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## PROGRESS, CONSTRAINTS AND LIMITATIONS OF FINANCIAL SECTOR REFORMS IN THE LEAST DEVELOPED COUNTRIES

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## 1. Introduction

Many developing countries implemented financial sector reforms, as part of broader market oriented economic reforms since the late 1980s. This paper evaluates the achievements, limitations and constraints of financial sector reforms implemented in eight Least Developed Countries (LDCs):[1] Madagascar, Malawi, Tanzania, Uganda and Zambia in sub-Saharan Africa (SSA), and Bangladesh, Laos and Nepal in Asia. All are low-income countries characterised by shallow and undiversified financial sectors, which have experienced considerable financial fragility. The research is based on an UNCTAD project undertaken during 1995-97.

The financial sector reform programmes implemented in the eight LDCs entailed financial liberalisation and institutional reforms to systems of prudential regulation and supervision and distressed public sector banks. The reforms began in the mid- to late- 1980s in some countries, and in the early 1990s in others. In none of the countries were the reform programmes complete in the mid-1990s. The banking system dominates the financial sectors of these LDCs and has been the major focus of the reforms, although some of the countries have begun reforms intended to develop capital markets and encourage the growth of non bank financial institutions (NBFIs) such as leasing and finance companies. This paper concentrates on the impact of the reforms on the banking system.

The objectives of the reforms are to build more efficient, robust and deeper financial systems, which can support the growth of private sector enterprise. Efficiency entails two components: improved credit allocation (i.e., credit allocated to borrowers with higher expected returns for given levels of risk) and more, or higher quality, financial services for a given level of inputs (e.g., bank staff). Improved credit allocation could be derived from reduced government intervention in directing credit or setting interest rates so that banks would have more freedom to allocate credit according to commercial criteria. The second component of efficiency could be brought about through increased competition, with competition resulting from liberalised entry and/or removal of regulations, which restrict competition, such as interest rate controls. But this assumes that financial markets will be competitive and not oligopolistic.

More robust financial systems are those less vulnerable to financial fragility. Financial fragility can impose heavy costs on taxpayers and disrupt the real economy through reduced availability of credit and other services such as payments (Goldstein and Turner, 1996; Llewelyn, 1997). Financial sector reforms can contribute to enhancing robustness through three mechanisms;

[1] Least Developed Countries are a group of 48 countries designated as least developed by the UN on the basis of low per capita incomes, lack of economic diversification and low human resource development.

reducing one of the causes of fragility, government direction of credit to uncreditworthy borrowers; restructuring distressed banks; and strengthening prudential regulation and supervision.

The literature includes some scepticism about the efficacy of financial liberalisation in low-income countries. Financial liberalisation has not always brought about the expected benefits: there have been few innovations in financial markets, competition is limited by oligopoly and liberalisation may exacerbate urban bias (Chandavarkar, 1992). There is doubt as to whether higher real interest rates encourage greater financial saving, and thus deepen the financial system.

Market failure, arising from informational imperfections, is pervasive in financial markets, and are especially severe in rural areas (Stiglitz, 1994). Market failures may prevent liberalisation from improving the efficiency of credit allocation. In particular, potentially profitable borrowers may be denied credit because of high informational and transactions costs. In Africa the severe informational problems afflicting financial markets suggest that even the long term benefits of liberalised financial systems may be small, while in the short term, financial liberalisation might actually worsen the efficiency of intermediation because, lacking information about firms' expected profitability, banks lend on the basis of collateral values (Collier, 1994).

The segmentation of financial markets between formal and informal sectors impedes the efficacy of liberalisation to enhance competition and efficiency (Aryeetey et al, 1997). The liberalisation of financial markets may lead to financial crisis unless preceded by macroeconomic stabilisation and prudential reforms (Alawode and Ikhide, 1997; McKinnon, 1988). Caskey (1992) questions the costs of financial sector reform programmes, in particular rehabilitating government banks at government expense and the scarce human resources, which the reforms absorb.

The rest of the paper is organised as follows. The next section outlines the main components of the financial sector reforms implemented in the eight LDCs. Section 3 assesses the impact of the reforms on financial depth, on competition in the banking system and on credit allocation, factors related to the efficiency of financial intermediation. The subsequent section examines the extent to which the reforms have created more robust financial systems. It analyses the causes of financial distress and evaluates measures to rehabilitate government banks and the reforms to the prudential system. A final section concludes.

## 2. What Financial Sector Reforms were Implemented in LDCs?

### *2.1 Pre-reform policies*

The eight LDCs covered in this paper began their reforms from different starting points for a variety of reasons, but mainly because they experienced different levels of financial repression or financial sector inefficiency, which reflected differences in pre-reform financial sector policies. In addition, some governments were slow in identifying the problem and acknowledging the need for reforms.

Pre-reform policies in all eight LDCs included controls over interest rates, and most used a variety of lending directives, rediscount facilities or special lending schemes designed to increase the volume of bank credit extended to priority sectors such as agriculture, often at preferential interest rates. Government ownership of banks was important in all eight LDCs, but the share of the private sector, if any, and the role of market forces in financial intermediation varied considerably between countries.

In Laos, Madagascar and Tanzania government-owned financial institutions had a monopoly of formal sector financial markets: private sector banks had been nationalised and new entry from the private sector was not allowed. Financial resources were allocated according to administrative directives, and banking was essentially a form of quasi government financing for state owned enterprises (SOEs), rather than genuine financial intermediation. Until 1988 Laos had a soviet style banking system comprising a single monobank incorporating both central and commercial banking functions.

The other five LDCs had mixed banking systems comprising government and private sector banks, or joint ventures between government and the private sector, although except in Zambia, wholly owned private sector banks commanded much less than half the banking market. In these countries government-owned banks were expected to pursue a variety of non-commercial objectives, such as lending to SOEs and small farmers. In Bangladesh, Nepal and Uganda the government banks also undertook major branch expansion programmes in the rural areas in response to government directives. The private sector banks were operated along commercial principles, although they were constrained by the controls imposed by the central banks on interest rates and where applicable, sectoral credit directives and controls on the location of branches.

### *2.2 Components of Reforms*

The reforms implemented in the eight LDCs included liberalisation of financial markets and institutional reforms to the prudential regulatory framework and government banks. Annex table 1 lists the main components of the reforms in each country.

In all eight LDCs interest rates were liberalised. With the exception of Zambia (where liberalisation was implemented in a short space of time), this took place in a phased manner lasting several years, which began with administered interest rates being raised before partial and then full decontrol was implemented. Treasury bill (TB) auctions were introduced in Nepal, Uganda, Malawi, Tanzania and Zambia to allow a role for market forces to influence TB rates and to facilitate the use of indirect techniques of monetary control. Most of the LDCs, but not Nepal, liberalised sectoral credit directives.

All the LDCs have allowed new entry by private sector banks and other financial institutions, although only in Tanzania, Laos, Madagascar and Malawi were entry restrictions liberalised by the reforms. In Laos the private banks are restricted to the capital city. Nepal, Bangladesh, Uganda and Zambia all licensed private sector banks and financial institutions during the 1980s before their reform programmes began, at a time when prudential regulations were weak and hence prudential requirements on new entrants were low. In these countries the revisions to the banking legislation raised entry barriers in terms of minimum capital, expertise of promoters, etc, once this legislation had been enacted in the late 1980s or early 1990s. All the LDCs have allowed entry by foreign as well as domestic banks, but in Nepal foreign investment must be in the form of joint ventures with domestic partners with foreign ownership restricted to 50 percent of the equity.

New banking legislation, comprising stronger prudential regulations, was enacted in all the LDCs, and was accompanied by institutional reforms to strengthen the supervisory capacities of the central banks. All the LDCs implemented measures to tackle the financial distress in their government-owned banks, including recapitalisation and reforms to the management and operations of these banks. These reforms are discussed in greater detail in section 4. In Laos, the reforms began with the single monobank being split into a central bank and state-owned commercial banks in 1988.

There were differences in the timing and sequencing of reforms between the eight LDCs, but some common features are evident. Most of the countries had implemented stabilisation programmes, beginning in the mid- or late 1980s, several years before embarking on the main programme of financial sector reforms. Stabilisation measures had included raising controlled nominal interest rates, as noted above, in order to achieve positive, or less negative, real interest rates. The main programme of financial sector reforms in the eight LDCs began in the late 1980s or early 1990s. In most of these programmes liberalisation was begun alongside the institutional reforms to the prudential systems and the distressed banks, but the institutional reforms, and in particular the reform of distressed banks, took much longer to implement than the removal of administrative controls. While most of the latter had been abolished by the mid-1990s, many of the institutional reforms were still ongoing in 1996/97.

## 3. Have Reforms Enhanced the Efficiency of Financial Intermediation?

### *3.1 Financial Deepening*

A major objective of financial sector reforms is to boost financial depth, and therefore increase the resources available for financial intermediation. The main channel through which this should occur are interest rate reforms (raising controlled rates or deregulating interest rates), which are intended to lead to higher real deposit rates and hence price incentives for depositors. Greater non-price competition among banks for deposits might also boost deposit mobilisation.

The impact of the financial sector reforms on financial depth, as measured by bank deposits and M2 as percentages of GDP, varied between countries. In each of the three Asian LDCs, a marked financial deepening took place. In both Bangladesh and Nepal, bank deposits increased by around eight percentage points of GDP between 1985 and 1995, while in Laos bank deposits rose by almost seven percentage points of GDP between 1990 and 1995, albeit from a very small base (see table 1). In contrast there was little change in financial depth in Madagascar and a small decline in Malawi (the growth of NBFI deposits, which are excluded from bank deposit and M2 data, at least partly explain the decline in Malawi). Tanzania suffered a sharp contraction of financial depth in the second half of the 1980s but recovered almost half of the fall in the first half of the 1990s. In Uganda, a small recovery was achieved in the first half of the 1990s after the collapse in financial depth in the 1980s, but the financial system remained very shallow. In Zambia the reforms were unable to prevent continued rapid decline in financial depth which began in the first half of the 1980s.

The better performance of the Asian LDCs in enhancing financial depth is probably attributable to the greater macroeconomic stability in these countries. Inflation rates were relatively moderate in the three Asian countries, which has allowed real deposit rates to be generally positive (in Bangladesh and Laos) or only marginally negative (in Nepal): see table 2. In contrast, the five African LDCs suffered higher, and more volatile, rates of inflation. In these conditions it has been difficult to maintain deposit rates at positive real levels, especially during bouts of very high inflation. Moreover high inflation made rates of return on current account deposits, which account for a large share of deposits, steeply negative. Two other factors may also have contributed to the lack of financial deepening in the African LDCs. First, the removal of foreign exchange controls allowed residents to purchase and hold foreign currency legally, while rapid exchange rate depreciation would have made the holding of foreign currency assets more attractive relative to domestic currency assets.[2] Second, the introduction of TB auctions

[2] Foreign currency also circulates freely in Laos, and banks have been allowed to accept foreign currency deposits. The latter are included in the computation of broad money in Laos.

led to steep rises in TB rates, often surpassing time deposit rates, and this is likely to have led some of the larger depositors to substitute TBs for time deposits (Adam, 1995).

*3.2 New Entry and Competition*

Financial liberalisation is intended to stimulate greater competition in banking markets through two channels: new entry by private sector banks to challenge the oligopolistic market position of the established public sector and/or foreign banks, and the removal of administrative constraints on competition such as the interest rate controls. This should in turn lead to an improvement in the quality, and lower cost, of services offered to the public, as banks compete for business. Competition may also encourage banks to provide a broader range of financial products in an attempt to attract business.

In all the eight LDCs the reforms facilitated new entry, mainly by the private sector, into banking markets. The number of banks and financial institutions increased, and the dominant market share of the major banks was eroded, although it remained large.

In Laos, eight private sector banks had captured 30 percent of the deposit market since banking markets were opened to the private sector in 1989. Eight joint ventures banks had been set up since the mid-1980s in Nepal. There were 20 private sector banks in Bangladesh in the mid-1990s with 28 percent of the deposit market. Two new private sector banks were set up in Madagascar while the government sold equity in two of the three government-owned banks to foreign banks.

Considerable new entry by domestic private sector banks occurred in both Uganda and Zambia (although in both countries new entry preceded the start of financial sector reforms). Since the mid-1980s, eight new banks were set up in Uganda, and 15 in Zambia, of which six were later closed down by the central bank. The domestic private sector banks had captured deposit market shares of approximately 15 percent and 20 percent in Uganda and Zambia respectively at the end of 1995. New entrants have been fewer and more recent in both Malawi and Tanzania, reflecting a more cautious licensing policy by the authorities. In Tanzania, five private sector banks have been set up since 1993 while in Malawi two new banks were set up in the first half of the 1990s. In Malawi, Zambia and Nepal, the reforms also facilitated the growth of NBFIs, such as leasing companies and building societies. The NBFIs provided some diversification in lending products and competition for deposits (usually wholesale deposits) with the commercial banks.

Increased competition stimulated some improvements in financial services. Some of the new entrants introduced longer openings hours, cut queues in banking halls and provided more personalised services. A number of innovations occurred and new products were made

available: these included credit and debit cards, automated teller machines (ATMs), interest bearing current accounts, and savings accounts with cheque books. Cheque clearing has been speeded up. Competition for deposits increased in the urban areas, with both price and non-price competition. There is more competition for corporate clients, especially from the entry of foreign banks, which focus on this sector. The government-owned banks are making efforts to improve services and to provide services oriented to customer needs. However the impact of new entrants on the cost, quality and range of financial services has been limited for a number of reasons.

First, although the major government and/or foreign banks lost some of their market share to the new entrants, they still retain a large enough share to exercise a degree of oligopoly. This has enabled them to maintain large interest rate spreads, needed to cover the cost of their own inefficiencies and of their non-performing loans. Second, the slow pace of reform of some of the government banks retarded improvements in the cost and quality of their services. Third, with few exceptions,[3] the new entrants (both foreign and domestic banks) have avoided the rural areas, hence what benefits that have occurred have been confined to the urban areas. Some rural areas are likely to have suffered deterioration in the availability of financial services as a result of branch closures by government banks. Fourth, competition has been impeded because banking markets, particularly credit markets, are segmented. The foreign banks serve large, and especially foreign, corporate customers, the government-owned banks remain focused on SOEs, or privatised SOEs, while the domestic private sector banks and NBFIs mainly lend to local urban-based SMEs and to the informal trade and service sector.

*3.3 Impact of the Reforms on Lending*

Interest rate liberalisation, together with the removal of allocative credit directives and the adoption of commercial lending policies by public sector banks, is intended to enhance the efficiency of credit allocation, by allowing the price mechanism and the commercial judgement of bankers to determine credit allocation (Fry, 1988). A crucial premise underlying liberalisation is that inefficiencies in credit allocation arising from market imperfections such as imperfect information are less important than government failures arising from directed credit policies. It is also assumed that there exists demand for loans from creditworthy borrowers with profitable investment opportunities, which would be denied credit under a repressed financial system because administrative controls or the non-commercial lending policies of public sector banks channel the available credit to less efficient borrowers, such as loss making SOEs. Hence liberalisation is expected to allow a reallocation of credit towards the users most capable of

[3] One exception is Finance Bank in Zambia, which purchased some of the rural branches of Standard Chartered Bank in 1995.

generating higher rates of return to capital. Liberalisation could also reduce the pressure on banks to accommodate less creditworthy borrowers and therefore lead to an improvement in the quality of their loan portfolios. (Gelb and Honahan, 1991: *passim*)

An objective assessment of whether the financial sector reforms have actually brought about a more efficient allocation of credit is very difficult. Ideally one would need data on private and social rates of return earned by borrowers plus a counterfactual with which to make a comparison. Such data are not available. Instead, we examine the volume of bank credit to the private sector on the grounds that the private sector is assumed to use resources more efficiently than the public sector. Moreover the economic reforms being implemented by all eight LDCs aim to boost incentives for private investment, hence if the banking system responds to this change in incentives, it should extend more credit to the private sector. Other factors, however, may have a bigger influence than financial sector reforms on the volume of credit extended to the private sector, not least macroeconomic variables such as the government borrowing requirements and monetary policy, hence observed changes in private sector borrowing are not necessarily attributable to financial sector reforms.

Bank credit to the private sector as a share of GDP has expanded strongly in Nepal since the mid-1980s and in Laos during the 1990s. In the latter case this was attributable to the privatisation of SOEs. There was a small increase in Bangladesh. Zambia, Malawi, Madagascar and Tanzania all suffered sharp declines in private sector bank borrowing during the 1990s. Uganda registered a small increase, but from a negligible base. In all four mainland African LDCs, private sector bank borrowing amounted to less than 10 percent of GDP in the mid-1990s.

Clearly the efficacy of the reforms in terms of enabling banks to channel more credit to the private sector faced major constraints in the African LDCs. The lack of financial deepening constrained the funds available to banks, and large government domestic borrowing requirements crowded out the private sector. Moreover, in conditions of high inflation, as in Zambia, banks were very reluctant to extend credit to private sector borrowers even when funds were available, because of the fear that borrowers would not be able to service the very high nominal interest costs of the loans. High interest rates had contributed to widespread loan defaults by farmers hit by drought in Zambia in the early 1990s. Banks instead invested in TBs, a safer alternative.

It is likely that financial liberalisation has also affected the sectoral allocation of credit. Banks probably extend less credit to agriculture and to small farmers in particular because of the removal of lending directives, the cut back of special lending and refinancing schemes and

closure of rural branches, although some banks fund the larger commercial farmers.[4] The share of agriculture in total bank lending has fallen sharply in Malawi since the mid-1980s and in Bangladesh during the 1990s. Because of the high administrative costs, informational problems and difficulties in enforcing loan repayment, lending to small farmers on a purely commercial basis is unlikely to be viable for the banks.[5]

## 4. Have Reforms Led to More Robust Financial Systems?

All the LDCs experienced banking crises involving financial distress in one or more major banks in the late 1980s and/or early 1990s, with the exception of Malawi where financial distress had been diagnosed and effectively tackled in the early 1980s prior to the reforms. This section assesses whether the reforms have made banking systems more robust; i.e., less vulnerable to financial distress. We start by examining the causes of financial distress and also discuss whether financial liberalisation may have contributed to distress. We then assess the efficacy of the remedial measures taken to deal with distressed banks and the reforms to strengthen prudential regulation and supervision.

### *4.1 Causes of Financial Distress*

Two distinct types of financial distress afflicted the banking systems of the LDCs. The most important in terms of the scale of losses, and the fact that it was common to all LDCs, entailed endemic distress in government commercial banks; banks which, except in Zambia, accounted for over 50 percent of the banking market. Most of these banks were insolvent and required some form of recapitalisation by the government.[6] The second, which was important only in Bangladesh, Uganda and Zambia, involved domestic private sector banks with much smaller shares of the banking market. Six private sector banks were closed down by the central bank in Zambia in 1995 and 1997, while in Uganda one was closed down and two were restructured in the mid-1990s. Non-performing loans were at the core of both types of distress, but the causes of poor loan quality were different.

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[4] The financial problems afflicting some of the agricultural development finance institutions and cooperative banks have also cut the supply of credit to farmers.

[5] In Nepal, where banks have to comply with directives to lend to priority sectors, the private sector banks, most of which have very few rural branches, prefer to meet the requirement by lending to the Agricultural Development Bank of Nepal (ADBN) rather than by lending directly to farmers, although the interest rates on such lending were lower than those on direct loans to farmers. But this is not a solution to the problems of rural credit supply because the ADBN has a very poor record in loan recovery.

[6] In addition many other FIs owned directly or indirectly by governments suffered severe distress. These included development finance institutions, cooperative banks, government savings banks and housing banks.

Honohan's typology of bank crises distinguishes between (i) epidemics caused by macroeconomic shocks; (ii) epidemics caused by poor management and microeconomic deficiencies; and (iii) "endemic crises in government permeated banking systems" in which banks were subjected to non commercial principles which undermined their solvency (Honohan, 1997: 2-10). Using this typology the distress to the government banks in LDCs is an example of (iii), and that to the private sector banks an example of (ii).

Political pressure to lend to uncreditworthy borrowers was the main reason why the government-owned banks incurred substantial levels of non-performing loans (in Nepal, Tanzania and Uganda non-performing loans accounted for between 60 and 80 percent of the total loans of the government-owned banks). Except in Uganda and Malawi, the largest share of their bad debts were to state-owned enterprises (SOEs). Most of the SOEs were not profitable, but because of political pressure, backed up in some cases by government loan guarantees and collateral which was to prove of limited value, the government banks had little choice but to fund this sector. The government-owned banks also incurred bad debts from lending to farmers, especially in Bangladesh, Malawi, Nepal and Uganda, usually as part of government schemes aimed at supporting agricultural development, and to politically connected private sector borrowers. Governments pressured their banks not to foreclose on borrowers when they defaulted, and in some cases encouraged default by periodically announcing that loans to farmers would be rescheduled or written off after droughts or other disasters, as in Bangladesh. Even where banks did pursue defaulters, weaknesses in the legal systems often meant that foreclosure was a very difficult and lengthy process.

The loan portfolios of the government-owned banks were further undermined because in most cases their own policies: procedures, and capacities to appraise loan applicants and to monitor and recover loans, were very weak, as were internal controls. Furthermore, the banks were overstaffed and had overextended their branch networks; hence operating costs were high.

The distress afflicting the private sector banks in Bangladesh, Uganda and Zambia was mainly a result of poor management and fraud. Insider lending was a major contributor to their bad debts: directors took loans from their own banks and failed to repay. Loan quality was further impaired by a failure to adequately diversify loan portfolios and by the adverse selection of many of the banks' borrowers: the banks lent at high interest rates to borrowers in the least creditworthy segments of the market where default rates were high. Undercapitalisation afforded them little protection against distress when problems afflicted their loan portfolios. Incentives on owners for prudent management were weak because of undercapitalisation, concentration of ownership in one man or family, and deficient and poorly enforced prudential legislation (Brownbridge, 1998).

With few exceptions, the foreign owned banks, including the joint ventures in Nepal, avoided financial distress in all of the countries where they were allowed to operate.[7] They were much less subject to politically pressured lending than were the government banks, and most had experienced management, prudent lending policies which focused on creditworthy corporate customers, and good internal controls which prevented the type of lending problems which afflicted some of the domestic private sector banks.

Financial liberalisation, specifically liberal licensing criteria and the decontrol of interest rates, may contribute to financial crises if undertaken too abruptly or if poorly sequenced with reforms to prudential regulation, the real sector and macroeconomic stabilisation (Alawode and Ikhide, 1997). The rest of this sub-section considers whether the financial liberalisation, which was undertaken in the LDCs contributed to the financial distress in their banking sectors.

Financial liberalisation was not a significant contributor to the distress afflicting the government-owned banks. This was caused by politically pressured lending, a characteristic of the controlled financial markets. Their distress was chronic and pre-dated financial liberalisation in all the LDCs covered here. In most cases the government-owned banks were already insolvent and reliant upon liquidity support from central banks for several years prior to financial liberalisation. The financial distress in these banks was concealed by poor accounting practices for years while losses mounted, but the true scale of the losses only became apparent after the financial sector reform programmes began, when new loan classification and provisioning rules were introduced, when limits were placed on liquidity support by the Central Bank, and when external audits were carried out as a prelude to the restructuring of the banks. Further losses by government banks were undoubtedly incurred after financial markets were liberalised, but this was mainly because lending practices did not change rather than as a result of lending in liberalised markets - the banks continued to fund loss making SOEs, in a few cases, because of political pressure.

The link between financial liberalisation and the distress of the private sector banks in Bangladesh, Uganda and Zambia is more ambiguous. These banks were licensed at a time when prudential criteria for entry, such as minimum capital requirements, were low, when other prudential regulations were deficient and when supervisory capacities were weak,[8] although not

[7] The exceptions included the local subsidiaries of Meridian BIAO in Zambia and Tanzania, which were closed down in 1995. This bank had originated in Zambia, before expanding into an international bank with a network across Africa.

[8] During the pre-reform period prudential supervision was itself undermined by the allocative controls imposed on the banks: supervisors placed more emphasis on checking that banks complied with foreign exchange controls or sectoral lending directives than on compliance with prudential regulations.

all banks, which were licensed in this period suffered distress. By itself, however, the licensing of private sector banks does not amount to financial liberalisation, especially as licensing procedure was generally not transparent, and the set of criteria for accepting or rejecting applicants for bank licenses was neither clearly defined nor transparent. The liberalisation of interest rates probably made some contribution to the distress in the private sector banks, at least in Zambia where nominal lending rates rose to over 100 percent following liberalisation and undoubtedly made lending much more risky. But the distress resulting from insider lending would have occurred irrespective of whether interest rates were controlled or liberalised.

Wilful default by some borrowers because of political interference, or simply weak bank management, is a major contributor to financial distress in both government-owned and private sector banks. Experiences of all the LDCs studied demonstrate that it is often difficult, if not contradictory, for commercial banks to attain social objectives, (for example, poverty reduction), as well as operate profitably, or along commercial principles. The management and work culture have to be improved substantially in financial institutions in LDCs, especially in the private sector banks, if they are to survive the competition unleashed by financial liberalisation. Even if capital markets become fully operational, it may take a while for private sector banks to be able to raise equity capital on them. The management of these banks would need to demonstrate its capacity to run banks efficiently and profitably, given the bad track record of co-operative unions in Tanzania and Uganda, for example.

*4.2 Reforms to Distressed Government-owned Banks*

Reforms to distressed government-owned banks were implemented, and in most cases were still ongoing in 1997, in all the LDCs, with the aim of creating solvent and commercially viable banks. The scale of the distress in the government-owned banks necessitated some form of balance sheet restructuring: with one exception - Zambia National Commercial Bank (ZANACO) in Zambia - they received some form of recapitalisation from the government budget. They also undertook, or were planning to undertake, reforms to their management and operational structures. Rehabilitating these banks has proved to be a costly, lengthy and difficult process, and only in Malawi has it been an unambiguous success.[9] None of the insolvent government commercial banks was liquidated and only in Madagascar had any been privatised or otherwise divested at the time of writing.[10]

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[9] To recapitalise government banks, governments provided assets (or cancelled liabilities) which amounted to three percent of GDP in Malawi and Bangladesh, two percent of GDP in both Laos and Uganda, 1.3 percent of GDP in Nepal, and seven percent of GDP in Tanzania. It is likely that banks in some of these countries will require further capital injections to restore solvency.

[10] A few small government FIs were put into liquidation, including the Tanzania Housing Bank and the Export-Import Bank in Zambia, and in Madagascar the government sold a majority share in one of its banks to Credit

The circumstances in which rehabilitation efforts were, and are, being carried out are not propitious. Commercial banking and accounting skills are scarce, especially in those countries which previously had socialist banking systems without any private sector involvement, government financial resources are very limited, there has been only limited restructuring of major borrowers in most countries, and the legal framework for enforcing financial contracts is weak (Sheng, 1996). Moreover successful rehabilitation may entail significant economic and political costs in terms of lost jobs, closure of rural branches and lending programmes for farmers, and the curtailment of credit to loss making SOEs and to politically influential private sector borrowers.

Unlike in the other LDCs, the financial problems afflicting the two Malawian commercial banks (both were joint ventures with the private sector) were diagnosed at an early stage, at the start of the 1980s, and then tackled promptly, while the scale of the losses was still relatively manageable. The banks received a capital injection from the government to compensate for some of their bad loans, but more importantly for their long term viability, their largest borrower was itself restructured and restored to profitability,[11] while the banks strengthened their lending policies and loan recovery efforts. Moreover the political pressure to lend to priority sectors, which was a cause of many of their bad debts, appears to have eased. As a consequence both banks have avoided any further distress.

In the other LDCs, there were delays in both recognising the scale of the problems afflicting the distressed banks and in implementing rehabilitation measures. Major restructuring programmes to Uganda Commercial Bank (UCB) in Uganda and the National Bank of Commerce (NBC) in Tanzania were begun in 1992 but were still ongoing in 1996. Bad debts from both banks were transferred to specially created debt recovery agencies,[12] in return for which the banks received, or were due to receive, government bonds alongside other forms of recapitalisation, such as the write-off of liabilities to government. Recapitalisation will place a considerable burden on government budgets. Both banks had also retrenched more than 50 percent of staff, closed

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Lyonnais, a French state owned bank which itself suffered severe financial distress in the 1990s

[11] This was Press Corporation, a major shareholder in both banks, owned by the late President.

[12] This method of dealing with bad debts follows the approach of the U.S. Resolution Trust Corporation, in which bad debts are transferred to, and centralised in, a government agency which is charged with debt restructuring and recovery. An alternative approach is for the banks themselves to undertake debt workouts with their borrowers, but this requires that the banks have the necessary skills for this. The advantage of the first approach is that it allows the removal from the bank of a large volume of non-performing assets, which would otherwise jeopardise the normal operations of the bank. (Sheng, 1996)

branches and were revamping credit policies and internal controls. Despite these efforts, neither bank had yet been restored to solvency by 1995/96 nor was making operating profits. The government was planning to privatise UCB, but the sale had not taken place by early 1998.

Attempts were first made to tackle the distress in the three government-owned banks in Madagascar in 1988. The banks received interest free government loans, wrote off bad debts and revalued fixed assets. But these measures were unsuccessful and in 1992 administrators were appointed to manage two of the government-owned banks,[13] one of which required a capital injection from the government in 1996. The evaluations of the two banks, carried out as part of the preparations for privatisation, were only completed in 1997.

Restructuring plans for the two government-owned banks in Nepal were formulated in 1992 following diagnostic studies undertaken two years earlier. The government recapitalised both banks in 1992/93 but by 1996 only the Nepal Bank (NBL), a joint venture had made any progress in implementing the restructuring plans. It had cut staff and improved credit policies, but its true financial condition could not be assessed because it did not publish up-to-date accounts. The other bank, the Rastriya Banijya Bank (RBB), had made few efforts to implement reforms, continued to lend heavily to loss-making SOEs and was unable even to provide the central bank with basic balance sheet data. There appeared to be a lack of political will to tackle the very severe managerial and operational problems afflicting this bank.

Progress had also been limited in Bangladesh. The four nationalised commercial banks (NCBs) together received around $750 million of new capital from the government budget, but they were still undercapitalised in the mid 1990s. The NCBs were undertaking measures to improve their management and accounting systems, but still faced political instructions to lend to SOEs and politically influential private sector entrepreneurs. Government had begun to restructure some of the major SOE debtors and established a financial loan court to facilitate debt recovery.

Restructuring of the state banks in Laos began in 1990. They were recapitalised in 1993/94 with bad debts transferred to a debt disposal agency in the central bank and replaced by government bonds, which restored their solvency. The government tackled the problems in the banks' major borrowers by implementing a major privatisation programme under which three quarters of all the SOEs had been privatised by 1995. However the internal restructuring of the state banks still had a long way to go: it was constrained by serious shortages of skills and their management's lack of experience of independent decision making based on commercial principles.

[13] The government had sold a 22 percent equity stake in one of these banks to the private sector in 1991. The other bank remained wholly government owned.

ZANACO was alone among the major government banks in the eight LDCs in not having received a capital injection from the government. It was attempting to restore solvency through internal efforts to cut costs and recover loans, in some cases by establishing debt work-outs with SOE borrowers. Loan recovery efforts were facilitated by the programme of privatisation or liquidation of SOEs implemented in Zambia. ZANACO was able to recover some of the loans made to SOEs either from their new owners or from the liquidator.

What conclusions can be drawn from the experience to date of the LDCs in attempting to rehabilitate their government banks? The problems have clearly not yet been resolved, Malawi excepted, and whether or not all these banks will eventually be successfully rehabilitated is doubtful. Governments have provided substantial financial assistance to recapitalise the banks and to fund redundancies, but several banks were still insolvent and making losses in the mid-1990s. In some countries political opposition held up the necessary reforms. Reputable private sector banks have shown little interest in taking over the government banks. There is an obvious danger that recapitalisation will merely provide the funds for further large losses to be incurred if the restructuring of the banks' management and operational policies are not effectively implemented, and if they face renewed political pressure to undertake lending which is not commercially viable.

Three notable lessons can be drawn from the success of Malawi in dealing with financial distress in the early 1980s. First, prompt recognition of the problem and implementation of remedial action makes restructuring less costly and more likely to succeed. Second, restructuring or privatisation of major clients or borrowers (e.g., SOEs) is essential if bad debts are to be recovered and if any future lending to these borrowers is to be viable. Third, once banks have been restored to solvency, avoidance of further distress depends upon their being allowed to operate purely along commercial principles free of political pressure to lend to priority sectors or favoured borrowers.

Some of the government banks (e.g., UCB, ZANACO, NBL) have made much greater progress in implementing the necessary reforms than others, but they still face large problems. Even after major programmes of retrenchment operating costs are very high. Most have the advantage of a large current account deposit base, partly from having a near monopoly of public sector deposits, hence interest costs are fairly low, but earnings are also low because of the past problems in their asset portfolios. Although recapitalisation by the government can restore solvency, these banks have to find new, commercially viable, borrowers to replace their previous borrowers if they are to generate sustained profits.

Building up and sustaining a sound loan portfolio is the biggest challenge facing the government banks. Clearly it will be easier to achieve this if major borrowers such as the SOEs are themselves restructured and privatised, as has occurred in Laos and Zambia, but to a lesser extent elsewhere. The banks also need to develop the skills required to appraise and monitor borrowers in a market economy, skills, which are in short supply. Most importantly, however, the management need the independence from political pressure, and the incentives, to concentrating their lending on borrowers which can be served on a strictly commercial basis. This will probably require some form of privatisation.

Despite financial liberalisation and increased competition in financial markets, interest rates were still prohibitively high because of the large domestic borrowing requirements of governments which are financed by the auction of Treasury Bills in which most commercial banks and other financial institutions invested heavily, and in a few cases, because of excessive increases in money supply. While this has encouraged financial institutions to finance commercial activities with quick and assured returns, it has deterred them from providing long term capital to finance the fixed investment necessary for the development of these LDCs. This points to the need for governments to exercise more fiscal prudence by bringing their expenditure under control and by curbing the growth in money supply. Financial institutions will provide long-term capital only when they are convinced that the economy has stabilised; that is, in an environment of low inflation and restrained growth in money supply. Equally important is the need for LDC governments to address the lack of indigenous entrepreneurs and industrialists capable and willing to take on the risks associated with long term investment.

*4.3 Prudential Regulation and Supervision*

The financial sector reform programmes have led to substantial improvements to the regulation and supervision of the financial system, especially in the mainland African LDCs. Legislation and supervisory capacities were strengthened, and while deficiencies remain, prudential supervision is now taken seriously in all the LDCs.

Major weaknesses in both prudential legislation and supervisory capacities characterised all the LDCs in the pre-reform period (In Laos no prudential legislation existed prior to the reforms). Legislative weaknesses included minimum capital requirements that had not been raised in line with inflation, thus allowing poorly capitalised banks to be set up, and the omission of restrictions on imprudent activities, such as large loan exposures or insider lending. No objective loan classification and provisioning criteria were imposed, allowing banks to overstate the value of their assets, profits and capital. Central banks lacked the authority to intervene in distressed banks or sanction violations of the regulations. Many financial institutions, particularly those, set up by statute, were not subject to the banking laws. Governments did not

accord a high priority to prudential supervision. Central banks lacked adequate resources for this task, they did not receive the appropriate data from banks to enable them to undertake off-site monitoring and much of the supervision that did take place focused on checking compliance with allocative controls (on interest rates, sectoral credit directives and foreign exchange) rather than on prudential requirements.

The reforms adopted in the LDCs have followed the US model, which involves detailed prudential regulations monitored and enforced through direct supervision by the supervisory authorities (the central banks are the supervisory authorities in all these LDCs). All the LDCs except Laos enacted revised banking legislation in the late 1980s or early 1990s. In the mainland African LDCs this brought most (but not all) aspects of their legislation into line with international best practice, although the capacity to implement such legislation was still weak. Capital adequacy requirements identical or similar to those of the Basle Accord were adopted. Minimum capital requirements were raised, and restrictions were imposed on large loan exposures, insider lending and investment in real estate and non-banking business. Besides banks, the new legislation covered some of the NBFIs, which had not been covered under the previous legislation in some LDCs. Central banks issued directives on loan classification and provisioning.

The revised legislation gave some of the central banks greater flexibility to issue prudential directives. It also gave them a degree of authority to intervene in the event of bank distress. In Uganda and Zambia central banks used their authority under the new legislation to take over or close down private sector banks which were insolvent or otherwise unable to meet prudential requirements, including banks in both countries with political connections.

Supervisory capacities, methodologies and procedures were also strengthened, with increased staffing levels, technical assistance, and training for supervisors. In most countries, off site reporting was revamped, with central banks demanding more timely and relevant data from the banks. More regular on site inspections, focusing on prudential issues, have been carried out.

The mainland African LDCs, notably Zambia and Uganda, have made more progress in strengthening regulation and supervision than Madagascar and the Asian countries. Nepal had revised its legislation but off site reporting was impeded by a lack of timely data and on site inspections were not conducted regularly. Some of the provisions in the legislation of Bangladesh were weak by international standards (e.g., loan classification, although this was being strengthened in 1995). Weaknesses in the legislation facilitated the insider lending which jeopardised the solvency of Bangladeshi private sector banks, none of which were closed down by the central bank. The 1988 banking act in Madagascar lacked many objective prudential requirements, and it was necessary to enact a new banking act in 1996. In Laos comprehensive

prudential regulations had not been formulated by 1995 and supervisory skills were rudimentary, although a programme of training was underway.

Deposit insurance schemes were set up or planned in Tanzania, Uganda, Zambia and Nepal. This will make it easier for new entrants without a good reputation to mobilise deposits from the public. There are sound reasons for explicit schemes to protect small depositors, they can enable governments to acknowledge the costs of financial distress in a more transparent manner, but the dangers of moral hazard are well known and this makes effective prudential supervision even more important (Garcia, 1996). LDC governments need to reassure depositors that their deposits are safe through the enforcement of prudential regulations to be able to detect financial fragility early, and possibly prevent insolvency. Governments in LDCs also owe a duty to taxpayers not to use their money to support bad management and inefficiency in private sector banks and other financial institutions.

Despite the reforms, all the LDCs still face a number of constraints to the effective regulation and supervision of the financial system. Supervision is impeded by human resource constraints. As in many other developing countries, there is a shortage of qualified professionals, bank supervisors require substantial training in the specific techniques of bank supervision, and there is strong competition from the private sector to attract qualified professionals (Caprio, 1996). Because accounting standards are poor, supervisors cannot generally rely on the accuracy of the accounts produced by banks, or even by their external auditors. Supervisors will often have to rely on their own efforts to detect fraudulent practices such as insider lending, and will need to develop skills in detecting false accounting.

Political interference is another constraint. Although central banks have gained more authority to act independently, governments retain a lot of both formal control (often action by the central bank requires the approval of the Finance Minister) and informal influence. Governments are often very reluctant to allow banks to be closed down, even when they are insolvent, for various reasons: the bank owners may be politically influential (in some cases politicians are bank directors), and governments fear the political fallout from lost jobs, lost deposits and reduced access to credit which a bank closure would entail. Hence central banks often face political pressure to exercise "regulatory forbearance", which also undermines incentives for prudential management in banks which expect to be able to draw on political support. Explicit prompt corrective action rules, detailing the circumstances in which supervisors will intervene in distressed banks, can provide the supervisors some support to resist pressure for regulatory forbearance, and also improve incentives for bank owners to avoid getting into situations where supervisors would intervene (Glaessner and Mas, 1995). Supervision is likely to be more effective if central banks, with the necessary skilled personnel, can establish a greater degree of operational independence from governments.

The revised prudential legislation in the LDCs incorporates regulations modelled on those of the industrialised countries, such as the Basle capital adequacy rules. But these may not be adequate for developing countries where accounting standards are weaker and economic conditions less stable (Dziobeck, Frecault and Nieto, 1995). In several respects banks in LDCs may be more vulnerable to distress than their industrialised country counterparts, which may justify imposing stricter regulations, such as higher capital adequacy ratios, higher risk weightings for interbank loans, and a complete ban on insider lending as is the case in Nepal.

**6. Conclusions**

The impact of the financial sector reforms implemented in the eight LDCs covered in this paper was relatively modest. Progress was constrained because some of the reforms, such as the restructuring of government banks, proved very difficult to implement and because economic conditions have not been conducive to the development of dynamic market oriented financial sectors.

In the three Asian LDCs the reforms facilitated both financial deepening and an increase in bank lending to the private sector. In the African LDCs this did not occur, probably because macroeconomic conditions were much more unstable. All the LDCs experienced some new entry from private sector banks but the increase in competition and its impact on efficiency was limited. Banking markets remained largely oligopolistic and were still dominated in most countries by inefficient government-owned banks. The new entrants brought some benefits in terms of improved services and wider access to credit, but bank failures afflicted private sector banks in some countries.

The rehabilitation of insolvent government banks was a major component of the reforms in all the LDCs other than Malawi (where similar problems had been diagnosed and effective remedies undertaken in the early 1980s). In many cases there were long delays in implementing the necessary rehabilitation measures, in part because of the political costs involved. All these banks, except for ZANACO in Zambia, received some form of recapitalisation by the government, but several were still insolvent and making losses in the mid 1990s. Only in Madagascar had any of these banks been privatised.

Reforms to the prudential system have made substantial progress, especially in the mainland African LDCs, where prudential legislation has been brought up to the standards of international best practise and supervisory capacities and procedures considerably strengthened. Moreover, bank supervisors have demonstrated a much greater determination to enforce the banking laws and to intervene in distressed banks.

The reforms have begun to move what were all, to varying degrees, previously repressed banking systems towards ones which are predominantly commercially oriented, with regulation restricted mainly to prudential concerns. The reforms are still ongoing and future policy reforms will have to address several key issues, including bank-licensing policy, the future of government-owned banks, development of NBFIs and financial system regulation.

Further new entry by banks and NBFIs should be encouraged but licensing policy should be relatively cautious both to ensure the probity and expertise of new entrants and to avoid supervisory capacities being overwhelmed by the numbers of financial institutions needing supervision. The entry of local private sector banks and NBFIs can widen the range of financial services and access to credit, especially of SMEs, and stimulate more competition, particularly in retail banking markets. But their vulnerability to financial distress means that strong prudential regulation and close supervision is essential, an issue discussed below.

New entrants should include reputable foreign banks. While they will serve only limited sections of the banking markets, foreign banks can improve services, particularly for corporate customers. Some of the foreign banks also provide valuable training programmes for bank employees, which is an important externality. Foreign banks have been much less prone to financial distress than either government or locally owned private sector banks in the LDCs, hence they provide some stability and credibility to the banking system. However, they are narrowly focused on a group of prime borrowers outside of which they undertake very little lending in LDCs.

Even with more new entry from the private sector, a commercially oriented banking system is likely to have a relatively narrow focus. Rural banking and lending to small farmers is unlikely to be commercially viable because of the high administrative and information costs involved and the difficulties in enforcing loan repayment. Commercial banks rarely have the expertise needed for lending to small farmers, their lending procedures (e.g., the focus on realisable collateral) are not suitable and some do not have a rural branch network. The banking system is also unlikely to provide long term finance, especially in the unstable macroeconomic conditions prevailing in the LDCs.

Consequently it will be necessary to encourage the growth of different types of NBFIs to serve the segments of financial markets which are unattractive to the commercial banks. Leasing companies provide a potentially useful vehicle for short to medium term asset financing for SMEs. Leasing should be commercially viable (it is already occurring on a significant scale in Zambia, and to a lesser extent in Malawi), but the legal framework needs to be conducive to

leasing and it is also essential to ensure that leasing companies are subject to prudential regulation and supervision if they are to mobilise funds from the market.

Market failures are pervasive in rural financial markets. Some form of government intervention to facilitate credit supply to small farmers could improve social welfare, although this would not necessarily be so in practise (Besley, 1994). The key to developing rural financial markets is to find the institutional arrangements, which can best overcome the specific types of market failures afflicting these markets.[14]
The type of innovative microfinance organisations whose lending technologies (such as group lending and intensive loan administration) are designed to cope with the problems entailed in lending to small scale borrowers without collateral may provide a viable means of serving rural financial markets, but they are likely to need some form of public subsidy to cover the very high administrative costs involved (Hulme and Mosley, 1996). Microfinance institutions, notably the Grameen Bank, have achieved success in Bangladesh, and the model has been adopted in Nepal and some African LDCs. Microfinance organisations could improve the range of services they offer the poor by placing greater emphasis on the provision of savings facilities (Rutherford, 1998). This would help offset the negative impact on savings facilities of the closure of unprofitable rural branches by the government and private sector banks.

The future of government commercial banks has not been resolved.[15] With the exception of those in Malawi, none of the distressed government banks in the LDCs has yet demonstrated conclusively that it can be commercially viable on a sustained basis, despite costly and lengthy restructuring programmes. Some of these banks have made progress in cutting costs and recovering loans and may have a viable future if they can build a base of creditworthy borrowers. But little progress has been made in restructuring other government banks. Governments will have to decide either to close these banks down or to sell whatever parts of them are saleable to the private sector. The alternative would be further waste of scarce financial resources and eventually larger costs to government budgets.

[14] The causes of imperfections in rural credit markets include: shortage of realisable collateral, lack of ancillary institutions (e.g. insurance markets), high co-variant risk among borrowers, and the very severe problems of enforcing repayment of loan contracts (Besley, 1994).

[15] The future of development finance institutions (DFIs), many of which are also financially distressed, is also a major policy issue for LDCs. In most LDCs far less progress has been made in reforming DFIs than commercial banks.

It will be important to continue strengthening prudential regulation and supervision of banks, and to extend supervision to NBFIs, especially deposit taking NBFIs. In controlled financial markets fragility mainly arose from government directed lending to unbankable borrowers. This source of fragility has been reduced, if not eliminated, by the reforms. But new sources of financial fragility have already arisen in liberalised markets, in particular from new entry by private sector banks and NBFIs, and greater competition for funds and borrowers. Competition may cut interest rate spreads and other forms of income, such as commissions on foreign exchange dealing, which have to some extent been able to protect banks from losses incurred in their loan portfolios. Some of the new entrants will lack adequate resources and experience of the markets they intend to serve, and some are likely to engage in fraud. Deposit insurance will allow new entrants without a reputation for prudent management to more easily mobilise deposits from the public. Liberalised interest rates and foreign exchange markets will expose banks and NBFIs to new sources of risk, of which they have little experience of coping with. Reforms to the prudential system should be a process, which benefits from constant monitoring. Some aspects of the prudential legislation may need to be revised to take account of the particular circumstances of financial markets in LDCs, for example, it may be appropriate to impose higher capital adequacy requirements and to ban all insider lending. The regulations should reinforce incentives for prudent management on the part of bank owners and managers (Caprio, 1996). Close supervision, particularly of lending policies and of recent entrants, is needed to detect problems at an early stage. Central banks should intervene promptly in distressed banks and NBFIs, and sanction infractions of prudential regulations, both to limit the scale of losses in distressed banks and to strengthen incentives for prudent bank management. Central banks need operational independence from politicians if regulation and supervision are to be effective.

Financial sector reforms have no doubt drawn the attention of governments in the eight LDCs to the advantages of efficient financial systems; for example, the cost to the public purse of politically connected lending is now widely acknowledged, despite the limited success in tackling the problem in a few LDCs. While it is difficult to rigorously assess the outcomes of the reforms in the eight LDCs, in part because reforms have yet to be completed in most, there is little doubt on-going financial liberalisation has enhanced the role and use of monetary policy in overall macroeconomic management. There has been some improvement in the efficiency of the banking system itself: competition, albeit limited in some cases, has been introduced, commercial bank lending to SOEs is now based on commercial criteria in almost all the LDCs, rules governing the operation of financial institutions have been strengthened, regulatory and supervisory systems of central banks have been enhanced despite weak capacities, in a few cases, to enforce the new rules; although much remains to be accomplished in the area of divestiture of public sector banks by governments.

The case studies presented in this paper demonstrate that a stable macroeconomic environment is a *sine qua non* for the success of financial liberalisation. Financial sector reforms are necessary, but the implementation of these reforms is insufficient to bring about enhanced financial intermediation through stable and sustainable real positive interest rates. The reforms have to be accompanied by sound macroeconomic, monetary and fiscal policies designed to attain low and sustainable rates of inflation. In addition the financial position of banks, and other financial institutions, must be strong, and programmes for recapitalising weak banks have to be agreed.

A period of instability in financial markets appears to be inevitable during the transition to financial deregulation: the relationships between monetary aggregates, economic activity, interest rates and prices change in ways that defy easy prediction and therefore policy prescription. This makes the management of monetary policy during financial sector reforms extremely difficult, especially in poor countries such as LDCs plagued with weak institutions and skill shortages. There is the need to corroborate monetary policy with effective regulation and supervision of financial institutions including, improved banking legislation (e.g. stringent capital adequacy requirements), and adequate enforcement of such legislation (e.g. effective bank supervision) alongside the introduction of market-based instruments (open market operations) to attain monetary targets. These difficulties notwithstanding, the inefficiencies of a monolithic financial system are no longer in doubt (e.g., as demonstrated in this paper by the major problems that afflicted, and still afflicts, the Tanzanian commercial banks); and underscore the need for a more diversified financial sector and ownership of financial institutions as well as the need to enhance competition and efficiency in the financial sector.

**Table 1**

**Indicators of Financial Depth: 1985, 1990, and 1995**
*(Percentage of GDP)*

| | 1985 | 1990 | 1995 |
|---|---|---|---|
| **Bangladesh** | | | |
| Bank deposits | 20.8 | 24.5 | 28.9 |
| M2 | 24.5 | 28.1 | 33.8 |
| **Lao PDR** | | | |
| Bank deposits* | n.a . | 4.1 | 10.8 |
| M2 | n.a. | 7.2 | 13.8 |
| **Nepal** | | | |
| Bank deposits | 15.9 | 19.0 | 23.8 |
| M2 | 23.4 | 27.6 | 33.6 |
| **Madagascar** | | | |
| Bank deposits | 12.4 | 11.5 | 13.6 |
| M2 | 18.8 | 16.2 | 19.2 |
| **Malawi** | | | |
| Bank deposits | 16.2 | 15.0 | 14.0 |
| M2 | 19.7 | 18.9 | 18.5 |
| **Tanzania** | | | |
| Bank deposits | 23.8 | 12.9 | 25.1 |
| M2 | 35.1 | 19.9 | 25.1 |
| **Uganda** | | | |
| Bank deposits | 5.9 | 4.2 | 6.1 |
| M2 | 10.2 | n.a. | 9.8 |
| **Zambia** | | | |
| Bank deposits* | 24.8 | 17.6 | 12.8 |
| M2 | 29.7 | 21.7 | 15.3 |

*Source*: IMF, International Financial Statistics (various years)

* Includes foreign currency deposits

**Table 2**

**Consumer Price Inflation and Real Deposit Rates: 1991-95**

| **Country** | **inflation (%)** | **real deposit rates* (%)** |
|---|---|---|
| **Bangladesh** | 4.2 | 4.3 |
| **Laos** | 11.2 | 4.1 |
| **Nepal** | 11.3 | 2.8 |
| **Madagascar** | 24.2 | n.a. |
| **Malawi** | 34.6 | 7.1 |
| **Tanzania** | 27.5 | 1.3** |
| **Uganda** | 21.0 | 0.1 |
| **Zambia** | 113.1 | 40.8*** |

*Sources*: IMF, *International Financial Statistics* except for the Nepali and Tanzanian interest rates, which are from Nepal Rastra Bank *Quarterly Economic Bulletins* and Bank of Tanzania *Economic Bulletins*.

*Real deposit rates may not be strictly comparable between countries, as they may pertain to different classes of deposits.
**91-94
***91-93

**Table 3**

**Financial Distress: Scale and Reforms**

| Country and banks | Market share | Bad debts share of total loans | Reforms | Cost of Recapitalisation |
|---|---|---|---|---|
| **Bangladesh:** 4 NCBs | 62% | N/A | Recapitalisation | Taka 30 billion ($750 million) |
| Several private banks | N/A | N/A | Directors ordered to pay back loans | |
| **Lao PDR**: State banks | 70% | 50% | Replacement of bad debts by govt bonds in 1994; and cash injection by govt | Kip 18 billion ($25 million) |
| **Nepal**: NBL and RBB | N/A | 60-80% | Payment of loan guarantees by govt NBL reduced staff and strengthened credit procedures. | Rs 2.3 billion ($40 million) |
| **Madagascar:** 3 banks | 100% | 40% | Administrators appointed to 2 banks in 1992. Govt provided capital injection in 1996. | FMG 45 billion ($11 million) |
| **Malawi:** CBM and NBM | 100% | 40-50% | Bad debts replaced by govt bonds in 1984 Debt recovery | Kw 54 million ($39 million) |
| **Tanzania:** NBC | 85% | 80% | bad debts replaced by govt bonds, restructuring programme | Tsh 78 billion ($200 million) |
| **Uganda**: UCB | 35% | 80% | bad debts replaced by govt bonds, restructuring programme | UgSh 72 billion ($70 million) |
| 3 private banks | 6% | | 2 restructured, 1 liquidated | |
| **Zambia**: ZANACO | 25% | 70% | Debt recovery, redundancies | none |
| 6 private banks | 25% | n.a. | closure | |

*Source*: Field data

**Annex Table 1**

**Components of Financial Sector Reforms in LDCs**

| **Policies:** | Interest rates | Directed lending | New entry | Prudential reforms | Restructuring of government-owned banks |
|---|---|---|---|---|---|
| **Countries** | | | | | |
| ***Bangladesh*** | Fixed rates raised in late1970s. Some controls on lending rates to priority sectors & a deposit rate floor retained. | Partial liberalisation to priority sectors | Private sector banks allowed since 1978. 2 govt banks nationalised in 1983. 20 private sector banks by 1995. | Loan classification & provisioning rules in 1989, & improved in 1995. New banking law, including capital adequacy rules intro. in 1991. Bank upervision restructured to include off-site surveillance. Credit Informa-tion Bureau set up for large loans. | Govt injected new capital into NCBs. Measures taken to imp-rove mgt & accounting. NCBs still expected to lend to SOEs & politically-connected borrowers. |
| ***Laos*** | Controls gradually liberalised between 1991-1995. Minimum saving rate remained by 1995. | Preferential lending eliminated in 1988, except for requirement to lend 10% percent of deposits to agric. | Monobank split into cent-ral & commercial banks in 1988. Private sector banks allowed in 1989, but branches restricted to Vientiane. 8 private sector banks (7 with. foreign shareholding) by 1995 | Central Bank started annual audits & bank inspections, and issued guidelines on accounting procedures. | State banks recapitalised in 1993-1994. Bad debts transfe-rred to Debt Disposal Unit of Central Bank in 1993. |
| ***Nepal*** for | Liberalisation began in 1986 with minimum & maximum deposit rates retained until 1989. Some | Sectoral credit directives remain in force. | Entry by foreign banks in partnership with domestic investors allowed in1984. | Regulations strengthened in 1989, including tighter capital adequacy, minimum capital, large loan expo- | Govt repaid loan guarantees bad debts to SOEs in 1992/93. Pressure to lend to SOEs redu- |

s

| | | | | | |
|---|---|---|---|---|---|
| branches | controls on freedom to vary rates for individual borrowers. remain in force TB & bond auctions introduced in 1988. | | Foreign participation restricted to between 20-50% of equity. New licensing suspended in 1995. Central Bank licensed finanace companies (domestically-owned & joint ventures) in 1995. | sures, & provisioning. Connected lending is not allowed. Finance company Act enacted. | ced, but not stopped. NBL undertook internal reforms; reduced staff; closed some strengthened credit procedures & loan recovery efforts. Govt reduced its stake in NBL from 51% to 46%. Few internal reforms undertaken by RBB. |
| ***Malawi*** port- | Lending rates deregulated in 1987 and deposit rates in 1988. Preferential rate for agriculture abolished in 1989. Informal control maintained until 1990. TB auction introduced in 1992. | No explicit directed imposed prior to reforms. | Revised Banking Act in 1989 set out conditions, for new entry. But new entry by private sector banks did not occur until 1995. | Revised Banking Act enacted in 1989 covers all FIs, & includes provision for minimum capital adequacy, & large loan exposure limits. Central Bank's supervision dept strengthened. | Bad debts owed by Press Corp. removed from banks' loan folios & replaced by govt securities in 1984. Loan recovery efforts & credit procedures strengthened by banks since the mid-1980s |
| ***Madagascar*** | Interest rates liberalised in 1990 | Liberalised | Private sector entry allowed since 1988. | Banking Law passed in 1988, but lacked important prudential regulations. New Banking Law passed in 1996 allowing regula tions to be imposed. | Banks wrote off bad debts in 1988, and revalued reserves with support of interest-free loans from govt. Problems persisted & administrators appointed to manage 2 govt. banks in 1992. Govt provided one bank with FMG 45 billion ($11 million) in fresh capital in 1996. |

| | | | | | |
|---|---|---|---|---|---|
| ***Tanzania*** | Nominal interest rates raised in 1987. Controls partially liberalised in 1991, but maximum lending rate retained until 1993. TB auction introduced in 1993. | Lending directives no longer imposed. | Revised Banking Act in 1991 allowed entry by private sector banks and FIs which meet strict licensing criteria imposed by Central Bank. 5 private sector banks & 1 FI began operations during 1993-1995. | Banking Act enacted in 1991 covering all FIs, gives Central Bank authority to issue prudential directives. Regulations strengthened on licensing, capital adequacy & minimum capital, loan exposure, and provisioning. Central Bank supervision department strengthened, and directives issued for off-site reporting & on-site examinations. | Govt took over bad debts of crop marketing parastatals in 1987. Following diagnostic studies in 1991/92, bad debts of NBC transferred to LART in 2 tranches during 1992-1994, & replaced by govt bonds, but NBC still insolvent in 1995. Restructuring plan for NBC, including staff retrenchment, & branch closures began in 1995. Tanzanian Housing Bank liquidated in 1995. |
| ***Uganda*** | Liberalisation began in 1992 with some rates decontrolled and others linked to the TB rate. Link with TB rate severed in 1994. TB auction introduced in 1992 | Formal lending directives were not imposed. | New entry by private sector banks and FIs allowed since mid-1980s. New Banking Act in 1993 raised entry requirements in terms of capital. | New Banking Act enacted in 1993 covering banks and other FIs, gives Central Bank flexibility to issue prudential directives and take over distressed FIs. New Act imposes minimum capital adequacy requirements and restrictions on large loan exposures and Insider-lending. Bank supervision reorganised, reporting - requirements strengthened and bank inspections instituted. | Govt injected capital into UCB Its debts were transferred to NPART in 1995/96 and replaced by govt bonds. Staffing cut by half by half by 1995, and branches were closed. Mgt was reorganised, and loan and accounting procedures revised. |

|  |  |  |  |  |  |
|---|---|---|---|---|---|
| ***Zambia*** | Interest rates first raised and then decontrolled in 1992. TB auction introduced in 1993. | Sectoral lending directives not imposed prior to reforms. | New entry by private sector banks allowed since 1984, although entry criteria not made explicit. Increase in new entry during 1991-1994 prior to enactment of new banking legislation indicates a *de facto* liberalisation of licensing. New banking legislation raised minimum capital requirements | New Banking Act enacted in 1994, covering banks and other FIs and gives Central Bank authority to issue prudential directives e.g. capital adequacy requirements, restrictions on large loan exposure, insider lending, etc. Bank supervision strengthened. | Govt has not recapitalised ZANACO, or other govt banks. ZANACO implemented some internal reforms to strengthen management and internal controls. |

*Source:* Field data

*Abbreviations:*

| | | | |
|---|---|---|---|
| NCB: | Nationalised Commercial Bank (Bangladesh) | TB: | Treasury Bills |
| NBL: | Nepal Bank Limited (Nepal) | UCB: | Uganda Commercial Bank (Uganda) |
| RBB: | Rastriya Banijya Bank (Nepal) | NPART: | Non-Performing Assets Recovery Trust (Uganda) |
| NBC: | National Bank of Commerce (Tanzania) | ZANACO: | Zambia National Commercial Bank (Zambia) |
| LART: | Loans and Advances Realisation Trust (Tanzania) | SOEs: | State-owned Enterprises |
| FIs: | Financial institutions | | |

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