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## Liberalization vs Regulation: Some Lessons for Financial Restructuring<sup>1</sup>

### I. INTRODUCTION

The traditional, and perhaps the best known, theory as to why banks are important is that they bring savers and investors together (Mishkin 1992). The obvious advantages of this match-making role are that:

a) it lowers the search costs of the two parties, thereby encouraging both saving and investment;

b) it helps channel the available investable resources into productive investment. The importance of saving and investment activities, in so far as the economic growth of a country is concerned, has been emphasized in neo-classical growth models (Domar 1946, Solow 1956).

However, while the traditional role of banks has not been totally disregarded, a

new and more important dimension has been added to the aforementioned match-making process, with the evolution of the literature on asymmetric information. There exists a serious information asymmetry between savers and investors as the former cannot know with any certainty the probabilities of success (or failure) of the various projects undertaken by the latter. Risk averse savers are, therefore, reluctant to lend money to investors, without a (high) risk premium, creating a number of so called efficiency problems. A bank, being a corporate entity and having, in principle, a well diversified portfolio, is presumably risk neutral. Hence, it is able to borrow from its savers (through deposits) and lend it to investors without the need for high risk premiums. A Bank's profits emerge from this borrowing-lending spread.

However, the banks themselves are not free of asymmetric information problems as they too cannot know, with certainty, the possibilities of success or failure of the projects to which they lend money. As profit maximizing entities, banks are concerned with the possibilities of default, and if the probabilities of such are high there can be a flight to quality (Minsky 1972, Mishkin 1991, Kindleberger 1978, Diamond 1991). In such an event, non-blue-chip borrowers would be rationed out of the market, thus throttling medium and small businesses, with potentially disastrous consequences. The other option for banks is to charge high risk premiums. However, given the stylized inverse relationship between risk and returns, only investors in high risk projects would be in a position to accept the resulting high

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- Bhaumik, S. K. (1994) "A Theory of Immiserizing Food-Feed Competition". Paper presented at the annual meeting of the Western Economic Association International, July

- Bhaumik, S. K., Jackimova, I., Koeva, S., & Georgiev, L. (1995) "An Economic Analysis of the Bulgarian Banking System: The Present and the Future". Paper presented at the annual meeting of the Western Economic Association International, July

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interest rate contracts. This introduces the familiar problem of adverse selection (Stiglitz & Weiss 1981).

Clearly, the adverse selection problem is unacceptable. Moreover, it is likely that competition between banks which can result from economic growth, as the financial sector in an economy grows, would keep lending rates lower than an asset pricing model such as, for example, CAPM, might predict<sup>2</sup>. As a consequence, in the absence of full disclosure by investors, an unlikely phenomenon, all banks would remain vulnerable to defaults on the loans they provide. It is obvious that, should the losses resulting from non-performing loans be high, a bank would be forced to declare bankruptcy. This is likely to lead to a fall in the confidence of savers in banking institutions and the consequence of such a fall in confidence would be bank panics and bank runs. However, there is more than a grain of truth in the monetarist claim that bank runs lead to financial crises and economic slumps (Friedman & Schwartz 1963). Therefore, in order to prevent panics and bank runs, governments in various countries insure the deposits of savers in banking institutions. The most widely known example of such deposit insurance is perhaps that provided by the Bank Insurance

Fund (BIF) of the Federal Deposit Insurance Corporation (FDIC) of the United States.

However, the creation of insurance funds like the BIF leads to moral hazard problems even as it attempts to solve the problems associated with bank runs. On the one hand, the savers no longer monitor the banks, secure in the knowledge that their deposits are insured. On the other hand, the banks do not always scrutinize the potential borrowers carefully, knowing that in the event of solvency crises the government will bail them out. Hence, bank insolvency resulting from a high incidence of non-performing loans is a distinct possibility. The cost of bailouts, borne in the long run by the taxpayers, is often quite high<sup>3</sup>. Moreover, the presence of insurance reduces incentives for savers to save more since they know that their wealth is secure. While this results in some benefits for the economy in the short run, in the form of higher consumption, the long run losses in productive capital outweigh the short run benefits (CBO 1992).

Today, the debate on the financial sector in an economy stands at a crossroads. On the one hand, many of the former socialist and/or planned economies are attempting to restructure their financial sectors through liberalization, as policy

makers have begun to agree on the inefficiencies which result from non-market mechanisms involved in the distribution of (financial and other) resources. This policy approach which can be clearly identified, at least partially, with financial repressionist theories (Shaw 1973), argues that interest rates, often regulated in developing economies, should be allowed to reflect the market price of capital. It further goes on to argue that so long as banks are nationalized, it would be optimal for the (central and state) governments to increase fiscal deficits (Novaes & Werlang 1995), thus creating cash flow problems for banks<sup>4</sup>. The usual policy prescription is the privatization of banks. It is argued that private banks, which, like firms, seek to maximize their total value, would not be willing to bail the government out since holding low yield (and often illiquid) government bonds would affect their balance sheets adversely and thus reduce their share prices.

On the other hand, the string of bank failures and financial crises that have taken place in the United States over the last ten years have given rise to the hypothesis that „financial reform calls for more nuances than simply *letting the market work*“ (Caprio et al. 1993). Indeed, Stiglitz (1993) argues that the idea of competition

2. The CAPM, as the Capital Asset Pricing Model is popularly called, was developed in the 1960s. It provides a mathematical algorithm which can be used by investors and lenders to judge the appropriate risk premiums, given the risk free rate of return, and the expected rate of return and riskiness of the project or investment concerned. A detailed exposition of the model, and some of its extensions can be found in Bodie et al. (1992).

3. Apart from the direct cost of the S&L bailout through taxes etc., the loss to the US GNP, i.e., the income of the taxpayers, was USD 200 billion between 1981 and 1990. It is estimated to be about USD 500 billion by the year 2000 (CBO 1992). Further, note that the method of financing the bailout - taxes, bonds, or monetizing the resultant budget deficit - are immaterial. They would affect the behaviour of the rational taxpayers similarly, and hence have the same effect on the economy (Barro 1974).

4. The logic of this argument is quite obvious. If the fiscal deficit increases, the government has three options, namely, increase taxes which is often politically infeasible, monetize the debt which will give rise to inflation in the short run and is hence also politically problematic, and sell government bonds. Indeed, the latter is perhaps the most politically acceptable (medium run) solution which is enforceable by the government through statutory liquidity ratio (SLR) and variability ratio requirements. It is of little wonder that, at the margin, the SLR and the reserve ratio accounts for about 63.5% of the deposits of Indian banks (NCR 1991).

leading to Pareto efficiency is constrained by the assumptions that markets are complete and that there is no asymmetry of information. However, not only are financial markets prey to information asymmetries, but markets are also incomplete partly because not all risks are insured and partly because credit is rationed. He argues, therefore, that government intervention in some form might be optimal and might guide the market towards Pareto optimality.

Generally, the focus of concern among the most vocal supporters of the market has shifted to improved and/or new regulations which would introduce market discipline in the banking/financial sector, and would reduce the costs accruing to the government, and in the long run to the taxpayers. This paper will trace the importance of financial restructuring, as indicated by the experiences of several emerging economies. It will highlight the inefficiencies faced by non-market/planned economies, as well as the vulnerability of banks to financial cycles in market economies. Finally, it will explore the importance of financial fine-tuning through regulations, as put forward in the ongoing debate on deposit insurance in the United States.

## II. FINANCIAL CRISES IN PLANNED ECONOMIES AND MARKETS

The past decade, given the political changes in the former socialist states in the so-called Soviet-bloc, has lent credence to what economists in the Western world have been suspecting for some time. The lack of market based incentives

has played havoc with the economies concerned, and almost all sectors remain affected. The banking/financial sectors have not been an exception.

The problems associated with banks have been quite in line with economic rationale. In the pre-1989 period, banks offered loans not in accordance with any risk-return rule; rather, these loans were dictated by political motives. At the same time, borrowing (government owned) corporations were not expected to earn profits, and hence their balance sheets were in the red, thus rendering them incapable of meeting their repayment obligations. Hence, after the changes in 1989, banks were left with non-performing loans representing an overwhelming share of their portfolios. The dynamics of the financial chaos can be summarized in figure 1<sup>5</sup>.

The centrally planned economies of Central and Eastern Europe (CEE) were marked by huge government owned enterprises which dominated the organized industrial sector, private enterprise being limited to informal activities. Since the essential objective defined in these plans was to meet output goals, firms remained largely unprofitable. At the same time, money and credit played a passive role in the economy as banks provided credit to firms whenever they were directed to do so, irrespective of a firms' viability. As a consequence, the portfolios of these banks were plagued by a high volume and proportion of bad loans, rendering them non-viable, unless propped up by government subsidies. The consequence of this near

bankruptcy of CEE banks was threefold. First, the volume of bad credit was so high that merely according provisions to them was unlikely to solve the problem, unless the volume of such provisions was high enough to create macroeconomic and budgetary problems. Second, in the wake of the marketization of Central Europe, the existing bank managers sought to preserve their positions by covering up the level of bad credit with the help of creative accounting, accounting processes in CEE during 1989-90 being largely inconsistent with international standards. Third, CEE banks, on the verge of bankruptcy and hungry for cash, became more prone to providing credit to borrowers who were willing to pay high interest rates and, hence, were involved in high-risk projects. This is the familiar adverse selection problem discussed by Stiglitz and Weiss (1981). In other words, in the absence of drastic measures, the bad loans and interest payments due were likely to be passed over by the old management reluctant to relinquish its position, thus compounding the problem of virtual bankruptcy facing the banks (see figure 1).

A case can clearly be made in favour of a form of liberalization that ushers in market oriented incentives. For such incentives, it is generally agreed, lead to the efficient allocation of resources. Indeed, the last decade has seen the liberalization of the banking/financial sector in a large number of emerging economies, including Indonesia, Malaysia, India, Korea, Turkey, and New Zealand. While there is a great deal of disparity

5. A description of the chaos in the banking-financial sector in Eastern and Central Europe can be found in Marresse (1994) and World Bank (1991). The depth of the crisis have also been discussed in detail in several issues of the Central European Economic Review, and The Economist.

between the macroeconomic conditions and the socio-political institutions of these economies, certain common trends are identifiable: the privatization of nationalized banks and/or the lifting of barriers preventing the entry of private (and foreign) organizations into the financial sector; the deregulation of interest rates and the elimination of capital controls; and the reduction or elimination of subsidies and/or priority lending programs (Caprio et al. 1993)<sup>6</sup>. Empirical evidence tends to show that in almost all these economies there was an increase in the savings rate, thereby eliminating fears that financial reforms might disrupt the existing systems so as to reduce savings<sup>7</sup>. At the same time, the incremental capital-output ratios of most of these economies registered increases, indicating that the allocation of resources was perhaps more efficient<sup>8</sup>.

Can it be argued, therefore, that the creation of market incentives through liberalization or deregulation unambiguously reduces the incentive problems associated with the banking sector? If the trends of the last ten years in the United States are any indication,

there is little reason to be comfortable in such a belief. It has been argued, in the wake of the Savings and Loans crisis, and other related and unrelated bank failures, that the moral hazard problems created by deposit insurance have been significantly high. As a consequence, many of the (relatively deregulated) banks were left with portfolios made up of a large proportion of various non-performing assets, as well as low capital-liability ratios (GAO 1991). The consequence was a large number of bank failures, the cost being borne by the taxpayer. The moral hazard problem as well as the vulnerability of banks to financial cycles have forced policy makers to rethink the importance of regulation driven fine-tunings that are now believed to be an integral part of any financial restructuring or reform<sup>9</sup>.

### III. FINANCIAL RESTRUCTURING: WHICH WAY TO GO?

At this juncture, a simplification is perhaps possible. The previous section described the chaos in the financial sectors of the former socialist economies. It can be argued that financial

restructuring, i.e., the introduction of major policy changes, is perhaps more appropriate for those economies which lack a market structure. Regulation, on the other hand, is a fine-tuning process pertinent to market economies such as the United States where policy changes would be more subtle and directed at particular incentive mechanisms rather than at the infrastructure as a whole. In this section, we shall address the former problem.

The problems facing the former socialist/planned countries clearly have their roots in the fact that there has been no incentive for resource allocation based on any risk-return evaluation. The manifestation of these problems is the de facto insolvency of a large number of banks left in possession of non-performing assets. The usual policy prescription is to privatize the banks as well as the corporations so as to introduce market based (profit/revenue maximizing) incentives. However, it is unlikely that private entrepreneurs would be willing to take over companies and banks which are deep in the red. The only feasible solution perhaps is to start afresh with a clean slate, implying that the

6. At the same time, most of these economies have initiated fiscal, monetary, and trade policy reforms. These include the reduction of tariffs, the privatization of industries, and the devaluation and/or introduction of floating exchange rates.

7. However, as pointed out by Akyuz (1993), the usual financial repressionist argument (Shaw 1973) that liberalization leads to financial deepening and higher savings is not very credible. For one, these arguments focus more on the increase in the savings rate given an increase in the post-liberalization rise in the interest rate (the substitution effect) and underestimate the potential effect of the rising interest rate on the macroeconomy, and hence on the volume of savings (the income effect). Further, these arguments overestimate the effect of the rising interest rate on savings by suggesting that in such an event savings in the emerging economy concerned will shift qualitatively from commodities to liquid financial resources. However, empirical evidence suggests that in most LDCs savings are held more in the form of gold or hard currencies than in the form of commodities. Finally, financial transactions may increase in number, thereby suggesting financial deepening, without an actual increase in the volume of savings.

8. It has been argued by Schiantarelli et al. (1992) that ICORs are good measures of efficiency only under the condition that the production functions are of the fixed-proportion or Leontief type. This, however, is a reasonable theoretical simplification.

9. Financial cycles describe the behaviour of banks during economic booms and busts. When an economy improves, banks lend more money and, owing to the prevailing optimism, continue to lend money past the point of any downturn in the economy. As a consequence, a large number of these loans, especially in the latter part of the cycle, are of a high risk nature. By the time the problem is discovered, however, it is usually too late, leaving banks with risky portfolios. It is important to note that financial cycles do not necessarily coincide with business cycles. A detailed discussion of this phenomenon can be found in Randall (1993).

bad debts of the banks, as well as the losses of government owned enterprises, would have to be written off (Singh 1994). Further, as emphasized by Thorne (1993), acknowledging the existence of non-performing loans, and attempting to eliminate them by recapitalization and/or debt underwriting, leads to an aggravation of the moral hazard problem if the banks continue to be state owned. Hence, the privatization of banks should be the final step towards a solution of the problem of inefficiency of which bad loans are but a manifestation. This has largely been the case in the Central European countries (Czech Republic, Slovakia, Hungary and Poland) where the total cost of debt-loss underwriting has exceeded USD 5 billion (Marresse 1994, Thorne 1993)<sup>10</sup>.

Given the high cost of underwriting bad loans, it has been argued by some policy makers that the development of the securities market is perhaps a better option instead (McKinnon 1991). However, the problem with this approach is that, in the presence of asymmetric information, only blue chip firms with proven track records would be able to raise money through equity and bonds (Singh 1994). The consequence, therefore, would be a crowding out of investible funds for medium and small firms with undesirable effects on the emerging private sector. Indeed, in the former socialist economies where almost all enterprises were government

owned and debt ridden, there might be a crowding out of funds for all companies, old and new, and a flight of capital abroad. As the recent Mexican crisis has shown, this problem can be further aggravated if the currency concerned depreciates sharply against hard currencies. In this light, therefore, it might be prudent to restructure the banking sector.

However, debt-loss underwriting is but the beginning of the process of financial restructuring. In a market economy with asymmetric information, the banks are likely to focus on the net worth of borrowers as an indicator of their ability to repay debts. The net worth of the borrowers, on the other hand, is positively related to the state of the real sector of the economy. Hence there is a close relationship between the financial and real sectors, such that financial reforms can only thrive if the real sector of the economy is performing well (Gertler & Rose 1992). The implication clearly is that financial reforms need to be timed such that the thrust of such reforms are undertaken during a boom. Otherwise, financial restructuring may have the perverse effect of rationing a large number of investors out of the market, thus reducing total investment. It also emphasizes the role of accompanying fiscal and other reforms which are essential for ushering in economic growth, the latter being crucial to the success of financial restructuring. The role played by the latter reforms are,

however, outside the scope of this paper.

As was mentioned in the previous section, interest rate deregulation (including the elimination of subsidies which leads to negative real lending rates) is a common policy instrument in the course of financial restructuring. The resultant market incentives are obvious. An increase in lending rates, however, especially after risk premiums are taken into consideration, is likely to reduce the net worth of firms, thus reintroducing the problem of investment „crowding out” described in the previous paragraph. The success of the reforms is, therefore, also dependent on the ability of the banks to identify new clients, who were earlier paying exorbitant interest rates in the informal markets, and whose net worth might increase if the deregulated lending rate is lower than the high rates in the informal credit market (Caprio et al. 1993)<sup>11</sup>.

The deregulation of movements of capital and the elimination of portfolio restrictions might also lead to undesirable consequences. Often, such liberalization efforts lead to increased bank loans for real estate development as industrialization and economic growth increase the demand for housing. This is likely to happen not only in emerging economies (e.g., Malaysia) but also, as proven by the recent crisis in the United States, in developed market economies (Randall

10. The underwriting of debts and losses was accompanied by efforts to improve the capital-asset ratios of the banks through recapitalization. The appropriate policies included dividend caps and raising capital through the issue of government bonds and vouchers (Marresse 1994). This policy was also advocated by the World Bank for other countries such as Bulgaria (World Bank 1991). These efforts, in general, have met with mixed success and many banks have still not been able to meet the expected capital requirements.

11. The initial efforts of Turkey to reform its financial sector included the deregulation of interest rates during a period of disinflation, and was accompanied by the introduction of free entry into the financial sector. The resulting combination of lower profits and, thereby, distress borrowing by enterprises on the one hand, and increased competition in the financial sector on the other, led to a fall in investment as well as an increase in the number of non-performing loans (Atiyas & Ersel 1992).

1993). Clearly, there is the need for the introduction of regulations concerning the portfolio concentration of banks.

Financial liberalization is clearly a necessary condition for fostering economic growth. Is it, however, a sufficient condition? Would the financial sector automatically become competitive if the banking industry were largely state owned, but with few or no barriers impeding entry? Novaes and Werlang (1995) argue that if banks are state owned then it is strategically optimal for the government to incur higher budget deficits and finance them using the banks' funds. This phenomenon, the best example of which is perhaps India (Sarkar & Bhaumik 1995), leads to severe liquidity constraints on banks, thus preventing them from diversifying their portfolios and/or investing in profitable projects. The problem is usually aggravated by the fact that in the majority of less developed and emerging economies welfare considerations force state owned banks to invest in priority sectors, much of this credit bearing low interest rates and being non-recoverable (NCR 1991)<sup>12</sup>. Hence, financial liberalization and the lifting of entry barriers should perhaps be supplemented by the privatization of banks (Sarkar & Bhaumik 1995).

While the need for financial restructuring is indisputable, there is reason to believe that the process of reform should be gradual, a view that has gained importance given the debate which continues to rage between the gradualists and the shock therapists in the CEE context. It is important to

note that gradualism does not imply inaction (Caprio et al. 1993). Rather, it stresses the importance of tailoring the reforms so that they move in step with the institutions and environments which need to be in place in order for those reforms to succeed. As the crisis in the United States, discussed in the next section, has highlighted, restructuring is not a one step process but rather a dynamic one which needs to move in harmony with the times.

#### IV. HOW TO REGULATE IN THE POST-REFORM ERA?: LESSONS FROM SOME INDUSTRIALIZED COUNTRIES

As indicated earlier, the viability of borrowers is a vital link in the transformation of the financial sector. In the absence of profitable enterprises and viable projects, market oriented banks might ration most potential borrowers out of the market, thus limiting their own ability both to provide more credit and to diversify their portfolios (Jackimova et al. 1995, Baldensperger & Dermine 1987). It would, however, be interesting to control this factor by taking into account industrialized countries where there are a large number of viable and profitable firms, and hence isolate policy issues in the post-transition state of the economy.

The Savings and Loans (S&L) crisis in the United States, together with the failure of a large number of banks, has raised the question as to how privately owned and managed banks can be regulated so as to minimize the possibility of bank failures, and hence the cost to the tax payers. Randall (1993) and CBO (1992) provide a

summary of the events that precipitated the crisis.

The early 1980s saw the deregulation of interest rates in the United States. The emergence of money market mutual funds during the 1970s had made the market for deposits more competitive. As a consequence, the borrowing rate for banks increased. The rise in inflation during the 1970s augmented this increase in interest rates. However, many of the bank assets were locked in long term lower interest loans or bonds. The net yields for the banks were, therefore, low and, in some cases, even negative. At the same time, the oil boom in the Southwest and the boom in Southern California during the 1970s led to a rash of real estate loans and many S&Ls held about 80% of their assets in real estate loans. With the crash of real estate prices in the 1980s, the banks were left holding a large number of non-performing loans. Hence, between the higher interest rates and the non-performing loans, the banks were facing severe cash flow problems.

It is at this point that the moral hazard problem became acute. The banks, desperate to earn higher yields, invested more and more in risky ventures. The emergence of junk bonds during the 1980s, as many firms chose to substitute equity for debt, and/or enter into leveraged buy-outs, contributed to the increased riskiness of their portfolios. To make matters worse, the banks valued their assets at book prices rather than market prices, thus hiding the problem till the very last moment by which time it had already become acute. The

12. In 1991, Indian banks had to maintain a variable reserve ratio and statutory legal reserves, the latter to be held primarily in government bonds, which, at the margin, amounted to 63.5% of the total reserves. At the same time, Indian banks had to direct about 40% of their credit to priority sectors. However, it is interesting to note that private banks, which were subject to the same regulations, were much more profitable than the majority of the nationalized banks.

consequence was that the US experienced the insolvency, and eventually the failure, of over 200 banks. The post-crisis regulatory measures also perhaps left a lot to be desired. In the case of the S&Ls, for example, the US Congress allowed thrift organizations to amortize their mortgage losses rather than recognize the losses immediately, thus allowing the problem to be postponed, and perhaps aggravated, rather than be eliminated (ERP 1991).

Can the problems of moral hazard and adverse selection be eliminated? As the Japanese banking crisis indicates, while a closely monitored system might eliminate adverse selection to a large extent, the problem of moral hazard is pervasive so long as there is an implicit or explicit guarantee by the government that banks will not be allowed to go bankrupt (Zysman 1983, Dale 1992).

One of the most crucial issues at stake in the deposit insurance debate is whether some banks should be deemed too-big-to-fail. During the previous crisis, the FDIC underwrote not only the insured deposits, those under USD 100,000 in value, but also 68% of uninsured loans (GAO 1991). The economic logic behind this is perhaps that the potential losses arising from economic chaos and loss of consumer confidence, when large deposits are not repayable, exceed the short term benefits resulting from the decreased burden on the government and the tax payers. However, this line of argument ensures that de facto all large banks, the bankruptcy of which might lead to financial and economic instability, should be bailed out in the event of a financial crisis. This gives banks the perverse incentive to expand and become too-big-to-fail if they

are in crises. Further, the de facto insurance of de jure uninsured deposits allows large depositors such as pension funds to „play the market“ and speculate on bank borrowing rates. But the resulting large deposits and withdrawals play havoc with the balance sheets of the banks. The problem is further aggravated if, as in the case of Japan, banks and firms are involved in the cross-ownership of stocks. In such a situation non-fallible banks become credit instruments of industry, credit being an instrument to foster industrial and economic growth.

It is presently being argued by experts both within and outside the banking system that coinsurance by large depositors is perhaps the best way out of this problem (Randall 1993, ERP 1991). If large depositors, together with the banks, had to pay for insurance premiums that varied positively not only with the amount of the deposits but also with the riskiness of the banks' portfolios, these large depositors would be much more willing to monitor the banks concerned. Such monitoring, together with legislation which would force banks to disclose more information to their depositors, would perhaps partially eliminate the problem of moral hazard, at least in the case of the large depositors.

Regulatory organizations such as the Federal Reserve System are also debating the possibility of direct supervision. Under the proposed new regulations, banks would be forced to maintain strict capital-asset ratios such that the assets would be evaluated at the market price, and the capital requirement would vary positively with the riskiness of the banks' portfolios. If a bank's capital were to fall below 10%

of its assets/liabilities, further expansion of the bank's activities would be halted, and recapitalization and other related measures would have to be undertaken under the direction of some regulatory body. However, if the financial situation of the bank continued to deteriorate and capital fell below 3% of its assets/liabilities, the bank would be forced to merge or liquidate. A crucial issue that needs to be addressed in this context is whether (and how) the capital requirements would (and can) be adjusted to be in harmony with the risks arising out of off-balance sheet activities. Over the last decade, off-balance sheet activities, as a key part of a bank's operation, have substantially increased in frequency and volume. However, as Berger et al. (1995) have pointed out, off-balance sheet activities would, in equilibrium, increase the capital requirements of a bank since they assure „senior claims“ to the benefactors of guarantees emanating from such off-balance sheet activities.

Simultaneously, efforts are being made to amend regulations which currently restrict the inter-state acquisition of banks by holding companies, and efforts are being made to usher in a system of universal banking. Indeed, the Glass-Steagall Act, which prohibited universal banking in the aftermath of the Great Depression, is increasingly being questioned by economists as relevant to present-day conditions (Kroszner & Rajan 1994, Bentson 1994). The usual argument against universal banking is that it would create large banks that are too-big-to-fail and would thus foster moral hazard problems. This argument is accompanied by the notion that volatile and underdeveloped financial markets with inadequate tools for supervision,

which is the case in most emerging countries as well as in Germany and Japan, might lead to risk taking losses for bank portfolios that would have significant and adverse budgetary and macroeconomic effects. This latter hypothesis is bolstered by the recent fiascos experienced by Barings and Daiwa Bank. Further, proponents of the Act have warned against the danger of large universal banks crowding out empirically more efficient stock markets, as well as other smaller financial organizations.

Indeed, both the US and Japan, the two largest economies in the world, have thus far shown remarkable similarity in their belief in the separation of traditional banking activities, as well as those divisions pertaining to securities markets. Such policy thinking is perhaps more surprising in the Japanese context since the Securities and Exchange Law and the Banking Law of Japan allow banks to cross-own stocks, have unlimited access to the financial futures markets, and undertake trade in financial securities on behalf of clients. In the US, on the other hand, while cross-ownership of stocks is prohibited, banks are allowed to deal in a wider range of securities than their Japanese counterparts. This is largely a consequence of the fact that securities houses in Japan are only allowed to deal directly with trust banks. Further, Japanese banks are not allowed to underwrite corporate bonds and stocks.

Current opinion in both countries, however, is gradually leaning towards some form of universal banking. This has been brought about largely by arguments favouring economies of scale and scope, and also by the historical experiences of the US and Germany which suggest that there is little or no empirical

support for the hypothesis that universal banking is inherently more risky. Indeed, although Japanese banks, which had invested heavily in stock index futures, suffered huge portfolio losses following the fall in the Nikkei index, the banking crises that occurred in both the US and Japan are primarily a consequence of bad credit and a fall in real estate prices.

While Germany perhaps provides the best example of a success story for universal banking, it is important to note that the German case is unique and would be rather difficult to emulate in emerging countries. It is often argued, incorrectly, that the German banking industry is oligopolistic and hence not competitive. In reality, while German banks are powerful, they are both heterogeneous - being comprised of commercial banks, savings banks and their central giro institutions, as well as agricultural and commercial credit cooperatives - and distinctly competitive (Zysman 1983, Cox 1986, Dale 1992). Indeed, during the 1980s, these different kinds of banks began to steadily encroach on each others territories, thus increasing the degree and intensity of competition. The difference between Germany and other market economies, however, lies primarily in the fact that in the former it is legally possible for a bank to own huge portions of a company's stock, so long as, in accordance with the European Second Banking Directive, individual investments are limited to 15%, and overall investment to 60% of the bank's capital. As a consequence, it is possible for German banks to maintain a strong presence on a firm's board of directors, either in the form of their own representatives or by means of proxy votes. They thus have monitoring power which significantly

reduces their market risk, both by providing them with information and allowing them to influence the decisions of firms. Such a situation is very difficult to emulate in other market economies without significant changes in the legal structures of the latter.

It has been argued by some policy makers that perhaps the simplest, yet most effective, solution lies in the division of banks into monetary service companies and financial service companies (Randall 1993). The monetary service companies would deal only with transaction accounts that are insured. However, the assets of these companies would have to meet strict credit rating regulations, forcing these companies to hold only short term blue chip assets. The financial services companies would accept all types of deposits, provide commercial and non-commercial loans, and invest in assets of their choice, but would be uninsured. It has been argued that this measure (which, in principle, was proposed in 1990 in the second interim report of the Second Financial Systems Committee of Japan) would largely eliminate moral hazard problems, and ensure the free flow of financial transactions which is essential for economic growth. Banks would act as an umbrella organization for these two types of companies, and the same employees would handle both types of assets and accounts. The key is that monetary service companies should not lend money to the other parts of the umbrella organization, nor be responsible for any debts of the latter.

While the aforementioned policies attempt to reduce the moral hazard problems which, it is believed, played a major role in the banking crisis in the US, others simply attempt to

minimize the losses to the government and the taxpayers. It has been suggested, for example, that the banks' assets be sold in the securities market, perhaps over the counter, as subordinated debts or pass through securities. It is hoped that the risk taking investors would then more effectively monitor the activities of the banks. Similarly, arguments have been made in favour of allowing banks to trade in non-performing loans in the securities market rather than exercising their implicit „put” option with the FDIC. In this event, it has been argued, cash rich banks interested in loans with long term growth potential, even if they are at present non-performing, might purchase these non-performing loans, and hence the „put” option, from the cash hungry bank, thus alleviating the pressure on the FDIC (Rosengren & Simons 1992).

#### V. CONCLUSION

The globalization of the economy, through increased trade in goods and services, as well as international capital investments, has enhanced the importance of the financial/banking sector in economic policy. Interestingly, while the former socialist and/or planned economies are focusing on the deregulation and liberalization of the financial/banking sector, market economies, as exemplified by the US, are attempting to regulate this area. Is there a paradox in these seemingly polar opposite approaches?

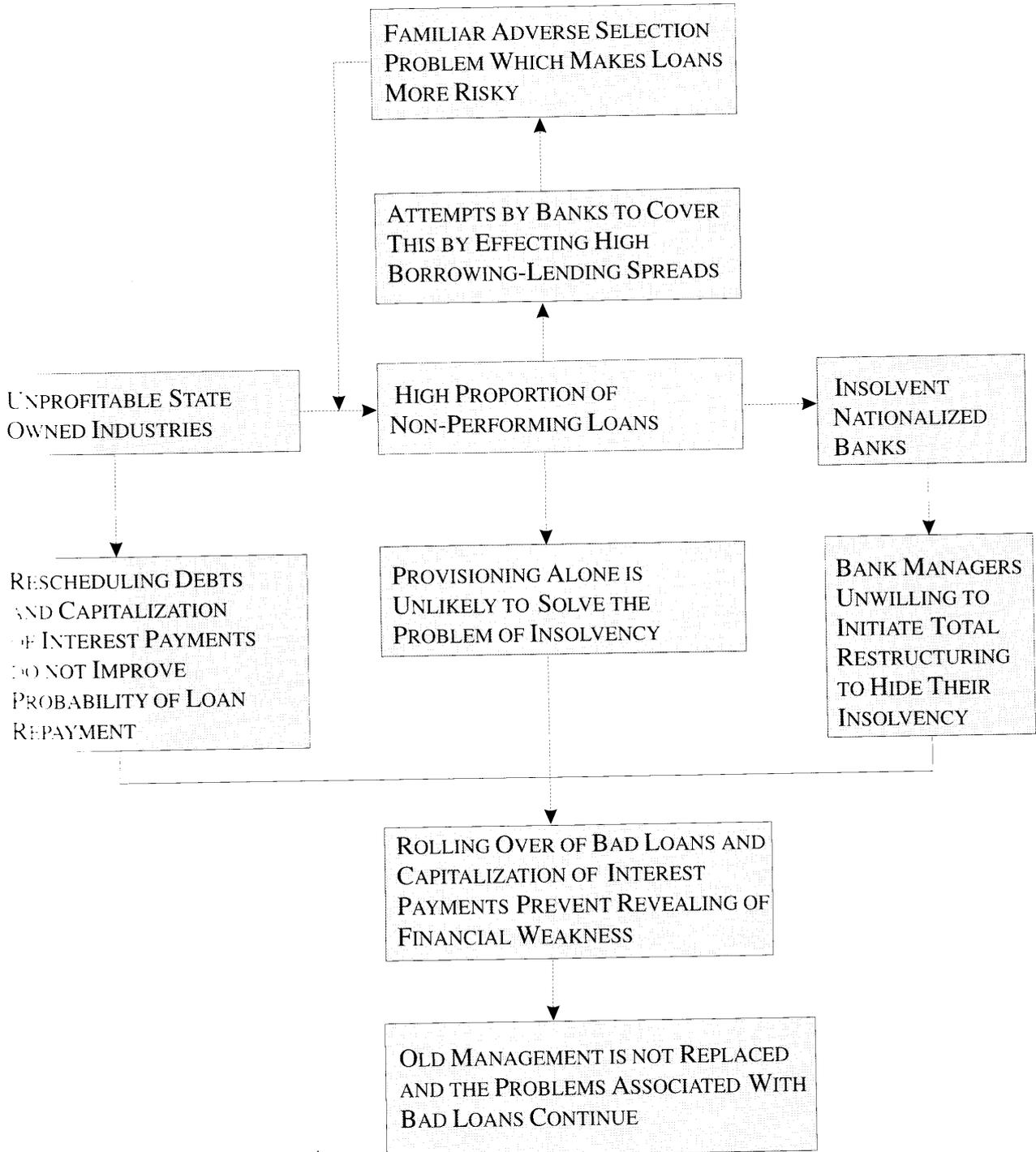
We must note that market economies are efficient, with respect to resource allocation, only to the extent that they are subject to the proper incentives. Given the frequent conflict of interests between a bank's management and its depositors, as well as between commercial and financial organizations, it is perfectly feasible that incentives may take perverse forms as the problems of moral hazard and adverse selection become apparent. Moreover, given the existence of asymmetric information and incomplete markets, laissez faire might well be a sub-optimal policy prescription. Hence the need for fine-tuning the incentives to match the prevailing conditions, and for vigilance on the part of the government. Market based incentives and regulations are inseparable in that they supplement each other in the complex dynamics of today's economies. The challenge before the emerging economies is not only to be able to time the policies, but also to find the right mix between the two.

What system, however, might be construed as a reasonable paradigm for the newly emerging markets of Central and Eastern Europe? These economies, especially those in Eastern Europe and the former Soviet Union, are marked by deindustrialization, and highly underdeveloped capital markets. In other words, banks could and should play a major role in these economies, at least in the short to medium run, by providing credit to industry and mobilizing financial resources.

At the same time, however, investment in these economies, in the form of credit or otherwise, continues to be risky owing not only to unstable macroeconomic conditions but also to the severe asymmetry of information between investors/creditors and the management of firms, and persisting firm level agency problems. Hence, the ability of banks to monitor the activities of debtor firms assumes paramount importance. The appropriate banking framework for these economies, therefore, is likely to be one similar to the German system which allows the close monitoring of firms by banks. To be sure, the Hausbank system is far from being perfect as it provides banks with quasi-monopolistic control over firms. However, this is likely to be a short to medium term problem as, in the long run, firms are likely to have access to alternative forms of investible funds as they become more profitable (and hence have available internal funds) and also as capital markets develop over time. Arguably, none of the existing banking systems are perfect, and are changing and improving continually as weaker links become increasingly evident. Hence, given that the US, German and Japanese systems are proving increasingly more effective than their counterparts under specific conditions, the issue is clearly one of appropriateness. The challenge facing the governments remains the formulation of regulations that would make the appropriate system most effective and efficient.

FIGURE

Figure 1



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