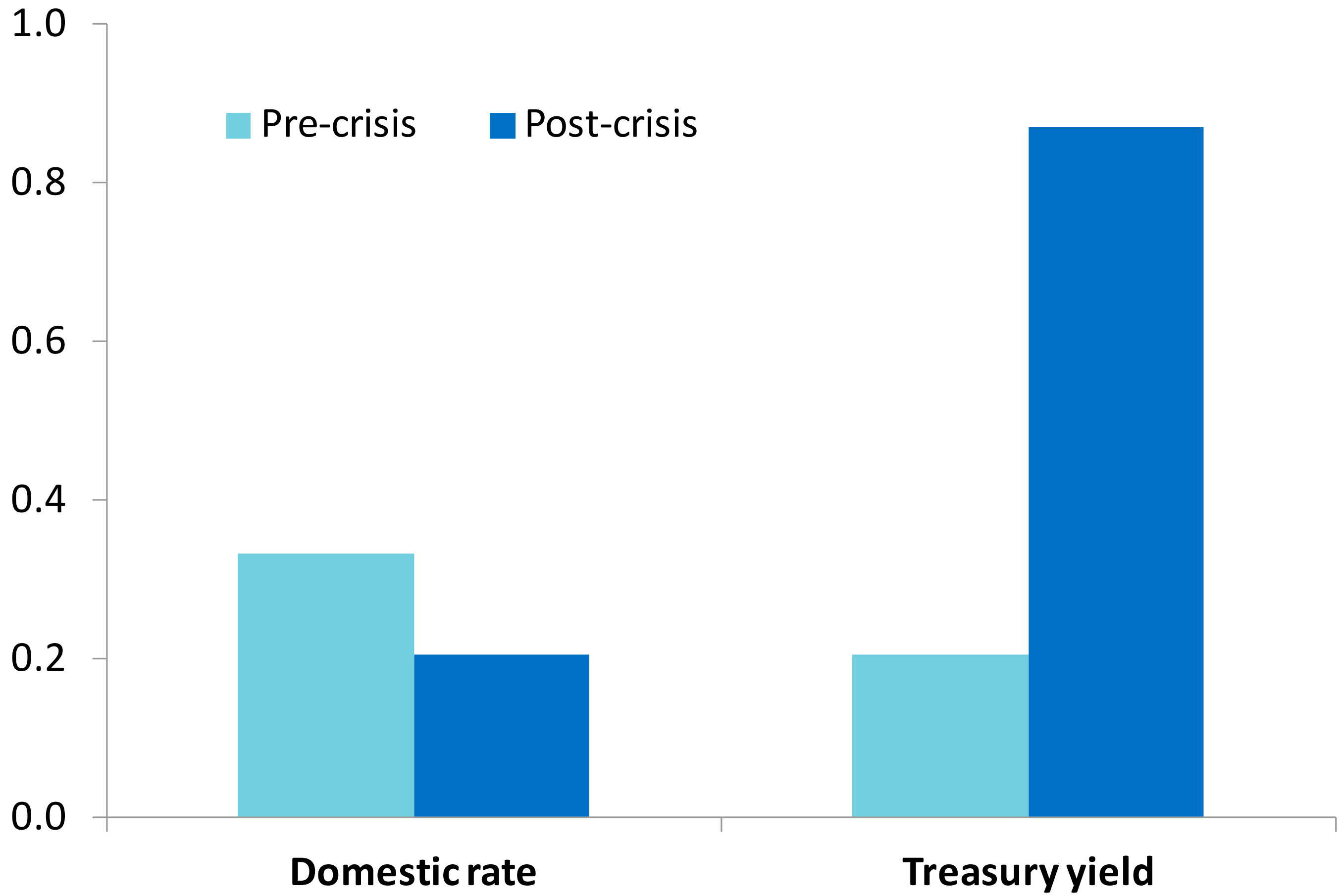
But, challenges remain to further diversify the financial system and enhance financial stability

- Reversal risk: a sudden exit of investors from bond markets with high foreign participation could prove destabilizing.

- Valuation risk: high prices and speculative dynamics are a concern in residential property

- Leverage risk: elevating debt levels with increasing external borrowing, heightening risks from stretched asset valuations

Be aware: integration brings dependence



- Average EM coefficients, local currency debts, Agur et al. (2014)

Some Financial Sector Issues in Lao PDR

- BoL lacks full operational independence
- Interbank market is rudimentary and financial intermediation is in the process of developing
- Monetary policy relies to a great extent on regulations based instruments
- Rapid credit growth and consequent asset quality concerns
- The capital of two state-owned commercial banks is well below the regulatory minimum, potentially a fiscal risk.
- Financial soundness indicators available are not up-to-date
- Supervisory capacity and risk management practices at banks weak

Some Financial Sector Issues in Myanmar

- The new CBM law, which separates the CBM from the Ministry of Finance and provides adequate autonomy, was enacted in July 2013
- The financial sector is small (credit is 15% of GDP), segmented, partly dollarized, and repressed due to administrative controls that limit intermediation
- The new CBM law, which separates the CBM from the Ministry of Finance and provides adequate autonomy, was enacted in July 2013
- A new Banking and Financial Institutions Law to modernize the prudential framework is in the final stage of drafting
- The authorities plan to grant licenses to 5–10 foreign bank branches during 2014

Final thoughts

- Financial reform is a long-term commitment.

- Cannot be seen in isolation. In fact, if proceeds too fast on its own can create large risks. Part of broader development plan

- Lao PDR and Myanmar face diverse but deep issues, ranging from financial repression and state-ownership to rapid credit and house price growth, on a shallow financial foundation