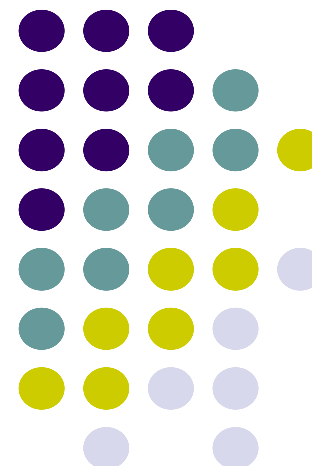
Discussion on the Financial Sector Reform and the Economy: Analytical and Empirical Evidence of the Linkages



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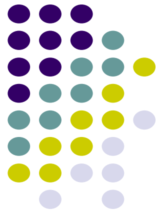
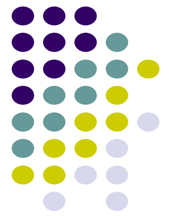
Outline of Discussion



- The Two papers- well documented the linkages between financial sector performances and economic development, drawing on both analytical literature and empirical evidences in SSA and beyond

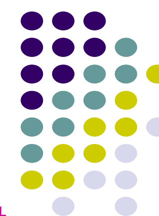
- Typical conditions of financial sector performances in the pre-reform period in SSA (financial repression in SSA vs restraints in East Asia).
- The achievements of financial sector reforms in SSA.
- Typical conditions prevailing in financial systems in SSA.
- Main tasks ahead for financial sector development strategy.

Conditions in the Pre-Reform Periods



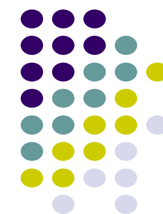
- Under financial repression in the pre-reform period
  - excessive regulation and controls that undermined competition for efficiency and growth were combined with high inflation and general macroeconomic instability.
  - governments chronically in a fiscal crisis tended to extract rents from the private sector: A number of measures such as interest rate controls or high reserve requirements were used as implicit taxation on the domestic financial system.
  - the household sector doubly lost out due to control on the deposit rate as well as to the inflation tax. Private agents were disenfranchised from the process of financial sector development and economic development.
  - Borrowers engaged in rent-seeking activities in search for rent transfers created by preferential lending rates and direct credit allocation.
  - Banks were discouraged from engaging vigorously in deposit mobilization and financial intermediation to the private sector and their incentives to build an institutional capacity in liquidity, assets and risk management were severely impaired.
  - Very little attention to development of stock and bond markets

Contrasts between and Financial Repression and Restraints



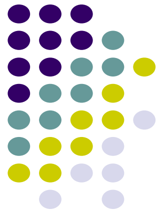
- In Northeast Asia, the policy of *financial restraints* was used contingent rents applied for institution building and incentive mechanisms in the financial sector for a powerful industrialisation drive.
- Contingent rents – a performance based system of distribution of economic rents.
- The objective of a policy of financial restraint is to create rent opportunities in the private sector through a set of financial policies such as interest rate control, entry regulation and managed competition.
- It is based on the premise that in the absence of rent opportunities, banks do not have sufficient incentives to provide the socially efficient level of financial services due to information-related problems.
- The size of rents captured by banks is proportionate to their efforts in expanding their business, i.e., rent opportunities are performance-indexed rewards to banks.
- The system created incentives for banks to step up their vigorous efforts to expand their deposit base and improve their loan portfolio by more diligent monitoring.

Financial Repression vs Financial Restraints (Con'd)



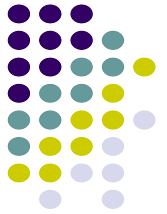
- Under financial restraints, banks were induced to provide services that are not supplied under perfectly competitive markets (e.g. term loans are usually under-supplied, because banks are reluctant to engage in long-term lending due to agency problems, inflation risk and the lack of liquidity that accompanies long-term lending).
- once interest rate control reduces the agency problems, banks were given incentives to forge a close link with firm-borrowers.
- Banks tried to build reputation capital by rescuing firms that are viable in the long run.
- Banks took an active role in corporate governance. Relation-specific capital thus developed between firms and banks further reduced agency costs related to financial intermediation.
- As banks become long-run agents, firms were induced to adopt long-term business perspectives and the time horizon for firms' investment decisions were extended (Relational banking for corporate governance and risk management).

Under Financial Restraints



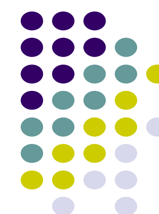
- Risks facing industrial firms were practically shared and socialized. Under financial restraint, co-insurance schemes and effective governance structures can be established in the tripartite “government-industrial firms-banks” relationships.
- government acts to create and distribute rents *within* the private sector.
- Rent opportunities are first accrued to banks, but eventually rents are distributed and shared within the private sector for higher social benefits.
- financial risks are practically shared between the government and banks, as the government does bear inflation risk through sound macroeconomic management while banks are left to bear credit risk through prudent portfolio management.
- governments act as a risk-taking partner at the critical stage of economic development.

Lessons from comparison between Financial Repression vs Financial Restraints



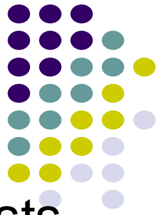
- The institutional arrangements that are responsible for how rents are created and captured have an important influence on their ultimate efficacy in promoting financial efficiency.
- financial restraint could be badly implemented or corrupted for other purposes and there is a danger for financial restraint turning into financial repression.
- The policy implementation context — in particular, the governance structure under which policies are carried out and the relationships between the government and the private sector — are so decisive to ensure positive outcome from intervention policies.
- The actual outcome from policies is essentially contingent upon the government's institutional capacity to set clear policy objectives and to design appropriate governance structures for implementation.
- the policy of financial restraint to create an institutional basis for relational banking is a time-specific instrument, applicable and pertinent only to a particular stage of economic development.
- Given the path-dependent nature of institutional evolution, financial policies should be evolved in the light of stages of financial market development.

What has been achieved in SSA with financial sector reforms



- Achievements
  - Macroeconomic stability
  - Massive bank restructuring and streamlining banking operations (often re-entry of foreign capital and privatisation)
  - Efforts of building stock markets (national and regional)
  - Efforts of strengthening bank supervision and regulation
- Typical prevailing conditions in the post-reform periods
  - High intermediation costs (very high interest spreads- a yard stick of intermediation efficiency), reflecting high credit risks and high transaction costs
  - High agency costs due to paucity of information endowments and risk management capacity in dealing with private agents
  - Fragmented markets, little effective linkages and competition between market segments – the majority of population remain outside of mainstream banking activities - left to development of microfinance institutions or informal arrangements.
  - Prevalence and persistence of excess liquidity syndrome and credit crunch and constraints by private sector agents (de-facto crowding out).

Tasks ahead



- Institution building for risk management and reduction in transaction costs.
- Nurturing culture for good corporate governance (reducing the agency problems) at every level (democratic oversights ®ulation).
- Creating a true development partnership between governments and private sector agents with financial institutions playing a key role in reducing risks (collective action for shared growth).
- Macroeconomic stability with eye on managing currency stability (a reduction of currency risk is pre-requisite for a successful integration into global financial markets- exchange rate management).
- Understanding the symbiotic relationships (co-evolution) between financial sector development and real sector developments (a deeper understanding of demand-supply interactions for financial services).
- need both for product innovation and institution innovation in financial service provision, which are firmly anchored in local conditions in SSA.
- Development of a system-wide capability for maturity transformation and liquidity provision (deep equity and bond markets).
- Create inclusive incentive mechanisms and systems for active participation of all stake-holders in economic development