

Edited by  
José M. Fanelli and Rohinton Medhora

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# **FINANCIAL REFORM IN DEVELOPING COUNTRIES**

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DEVELOPING COUNTRIES**

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**José M. Fanelli**

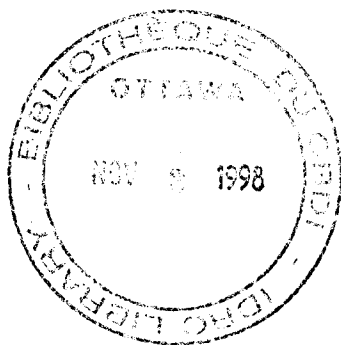
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Foreword by Lance Taylor



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**To my wife**

José M. Fanelli

**To my parents**

Rohinton Medhora

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James Powell

## 7.1 INTRODUCTION

Over the past fifteen or so years, financial liberalization has become increasingly popular around the world. Among industrial countries, we have witnessed the elimination of exchange controls in Europe, interest rate liberalization in Japan and the USA and major financial sector reforms virtually everywhere, most notably London's 'Big Bang' in 1986. In the USA, inter-state banking has been liberalized, while Glass-Steagall restrictions separating banking and securities business have been significantly eroded; this latter type of development is occurring in Japan as well.

While they are at an earlier stage than industrial countries, developing countries are also liberalizing exchange markets and introducing financial sector reforms. The number of countries maintaining multiple exchange rate regimes continues to decline, while a growing number of countries have moved or are moving towards full capital account convertibility (see Quirk *et al.*, 1995). On the domestic front, countries have concurrently liberalized interest rates and introduced financial sector reforms, often in the context of macroeconomic and structural programmes endorsed by the IMF and the World Bank.

These developments have been motivated by many factors, including changing macroeconomic conditions, financial innovation and increased competition among suppliers of financial services. Behind these factors also lies a general acceptance of the market-oriented paradigm for economic development and growth. By allowing market forces to set prices, including interest rates, economic decision-making should be enhanced which would lead to efficiency gains. Financial sector reform is viewed as a way to provide consumers of financial services with greater choice and access to financial instruments, make financial intermediation more efficient and possibly increase domestic savings and investment.

At the macro level, liberalization can have a profound impact on capital flows, exchange rates, financial systems and, as a consequence, on

monetary policy. Not only must central banks learn to cope with market forces that do not always act in the fashion desired by the authorities, but liberalization often means learning new ways of doing things. For example, the elimination of interest rate and credit controls will require the central bank to shift to indirect means of controlling monetary growth.

At the micro level, financial reforms such as changes in the powers of institutions to promote greater competition, are also important to a central bank. As lender of last resort and, in many countries, regulator and supervisor of financial institutions, a central bank has a very direct interest in monitoring developments that can affect more broadly the health of financial institutions and the financial system. A sound financial system is also important for the successful conduct of monetary policy, a central bank's principal responsibility. A weak financial system, for example, might inhibit a central bank from raising interest rates sufficiently to combat inflationary pressures.

While there has been a general acceptance of the desirability of financial liberalization at both levels, its achievement has often been difficult and sometimes costly. The dismantling of capital controls has, for example, contributed to increased capital flows across national boundaries, which can complicate monetary policy and accentuate foreign exchange crises. The most recent examples include the collapse of the Exchange Rate Mechanism in Europe during 1992–3 and the Mexican peso crisis of 1994–5.

By the same token, the granting of broader powers to financial institutions can lead to excessive risk-taking, particularly if the prudential and regulatory environment is weak. For example, the granting of additional powers to savings and loan companies in the United States during the 1980s, combined with regulatory forbearance, exacerbated existing problems related to interest rate mismatching. A costly government bailout estimated at \$180 billion over the 1980–92 period was required (Edey and Hviding, 1995). Finland, Norway and Sweden also experienced serious bank failures during the late 1980s and early 1990s leading to government take-overs of major banks and massive liquidity and capital support. Currently, Japan is experiencing financial fragility that was caused in part by excessive risk-taking during the late 1980s. Major banking crises have also occurred in developing countries following financial sector liberalization (for example, in Chile, during the early 1980s, and, more recently, in Venezuela, Brazil, Mexico and Argentina).

Such experiences provide food for thought. Clearly, if done inappropriately, financial liberalization can have very unpleasant side-effects, however desirable it might be in the long run. Moreover, there appears to be a link between banking crises and balance of payments crises. While

the causality is unclear, experience has shown that a banking crisis often precedes the latter. (Kaminsky and Reinhart,<sup>3</sup> 1996) Note, however, that authorities may have little choice on whether to reform or not. Even if a tightly controlled financial sector is desired, the evidence shows that controls are likely to be circumvented. It may therefore be preferable for authorities to be proactive and manage the reform process rather than wait and be caught unprepared. In this light, it is advisable to examine the experiences of other countries to be better able to avoid the various pitfalls, or at least to learn how to deal with the consequences of a liberalized environment.

Canada's experience may be of particular interest to developing countries for a number of reasons. First, the structure of the Canadian economy is similar in many respects to that of a developing country. For example, Canada has traditionally been a major net borrower in international capital markets, relying on foreign savings to finance a significant proportion of domestic spending. In 1995, Canada's gross external indebtedness (including direct investment) totalled 89 per cent of GDP, while Canadian net external indebtedness was 45 per cent of GDP. In addition, Canada, like many developing countries, has a relatively small, open economy, significantly influenced by movements in its terms of trade owing to swings in commodity prices.

Second, Canada has been, in many respects, a pioneer in financial reform, having eliminated foreign exchange and interest rate controls in 1951 and 1967, respectively. With Canadian markets closely integrated with US markets, the Bank of Canada has developed considerable expertise in conducting policy in a very open, globalized environment.

Third, over the past decade, partly in response to several failures of deposit-taking institutions, the federal authorities have examined very closely the structure of the Canadian financial system and have implemented reforms aimed at enhancing the soundness of the system, while improving efficiency. The issues examined have included such things as the structure and powers of financial groups, ownership, foreign competition, the powers of the supervisor and or regulator, reserve requirements, and the payments and settlements system. While we do not necessarily profess to have found the definitive solution to all of these issues, what we have done and the supporting rationale may nevertheless be of interest to policy-makers in other countries.

This chapter is divided into four sections. Section 7.2 focuses on macro-level liberalization and examines how Canada deals with the challenges posed by open capital markets and increasing globalization. Attention is paid to the exchange rate regime, the current account balance and the

conduct of monetary policy, including the tools used by the central bank. Section 7.3 examines the micro-level reforms that have been introduced in Canada over the past decade. This review is followed by a short conclusion.

## 7.2 MACRO-LEVEL LIBERALIZATION

### **Capital Movements and the Exchange Rate**

The easing of exchange restrictions around the world, trade liberalization, advances in telecommunications and portfolio diversification have all contributed to the globalization of financial markets and greater cross-border capital flows. As a rough measure of these developments, preliminary data for April 1995 indicate that the daily turnover in major foreign exchange markets has increased by roughly 45 per cent to \$1230 billion over the past three years (Bank for International Settlements, 1995). This compares with global international reserves of only \$807 billion as of the same date (International Monetary Fund, 1995).

Numbers such as these, combined with recent exchange rate crises in Europe and Mexico, have heightened concerns regarding the ability of a country to pursue independent policies in the face of global capital markets. Some observers have pointed to the 'dollarization' of some developing country economies as further evidence of this loss of monetary control.<sup>1</sup> However, dollarization is not a product of capital market liberalization, but rather is due to a loss of confidence by residents in the domestic currency owing to years of poor macroeconomic policies. In Canada, despite three-quarters of the population living within a hundred miles of the US border and unrestricted foreign exchange markets, where domestic banks offer foreign currency accounts to residents, foreign currency deposits of Canadian residents booked in Canada amounted to only C\$27 billion in March 1996, equivalent to less than 6 per cent of broadly defined money supply (M3).

Nevertheless, concerns regarding the ability of countries to pursue completely independent monetary policies in an environment of global, integrated capital markets contain an element of truth. In particular, a country cannot pursue an independent monetary policy and at the same time maintain a fixed exchange rate. Moreover, while integrated capital markets and increased capital mobility have enhanced the ability of countries to borrow, they must maintain the confidence of the market. Persistent heavy borrowers, especially those with existing large debts, have therefore found

their freedom of action to be increasingly constrained. Deteriorating credit ratings and rising risk premia have put pressure on governments to make fiscal cuts and pursue consistent and sound macroeconomic policies. Although the market is a demanding taskmaster, most observers would still consider the discipline it exerts as being both necessary and appropriate. Indeed, the record has shown that exchange market pressures are typically well founded.

Notwithstanding this sanguine assessment of capital flows, problems can be identified. The market does not necessarily apply the brakes to country borrowing in an even and consistent fashion. Experience has shown that market access is not continuous. Countries on the cusp of investor acceptance can find their access to funds cut off abruptly in response to changing market conditions. At other times, ready and easy access to foreign financing may encourage excessive borrowing by both governments and private entities. Market sentiment can also be affected by extrapolative expectations. Although such speculative bubbles are hard to identify, especially *ex ante*, they pose challenges in the conduct of monetary policy.

How does Canada deal with potentially volatile capital flows? The short answer is a flexible exchange rate – a regime that Canada has pursued for much of the period since exchange controls were abolished in 1951, notwithstanding international pressures to conform to the Bretton Woods system of fixed exchange rates prior to 1973. This preference reflects in large measure two factors – the usefulness of a flexible exchange rate regime in facilitating adjustment to external shocks, and the continuing desire of Canadian monetary authorities for an independent monetary policy.<sup>2</sup>

Frequently over its history, Canada has been confronted with sizeable swings in its terms of trade and capital movements, which would have made it difficult if not impossible to sustain a fixed exchange rate. Indeed, the decision to float the exchange rate in 1951, and again in 1970 after an eight-year experiment with a fixed rate, was related to external factors. In both cases, faced with large balance of payments surpluses, the monetary authorities preferred a nominal appreciation of the exchange rate to keep domestic inflationary pressures under control over the maintenance of the fixed peg, which would risk an inflationary increase in the money supply.

This choice is as relevant today as it was in 1951. A fixed exchange rate requires monetary policy to be directed toward maintaining the external as opposed to its internal purchasing power. In other words, fixing the exchange rate implies the relinquishment of monetary independence. In the face of large capital inflows such as those experienced in Canada in the

past, and more recently by a number of emerging markets, a fixed exchange rate will inevitably lead to a monetary expansion and higher domestic inflation. When such capital inflows slow, or reverse themselves, the exchange rate peg will be tested. This will be reflected in a drawdown of foreign exchange reserves leading potentially to an exchange rate crisis (as occurred for example in Mexico in 1994–5).

While higher interest rates aimed at defending the exchange rate peg can forestall such a development, they may not be sufficient if the disequilibrium is large and the market views higher interest rates to be inappropriate given domestic economic conditions. The most notable example of this was the 500 per cent interest rate in Sweden during the Exchange Rate Mechanism crisis in 1992, as the Swedish authorities tried in vain to maintain the Swedish crown's peg to the European Currency Unit, notwithstanding the prevailing weak domestic economic situation. Such a policy was correctly perceived by market participants as not being credible.

These problems can be greatly mitigated by a flexible exchange rate regime. By allowing the nominal exchange rate to change in response to capital movements, the exchange rate can bear at least a portion of the weight of adjustment to shocks rather than being entirely borne by domestic variables. Moreover, the fact that the exchange rate will move may itself reduce or deter speculative flows; there are no 'one-way' bets to attract speculators.

Although a flexible exchange rate has much to recommend it, this is not to say that a fixed exchange rate is necessarily inappropriate in all circumstances. There is an extensive academic literature examining the relative merits of fixed versus flexible exchange rates for countries (Barth and Wong, 1994). Of particular importance is whether two or more countries form an optimum currency area (see Fenton and Murray, 1992). Factors to be taken into account include the openness of an economy, the types of shocks countries experience, the objectives of monetary authorities and the impact of the exchange rate on trade and economic efficiency. Also, second-best considerations might be important. For example, while it is doubtful whether Argentina forms an optimum currency area with the USA, one could plausibly argue that the currency board arrangement introduced in Argentina was a good second-best solution, given the lack of policy credibility in that country and its history of hyperinflation. Nevertheless, the use of the exchange rate as a nominal anchor, particularly by countries trying to acquire the credibility of the anchor country, is a high-risk strategy. Experience has shown that it can be very difficult politically to move to more flexible exchange rate arrangements in a timely fashion.



## **Flexible Exchange Rates and Monetary Policy**

Without an external anchor for policy, one needs to have an internal anchor. Various types of these are possible, including targeting the growth of monetary aggregates, nominal income or, as in the case of Canada, inflation control targets. Such targets were introduced in Canada in early 1991 in conjunction with the government of the day. They were expressed in terms of the year-over-year rate of increase in the consumer price index and set to decline over time, reaching 2 per cent plus or minus 1 per cent. These targets were subsequently reaffirmed in December 1993 by the central bank and the current government, and extended out to the end of 1998. By 1998, a decision will have been made regarding what rate of change in the CPI is consistent with our ultimate target of achieving price stability.

Decisions regarding the conduct of monetary policy are taken in the context of these inflation control targets. In an open economy, such as Canada, monetary policy is transmitted through two channels – interest rates and the exchange rate. To operationalize this, the Bank of Canada has constructed a monetary conditions index (the MCI) for Canada consisting of changes in both real short-term interest rates and the real effective exchange rate (see Freedman, 1994). The relative weights were derived from averaging the results of a number of empirical studies that estimated the impact on Canadian aggregate demand of changes in the two variables. On this basis, a 1 : 3 ratio of effects was obtained, that is, a one percentage point change in real interest rates has approximately the same impact on aggregate demand as a three percentage point change in the real effective exchange rate.<sup>3</sup> For simplicity, and over short periods of time, the Bank typically focuses, however, on the nominal MCI, given the prevailing low level of inflation in Canada and its major trading partners.

Given the lags between monetary actions and their effect on aggregate demand, the Bank of Canada establishes a path for monetary conditions that is consistent with achieving the inflation control targets six to eight quarters in the future. In this context, the monetary authorities explicitly take into account the impact of exchange rate movements on the economy, something that might be ignored were the short-term interest rate alone to be used as the operational target for policy. For example, should the Canadian dollar rise as a result of capital inflows associated with a portfolio shift then interest rates can be lowered to maintain the same overall level of monetary conditions. Note, however, that while the overall monetary conditions may be unchanged on balance, different sectors of the economy will be affected differently. Interest-sensitive sectors will be

affected primarily by changes in interest rates, the export sector primarily by movements in the exchange rate.

While the central bank can affect the level of the MCI, through its influence over short-term interest rates, it has little or no control over the mix, which is determined by the market. In essence, there are an infinite number of interest rate and exchange rate combinations, which, on balance, will have similar effects on aggregate demand.

The conduct of monetary policy can at times be complicated by market dynamics related to the interaction of money and foreign exchange markets. For example, should market expectations be poorly anchored and the exchange rate come under downward pressure then market forces may simultaneously cause short-term interest rates to rise in such a fashion that monetary conditions on balance tighten. In such circumstances, should the monetary authorities add liquidity to the system in an effort to re-establish the desired easier monetary conditions then the market may react negatively, putting still further downward pressure on the currency.

As a consequence, tactical considerations may lead the Bank of Canada to take steps to calm the market even if in the short term this implies somewhat different monetary conditions than those desired. In short, even with a flexible exchange rate, the Bank does not have complete freedom of action. Indeed, it may have considerable difficulty in achieving a desired level of monetary conditions if the market has a markedly different view of the economic outlook and inflation trends (Zelmer, 1995). Nevertheless, once market conditions settle, the monetary authorities can take the necessary steps to return the MCI to the desired path.

To anchor the expectations of financial markets more soundly, the Bank's policy actions have become more transparent. In addition to the setting of inflation control targets on the road to achieving price stability, it now publishes a monetary policy report twice a year that is designed to improve the public's understanding of Canadian monetary policy. The Bank has also made efforts to explain its day-to-day operations in a clearer fashion.

### **What About the Current Account?**

The recent Mexican experience has focused attention on international competitiveness and the current account. In an effort to maintain a 'sustainable' current account, policy-makers may be tempted to use monetary policy to target a specific real exchange rate. Two observations can be made about such a policy. First, given the absence of a nominal anchor, it will be destabilizing. For example, an exchange rate depreciation could lead to higher domestic inflation and, as a result, a stronger real exchange

rate. An easing of monetary policy aimed at restoring the original real exchange rate would raise domestic inflation, leading once again to a stronger real exchange rate.

Second, as a central bank has essentially only one tool at its disposal – changes in its balance sheet – it can only achieve one objective. Faced with this choice, the Bank of Canada focuses on something that it knows a central bank can achieve, that is, price stability.

However, it is nevertheless true that a sizeable current account deficit can be a sign of excessive domestic demand pressures. If a tightening of monetary conditions to slow demand results in a real appreciation of the exchange rate that is unacceptable to the authorities then other tools are required. Tighter fiscal policy, an approach used by several countries in recent years, may be a useful alternative, though one that may not be very timely (Schadler *et al.*, 1993).

Another potential tool that has received a lot of attention in recent months is short-term capital controls. Particular attention has been given to Chile, which introduced such controls in 1991 and managed to avoid the problem with surges in capital that were experienced by Mexico and other countries in Latin America. Although the Chilean authorities and certain authors argue that controls on short-term capital inflows were in part responsible for Chile's success,<sup>4</sup> other observers disagree, noting that the controls were easy to evade, an observation borne out the repeated need to broaden the controls (Resende, 1995). Moreover, recent empirical work has indicated that long-term flows, even direct investment, can be as volatile as short-term flows. Hence, an attempt to reduce the volatility of the capital account through the introduction of controls over short-term capital movements is unlikely to be effective (Claessens *et al.*, 1995).

It is also worth noting that Chile introduced during the early 1990s a number of changes to its exchange rate policy, which effectively provided the exchange rate greater nominal flexibility. This flexibility may have been more important in curbing speculative inflows than the controls on short-term capital. Measures taken included the adoption of a basket of currencies to determine its reference exchange rate, a widening of the fluctuation band and, on several occasions, upward revaluations of the band itself.

### **The Instruments of Monetary Policy in a Liberalized Environment**

Much has been written on this subject. Most recently, the IMF published an extensive overview of research in the area and a number of developing country case studies (Alexander, 1995). Suffice to say that the Bank of Canada has found that the use of indirect instruments in the conduct of

monetary policy is strongly supported on the grounds that such a system provides effective monetary control and leads to efficient financial intermediation. Moreover, credit can be allocated by the market in an impersonal, non-discriminatory fashion.

Conversely, it is difficult to find examples where administrative controls have been useful in the long-run for monetary policy. In this regard, controls are typically designed to achieve non-monetary objectives such as the maintenance of low interest rates to promote investment or the provision of subsidies to certain sectors, notably the government. As with exchange controls, direct monetary controls are welfare-reducing. They also provide strong incentives to the public to try and circumvent them. This leads to disintermediation and, in the extreme, thriving informal markets.

In Canada, the central bank currently uses a number of techniques to adjust the liquidity of the financial system. These include the movement of government deposits between the central bank and commercial banks, repurchase agreements and open-market operations. It is noteworthy that mandatory reserve requirements are not used, having been phased out by mid-1994. The rationale for this development was threefold. First, banks were at a disadvantage *vis-à-vis* other financial institutions, since they were the only institutions required to hold mandatory, non-interest-bearing reserves at the central bank – in essence a hidden tax. On competitive equity grounds, the decision was made to eliminate reserve requirements rather than try to extend them to all financial institutions that took deposits (or offered products that closely resembled deposits) or to compensate banks for having to maintain mandatory deposits at the central bank.

Second, it was appreciated that reserve requirements were not required as some sort of prudential measure. Rather, Canadian authorities took the view that prudential concerns are better addressed through appropriate capital adequacy requirements, proper asset valuation and regulations regarding the type and concentration of assets that financial institutions can hold.

Third, and most important, mandatory reserve requirements were recognized as being unnecessary in the conduct of monetary policy. As large deposit-taking institutions ('direct clearers') are required to settle their obligations with each other on the books of the central bank, they must hold deposits (settlement balances) at the Bank of Canada to cover the daily clearing of cheques and other payments.<sup>5</sup> As these deposits do not earn interest, direct clearers have an incentive to minimize them. At the same time, overdrafts from the central bank incur interest charges. As a consequence, the major financial institutions aim to hold zero, or only very

small positive balances with the Bank of Canada. Given this environment, the central bank can influence short-term interest rates, thereby maintaining monetary control, through its ability to alter the banks' settlement balances by transferring government deposits between itself and the direct clearers or through open-market operations.<sup>6</sup>

### 7.3 MICRO-LEVEL LIBERALIZATION

Even though financial sector reform does not have a direct impact on monetary policy, central banks, even those not responsible for regulation and supervision of financial institutions, take a keen and understandable interest in financial liberalization. As noted previously, not only is the health of the financial system an important goal for public policy; systemic weakness of the financial system can compromise a central bank's ability to conduct monetary policy. Central banks are also typically lenders of last resort, and, as a consequence, must be confident that financial institutions are well managed and supervised.

One of the key motivating forces behind financial sector reform has been to increase competition in the financial sector, thereby enhancing investment through lower borrowing costs and fostering greater domestic savings through higher returns on deposits and a wider range of investment products. There may, however, be a trade-off between financial sector stability and market efficiency. A tightly controlled financial system may be, at least in the short run, more stable. However, this stability may come with a high pricetag in lost efficiency. Moreover, the stability could be illusory if a heavy regulatory burden gives rise to a large portion of financial activity being conducted in unregulated, unsupervised, informal markets, or if highly disruptive changes to the system occur in the longer run.

On the other hand, a competitive, market-based financial system will have failures, notwithstanding an effective regulatory and supervisory system. Indeed, the right of entry must also imply the right of exit. It is therefore important to ensure not that financial institutions cannot fail, but that they have the right incentives to avoid excessive risk-taking, and that failures, when they occur, do not destabilize the financial system. The authorities must also have the capacity and the willingness to act quickly. As can be seen in many countries, most vividly with respect to the savings and loan problem in the USA and most recently in Japan, regulatory forbearance not only delays the resolution of financial problems, but it can also often compound them.

Over the past decade, partly in response to the failures of two small chartered banks in the mid-1980s and subsequently other non-bank financial institutions, the federal authorities in Canada have examined closely all federal financial legislations.<sup>7</sup> In 1992, sweeping changes were made to the legislative framework for federal financial institutions covering the powers of financial institutions, ownership structure and prudential safeguards.<sup>8</sup> Considerable attention is now being paid to risk-proofing the payments and settlements system – an often overlooked but essential element of a financial system's infrastructure, and enhancing more generally the soundness of the Canadian financial system. (Government of Canada, 1995). While the Canadian system may still not be perfect, Canadian authorities believe that Canada has a financial system that is both competitive and safe.

Before examining the consensus that has emerged in Canada on financial sector reform over the past decade, it is important to note that the starting conditions in Canada were very different from those in many developing countries. For example, the macro-level reforms discussed in Section 7.2, such as capital account convertibility, market-set interest rates and a competitive financial industry, have long been features of the Canadian financial landscape. Canada also has a well-established legal structure, dealing with such things as property rights, contracts and bankruptcy and a solid supervisory structure – essential elements for a successful financial system. Canada has additionally maintained a relatively stable macroeconomic environment, something that experience from around the world has shown to be highly desirable in embarking upon financial sector reform (see World Bank, 1989).

As a consequence, Canada, unlike many developing countries, has not had to deal with many of the problems that can arise from the interaction of macro and micro liberalization. For example, a stabilization programme that is anchored by a fixed nominal exchange rate can lead to a real appreciation and an unsustainable consumption boom. Capital inflows made possible in part by the opening of the capital account, and which are typically intermediated by the banking system in developing countries, can further fuel this boom. In this regard, concern has been expressed about the possibility of excessive optimism emerging in a reforming developing country, leading to 'overborrowing' and ultimately a financial crisis (McKinnon and Pill, 1994). Greater intermediation, combined with banking-sector liberalization in an environment of explicit or implicit government guarantees, can lead to banks venturing into little-understood, high-risk types of lending (for example, property development). This is particularly a concern for institutions that prior to liberalization were pri-

marily in the business of lending to governments. Such institutions may have little knowledge about assessing credit risk.

Moreover, financial institutions in developing countries may also be encumbered with low-yielding or non-performing loans, the product of government-directed lending. Unless their balance sheets are put on a more solid footing through capital injections, or the bad debts offloaded (presumably to the government), then they will not face the right incentives. High risk, 'shoot-for-the-moon' strategies may result as these institutions attempt to restore their solvency. Such institutions would also be competitively handicapped, potentially making it more difficult politically to introduce greater competition, especially from potential foreign entrants. As a result, the benefits of financial liberalization may be slow to materialize.

At the same time, lenders may also face the wrong incentives. Capital inflows into developing countries may be partially a response to a 'chain of guarantees' provided by governments (Dooley, 1994). Such guarantees would include a commitment to a fixed or quasi-fixed exchange rate, implicit or explicit guarantees to domestic financial institutions and, conceivably, international 'guarantees' to provide financial support to countries that get into difficulties.

The following is a summary of the consensus in Canada on a range of issues associated with financial-sector liberalization.

### **Powers of Financial Institutions**

Under the new Canadian federal legislative framework, financial institutions are permitted, either directly on their own books or indirectly through subsidiaries, to engage in a wide spectrum of financial activities. These include: deposit-taking, corporate lending, insurance (life and general accident), stockbrokerage and investment dealing, and fiduciary business. Suitable 'Chinese walls' are required between various types of business to minimize conflicts of interest. Some restrictions are imposed on small financial institutions with regard to the extent to which they can engage in corporate lending, which is viewed as being more risky than other activities.

One important missing item from this list of permissible activities is the power of financial institutions to own controlling positions in non-financial enterprises (that is, downstream commercial linkages), other than on a temporary basis through the realization of collateral. Thus, Canada subscribes to a narrow universal bank model as opposed to the broad

model practised in Germany. This reflects our concern about possible distortions to the credit allocation process arising from such linkages, and the appropriateness of deposit-taking financial institutions holding substantial amounts of equities given the nature of their liabilities.

By the same token, concerns have been expressed about upstream corporate linkages, which are viewed by some as being more problematic than downstream linkages, given the risk that the financial institution might be used as a funding tool by its corporate parent. Wide ownership is one method of controlling this risk. Strong rules on non-arm's-length transactions are another method, though one that would be dependent on such rules being enforced.

### **Ownership**

Historically, there has been a preference in Canada for widely held financial institutions (that is, no single shareholder owning more than 10 per cent of the outstanding shares). As a result, all major banks are widely held, as are many major insurance companies by virtue of them being mutual companies and hence owned by their policyholders. In the past, this preference in part reflected concerns about the possibility of foreign ownership of the financial sector; the requirement of wide ownership deterred foreign take-over of Canadian financial institutions. More recently, and perhaps more importantly, this preference has reflected a view that such institutions are less prone to serious (that is, solvency-threatening) forms of non-arm's-length transactions. Experience both in Canada and abroad has shown that such loans, which lack independent third-party judgement, can pose a significant hazard to the health of financial institutions.

However, it is also recognized that a controlling shareholder can provide a useful direction to a financial institution; in contrast, wide ownership can contribute to complaisant management practices. Indeed, successful, closely held, deposit-taking institutions exist in Canada. Nevertheless, even if regulations are put in place to deter and limit self-dealing, concerns remain regarding this type of ownership, particularly when large institutions are involved – those whose failure may have systemic implications. Therefore, a compromise was reached. Canadian-owned banks must remain or become widely held, while non-bank financial institutions must have at least 35 per cent of their shares widely held when they attain a given size set in terms of capital. A widely held position of this magnitude was viewed as being sufficiently large to attract independent third-party scrutiny by market analysts.



It is interesting to note that Canada does not permit foreign deposit-taking institutions to operate in Canada via branches; only subsidiaries are permitted. While this provision has been criticized by some of Canada's trading partners, and may have to be modified in the light of the North American Free Trade Agreement, it has served Canada well. Because subsidiaries have their own capital base, Canadian depositors and the Canada Deposit Insurance Corporation (CDIC) are better protected than if the Canadian operations of the foreign entity took the form of a branch. In this regard, a foreign parent financial institution can fail without its Canadian operations being forced to close. Legally separate Canadian operations are also helpful in clearing and settlement systems, because, in the event of a failure, it would be clear which country's laws would apply, namely those of Canada. More legal certainty is also provided regarding collateral pledges and the netting of payments.

### **Self-Dealing and Conflicts of Interest**

Mention has already been made regarding the problem of non-arm's-length transactions, often called self-dealing, and conflicts of interest. Given that Canada has closely held institutions, controls over transactions involving a financial institution and its controlling shareholders, directors, their relatives and their outside commercial interests were viewed as essential. Widely owned institutions are also subject to this regime, although the risks posed by such transactions were seen to be less serious for these institutions, given the nature of their ownership. In addition to regulations and supervisory oversight of non-arm's-length transactions, corporate governance has been enhanced. The new legislation requires that at least a third of a financial institution's board to be unaffiliated, directly or indirectly, to the financial institution. These directors are required to make up the majority of conduct review committees that must approve non-arm's-length transactions.

The control of non-arm's-length transactions and conflicts of interest may be more difficult in developing countries than in a relatively large industrial country such as Canada. First, developing countries, particularly small ones, may have a very small pool of qualified financial talent from which to draw. It may therefore be difficult to find 'unaffiliated' directors for financial institutions. Second, cultural practices may pose a problem in some countries. Impersonal lending practices that characterize a market-based financial system can conflict with 'accepted social norms that family and friends come first' (Tanzi, 1995).

**Supervisory System, Market Discipline and Transparency**

Strong prudential supervision is clearly important for the health of a financial system, especially systems undergoing liberalization, because liberalization usually implies exposing financial institutions to new, unfamiliar risks. Indeed, in the sequencing of financial reforms, the introduction of an adequate supervisory system is key if delays or, worse, financial crises are to be avoided (Sundararajan, 1995; Quirk and Evans, 1995). Such supervision has two elements – the formal supervisory system and market discipline.

While a formal supervisory and regulatory framework ought not to, eliminate failures, and indeed cannot, it should permit an orderly resolution of problems. After examining supervisory models used in other countries, the Canadian authorities favour a flexible approach that permits early intervention, and, if necessary, allows the supervisor to close a financial institution in financial difficulty, even though it still has positive capital and, hence, is not technically insolvent (Government of Canada, 1995). This latter power is valuable in ensuring that depositors and the deposit insurance fund are better protected from loss. It can also minimize the systemic consequences of a failure, as well as the problem of institutions being 'too big to fail'.<sup>9</sup>

This early intervention policy should be expressed in a legislated mandate for the supervisor. The value of this is twofold. First, it clarifies the intent of the authorities and what the supervisors will do or require a financial institution to do should it get into difficulty. Second, greater transparency will enhance the rule of law and makes the supervisory agency more accountable. It would also help to clarify that the failure of a financial institution does not imply a failure of the supervisory and regulatory system.

Reliance cannot, however, be placed solely on the formal supervisory system. Market discipline is an essential element of strong prudential oversight. The key to effective market discipline is timely and accurate information on the activities of financial institutions, both on their balance sheets and off. Greater financial transparency will contribute to more prudent behaviour by banks and help to nip any problem in the bud. For this to be possible, however, accounting standards must be high and assets valued appropriately. Of course, for market discipline to work, governments, cannot extend any explicit or implicit guarantees of financial institutions (that is, it must be possible for depositors and shareholders to lose money).

While the market can discipline financial institutions that take excessive risk, non-diversifiable systemic risks may exist that may be difficult

for markets to cope with. A major negative terms of trade shock could, for example, pose difficulties for a country's financial system. However, even in countries that routinely experience unstable macroeconomic conditions, financial institutions can adapt by maintaining conservative lending practices and larger capital bases. To the extent that policy is responsible for the unstable macroeconomic conditions, capital outflows will help discipline governments.

### **Capital Adequacy**

While the Basle standards regarding adequate capital for financial institutions with an international presence provide a good foundation upon which to assess capital adequacy, they may not be sufficient. For example, the guidelines are currently meant to address only counter-party risk. While they will be broadened to cover market risk by 1997, there are other forms of risks that will still not be covered. For financial institutions taking advantage of broader powers following liberalization, more capital than otherwise may be required. Although broader powers may reduce overall risk, assuming the returns on the new activities are not positively correlated, the opportunity for excessive risk-taking in unfamiliar areas by management who may have little experience in making credit judgements argues for a stronger capital base, at least initially. Higher capital standards could, but not necessarily, lead to interest rates that were somewhat higher than they might otherwise be.

### **Deposit Insurance**

Deposit insurance has been hotly debated in Canada. On the one hand, Canadian authorities are very aware of the moral hazards associated with deposit insurance. In particular, depositors, at least those below the insurance threshold of 60 000 C\$, have no incentive to monitor the health of financial institutions. Concurrently, financial institutions that engage in relatively risky activities can borrow and fund such activities on the basis of the government guarantee. On the other hand, deposit insurance reduces the likelihood of runs on financial institutions, facilitates the entry of new deposit-takers and protects small, unsophisticated depositors from loss.

In recognition of these conflicting arguments, there has been considerable discussion regarding ways of improving the incentive structure of deposit insurance, while preserving its beneficial aspects. Coinsurance, a plan whereby depositors would share in any losses was considered

but in the end rejected. Instead, a risk-based deposit insurance system has been proposed, under which the deposit insurer would charge a deposit-taking institution a variable premium based upon a number of criteria, including the quality and diversification of assets, financial strength and the quality of management. This is expected to be implemented in 1997.

### **Payment and Settlement Systems**

Payment and settlement systems have become a major topic of interest in international fora, especially the Bank for International Settlements and the G-10, in recent years. Part of the essential infrastructure of the financial system, such systems have often been overlooked, because most of the time they function behind the scenes without any apparent problem. However, problems can arise, and when they do they can pose a significant systemic threat to the financial system. This fact was made very apparent in the USA in 1985, when owing to a computer malfunction, the Bank of New York was unable one day to make payments due on its security operations. In order to avoid knock-on defaults of institutions that were expecting funds from the Bank of New York, the Federal Reserve made an unprecedented discount window advance of about \$23 billion to the Bank of New York (Corrigan, 1986).

It is in this context that considerable work has been done in G-10 countries to develop effective and competitive payments and settlements systems that deal with systemic risk concerns. Two approaches are being pursued – a gross real-time payments system and ‘Lamfalussy-compliant’ netting arrangements, that is, arrangements that meet internationally recognized prudential standards for the design and operation of cross currency and multi-currency netting and settlement systems (Committee on Interbank Netting Schemes, 1990). Both approaches provide the same benefits, in particular certainty of settlement for participants and intro-day receiver finality to end users.

Most G-10 countries favour a gross, real-time payments system, whereby payments are cleared and settled one at a time. Such a system ensures intra-day finality and minimizes risk, because a payment cannot be made until sufficient funds are in the paying financial institution’s account. However, to avoid gridlock at the beginning of the day, high-quality securities, typically government securities, are required to serve as collateral or be used in repo transactions.

Canada has opted for the second alternative, and intends to introduce by 1997 a Lamfalussy-compliant netting system for clearing and settling pay-

ments. Each transaction will be processed in real time and will be subject to risk control measures, that is to caps on bilateral and multilateral exposures, which will be set at the beginning of the day. Collateral will also be required to ensure that the system will settle in the event of the failure of the largest single participant in the system. The Bank of Canada will stand ready to provide if necessary additional guarantees to cover the very remote possibility of two or more large failures occurring the same day. Intra-day certainty of settlement for large payments will be assured through the large value transfer system (LVTS), which is currently being developed by Canadian financial institutions through the Canadian Payments Association in conjunction with the Bank of Canada.

Draft legislation has also been introduced into Parliament that would give the Bank of Canada a more formal and explicit role in the oversight of clearing and settlement systems, with the objective of controlling systemic risk. This would mean that private sector operations of those clearing and settlement systems that could potentially pose systemic risks (for example, systems for clearing and settling foreign exchange transactions or securities transactions) would be required to obtain the approval of the Bank of Canada regarding the arrangements in their systems to monitor and control risks (see Thiessen, 1995).

#### 7.4 CONCLUSION

The transition from a closed, heavily regulated financial system to one that is open and market-based can be difficult. The removal of foreign exchange and interest rate controls will accelerate the integration of domestic and international financial markets. For those countries unfamiliar with the ebb and flow of market forces, this may feel like a loss of control. However, an independent monetary policy is possible if a country adopts a flexible exchange rate regime. This independence is, however, not absolute. A central bank's actions will be circumscribed by market forces. However, it can acquire manoeuvring room by pursuing credible policies. Greater transparency of central bank policy objectives and actions is helpful in this regard.

Micro-level reforms, including most importantly a broadening of powers available to financial institutions, can be costly if not undertaken carefully. For countries attempting to undertake such reforms concurrently with a removal of barriers to capital movements, the introduction of a stabilization programme and a move to indirect monetary instruments, the challenges are that much greater. To the extent possible, thought should be

given to the sequencing of reforms. Evidence from around the world strongly suggests that a stable macroeconomic environment is very helpful when embarking upon financial liberalization. Other prerequisites include a suitable legal and accounting environment. Nevertheless, problems can be minimized if: (1) institutions have the right incentives to act prudently and competitively; (2) the supervisory system is effective; (3) institutions are strongly capitalized and (4) there is a strong dose of market discipline.

## Notes

1. In dollarized economies, foreign currency, typically US dollars, is preferred by residents over domestic currency in transactions and as a store of value.
2. For a review of the case for a flexible Canadian dollar, see Laidler and Robson (1990) and Crow (1995).
3. In constructing MCIs for other countries, different weights are likely to be required, depending on how open their economies are. For example, a relatively closed economy would have a small weight for the exchange rate.
4. For example, see Ffrench-Davis, R. *et al.* (1995).
5. Direct clearers consist of major banks and large, non-bank deposit-taking institutions that maintain deposits at the central bank. Smaller financial institutions (indirect clearers) clear through one of the direct clearers.
6. For more information, see Thiessen, G.G., 'Uncertainty and the transmission of monetary policy in Canada,' the Hermes-Glendon Lecture, York University, March 30, 1995, Bank of Canada Review, Summer 1995. See also, Noël, T., 'Bank of Canada Operations,' Remarks made to the Toronto Association for Business and Economics and the Treasury Management Association of Toronto, October 25, 1995.
7. Note that financial institutions in Canada come under both federal and provincial jurisdiction. All banks are incorporated at the federal level and, hence, are federally regulated and supervised. While most large non-bank deposit-taking institutions and insurance companies are also under federal jurisdiction, some such institutions are provincially incorporated and supervised. Dealers in securities are also provincially supervised.
8. For a review, see Daniel *et al.* (1993).
9. Risk-proofing major clearing and settlement systems can also reduce the problem of some institutions being considered as 'too big to fail'.
10. Committee on Interbank Netting Schemes (1990) *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries* (Basle: Bank for International Settlements) (November).

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